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3Q16 Money Market Credit Trends by Sector

INVESTMENT FOCUS

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Commentary by the Credit Research Team at BNY Mellon Cash Investment Strategies (CIS), a division of The Dreyfus Corporation

As the third quarter ended on September 30, 2016, financial data reported by the large financial and corporate conglomerates common to money markets indicated that issuers were well prepared heading into money market reform (MMF), which took effect on October 14, 2016. Commentary from the rating agencies in October 2016 validated this sentiment. Moody's issued a report on October 5, 2016 titled "Decline of U.S. Prime MMFs Won't Harm Bank, Corporate, Muni Issuers" followed by an October 11, 2016 report from Standard & Poor's titled "Banks Feel the Pinch From U.S. Money Market Reform, but It Won't Be Too Painful." While money funds had a two-year window to get ready for money market reform, issuers as well had time to adjust their funding profiles in anticipation of outflows from prime money market funds into government money market funds. For financial institutions, Basel III regulations stipulating liquidity coverage, net stable funding and leverage ratio requirements in addition to higher capital buffers all served to reduce reliance on short-term funding. In order to meet U.S. Dollar needs, issuers demonstrated a great deal of flexibility, such as borrowing at longer maturities, utilizing cross-currency swaps, deleveraging or finding alternative sources of short-term funding outside of U.S. money funds. As such, the increased short-term funding costs due to the sharp rise in LIBOR rates during the quarter were more reflective of market dynamics around asset flows in the money market space as opposed to concerns over the health of issuers. The commentary below summarizes our view on the various sectors.

U.S. BANKS

For the large U.S. banks, 3Q16 was marked by a rebound in capital markets revenue and, to a lesser extent, improved credit costs and operating expenses. In particular, all banks saw good growth in FICC, softer equities revenues and mixed results in investment banking. Some banks posted increases in spread income on the back of decent loan growth, but the general trend was lower net interest margins as growth in long-term debt and deposits served to increase funding costs. Banks also benefited from increased fee income along insurance, mortgage banking and trust and investment management activities. Asset quality trends at the banks were stable to improving, helped in part by stabilization in the energy portfolios.

All of the large banks maintained capital levels that were sound, and above the fully phased-in requirement, with an average CET1 ratio of 12.4% at quarter-end. During the quarter, the Federal Reserve announced that a Stress Capital Buffer will replace the Capital Conservation Buffer in annual stress testing, which could increase capital requirements for the largest banks. The Fed also announced a Notice of Proposed Rulemaking (NPR) that it is no longer planning to require the qualitative aspect of the Comprehensive Capital Analysis and Review (CCAR) for banks with assets under $250 billion.

U.S. money market reform is expected to have a very limited impact on U.S. banks as there has been an ongoing reduction in short-term funding in order to support regulatory ratios. Specifically, S&P notes that U.S. banks have reduced loan-to-deposit ratios from 92% in 2006 to 73% as of the second quarter 2016. U.S. banks have also reduced their usage of commercial paper and repo.

CANADIAN BANKS

Canadian banks continued to grapple with the challenges presented by the low levels of global oil prices, although this pressure eased in the quarter with oil prices stabilizing and banks' drawn exposure to oil and gas at just 1%-3.3% of total loans. Rating agencies and regulators have

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focused on the high level of consumer indebtedness and the possibility that there could be some overvaluation in the Canadian Housing market. Despite solid performance in Canadian mortgage books, The Ministry of Finance recently introduced the 'lender risk sharing policy,' which is meant to counter further run-up in house prices and will shift some default risk to banks over time.

Quarterly earnings benefited from improved capital markets revenue and lower credit costs due to the stabilization in oil prices. Banks continued to produce solid double-digit ROEs with earnings supported by revenue growth in both domestic and international banking business despite the challenging operating environment. Notwithstanding a potential increase in risk profiles, banks continue to seek earnings diversification via expansion into U.S. markets and the Wealth Management business. Overall, asset quality remained healthy. Capital metrics were sound with the banks having an average CET1 ratio of 10.4%, well above the fully phased-in D-SIB requirement of 8%. Bank ratings still benefit from government support as Canadian regulators have yet to adopt an 'effective' bail-in regime. However, bank ratings are expected to remain favorable even if such support is reduced or stripped out given rating agency comments of consideration of ratings uplift from other factors such as additional loss-absorbing capacity.

As it pertains to the impact of U.S. MMF reforms, Canadian banks have significantly reduced reliance on short-term wholesale funding to a single-digit percentage of overall funding by terming out their funding through existing medium-term note (MTN) programs while finding new institutional investors outside of the money fund space to participate in their existing commercial paper programs. The Canadian banks also benefit from large, stable deposit bases.

CORPORATES 3Q16

In the third quarter of 2016, earnings overall were mixed with continued pressure on the Oil & Gas sector due to pressure on commodity prices. However, some Oil & Gas companies saw better sequential results, suggesting we have reached the bottom of the cycle or are close to the bottom of the cycle. Currency and geopolitical issues also remained headwinds for many companies. Pharmaceuticals were mixed as earnings were hurt by generic competition and higher expenses, partially offset by new product launches. Consumer Products' results were good on an organic basis due to new innovations and product and geographic diversity. Overall balance sheets and credit profiles were healthy and we believe the companies in our universe continue to value having financial flexibility. We did see some corporates with higher leverage due to additional debt for general corporate purposes or because of lower EBITDA from divested assets but expect ratings to remain the same given the financial flexibility afforded at these ratings levels. We continue to expect ratings pressure on the Oil & Gas sector. The outlook remains cautious given the expectation for continued pressure on commodity prices and the uncertainty of the global economy. Corporate borrowers were largely unaffected by the impact of money market reform as issuers took advantage of favorable long-term rates to term out their funding, found alternative investors for commercial paper or shifted some funding to international markets.

EUROPEAN BANKS

European banks reported generally sound results in the third quarter of 2016. Client activity picked up following the slowdown leading into the Brexit vote at the end of June. Though operational results have generally been rather solid, the UK banks still suffer from high regulatory charges and restructuring costs. In this environment, the banks continued to shrink their balance sheets. For the remainder of the European banks, performance was largely up on a quarterly basis when adjusted for the gain on the Visa share sale that most banks benefited from in 2Q16. Interest income remained pressured due to the low-rate environment but benefited from the re-pricing of deposit products, low funding costs, and moderate loan growth. For institutions with large investment banking operations, FICC income picked up in the quarter. Litigation charges, restructuring costs, and the earnings drag of run-off units continued to be headwinds for several banks. Several banks announced new rounds of savings initiatives given the ongoing need to reduce costs with digitization being a major focus. Although there was some credit deterioration in oil-and-shipping related lending portfolios, this has largely been offset by improvements in other segments, allowing for asset quality to remain generally strong.

Capital ratios continued to gradually rise with all banks in our coverage meeting the requirements defined by the European Central Bank's Supervisory Review and Evaluation Process (SREP); however, banks could potentially benefit

from lower 2017 requirement as the Pillar II component will be split into a required and guidance portion. The Bank of England published the results of its annual stress test at the end of November. They signaled the UK banking system on aggregate to be rather resilient, but also revealed some weakness by three of the lenders with one bank being required to submit a revised capital plan, which was approved.

In the wake of U.S. money market reform, the European banks have displayed a high degree of flexibility. Since the financial crisis, regulatory demands to meet certain requirements such as a liquidity coverage ratio, net stable funding ratio and a leverage ratio have pushed European banks in particular to deleverage their balance sheets, hold higher levels of liquidity and term out their funding — all of which have led to reduced reliance on short-term wholesale funding. Lending demand across Europe has remained weak and outpaced by solid deposit growth such that funding profiles have steadily improved. As money market reform drew closer, European banks increasingly shifted U.S. dollar short-term funding borrowings to alternative investors such as pension funds, insurers or securities lenders or they paid up for longer-term funding. Additionally, some banks were able to reduce U.S. dollar funding needs by shrinking trading assets. In the case of repo, some of the traditional U.S. Treasury and agency collateral that was being funded in prime funds is now being funded by repo in the government funds.

ASIA-PACIFIC BANKS

Profitability among the Australian banks moderated in 2016 due to slight margin pressure and a modest increase in credit costs; however, overall earnings remained solid and among the strongest globally with average ROEs in the 13% to 14% range. The Aussie banks have increasingly focused on growing business in the more stable Australian and New Zealand markets with some banks backing away from international strategies. Asset quality trends remained generally benign with overall credit costs and non-performers averaging below 50 bps relative to loans due to stability in the low-risk prime mortgage books with a slight uptick in credit costs within the relatively small commodities and agricultural-related loan books.

While Aussie banks still have a reliance on wholesale funding, they were able to adjust to the implementation of money market reform as the banks have been terming out their funding books while diversifying their sources of short-term wholesale funding to other markets such as the domestic money market in Australia or within the European money markets. The average LCR was 126.5% and all mentioned they were in compliance with the NSFR, with two banks posting a ratio of 105%.

Profitability among the major Japanese banks continued to be pressured by the challenging operating environment of negative interest rates and low economic growth, both of which contributed to further margin compression as well as flat to negative loan growth. Japanese bank profitability was supported by continued securities gains, which accounted for over 40% of pre-tax income among the major banks, and a benign credit environment that kept impairment costs low. Overall returns trended lower with the banks posting a moderate average ROE of 7.75%. With respect to money market reform, Japanese banks have curtailed CD/CP issuance while focusing on growing foreign currency deposits. They have also increased yen-based funding and swapped into U.S. dollars in order to fund overseas loan growth. With strong loan-to-deposit ratios of 67% on average, the Japanese banks have limited reliance on market funding. Despite a noticeable decline recently, Japanese banks still hold significant JGB holdings as a deep pool of highly liquid assets that can be pledged as collateral for JPY or USD funding.

Singaporean banks reported slightly weaker results for 3Q16 as higher credit costs related to Oil & Gas exposures and margin compression offset decent loan growth, albeit at a slower pace than recent trends. Asset quality remained healthy despite a jump in non-performers related to Oil & Gas exposure, which relative to other banks remained elevated at 6% of loans, on average. Capital metrics were sound with CET1 ratios in the 12%-13% range on a fully loaded basis. Singaporean banks easily met LCR requirements across all currencies. The Singaporean banks have limited reliance on wholesale funding, with loan to deposit ratios all below 90%. As it relates to money market reform, Singaporean banks pared back trade finance activities that necessitated USD funding. As a result, U.S. commercial paper balances declined noticeably to low single digits as a percentage of total assets from mid-single digits.

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