

**Telephone Call Between Staff of the FRB, OCC, and FDIC and
Representatives and Members of The Clearinghouse
February 19, 2013**

Participants: Staff of the Federal Reserve Board, the Office of the Comptroller of the Currency, and the Federal Deposit Insurance Corporation (collectively, the Agencies)

Representatives and Members of The Clearinghouse (TCH)
(See attached list for dial-in participants)¹

Summary: Representatives and members of TCH participated in a conference call with staff of the Agencies to discuss the Agencies' proposed regulatory capital rules and to follow up on the written comments of TCH. Representatives and members of TCH identified issues to consider in finalizing the proposed regulatory capital rules and suggested specific changes to certain aspects of the rules. As part of this discussion, representatives and members of TCH focused on topics identified in advance. A copy of this list of topics and supporting documentation is included as an attachment.²

Staff of the Agencies thanked all participants on the call for their comments and suggestions.

Attachments

¹ The attached list contains all participants who identified themselves and was provided by the supplier of conference call services. It is possible that there were additional participants in the conference.

² This summary has been updated to reflect additional information received after the call.

ATTACHMENT A

1.	WAGNER, DAVID	THE CLEARING HOUSE
2.	FALLON, KIERAN	PNC
3.	GLADIN, ANDREW	SULLIVAN CROMWELL
4.	HUBERTUS, MICHELLE	CITI
5.	PICOULT, EVAN	CITI
6.	SHENDER, ANNA	BANK OF AMERICA
7.	WELSHIMER, MARK	SULLIVAN CROMWELL
8.	O'KEEFE, JEFF	WELLS FARGO
9.	ADIGA, RAMESH	WELLS FARGO
10.	AGARWAL, AJAY	J P MORGAN
11.	AGARWAL, VIKAS	CAPITAL ONE
12.	AGENS, NATHAN	PNC BANK
13.	ALEXANDER, DAVID	FEDERAL RESERVE
14.	BILLINGSLEY, RYAN	FDIC
15.	BURESH, MARK	FEDERAL RESERVE
16.	BURKI, SAIRAH	CAPITAL ONE
17.	CHARTRES, JOHN	GOLDMAN SACHS
18.	CHRISTENSEN, MIKE	US BANK
19.	CLIMENT, JUAN	FEDERAL RESERVE
20.	CONNELLY, SEAN	CITIGROUP
21.	DALEY, DIANE	CITIGROUP
22.	DONAGHY, EDWARD	CITIGROUP
23.	DOWELL, RODNEY	CITIGROUP
24.	DREXLER, ALLAN	BNY MELLON
25.	ELLIOTT, ERNA	FEDERAL RESERVE
26.	ELLIOTT, LORNE	CITIGROUP
27.	EWING, LIZ	GOLDMAN SACHS
28.	GILBERT, ADAM	J P MORGAN
29.	GU, EMILY	UBS
30.	HARRIS, DAVID	PNC
31.	HOPPER, GREG	GOLDMAN SACHS
32.	HORTON, JIM	WELLS FARGO
33.	JONNALAGEDDA, SUBBU	CITI
34.	JOSYULA, RAJREV	WELLS FARGO
35.	KATZ, BEN	HSBC
36.	KESTENMAN, JULIE	BANK OF AMERICA
37.	LEE, VINCE	CITIGROUP
38.	MAJMUDAR, GINA	PNC FINANCIAL SERVICES
39.	MASON, DAVID	WELLS FARGO
40.	MASSEY, KERRY	UNION BANK
41.	MCCUE, JAMES	CITIGROUP
42.	MIRA, PAUL	PNC FINANCIAL
43.	MOFFITT, AL	J P MORGAN
44.	O'CONNELL, JOHN	CITIGROUP

45.	PADULLA, JIM	CITIGROUP
46.	PETERSON, ELI	BNY MELLON
47.	POZIN, RYAN	THE CLEARING HOUSE
48.	PULAVARTI, VID	J P MORGAN
49.	QUIGLEY, KATHRYN	BNY MELLON
50.	RAFFIS, LOUIS	KEY BANK
51.	SCHWADRON, MARGOT	OCC
52.	SEGUINE, DAN	BANK OF AMERICA
53.	SENTLINGER, JIM	WELLS FARGO
54.	SMITH, RANDALL	FDIC
55.	SNYDER, APRIL	FEDERAL RESERVE
56.	SPAULDING, MARK	WELLS FARGO
57.	SUTTON, KIM	CAPITAL ONE
58.	TENNOIS, DEBBIE	J P MORGAN CHASE
59.	VEDULA, BHASKAR	CITIGROUP
60.	WALTER, JOHN	BANK OF AMERICA
61.	WAXMAN, BRETT	CLEARING HOUSE
62.	WAYNE, HENRY	CITIGROUP
63.	WEINBERG, MARC	CITIGROUP
64.	XI, YINGLY	CITIGROUP
65.	YANG, ILSOON	HSBC
66.	YU, MARY	WELLS FARGO

ATTACHMENT B



TCH-Interagency Meeting Regarding Basel III Capital NPRs

February 19, 2013

TCH Staff Draft - For Discussion Purposes Only

DISCUSSION AGENDA

1. AOCI
2. Delaware corporate law provisions
3. Investments in financial institutions
4. DTAs
5. BOLI separate accounts
6. Leverage ratio level playing field concerns
7. Removal of the 50% cap for OTC derivatives
8. Hedge pairs
9. CVA
10. Closing remarks

INVESTMENTS IN FINANCIAL INSTITUTIONS

INVESTMENTS IN “FINANCIAL INSTITUTIONS”

- The BIS rules that eventually became the Basel III proposed limitations on unconsolidated investments in financial institutions to remove the “double counting” of capital
- The NPRs define “financial institution” much more broadly to include:
 - Companies engaged in a broad range of financial activities, irrespective of whether those companies are subject to regulatory capital requirements;
 - All “covered funds” as defined by Volcker rule; and
 - All commodity pools
- Definition should be revised to include only “regulated financial institutions”, i.e., those subject to regulatory capital requirements and SIFIs designated by FSOC that become subject to regulatory capital requirements
 - Definition would address the policy behind the deductions for unconsolidated investments in financial institutions

- It is not necessary or prudent to expand the limitation on investments in unconsolidated financial institutions to address concerns other than double counting of capital.
 - Any additional potential risks, such as interconnectivity, are addressed by other laws and regulations (e.g., 165(e) SCCL)
 - The more limited risks associated with other investments in financial institutions is adequately addressed through the higher system-wide risk weighting for equity exposures that are not deducted from CET1, as amended by NPRs (e.g., 300% RW for publicly traded securities; 400% RW of non-publicly traded securities.)

- Several portions of the definition of financial institution do not seem necessary, even in the context of interconnectivity:
 - *Companies predominantly engaged in financial activities*: Unless an entity is subject to regulatory capital requirements, subjecting an investment to limitations on non-significant investments does not further the goal of eliminating double counting.
 - Treating asset managers as financial institutions is particularly inappropriate given the fact that the FSOC has not yet determined whether or how an asset manager might be systemically important.
 - *Covered Funds*: No reason that capital treatment should be based solely on the condition of Volcker Rule designation. In addition, the Volcker Rule itself provides for a capital deduction to be applied only to one set of covered funds (i.e. those offered under §1852(d)(1)(G))
 - *Commodity Pools*: Eliminating this category would not give rise to concerns of double counting capital or interconnectedness risk.
 - Moreover, under CFTC interpretations, any entity that enters into even just one swap may be a commodity pool. While the CFTC has recently granted no-action relief exempting sponsors of a variety of entities (such as securitization vehicles) from registering as a commodity pool operator, these letters do not exempt the underlying entity from the definition of commodity pool.

CONCLUSION

- The definition of “financial institution” should be revised to encompass only “regulated financial institutions” as defined in the Basel III NPR, which would include designated nonbank SIFIs regulated by the Federal Reserve under Title I of Dodd-Frank
- The broad definition of “financial institution” proposed in the Basel III NPR is not necessary to eliminate double-counting of capital in the financial system. Existing regulation and pending reforms deal with perceived interconnectivity issues among financial firms in a more direct manner.
- The combination of the proposed definition of “financial institutions” and the requirement that banks “include direct, indirect and synthetic exposures to capital instruments” when determining their investments in unconsolidated financial institutions, creates significant practical difficulties in how banks would need to calculate the applicable minority interest deduction for purposes of their capital ratios.

BOLI SEPARATE ACCOUNTS

BOLI OVERVIEW

- BOLI separate accounts are estimated to represent approximately \$75 - \$100 billion of exposure on U.S. banks' balance sheets
- Basel does not specifically address the treatment of BOLI assets. The OCC has written prior guidance which specifies two look through approaches which rely on investment guidelines
- The Basel II Equity look through approaches were written with the Ratings Based Approach in mind. The Basel III proposed approaches appear to be extremely punitive for funds which allow investments in securitizations
- In addition to the challenges with the modified look through approach, the full look through approach does not appear without challenge either
 - Historically insurance carriers have not made CUSIP level data for investment funds available
 - Even if data is available, operational challenges to full look through would be significant (multiple exposure types, data, etc.)
 - Estimate suggest an individual bank's BOLI separate accounts could hold in excess of 10,000 positions, which could translate to greater than 20,000 CUSIPS
- The use of the modified look through approaches as proposed would have a significantly detrimental impact to bank capital levels
 - RWA for separate accounts could increase from 20-30 times current levels

EXAMPLE OF POTENTIAL IMPACT

MBS Fund Market Value \$ 1,395,151,330
As of 12/31/2012

Current Basel II					Basel III NPR					TCH Proposed			
Basel II Category	A	B	C	D	Basel III Category	A	B	C	D	Market Sector ⁽¹⁾	Market Value %	Risk Weight %	Total
Sovereign	100%	20%	0%	0%	US Government	100%	0%	0%	0%	Cash	4.47%	0%	0%
AA-AAA	80%	80%	20%	16%	Agencies	100%	0%	20%	0%	US Government	0%	0%	0%
A	0%	0%	50%	0%	Corporate Debt	100%	0%	100%	0%	Agencies	94.92%	20%	19%
BBB	0%	0%	100%	0%	Equity	100%	0%	100%	0%	Corporate Debt	0%	100%	0%
Below Investment	0%	0%	200%	0%	Foreign Sovereign	100%	0%	150%	0%	Equity	0%	100%	0%
					Securitized	100%	100%	1250%	1250%	Derivatives	0%	1250%	0%
										Securitized	0.61%	100%	1%
Total Fund RWA%				16%	Total RWA				1250%	19.60%			
Total RWA				\$ 223,224,213	Total RWA				\$ 17,439,391,625	\$ 273,449,661			

- Illustration of proposed rule impact using actual BOLI separate account example; fund manager hidden for privacy purposes
 - Current Basel II Modified Look Through Approach
 - Basel III NPR Modified Look Through Approach
 - TCH Proposed Modified Look Through Approach
- Column definitions
 - A: Maximum investment allowed in prospectus
 - B: Maximum investment used per category, most restrictive categories filled first
 - C: RWA percentage for category
 - D: B x C

¹ See page 11 for detailed example of proposed Sector Allocation Look Through Approach

APPENDIX A – DETAILED SECTOR ALLOCATION TEMPLATE

Investment Fund Name:	MBS
Investment Manager:	INV MGR
Portfolio Market Value (\$):	\$ 1,395,151,330
As of Date:	12/31/2012

Sector Allocation	Portfolio Market Value (%)	Portfolio Market Value (\$)	RW %	RWA (\$)	%
Government	0.00%	-			
Domestic Sovereign			0.00%	-	0.00%
Foreign Sovereign			0.00%	-	0.00%
Quasi Government	0.00%	-			
Agency Govt Guarantee			20.00%	-	0.00%
Agency Non Govt Guarantee			20.00%	-	0.00%
Govt Guarantee Corp			0.00%	-	0.00%
Local Government			20.00%	-	0.00%
Supranational			0.00%	-	0.00%
Asset Back Securities (ABS)	0.00%	55,242.24			
Auto			100.00%	-	0.00%
Credit Card			100.00%	-	0.00%
Home Loan	0.00%	55,242.24	100.00%	55,242.24	0.01%
HELOC			100.00%	-	0.00%
Student Loans			100.00%	-	0.00%
Other			100.00%	-	0.00%
Commercial Mortgages (CMBS)	0.50%	6,921,871.72	100.00%	6,921,871.72	1.86%
Residential Mortgages (RMBS)	95.08%	1,325,818,049.71			
Non-Agency ARMs - Prime			100.00%	-	0.00%
Non-Agency ARMs - Alt A			100.00%	-	0.00%
Non-Agency ARMs - Alt-A Negative Amortization			100.00%	-	0.00%
Non-Agency CMO	0.11%	1,563,330.77	100.00%	1,563,330.77	0.42%
Agency ARMs			20.00%	-	0.00%
Agency CMO	0.69%	9,668,444.91	20.00%	1,933,888.98	0.52%
MBS Derivative			1250.00%	-	0.00%
Non U.S.			1250.00%	-	0.00%
Pass-Through	94.28%	1,314,585,274.03	20.00%	262,917,054.81	70.75%
Covered Bond	0.00%	-			
Pfandbrief			20.00%	-	0.00%
Non-Pfandbrief			100.00%	-	0.00%
Corporate	0.00%	-			
Financial			100.00%	-	0.00%
Industrial			100.00%	-	0.00%
Utility			100.00%	-	0.00%
Index			100.00%	-	0.00%
Other			100.00%	-	0.00%
Emerging Market Debt			150.00%	-	0.00%
Municipal	0.00%	-			
General Obligation			20.00%	-	0.00%
Revenue Obligation			50.00%	-	0.00%
Commodities			100.00%	-	0.00%
Cash	4.47%	62,356,166.31	0.00%	-	0.00%
Derivatives	0.00%	-			
For Hedging Purposes			1250.00%	-	0.00%
For Non-Hedging Purposes			1250.00%	-	0.00%
	100.00%	\$ 1,395,151,330	19.60%	\$ 273,391,389	

BASEL III CVA VAR IMPLEMENTATION ISSUES

OVERVIEW

- Current Basel III rules on which CDS hedges can be recognized, the treatment of CVA rates hedges, and the interpretation of LGD in the CVA VaR formula will encourage worse counterparty credit risk management in banks and will discourage end users from effectively managing long-term risks
- We illustrate these points quantitatively using a number of examples
- We conclude by requesting that Basel III CVA VaR rules be modified as follows:
 - Single name proxy CDS trades should be allowed as hedges in the CVA VaR calculation
 - CVA rates hedges (to the extent they are covered positions) should be excluded from Basel 2.5 capital calculations (consistent with interest rate risk in the banking book) until supervisors are ready to approve allowing CVA rates sensitivities to be put in VaR
 - Banks should be allowed to distinguish the recovery rate implicit in the CDS spread from the recovery rate on a specific trade in the CVA VaR formula

INCLUSION OF PROXY HEDGES CONSISTENT WITH FED/OCC REGULATORY GOALS

- For Advanced Approaches banks, the Fed/OCC stated in the July 2011 Interagency Supervisory Guidance on Counterparty Credit Risk Management:
 - “CVA VaR should incorporate all forms of CVA hedging. Banking organizations and examiners should assess the ability of the VaR measure to accurately capture the types of hedging used by the banking organisation.”
- CCAR itself encapsulates all fair-value and tests the effectiveness of hedge strategies.
- This suggests that the US implementation of Basel 3 should permit proxy hedges subject to the approval of their treatment under VaR
- Inclusion of proxy hedges would produce a clear and consistent set of risk management and capital management objectives at firms that align with the publicly stated goals of the regulators

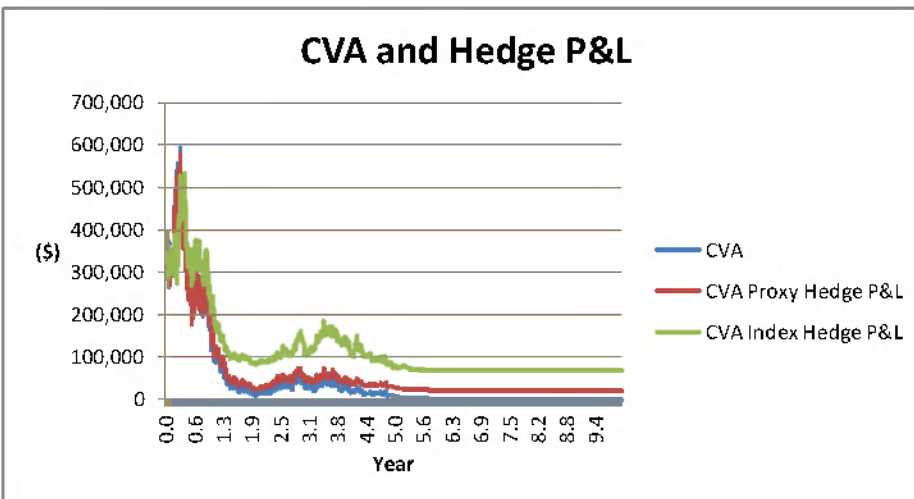
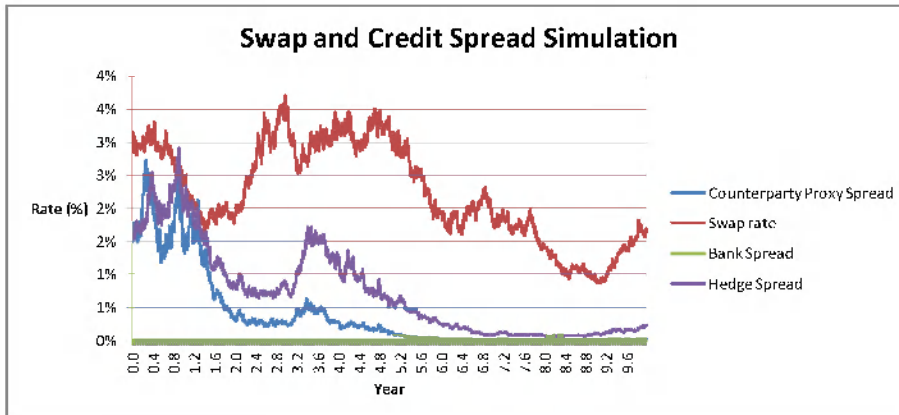
THE SUCCESS OF CVA HEDGING STRATEGIES ARE APPARENT IN CCAR

- CCAR results and Fed/OCC supervision in the detail show:
 - Success of firms hedging strategies for European Sovereign ACVA.
 - Success of market vector CVA hedging strategies in reducing CVA losses:
 - For US Muni counterparty exposures.
 - For wrong-way currency-related cross-border exposures.
- The Fed/OCC have this data. It is natural to ask “How would this perform in a stressed scenario?” That is a concern about VaR, and choosing to reflect that concern through eligibility of hedge offsets creates incentives to negatively select the risk profile of a Firm.

EXAMPLE 1: MODEL SETUP

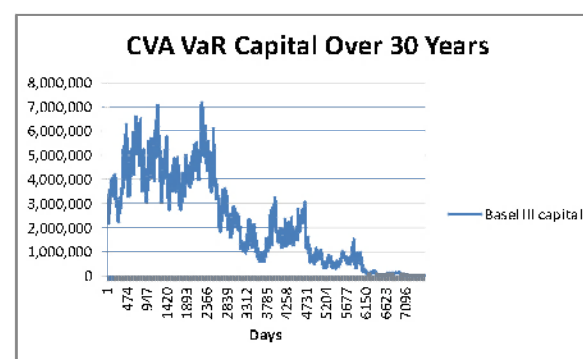
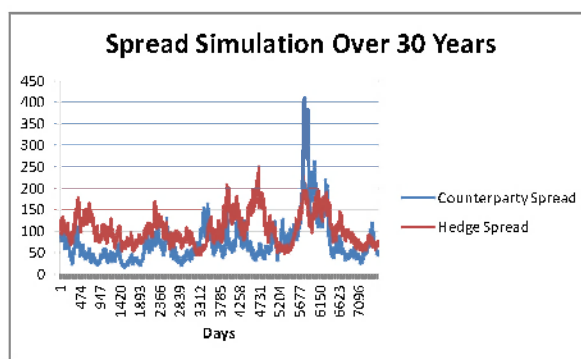
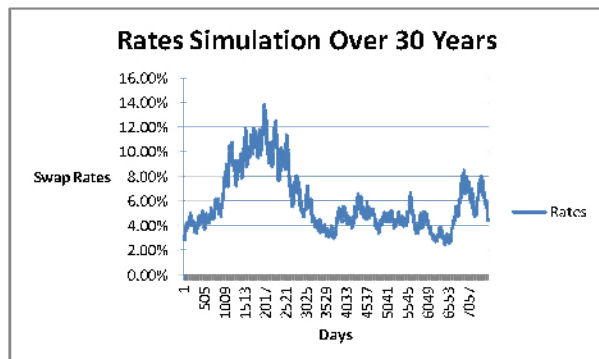
- We take representative swap trades and simulate their value daily over the life of the trade
- Each day, we calculate bilateral CVA, the CVA spread hedge, and the CVA rates hedge
- On each day, we also calculate Basel II capital (with $M = 1$), Basel III CVA VaR capital, and, where the position is a covered position, Basel 2.5 capital on the CVA rates hedge
- Using these simulations, we examine incentives to hedge CVA as well as the effect on the economics of specific trades

SIMULATION OF INTEREST RATE SWAP OVER LIFE OF TRADE



- \$100 million pay fixed 10-year swap
- CVA marked to proxy spread
- CVA is hedged with index CDS
- Proxy spread has 75% vol while index spread has 50% vol
- Correlation between proxy and index spread is 50%
- Note that when index spread departs from proxy spread to which CVA is marked, hedge P&L departs from CVA P&L
- To minimize P&L drift, Bank needs to hedge with CDS on the proxy spread or with a CDS on a different proxy spread that has a similar vol to and high correlation with the proxy spread
- Under current Basel III rules, however, the bank is incentivized to use an index hedge, thus introducing hedge tracking error unnecessarily

EFFECTS OF INDEX HEDGE REQUIREMENT ON ECONOMICS OF LONG-DATED TRADES



- \$100 million pay fixed 30-year interest rate swap simulated daily over 30 year horizon
- We hedge CVA with an index swap that is 50% correlated with the marked spread of the counterparty
- We calculate Basel III CVA VaR capital every day over the 30 year horizon
- Daily CVA VaR capital initially rises since interest rates in the simulation rise and the swap goes in the money
- Over time, capital falls off as interest rates decline and the maturity of the trade decreases
- If we assume the cost of capital is 10% for a hypothetical bank, the cost of capital on this simulated path is 26 bps running on the \$100 million notional, a very large increase in the price of the swap

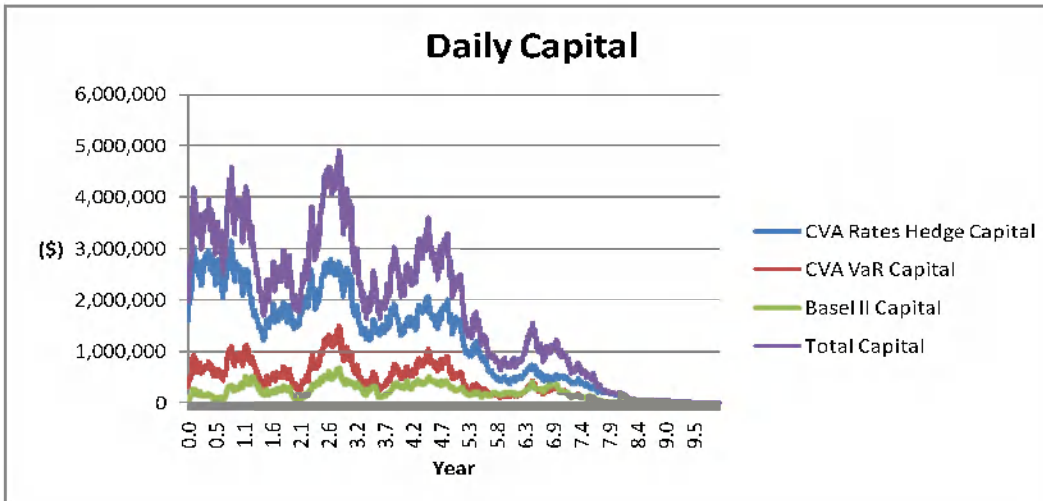
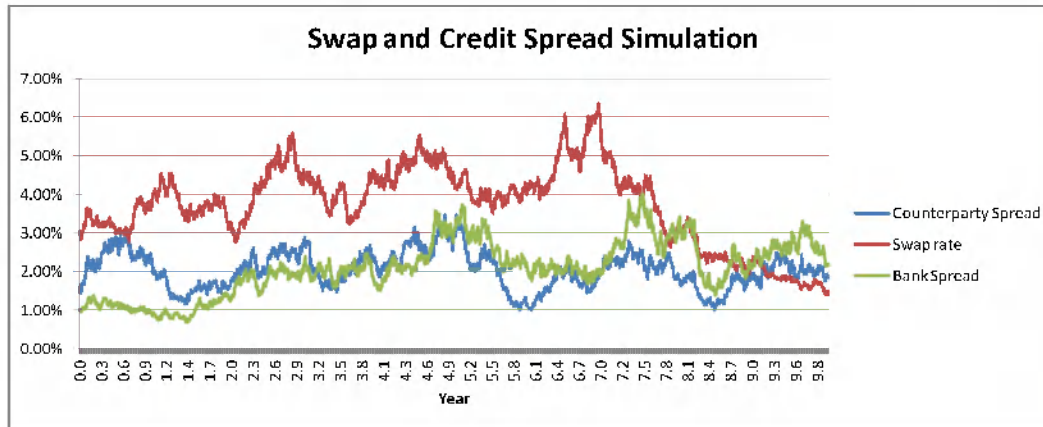
ESTIMATING COST OF CVA VaR CAPITAL ON ECONOMICS OF SWAP

- Do 1000 simulations of model, estimating cost of CVA VaR capital with index hedge on each path
- We assume that index CDS hedge is 50% correlated with proxy spread used to mark CVA
- We average cost of CVA VaR capital across paths
- 13 bps running on average is required to cover cost of CVA VaR capital on this swap, still a large increase
- If a CDS hedge that is 90% correlated with the proxy spread is used, cost of CVA VaR capital drops to 8bps running
- If the CDS hedge is the same as the proxy spread used to mark the position, the impact on pricing drops to on the order of 1 bps
- Thus, the requirement to use a sub-optimal index hedge can have a very large impact on the economics of long-dated derivatives transactions
- Changes in economics of this magnitude will discourage end users from managing long term risks
- Industry survey (AFME, April 2012) suggests a 2.5x increase on average in swap spreads to achieve a 10% return on capital. If proxy hedges are disallowed, this is 3-5x.

EFFECT OF INCLUDING CVA INTEREST RATE HEDGES IN CAPITAL

- Unlike spread hedges, CVA interest rate hedges are not offset by the CVA itself in the regulatory capital calculation
- Thus, as the portfolio becomes directional, capital costs can climb very fast
- These capital costs do not reflect the true risk since the CVA rates hedge is offset by the CVA itself
- These costs induce the same incentives to mishedge CVA and will discourage the management of long term risks by end users

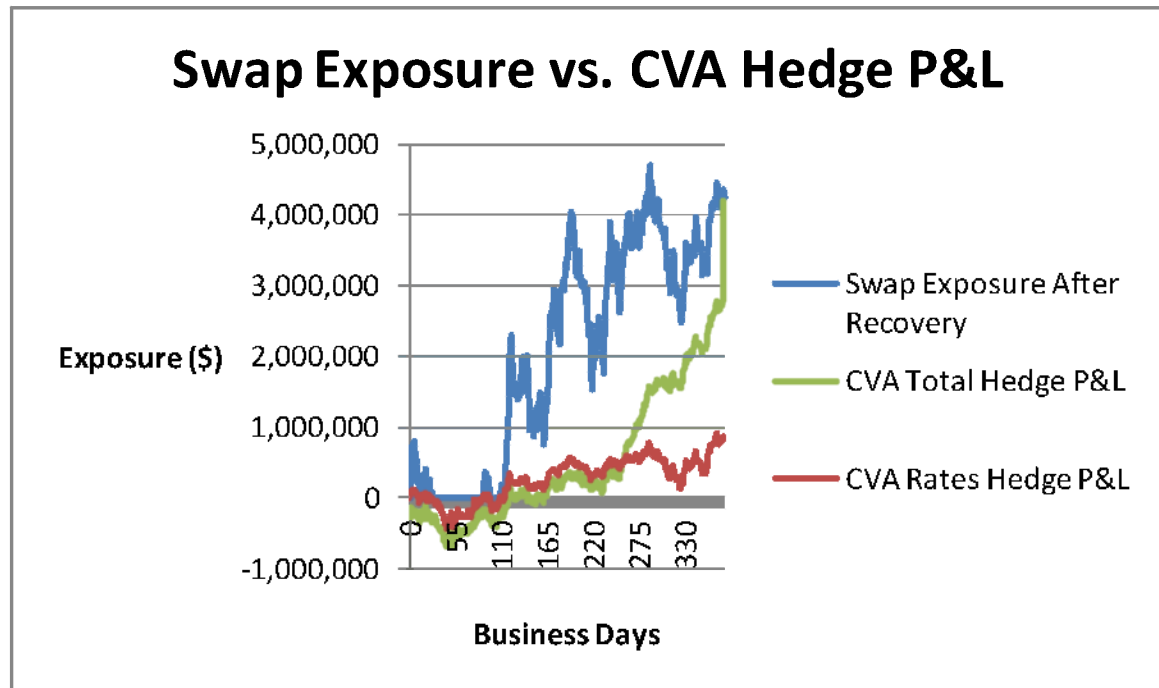
COMPARISON OF BASEL 2.5 AND BASEL III CAPITAL



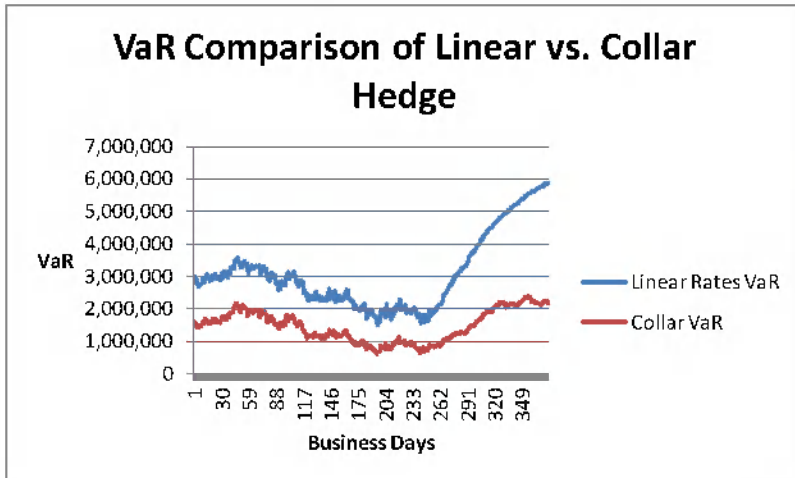
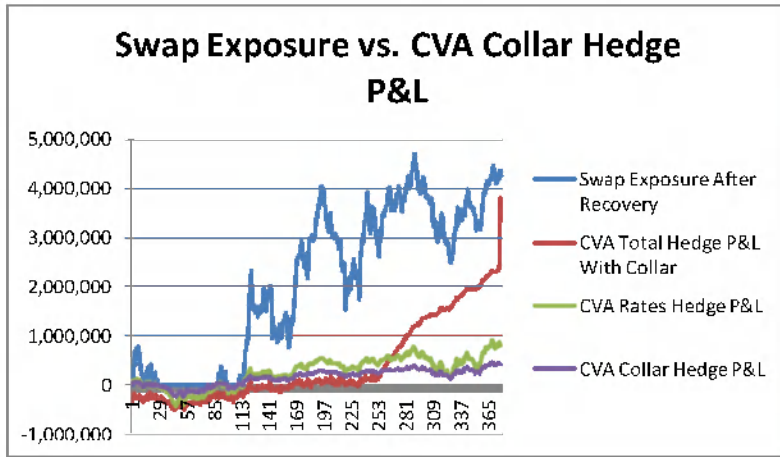
- We simulate 10-year swap over the life of the trade
- We calculate Basel II (M=1), Basel III CVA VaR capital, and Basel 2.5 capital (where a covered position) resulting from the CVA rates hedge on each day
- We see that the rates hedge capital under Basel 2.5 can be much larger than BIII, introducing even more severely perverse incentives than BIII does
- Banks are incentivized to reduce CVA rates hedging

EFFECT OF FAILING TO HEDGE RATES COMPONENT OF CVA

- Simulation of counterparty with 10-year swap that defaults in 1.5 years
- In this case, the rates hedge P&L is about 25% of the total credit loss
- If bank failed to hedge CVA rate risk, only 75% covered for loss



ALTERNATIVE CVA RATE RISK HEDGING STRATEGY



- As an alternative to failing to hedge rates risk, bank may be incentivized to find rates hedges with reduced interest rate sensitivity
- We hedge the same default case with a collar of out of the money swaptions
- On this simulated path, we cover 90% of the CVA rates hedge P&L
- However, this strategy and others like it may be impossible to execute and may not work as well in other environments
- Even if such strategies could work, there is always a tradeoff between capital incentives and proper CVA risk management

EXAMPLE 2: ILLUSTRATING THE SPLIT AND PROXY HEDGE PROBLEM THROUGH THE FINANCIAL CRISIS

- Roll a 10yr USD swap through the 2008 period onwards. Plot the actual credit vector only hedged CVA against just the B3 CVA variability charge, and B2.5 on the swaption mkt vector hedges (assuming it is a covered position).
- Recalculate MTM, Asset CVA, CVA Market & Credit Hedges, B3 CVA Variability Charge, and 'Total' Capital = B3 CVA V/C + B2.5 on the Rate Hedges.
- Key messages:
 - Capital is still too procyclical, exacerbated by the split hedge.
 - Proxy hedging relieves P&L volatility. If regulators are concerned about VaR performance, excluding proxy hedges is not the answer.

OVERVIEW OF SWAP MTM, CREDIT SPREAD AND ASSET CVA FROM 2008-2010



RESIDUAL JTD EXPOSURE, HEDGED CVA P&L, AND CAPITAL METRICS



TREATMENT OF LGD WHEN RECOVERY ON REFERENCE NAME OF CDS IS SAME AS RECOVERY OF TRADE

- If recovery on trade is the same as recovery on the reference asset to which spread applies, then we use the same recovery to determine risk neutral PD as well as to calculate expected loss in CVA
- A common case is that the reference obligation underlying the CDS spread and the trade are both unsecured

$$CVA = \sum_{i=1}^T \left(\frac{EE_{i-1} D_{i-1}}{2} \right) \times \left(e^{\frac{-s_{i-1} t_{i-1}}{(1-R_u)}} - e^{\frac{-s_i t_i}{(1-R_u)}} \right) \times (1 - R_u)$$

$$CS01 = \sum_{i=1}^T \left(\frac{EE_{i-1} D_{i-1}}{2} \right) \times \left(t_i e^{\frac{-s_i t_i}{(1-R_u)}} - t_{i-1} e^{\frac{-s_{i-1} t_{i-1}}{(1-R_u)}} \right) \quad \bullet \text{ CS01 determines CVA hedge ratio}$$

TREATMENT OF LGD WHEN RECOVERY ON UNDERLYING REFERENCE NAME OF CDS IS DIFFERENT FROM RECOVERY OF TRADE

- However, it is not uncommon for the recovery on the trade to be different from the recovery on the reference asset underlying the CDS spread
- For example, the spread may reflect an unsecured obligation but the trade is secured
- In this case, CVA formula must be modified:

$$CVA_{secured} = \sum_{i=1}^T \left(\frac{EE_{i-1} D_{i-1}}{2} \right) \times \left(e^{\frac{-s_{i-1} t_{i-1}}{(1-R_u)}} - e^{\frac{-s_i t_i}{(1-R_u)}} \right) \times (1 - R_s)$$

$$CS01_{secured} = \sum_{i=1}^T \left(\frac{EE_{i-1} D_{i-1}}{2} \right) \times \left(t_i e^{\frac{-s_i t_i}{(1-R_u)}} - t_{i-1} e^{\frac{-s_{i-1} t_{i-1}}{(1-R_u)}} \right) \times \frac{(1 - R_s)}{(1 - R_u)}$$

- Note that hedge ratio has changed
- However, bank will be incentivized to over or under hedge if the difference in recovery rates cannot be recognized, producing the same incentive problems discussed before

CONCLUSION

- Restrictions on spread hedges, inclusion of rates hedges in capital without the offsetting CVA, and restrictions on LGD provide incentives for banks to reduce the effectiveness of risk management of counterparty credit risk
- These restrictions will also discourage end users from properly managing long term risks
- We request that these rules be changed so that capital is more closely aligned with sound risk management practices



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Hedge Pairs - Examples

Example A: Trade Description (Hedge Fund Linked Note)

- Bank issues EMTN hedge fund linked \$100m 10yr Notes to investors in exchange for \$100m. At maturity the Notes pay the performance of hedge fund ABC on \$100m of notional exposure.
- Simultaneously Bank hedges the exposure generated by the Notes by investing \$100m in hedge fund ABC.
- The notes are designed to pass through all returns one-to-one to investors, both upside and downside and Bank only has to pay if the Bank receives proceeds from redemptions in the hedge fund.

Max Loss

- If hedge fund ABC goes to zero instantaneously the following takes place:
 - Bank loses \$100m on its investment in hedge fund ABC
 - Bank makes \$100m on the Notes it has issued
 - Therefore, the Bank crystallises a \$0 maximum loss which is entirely deterministic (and not statistically or model driven).

Capital Treatment

- Prior to Basel 2.5, the trade and hedge remain in trading book and netting is applied. RWA is \$0 driven off VAR. No capital is required.
- Under Basel 2.5, the trade and hedge go into banking book. Under Basel 2/ Basel 3, no netting is available in the banking book and RWA is $600\% * \$100m = \$600m$ so \$60m capital is required against max loss of \$0. In addition, this outcome would be made worse as the bank may be required to hold additional capital on the \$100 EMTN linked note.
- Under Basel 2.5/ Basel 3 if Max Loss treatment were permitted in the banking book, we would seek to apply $\$0 \text{ max loss} * 1250\% = \0 RWA .

Example B: Trade Description (Cash Hedged Non-Public Equity)

- Bank enters into a fully cash collateralised (collateralised to full notional) Total Return Swap (TRS) with Corporate A to acquire 10% of the equity of Corporate B. This is typically a pre-M&A step while Corporate A is awaiting regulatory clearance etc. Notional of the TRS and cash collateral posted are both \$100 million.
- Simultaneously, Bank acquires \$100m of equity of Corporate B.
- TRS either terminates with regulatory approval (or disapproval), or at a maturity date. In any scenario, Bank settles the TRS based on the cash price for the sale of equity.

Max Loss

- If value of equity of Corporate B goes to zero instantaneously the following takes place:
 - Bank loses \$100m on its investment in equity of Corporate B

- Bank makes \$100m on the TRS it has issued
- Therefore Bank crystallises a \$0 mark-to-market maximum loss which is entirely deterministic (and not statistically or model driven).

Capital Treatment

- Under Basel 2.5, the trade and hedge go into banking book. No netting is available in the banking book rules (US Basel 2, and Basel 3 NPR) and RWA is $400\% * \$100m = \$400m$ so \$40m capital is required against max loss \$0m.
- Under Basel 2.5 / Basel 3 if Max Loss treatment were permitted in the banking book, we would seek to apply \$0m max loss * 1250% = \$0m RWA.

Example C: Trade Description (Open End Mutual Fund)

- Bank enters into a \$100m notional TRS with Counterparty A referencing Open End Mutual Fund ABC shares.
- Bank simultaneously purchases \$100m of Open End Mutual Fund ABC shares as its hedge to the TRS.
- The TRS is designed to pass through all returns one-to-one to the counterparty, both upside and downside. At termination of the TRS, the Bank submits a redemption request in the mutual fund shares to close out the hedge.
- Counterparty credit risk on the TRS is mitigated through either full cash collateralization or initial margin and variation margin requirements.
- Mutual Fund ABC, as is true for all Open End Mutual Funds is regulated under the Securities Act of 1940, which requires daily NAV and liquidity calculations.
- Investors enter in subscription agreements for these funds and invest directly into newly issued fund shares. To exit the investment in the fund shares, the investor submits a redemption request and receives the cash proceeds on a next day basis.
- Unlike the similar listed Closed End Mutual Funds, the Open End Funds are not treated as publicly traded despite near identical economics to the Bank.

Max Loss

- If value of Open End Mutual Fund ABC goes to zero instantaneously the following takes place:
 - Bank loses \$100m on its investment in Open End Mutual Fund ABC shares
 - Bank makes \$100m on the TRS it has issued
 - Therefore Bank crystallises a \$0 mark-to-market maximum loss which is entirely deterministic (and not statistically or model driven).

Capital Treatment

- Prior to Basel 2.5, the trade and hedge remain in trading book. Netting is applied. Market risk RWA is \$0 driven off VAR. No market risk capital is required. Counterparty credit risk is mitigated by the collateral requirements.
- Under Basel 2.5, the trade and the hedge may not satisfy the covered position criteria (as non-publicly traded equity positions), which would result in both being moved into the banking book. If the trade and the hedge are included in the banking book, under Basel 2/ Basel 3, the Open End Mutual Fund will fail hedge

pair treatment as it is not publicly traded and this will result in a requirement for capital on the TRS as well as the Open End Mutual Fund despite the Bank's maximum loss of \$0.

- Under Basel 2.5 / Basel 3 if Max Loss treatment were permitted in the banking book, we would seek to apply \$0m max loss * 1250% = \$0m RWA.

Proposed Revision to Text:

Sec 152 (c) (1)

"A hedge pair is two equity exposures that form an effective hedge so long as each equity position is publicly-traded or has a return that is primarily based on a publicly-traded exposure." **A hedge pair may comprise a non-publicly traded security if a bank has determined, in accordance with pre-existing policies, procedures and methodologies which have been approved by its primary regulator, that the exposures comprise an effective economic hedge.**

Sec 152 (c) (3)

If the effective portion of a hedge pair $E = 1$, the assigned risk weight is 0% [Consistent with Subpart F, Section 10 (a) (4)].

Section 152 (b) (3) (ii)

Move this section to 152 (b) (2) in order to be consistent with Subpart F, Section 10 (a) (5)].



Basel III Treatment of REIT Preferred Securities

February 26, 2013

Overview and Summary

- As the Basel III NPR recognizes, the existing structure for REIT Preferred securities includes an exchange feature that permits the primary federal supervisor of the bank to cause the securities to convert into non-cumulative perpetual preferred stock in times of financial stress. For some existing deals the exchange is into bank preferred—in others to BHC preferred.
- In light of this unique exchange feature, which triggers when “loss absorption” is of issue, we believe that the minority interest rules in Section 21 of the Proposed Rules should not apply to REIT Preferred securities.
 - As discussed below, an alternative way of recognizing this unique exchange feature would be to apply the minority interest limitations in Section 21 of the Proposed Rules to REIT Preferred Securities, but only after assuming that an exchange event has occurred.
- We recognize that as a result of certain individual cases during the financial crisis, the Agencies may wish to further ensure the effectiveness of the REIT Preferred exchange mechanics and, therefore, “going concern” loss absorption capability. As discussed below, we believe such effectiveness can be ensured by requiring that newly issued REIT Preferred include terms that clearly address these operational issues.
- We also discuss below ways of addressing the use of rating agency and Investment Company Act exchange triggers in future REIT Preferred issuances.
- Existing REIT Preferred that has been outstanding for at least 5 years should be grandfathered.

Exchange Events

- We understand that the Agencies may be concerned that the existing exchange trigger events—which are based on “undercapitalized” capital levels or placement into a conservatorship or receivership may:
 - Be too low to allow REIT Preferred (once converted) to serve as “going concern” capital; and
 - Have adverse signaling effects, because Agency action is necessary to cause an exchange.
- We believe these concerns can be addressed for future REIT Preferred issuances by modifying the exchange conditions such that the securities would be automatically exchanged, with no agency action required for the exchange to trigger, if the bank:
 - Ceases to be at least “adequately capitalized” at any time; or
 - Ceases to be “well capitalized” and does not restore itself to “well capitalized status” within two calendar quarters.

Exchange Events (continued)

- Optionally, the Agencies could also require that a conversion occur if:
 - The Agency, in its sole discretion, anticipates that the bank will (i) become less than “well capitalized” in the near term; and (ii) remain less than “well capitalized” for at least two consecutive quarters; and/or
 - The Agency, in its sole discretion, anticipates that the bank will be placed into conservatorship or receivership in the near term.
- These exchange events could be altered so that the conditions are based on the condition of the bank, the BHC, or at either level depending on Agency preference.

Exchange Events (continued)

- “Well capitalized” and “adequately capitalized” for these purposes would be:
 - Based on the Agencies’ prompt corrective action regulations; and
 - Determined applying the capital rules then in effect and applicable to the institution, e.g.—
 - Based on Basel III rules, including the phase-in of well-capitalized minimums, after the Basel III effective date; and
 - For Advanced Approaches Banks, based on the lower of the ratios calculated using (i) Advanced Approaches RWA and (ii) RWA under the generally applicable capital rules.

Operational Issues

- To address operational issues that may have occurred in isolated circumstances in which the REIT Preferred securities exchanged into BHC preferred stock, the governing documents for future REIT Preferreds exchangeable into BHC preferred stock should clearly and unambiguously provide that the REIT Preferred securities are automatically cancelled upon the exchange.
 - Doing so eliminates the potential for BHC investors to challenge the contribution of the REIT Preferred securities to its bank subsidiary and removes any question about the bank's control of the REIT (and its assets) following the exchange.
 - We would be pleased to work with the Agencies to develop model forms that would ensure these goals are met.
- An alternative method for achieving these goals would be for the Agencies to mandate that REIT Preferred securities must exchange into bank-level preferred stock rather than BHC preferred stock.
 - This alternative is a less preferable solution due to its potential impact on the marketability of REIT Preferred securities—specifically to retail investors. However, REIT Preferred securities would remain a viable source of Additional Tier 1 capital if the Agencies believe this structure is necessary to ensure Basel III capital treatment.

Application of Minority Interest Rules to REIT Preferred

- REIT Preferred that is exchangeable into BHC preferred stock should not be subject to the minority interest limitations in Section 21 of the Proposed Rules.
- As noted earlier, a conceptually similar approach would be to apply the minority interest rules to REIT Preferred as if the exchange into BHC preferred stock has occurred.
 - Once converted, the BHC preferred stock would clearly be available to absorb losses on a “going concern” basis at the consolidated BHC level.
 - At the same time, the bank’s common equity capital is increased via the previously suggested cancelation of the REIT Preferred as held by the BHC after the exchange.

Application of Minority Interest Rules to REIT Preferred (continued)

- The Agencies also could mandate that exchanges of future REIT issuances be into bank-level preferred stock (rather than BHC preferred) if doing so is helpful to solve operational concerns or other goals of the Agencies.
- For future REIT issuances structured in this manner, we believe the Basel III minority interest rules also either should not apply or should apply as if the exchange into bank preferred has occurred.
- As in the case of BHC-exchangeable securities, REIT preferred exchangeable into bank preferred stock would clearly be available to absorb losses at the bank on a “going concern” basis.

Application of Minority Interest Rules to REIT Preferred (continued)

- REIT Preferred exchangeable into bank preferred also should be exempt from the minority interest rules at the BHC level.

- However, if it is determined that the minority interest rules at the BHC level are to be applied to REIT Preferred exchangeable into bank-level preferred, it is imperative that they be applied assuming that the exchange has occurred.
 - Thus, in calculating the amount of “excess” capital upon which the minority interest rules are based, the minority interest rules would be applied using the capital levels of the bank (and not the stand-alone REIT structure) to determine the amount of disallowed capital.

 - We believe this approach—which is consistent with how REIT investors would ultimately absorb loss in a stressed situation—would sufficiently address the punitive nature of the minority interest rules to allow for the viability of the REIT product for potential future issuers.

Redemptions Within the First 5 Years Following Issuance

- The international Basel III standard permits redemptions within 5 years of issuance only upon the occurrence of a “tax” or “regulatory” event. However, existing REIT Preferred structures also allow early redemptions for “rating agency” and “Investment Company Act” (“ICA”, herein) events.
 - Potential future issuers would very likely move forward with new issuances without the rating agency event allowing redemption until year 6. Rating agency “equity credit” is no longer perceived as the critical issue it once was.
 - However, an ability to redeem or otherwise resolve an ICA event occurring within the first 5 years is important to avoid unique challenges and risks posed to U.S. issuers as a result of the ICA.

Redemptions within the first 5 years following issuance (continued)

- The ICA issue is unique to the United States, and therefore could not have been expected to be included in the international Basel standard.
 - The U.S. Agencies could therefore consider adding this “event” to the U.S. Basel III rules.
 - The existing call right upon an ICA event is a low probability event and one that is unlikely to be correlated with financial stress at the issuer. However, an ICA event can have potentially high negative impacts on the issuer, which is why the call option should be preserved.
 - In any event, it is assumed an ICA-triggered redemption beginning in year 6 could be retained.

Redemptions within the first 5 years following issuance (continued)

- An alternative would be for an ICA event within the first 5 years not to trigger a call option, but instead an exchange into the same preferred stock into which a “financial stress” exchange would occur.
 - Potential REIT investors should not be adverse to this concept. Although there is a very low correlation between an ICA event and financial stress, such investors already understand their risk of loss absorption is equivalent to that of a preferred stock holder because of the “financial stress” exchange provisions.
 - Indeed, this is why the rating of REIT Preferred generally tracks the public rating of the non-cumulative perpetual preferred stock of the entity into which the REIT Preferred would be exchanged into upon an exchange event.
 - Such investors should also understand that the probability of an ICA event is low. If such an event does occur, the investors would not be materially impacted via holding preferred stock rather than the REIT preferred.

Grandfathering of Existing REIT Preferred

- In light of the existence of the exchange feature – a feature not present in trust preferred securities--the full amount of existing REIT preferred securities that has been outstanding for at least 5 years should, at minimum, be explicitly grandfathered as additional Tier 1 capital.
 - Doing so would be consistent with Basel III once the exchange feature is taken into account – a feature that is unique to the U.S. Moreover, unlike TRuPs, Dodd-Frank does not mandate the phase-out of REIT Preferred securities.
 - While the aggregate amount of REIT Preferred securities outstanding is currently limited for the industry as a whole (\$11.5B originally issued and \$3.5B currently outstanding),¹ they remain an important source of tax deductible capital for particular institutions.
 - Issuers also do not have the ability to alter the terms of existing REIT Preferred securities.
 - Because such securities would have already been outstanding for more than 5 years, any issues related to the existence of early redemption features related to rating agency or ICA events would be moot.

¹ Excludes intra-company structures.



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