INVESTOR DAY 2014: LIQUIDITY, CAPITAL AND FINANCIAL OUTLOOK

Todd Gibbons, Vice Chairman and Chief Financial Officer
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Thanks, Suresh. You are one of the few people who can make technology understandable.

I'm going to cover our balance sheet, mostly going to talk a little bit about our plans for aligning with the new regulatory and capital and liquidity ratios, actually go through that in some detail, and how all of that and what you've heard today rolls up ultimately into our financials.

As my colleagues demonstrated, BNY Mellon's business model is an excellent one. It has proven to be durable even in the most difficult banking environments. We generate recurring fees and significant capital and we do so with very low credit risk.

To continue to deliver strong returns, we're focused on five priorities.

- First, maintaining a strong balance sheet that has excellent credit quality, is highly liquid and very well capitalized.
- Secondly, we're complying with the new liquidity standards and we're going to do that also while optimizing our net interest margin.
- We're also addressing the new standards that we face relative to capital. We now know most of what the rules are – and, so far, it's been the supplemental leverage ratio that is turning out to be our binding constraint. So we'll describe our path to compliance and also how we intend to deploy capital effectively to meet both the regulatory requirements and also maximize our shareholder return.
- The fourth priority – and this is one we have to be pretty good at – is to position ourselves to efficiently adapt to the ongoing regulatory changes. I think that was a theme you probably saw with Brian.
- And finally, our most important financial goal is to increase earnings per share. Brian walked you through in detail our enterprise expense reduction plans. Successful execution will help to expand margins, lead to higher returns on tangible common equity and of course higher earnings per share.

Now, let's start with the balance sheet. This chart speaks to the excellent credit quality of our balance sheet, reflecting the de-risking actions that we've taken over the past number of years.

Post the financial crisis, we've improved the quality of our investment portfolio by focusing our purchase on treasuries, agencies and sovereigns.

On the credit side, we have either right-sized or exited relationships in order to improve the risk/reward profile, and the overall result has been a significant reduction in risk-weighted assets relative to the size of the balance sheet, down from 52% to 43%.

In addition, as you can see on the right-hand side, our NPAs [non-performing assets] are trending in the right direction as well. In fact, over the last couple of years, we've actually released credit provisions as the quality of our portfolio has improved. Now, it's unlikely that we're going to continue to have a negative provision, but given the very strong credit quality and the mix, provisions should be very low going forward.

This is a bit of a tutorial around the LCR [liquidity coverage ratio]. Like all U.S. banks with greater than $250 billion in assets, we will be required to comply with a liquidity coverage ratio beginning in 2015. We will need to hold sufficient high-quality liquid assets, what we call HQLA, that can be easily converted to cash to offset any regulatory-defined stressed net outflows. They determine what the net outflows are, you have adequate HQLA to cover that and that's over a 30-day time period. The outflow assumption for each deposit type is based on very specific regulatory definitions. This is having the effect we're seeing today of making certain types of deposits more or less valuable than others.

The LCR was finalized last month. It will require an 80% ratio by the beginning of 2015 and 100% by the beginning of 2017. We're already starting to see behaviors change. We're seeing banks looking to attract LCR-friendly funds and discourage the unfriendly types of deposits. And I have to say, frankly, we're doing a bit of the same. Increasing the stability of the deposit base is of course prudent, but it will also enable us to increase NII by holding higher-yielding assets in both flat and normalized environments.

I'll demonstrate shortly the fact that we are on track to meet the LCR requirements as we currently interpret them.

This slide is a bit complicated, but it is designed to illustrate how we are structured today. At this point, it's kind of early to calculate the denominator and the ratio, as each deposit actually has to be classified according to the standard and any excess amount has to be excluded. So the numbers I'm going to share with you right now are our best estimates at this point. If our funding source receives favorable LCR treatment, it enables us to invest in non-HQLA, and obviously that's a bit higher-yielding. As of 9/30, we estimate that we had $167 billion in LCR stable funding that comes mostly from core operational deposits, long-term debt and net cash flow from near-term maturities. Our non-HQLA assets were about $154 billion and they're made up of loans, certain securities including munis – there are some questions whether munis might be included or not – and interbank placements.

If you look to the right side of the chart, you'll be able to see roughly how the actual LCR for us is calculated. If the funding source does not receive the favorable treatment I just described, or if we have significant contingent calls on liquidity such as it would be the case with unfunded commitments, we will need to have a portfolio of high-quality liquid assets that at least equals or exceeds that amount.

As of 9/30, we estimate that we had $151 billion in potential LCR runoff and we also had HQLA assets of $164 billion. Thus, we estimate that the LCR was greater than 100%. If you just do the simple math, we had $164 billion HQLA divided by $151 billion of runoff. So what does this mean for yields that we can generate on our assets and our ability to achieve our desired mix relative to interest rate and credit risk?

This slide details the current estimated yields on non-HQLA and HQLA assets. You can see that the non-HQLA is about double and it's also broken down by fixed and floating-rate assets. We are currently a little bit under-invested in fixed-rate assets. This chart doesn't disclose that, but our NII sensitivity is disclosed in the 10-Q and you could pick it up there. And our mix between HQLA and non-HQLA is about right since we're meeting
the ratio requirement. This structure currently generates a net interest margin of 94 basis points.

If we kept things status quo, we would expect to meet the regulatory standards, but see the NIM drift slightly downward as our higher-yielding non-agency portfolio burns off.

So what are we doing about it? There are basically two things we can do.

- Number one, we can work on the liabilities to make them more valuable, so that we can invest them in higher-yielding assets.
- Or number two, we can reallocate the assets that we've got, and frankly, we're doing both.

We're taking some tactical actions in this flat interest-rate environment that are designed to maintain compliance with the LCR rule and enhance our net interest margin.

- From an asset perspective, we're allocating a portion of interbank placements to HQLA. The interbank placements are relatively low yielding. By doing this, it provides us some more room for non-HQLA so we can actually pick up a little bit of yield that way. We're increasing the yield on non-HQLA assets by investing in some different asset classes and we're carefully increasing the HQLA duration. I use the word carefully here because increasing duration may also increase the volatility of our capital. So the balance needs to be struck properly or it's going to defeat the purpose.
- On the liability side, we're adjusting our euro deposit rates downward reflecting the moves by the European Central Bank. And we are optimizing the composition of our deposit base to encourage or increase the LCR-friendly type of funding.

- And, finally, in order to encourage us from our businesses, we are adjusting our transfer pricing schemes so that they have the financial incentives to improve both the mix of liabilities, as well as the mix of assets.

I've described where we are today, but what's going to happen in the future if we do see rates rise?

Beyond the tactical actions we are taking, our LCR and net interest margin will benefit in a more normalized environment. The benefit will come from some expected deposit runoff, and we expect that to happen when monetary policy ultimately does tighten and short-term rates rise. To support this runoff assertion, we have developed a regression model that attempts to estimate our deposit levels and correlates them to what's going on with monetary policy, the monetary base, what's happening to interest rates as well as certain idiosyncratic things in our own operation. We've found it as you can see here to be a pretty good fit over the past few years.

We currently expect that if rates do normalize over the next two to three years – and I'll describe normalization in just a few minutes – we would see $40 billion to $70 billion of a decline in our deposits.

The actual course of tightening that the Fed ultimately takes will have some impact.

- If it's a traditional drain, we would expect about what you see in the chart.
- If it's exclusively executed by changing the rate on excess reserves that the Fed pays, the deposits are likely to stay in the banking system, but get redistributed to the banks that are willing to pay more for them.

Either way, the outcome for us is expected to be about the same.

Now let's take a look at our estimated LCR and net interest margin, both in a flat and a normalized environment.

In both environments, factoring in the impact of the asset and liability actions that I just mentioned, we estimate that our LCR is going to be greater than 100% in both cases.

- In a flat environment, we're looking at a NIM of about 95 basis points to 100 basis points.
- In a normalized environment, where interest rates rise and we experience some deposit runoff, we estimate a NIM of about 125 basis points to 150 basis points. In this case where we see the runoff, we would hold substantially less in Central Bank deposits as they would be the first assets to be liquidated.

So there is some modest upside to NIM in the current environment and, if client behavior is as expected, a substantial upside in a normalized environment. So the basic math is this: we're projecting something like a 20% decline in interest-earning assets, a 40% increase in the net interest margin, leaving you with a 20% increase in your NII.

Now let's look at capital.

Over the last three years, we've generated about $13 billion of tangible capital. About 20% was paid out in the form of dividends to shareholders. About a third went to repurchase shares and nearly half is retained to meet the more stringent capital requirements that we currently face.

So it's kind of interesting here. Although our risks have really not changed – and I would say they've probably gone down as we‘ve reduced credit risk, liquidity and market risks and substantially reduced the intraday exposures in our clearing business – our tangible capital has actually increased. It's up over 50% in the past four years.

Despite the fact that we managed through the financial crisis better than most, we are even less risky today with much more capital. It makes us a much more attractive counterparty and it helps us maintain the very high credit ratings that we enjoy.

However, there is a cost to holding higher capital and that can be seen in our return on tangible that you see here. It's still much higher than our peers but it has declined. We believe it should stay relatively flat in the current environment. And if rates rise, we expect it to increase over the next couple of years.

Now, academics like to argue that investors should be willing to accept lower returns for less risk. I would guess that we are seeing some reduction in our cost of capital reflecting that phenomenon as well as the impact of low rates. However, barring any unexpected regulatory requirements, the need to retain additional capital should start to subside and increased earnings should more than offset the capital growth, resulting in higher returns.

Our strong capital and low-risk business model prepare us to manage through stress test scenarios better than most every other large bank. You can see our performance in this year's test. This is looking at the Dodd-Frank stress test under the severely adverse case. Our capital position was only modestly impacted. In fact, the estimated loss of capital was second-lowest amongst the 30 largest bank holding companies included in the test. We are less exposed to equities. We have less than 20% of our revenues generated by net interest income. We have very small trading positions and low credit risk. This should continue to position us well on stress test as well as real-life stress situations, so that we can also continue to execute on the capital strategies.

Our capital position and ongoing commitment to repurchase shares has put us in an exclusive position. BNY Mellon is the only G-SIB whose share count has actually declined to pre-crisis levels, demonstrating the resiliency of our business models. The shares we issued in connection with repaying TARP and also in a custody acquisition in 2010 have been more than offset by repurchases.

We believe one of the most important things that we can do as a management team is manage our owners' capital well. We have a disciplined governance model around deploying capital. It helps ensure that we're maximizing returns. In terms of dividends and share repurchases, we're targeting a total payout ratio of between 80% and 100%, 25% to 30% of that being in the form of dividends, the remainder in share repurchases.

Even with a 100% payout ratio, we will see material increases in our capital. The after-tax add-back of intangibles and the impact of employee equity compensation plans together generate approximately $560 million to $740 million of capital per year.

In terms of how we use our capital, we consider acquisitions only when they enhance our core strategy and stand to achieve the targeted outcomes faster and more efficiently than could be achieved through organic means. All investments whether in organic growth or acquisitions must exceed our financial hurdles, which include an IRR well in excess of our cost of capital and projected returns that exceed that of repurchasing shares. It's pretty straightforward. If we're going to spend money, it should generate a return to our shareholders that exceeds buying back stock and there also should be a premium for risk and uncertainty.

This next slide provides an estimate of our 2017 regulatory ratios. This is the fully phased-in approach for both. In the first case, it's the Basel III Tier 1 common equity ratio. And here in both flat and normalized environments, we estimate that the ratio will be somewhere between 11% and 12%.

The increase relative to our current ratio reflects the impact of retained earnings as well as little need to grow risk-weighted assets. Both scenarios assume a total payout ratio of 100%. The reason the estimated ratios are the same under both environments is that increased earnings in a normalized scenario are bought back since we were buying back shares at 100%.

As for the supplemental leverage ratio, at the third quarter it ended at 4.6%. In a flat environment, we estimate our 2017 ratio to be in the vicinity of 5% to 6% and in a normalized environment, it would go to 6% to 7%. At these levels, we expect both the risk-weighted assets and leverage ratios to be at long-term targets.

How are we going to get to those levels? We wanted to share with you our path to our SLR compliance. First of all, we're looking at this both on a normalized and flat case.

- We would expect our deposit base to contract, which would have an impact of anywhere between 20 basis points and 110 basis points based on the scenario.
- Capital retention that we just described, even at a 100% payout ratio, should be 70 basis points, 80 basis points in both cases.
- We do have a bit of a matched book, which we would take down that would generate another 25 basis points to 35 basis points.
- We do expect that the variable interest entity that we consolidated will be able to be deconsolidated, and that would generate 10 basis points to 15 basis points.
- And finally, Kurt talked about some of the actions that he has taken to become more capital-efficient in our trading book, which should generate another 5 basis points to 10 basis points.

So the actions bring us into range of about 6% to 7%.

If necessary, there are of course other incremental actions that we could take. We don't have a lot of preferred stock outstanding. So we could issue additional preferred stock that certainly comes at a lower cost versus common equity. We could chase off more deposits by reducing our deposit pricing or we could be more aggressive in how we're looking at our unfunded commitments.

Now let's move on. We've talked about a normalized environment, how do we actually define it?

- Well, we're looking at equity growth still at a relatively moderate level, something like 4% to 5%.
- Fed funds growing something like at 25 basis points starting in the second or third quarter of next year.
- There would be a parallel shift up in the treasury curve.
- Volatility actually increasing a bit, maybe 10% to 20% off these historical low levels.
- Market volumes that will grow pretty much in line with GDP.
- And no significant geopolitical events.
- We are also assuming that our core expense base being impacted by our business mix, driven by where the revenues are being generated.
- We expect a higher occupancy cost next year because of the sale of our downtown facility at One Wall Street. As we move into our new facility in 2015, we're going to end up paying rents on both the new facility as well as the old facility. That's going to cost us about $30 million. That will change in 2016 as our downtown expense run-rate will drop another $10 million below where it was in 2014.
- We're also assuming regulatory costs will be increasing in absolute terms, although we think that the rate of growth will probably subside a bit.
- Pension costs are expected to rise next year due to lower interest rates as well as lower mortality rates. Right now, we guess that's going to be around $50 million to $60 million. It will depend on where we ultimately end the year.
- Our model also includes an annual loan loss provision of about $10 million to $30 million and a tax rate of 27%.

Now our assumption that regulatory costs will increase is based on a number of regulatory issues we are currently focused on. Brian did touch upon a few of these, but I think it's important that it reflects a number of pending regulations that could impact expenses, but they could also impact capital and liquidity requirements. We aren't absolutely clear where they could land. Again I mentioned that we expect to see the growth rates slow, but you should be aware that there is still more requirements coming and there's still some uncertainty here.

Here are our financial targets on an ongoing operating basis. In a flat environment scenario, our goals are:

- revenue growth of 3.5% to 4.5%;
- EPS growth of 7% to 9%; and
- return on tangible common equity of 17% to 19%.

We've chosen tangible capital as the best ROE [return on equity] metric since it is more closely aligned with the regulatory guidelines and it's also less impacted by legacy. This assumes in the flat case the net interest margin of 95 basis points to 100 basis points, our operating margin increases in the 28% to 30% range. No deterioration in FX volatility and volumes and short-term interest rates.

In a normalized environment, we're looking at:

- 6% to 8% revenue growth;
- EPS of 12% to 15%; and
- return on tangible common equity of 20% to 22%.

This also assumes that we see the NIM [net interest margin] that we talked about in the 125 basis point to 150 basis point range, substantial improvement in the operating margins of 30% to 32% and market drivers consistent with those that I just laid out in what a normalized environment was.

In both cases, we should point out that the targets both reflect 100% payout ratio. They assume that we will execute on the expense and revenue initiatives that you've heard this morning, that equity markets will grow at about 5%, client behavior will remain consistent and we'll see reasonable regulatory outcomes.

All these targets are the ones that we believe are achievable if we continue to execute.

on an operating basis; strategic priorities and key initiatives in investment management and margin impact; investment management financial goals in a flat and rising rate environment; positioning of markets group for outperformance; markets group strategic priorities and impact on growth, profitability and return on capital; estimated revenue contribution by business line of markets group; markets group revenue growth and operating margin; investment services strategic priorities and transformation process and impact on operating margins and earnings growth; strategic platform investments and margin impact; investment services fee growth; investment services financial goals in a flat rate and rising rate environment; strategic priorities in technology; estimated indexed storage demand, demand for computing, infrastructure cost, headcount, application development unit and total cost and strategic investment as a percentage of portfolio; technology infrastructure and monetizing technology capabilities; and statements regarding the Corporation's aspirations, as well as the Corporation's overall plans, strategies, goals, objectives, expectations, estimates, intentions, targets, opportunities and initiatives. These forward-looking statements are based on assumptions that involve risks and uncertainties and that are subject to change based on various important factors (some of which are beyond the Corporation's control).

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