TRILLIUM

Trillium's Approach to Investing in the Diversified Financials Sector

As our firm works to ensure that clients are invested in the best companies and investment opportunities, Trillium requires our research analysts to regularly complete thoroughly integrated environmental, social, and governance (ESG) reviews of the industries in their sector coverage areas.

We recently completed an ESG review of the Diversified Financials sub-industry, which represents about one-third of the market capitalization of the entire Financials sector, and is roughly 6% of the S&P 1500.

In these reviews, analysts identify the ESG areas that we believe are material to future company performance and investment returns, determine what we believe "best practices" behavior should be, and evaluate the selected companies' performance in these areas. We also work to ensure that our internal Buy List includes industry leaders or improving performers.

Our industry analyses go well beyond ESG analysis to include company strategies, business models, management performance, growth opportunities, the regulatory environment, financial management, returns on invested capital, return of capital to shareholders, and other benchmarks. Trillium prefers to invest in Diversified Banks that identify and pursue higher growth/return opportunities, manage their businesses efficiently and responsibly, respect and treat their employees and customers well, and consider environmental and social risks and opportunities in their strategies and operations.

> To maximize fees, many banks post account debits or withdrawals in order of high-to-low amounts. When a customer's account balance moves below zero, a bank can charge more fees due to more transactions hitting the account when it has a negative balance. This methodology is unfair to the customer and is a bad business practice.

Many banks have been required to scale back their operations in some areas due to regulatory changes. This has resulted in the sale of fewer products and services, no longer doing business with or reducing services to less profitable customer groups, and scaling down the geographies they sell in.

CHANGING REGULATORY ENVIRONMENT

New regulations require the largest global banks to ramp up their internal risk monitoring and control processes, which has resulted in the hiring of thousands of new employees and the spending of hundreds of millions of dollars on new technology and systems. We view these new requirements as positive, particularly because they address the regulators' investigation findings.

Some companies have gone beyond the required changes in their business models. For example, HSBC Holdings (NYSE: HSBC) implemented a new incentive compensation program beginning in 2013 for its Retail Banking and Wealth Management division customer-facing staff, whereby they are no longer incentivized by product-sale volumes but instead on meeting customers' needs. We believe this signals that customer feedback has become a material input in employee reviews and compensation at HSBC and removes a past performance metric that supports a short-term, not long-term, profit focus.

Another area where bank business models are changing is in how they do business with their retail bank customers, primarily due to technological innovation, new regulations, and low interest rates.

Specifically, banks are rolling out new technology to support more mobile banking services. Fewer traditional teller-type transactions (e.g. deposits) are occurring in the branch, and banks are shifting the purpose of one's bank branch visit to establishing and building relationships in their home mortgage and financial advisory businesses. This is due to banks searching for new fee revenues after new regulations limited areas in which they could generate revenues as well as the current low-interest environment. Overall, we expect that mobile banking will help reduce operating costs and bank branches should generate higher returns on investment with more stable revenue sources due to their transition to fee income.

New regulations require the largest banks (assets of $250 billion or more) to hold more equity capital or retained earnings on their balance sheet, have less and more stable sources of financial leverage, and hold a sufficient amount of liquid assets to fund short-term operations—all with the goal of working to ensure that these banks are able to withstand a future financial crisis.

Another significant regulatory change is the U.S. Federal Reserve Banks' Comprehensive Capital Analysis and Review (CCAR), which is the Fed's qualitative and quantitative assessment of the larger banks and which then provides authorization related to banks' request to return income and/or excess capital held to their shareholders. Failing the CCAR process is viewed negatively by the financial markets and is particularly concerning if it is for qualitative reasons, as it suggests that the Federal Reserve may be less confident in how they are managing their operations.

CONSUMER SAFETY

Our analysis focuses on consumer product/service, as this is a significant income generation area for the companies in this sector as well as an area with significant brand/reputation risk. There is nothing wrong or irresponsible about lending to low-income borrowers. Best practice in making subprime loans is that lenders address additional risks by more closely evaluating the borrower, setting higher standards for collateral, and charging interest rates that are commensurate with the increased risk.

Leading up to the 2008-2009 financial crisis, poor underwriting practices and declining standards for mortgages, coupled with incentives for underwriters, increased the volume of transactions and encouraged a disregard for credit quality. Our analysts attempt to identify potential future problem areas for the companies they review and evaluate internal governance, processes, and other factors that may result in outcomes detrimental to their retail customers.

Responsible lenders offer consumer product/services that are fairly structured, priced, offered, and transparent. Many Diversified Banks have established governance oversight in this area as most banks—not just the large Diversified Banks—have become more aggressive and less customer friendly in their consumer products as they seek to boost fee revenues during this environment of low-interest rates.

Following negative press and class-action litigation, one of the most visible and well-publicized problematic consumer product areas for banks in recent years has been checking account overdraft fees. To maximize fees, many banks post account debits or withdrawals in order of high-to-low amounts. As a result, when a customer's account balance moves below zero, a bank can charge more fees due to more transactions hitting the account when it has a negative balance. This bad business practice is unfair to the customer, and is counterintuitive to building long-term customer relationships. A number of banks have moved entirely away from high-to-low to either chronological or low-to-high amount posting order, which we believe is best practice.

Among the Diversified Banks we researched, we believe HSBC (NYSE: HSBC) and Wells Fargo (NYSE: WFC) adhere to best practices in this area, as they post entirely in low-to-high order on all transactions. While Bank of America (NASDAQ: BAC) and JPMorgan Chase (NYSE: JPM) both have comprehensive account disclosure documents, they fall short as they still post some debits in high-to-low order.

RISK OVERSIGHT

Most Diversified Banks have established Environmental and Social Risk Committees. As best practice, we believe this committee should include senior executives, business unit heads, and experts from outside the firm working to ensure that the company identifies, minimizes, and manages client environmental and social (E&S) risks and opportunities across the company's lending, investment, underwriting, and asset management business areas. In addition, the committee should also help the company pursue business opportunities and set goals in environmental and social impact areas, including mitigating climate change, water scarcity, biodiversity, and community lending. To ensure proper governance, we also believe this committee should report to the company's Board of Directors. These steps should help a company build a corporate culture that instills the importance of superior E&S performance.

This doesn't mean that banks aren't lending or investing in areas that some might view as controversial, such as the Energy sector. Investors should be aware if the bank audits its internal processes to ensure that its bankers are complying with its environmental and social risk due diligence requirements.

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