

**Meeting Between Federal Reserve Board Staff
And Representatives of Sandler O'Neill and Partners
October 18, 2011**

Participants: Art Lindo, Norah Barger, Anna Lee Hewko, Laurie Priest, Mary Aiken, Juan Climent, David Emmel, Page Conkling and Holly Kirkpatrick (Federal Reserve Board)

Fred Price, Thomas Killian, Raymond Chandonnet, and Adam Mandel (Sandler O'Neill)

Summary: Staff from the Federal Reserve Board met with representatives of Sandler O'Neill, who shared their views and concerns regarding the potential impact of Basel III on U.S. banking organizations. In particular, representatives of Sandler O'Neil discussed their concerns related to the treatment of accumulated other comprehensive income (AOCI) and cash flow hedges in the computation of regulatory capital. The representatives from Sandler O'Neill highlighted the importance of considering how the available for sale (AFS) securities are funded and expressed concern that an interest rate increase under the Basel III treatment may create excessive volatility in regulatory capital. In addition, representatives from Sandler O'Neill mentioned several strategies and alternatives that their clients might consider using in order to minimize the impact resulting from the Basel III treatment of AOCI on capital ratios while highlighting complexities and challenges associated with such strategies.

Materials Prepared For The Federal Reserve

October 18, 2011

SANDLER O'NEILL + PARTNERS, L.P.

New York + Atlanta + Boston + Chicago + San Francisco

+ www.SANDLERONEILL.com

GENERAL INFORMATION AND LIMITATIONS

This presentation, and the oral or video presentation that supplements it, have been developed by and are proprietary to Sandler O'Neill & Partners, L.P. and were prepared exclusively for the benefit and internal use of the recipient. Neither the printed presentation nor the oral or video presentation that supplements it, nor any of their contents, may be reproduced, distributed or used for any other purpose without the prior written consent of Sandler O'Neill & Partners, L.P.

The analyses contained herein rely upon information obtained from the recipient or from public sources, the accuracy of which has not been verified, and cannot be assured, by Sandler O'Neill & Partners, L.P. Moreover, many of the projections and financial analyses herein are based on estimated financial performance prepared by or in consultation with the recipient and are intended only to suggest reasonable ranges of results. Finally, the printed presentation is incomplete without the oral or video presentation that supplements it.

Sandler O'Neill & Partners, L.P. prohibits employees from offering, directly or indirectly, favorable research, a specific rating or a specific price target, or offering or threatening to change research, a rating or a price target to a company as consideration or inducement for the receipt of business or compensation. The Firm also prohibits research analysts from being compensated for their involvement in, or based upon, specific investment banking transactions.

Sandler O'Neill & Partners, L.P. is a limited partnership, the sole general partner of which is Sandler O'Neill & Partners Corp., a New York corporation. Sandler O'Neill & Partners, L.P. is a registered broker-dealer and a member of the Financial Industry Regulatory Authority. Sandler O'Neill Mortgage Finance L.P. is an indirect subsidiary of Sandler O'Neill & Partners Corp.

This material is protected under applicable copyright laws and does not carry any rights of publication or disclosure.

Table of Contents

I.	Executive Summary.....	5
II.	Balance Sheet Considerations.....	8
III.	Liquidity Considerations.....	17
IV.	Capital Considerations.....	22
V.	Bios.....	38

I. Executive Summary

Executive Summary

- ❑ The Dodd–Frank Act (DFA) and Basel III represent the most comprehensive and complicated restructuring of financial institution regulation since the 1930s
- ❑ While the Basel III rules have been finalized, the implementation of such rules in conjunction with DFA is subject to the rulemaking process currently underway with U.S. regulators
- ❑ Sandler O'Neill + Partners, L.P. is a full service investment bank that focuses exclusively on financial institutions primarily in the U.S. We maintain relationships with over 1,000 financial institutions and are consistently ranked among the top M&A advisors and leaders in capital raising for U.S. banks
- ❑ After months of internal discussions, meetings with banking clients and investors, a number of practical considerations have been identified which may impact implementation of DFA and Basel III regulations

Executive Summary

- Sandler O'Neill would like to use this opportunity to identify and discuss these considerations which we have divided into three categories:
 - Balance Sheet Considerations:
 - ✓ *Deduction of unrealized gains on cash flow hedge from regulatory capital in a rising rate environment (Basel III)*
 - ✓ *Deduction of unrealized losses from regulatory capital in a rising rate environment (Basel III)*
 - ✓ *Non-reliance on NRSRO credit ratings to determine investment permissibility and asset risk-weighting (DFA)*
 - ✓ *Impact on asset values caused by the distinction between qualified and non-qualified residential mortgages (DFA)*
 - Liquidity Considerations:
 - ✓ *Application of Liquidity Coverage Ratio (LCR) and Net Stable Funding (NSF) ratio to regional and smaller banks (Basel III)*
 - ✓ *Impact of LCR 25% haircut on funding secured by non-liquid assets and 15% haircut on funding secured by Level 2 assets (Basel III)*
 - ✓ *Impact of LCR 15% haircut on FNMA and FHLMC investments and 40% limit on Level 2 investments (Basel III)*
 - Capital Considerations
 - ✓ *Application of Basel III capital ratios to regional and smaller banks (Basel III)*
 - ✓ *Impact of Tier 1 capital phase out for TPS for BHCs > \$15 billion from 2013 to 2016 vs. 2013 to 2022 for Basel III (DFA and Basel III)*
 - ✓ *Impact of Tier 1 capital phase out for TPS for BHCs < \$15 billion -- will the Basel III phase out from 2013 to 2022 apply and override DFA grandfathering (DFA and Basel III)*
 - ✓ *Deduction from regulatory capital for cross holding of capital securities of other financial institutions (Basel III)*
 - ✓ *Deduction from regulatory capital for cross holdings of rated tranches of CDO securities with TPS and sub debt as collateral (Basel III)*
 - ✓ *Impact of "gone concern" language requirement for qualification as tier 1 or tier 2 capital (Basel III)*
 - ✓ *Potential acceleration of Basel III compliance through implementation of DFA required stress tests (DFA and Basel III)*

II. Balance Sheet Considerations

Overview of Balance Sheet Considerations

- ❑ **Cash Flow Hedge:** Basel III requires that any unrealized gain or loss on a cash flow hedge of a floating rate or short-term asset or liability (which resides in AOCI) be deducted from tier 1 common equity unless the associated asset or liability is also fair valued. This is problematic because (a) the potential negative impact on regulatory capital of unrealized losses will discourage banks from hedging interest rate risk, (b) unless grandfathering is permitted, implementation would cause an immediate decline in tier 1 common equity for all banks that currently have cash flow hedges that are “underwater”, (c) fair valuing the hedged item to avoid the deduction will do nothing more than introduce credit-spread volatility to earnings and capital, since the fair value of a floating rate or uncertain future cash flow by definition does not change as interest rates move, and (d) the derecognition of unrealized gains will take away a key tool banks use to limit the impact of rising rates on OCI and capital from the Available for Sale (“AFS”) securities portfolio.
- ❑ **Unrealized Gains and Losses:** In a rising interest rate environment, under Basel III banks will be exposed to deductions from tier 1 common equity from unrealized losses on AFS securities but not benefit from unrealized gains. This asymmetrical treatment will hit the least sophisticated banks the most as they may not have the expertise to structure a hedge to deal with this asymmetry. In response, they are likely to either classify investments as HTM, which creates liquidity risk, or shorten the duration of their investment portfolio, potentially impairing earnings or interest rate risk. While ongoing work by the FASB on revisions to accounting for financial instruments would retain an HTM classification, very few (if any) securities may qualify for amortized cost measurement as currently contemplated.
- ❑ **Non-reliance on Credit Ratings:** How can banks invest in credit securities if they cannot rely on credit rating to determine permissibility of investment and risk weighting of asset? Will they have to create a separate credit function within the bank to validate credit? This would become very expensive and inefficient for mid-size and smaller banks. Will this create a competitive disadvantage for U.S. banks with Basel III still utilizing NRSRO credit ratings to determine risk-weighting of assets?
- ❑ **QRM vs Non-QRM Assets:** The distinction between qualified and non-qualified residential mortgages has the potential to be disruptive to asset values in the banking market. Some economists project that Non-QRMs may be worth 80 to 180 BP less than QRMs. Residential mortgages represent a major loan category for most banks. If these assets are repriced on balance sheet, they could erode capital with no deterioration in credit or interest rate outlook but simply reflecting the impact of the reduced marketability of the asset due to the retained risk requirement.

Balance Sheet Considerations: Cash Flow Hedge

- ❑ Basel III would “back out” unrealized gains and losses on derivatives designated as Cash Flow Hedges from Tier 1 Common Equity, UNLESS the “hedged item” (uncertain future cashflows) is carried at Fair Value
- ❑ If implemented as written, there are several negative implications:
 - Banks will opt NOT to hedge interest rate risk using derivatives, or hedge at all – leading to more Interest Rate Risk at a time of historic lows in rates
 - Unless grandfathered, banks with existing cashflow hedges that are under-water will experience an immediate decline in their Tier 1 Common Equity ratio
 - These banks may choose to unwind these derivatives, leading to dislocations in the swap market
 - Banks will lose a key tool used to manage capital volatility from the AFS portfolio: swaps and caps as a cashflow hedge of short-duration liabilities appreciate in value in a rising rate environment, shielding capital (via OCI) from corresponding unrealized losses in the AFS portfolio. This is PARTICULARLY important in light of the proposed INCLUSION of unrealized gains / losses on AFS securities in Tier 1 Common Equity

Asset Size	Total Number of Banks	Total Assets	Derivatives Notional Amt - Hedge Accting
\$15 billion - \$50 billion	28	758,061,259	25,682,424
\$10 billion - \$15 billion	27	338,907,132	11,584,698
\$500 million - \$10 billion	1,181	1,803,660,765	55,141,791
<u>< \$500 million</u>	<u>5,767</u>	<u>875,182,864</u>	<u>4,116,745</u>
Total	7,003	3,775,812,020	96,525,658

- This table shows the total notional amount of interest rate derivatives used by banks less than \$50 billion in assets AND designated as hedges, as of 9/30/2011
- There is insufficient public data to distinguish between “cash flow” hedges and “fair value” hedges
- Banks larger than \$50 billion were excluded because a meaningful portion of their derivative positions are hedges against trading positions in their investment bank, rather than interest rate risk hedges at the bank itself

% of Derivs as CF Hedges Negatively Impacted	Duration of Cash Flow Hedges		
	2 Years	4 Years	6 Years
	25%	\$1,447,885	\$2,895,770
50%	\$2,895,770	\$5,791,539	\$8,687,309
75%	\$4,343,655	\$8,687,309	\$13,030,964
100%	\$5,791,539	\$11,583,079	\$17,374,618

- This table shows the potential impact on Tier 1 Common Equity of this rule, as applied to EXISTING derivative positions for all banks below \$50 billion in assets, if interest rates move 300bp
- Since insufficient public data exists to differentiate cash flow hedges from fair value hedges, or to identify their duration, the range of negative impact on Tier1CE is shown depending on how much of outstanding derivatives are cash flow hedges and their duration

Balance Sheet Considerations: Cash Flow Hedge

- Applying Fair Value accounting to the hedged exposure does not introduce more “symmetry” to capital treatment, and in fact would be quite problematic:
 - In most Cash Flow Hedges, the bank is hedging uncertain future cash flows, typically arising from short-term or floating rate assets or liabilities, or forecasted transactions in the future such as debt issuance
 - The Fair Value of a floating rate asset or liability, or expected future debt issuance, will NOT change as a result of changes in interest rates
 - However, the Fair Value of a floating rate asset or liability, or expected future debt issuance, WILL change as a result of changes in CREDIT SPREADS on that asset or liability
 - As a result, applying Fair Value treatment to the hedged cash flow in order to achieve symmetry of capital treatment would simply result in the introduction of potentially significant volatility to capital and earnings due to changes in credit spreads, which are unrelated to the cash flow hedge

Example

Hedged Item: 5 Year Floating Rate Debt
Hedge: 5 Year Swap at 4%
Par amount: \$100,000
Duration: 4.6 Years

How to interpret the exhibit to the left:

- If the hedged item (the floating rate debt) is NOT Fair-Valued, unrealized gains and losses are carried in OCI but NOT included in Tier 1 Common Equity
- However, if the hedged item IS fair-valued, you can clearly see that changes in interest rates do NOT impact the value of the debt – so Fair Valuing the debt would seem to simply flow the unrealized gain / loss to Tier 1 Common Equity as desired
- This would be true of ALL hedge relationships where interest rate risk or cash flows are being hedged, including floating rate debt, floating rate loans, and future debt issuance being hedged
- Thus – if the regulatory goal is to avoid giving “credit” for hedge gains without offsetting “debit” for losses in the hedged items, it seems clear that there is in fact NO offsetting loss

<u>IF Hedged Item Is Not Fair-Valued</u>			<u>IF Hedged Item IS FAIR VALUED</u>		
	Unrealized	Impact On	<i>(Assuming No Change In Credit Spread on Debt)</i>		
Rate	Gain/(Loss)	Tier 1	Unrealized	Realized	Impact On
<u>Shock</u>	<u>on Swap</u>	<u>Common</u>	<u>on Swap</u>	<u>Gain/(Loss)</u>	<u>Tier 1</u>
		<u>Equity</u>		<u>on Hedged</u>	<u>Common</u>
				<u>Item*</u>	<u>Equity</u>
-3%	(\$14,596)	\$0	(\$14,596)	\$0	(\$14,596)
-2%	(\$9,471)	\$0	(\$9,471)	\$0	(\$9,471)
-1%	(\$4,611)	\$0	(\$4,611)	\$0	(\$4,611)
Unchanged	(\$0)	\$0	(\$0)	\$0	(\$0)
+1%	\$4,376	\$0	\$4,376	\$0	\$4,376
+2%	\$8,530	\$0	\$8,530	\$0	\$8,530
+3%	\$12,475	\$0	\$12,475	\$0	\$12,475

* Since hedged item is floating rate, its FV will not change as rates change

- This assumes that credit spreads on the bank’s debt remain constant...what if they don’t?

Balance Sheet Considerations: Cash Flow Hedge

- Let's examine the impact of credit spreads on the use of fair value accounting on the floating rate debt

Impact of Changes in Credit Spreads on Hedged Item

(If Fair Value Accounting is Used)

<u>Credit Spread Change</u>	<u>Realized Gain/(Loss) on Hedged Item*</u>
-1.00%	(\$4,581)
-0.75%	(\$3,436)
-0.50%	(\$2,291)
-0.25%	(\$1,145)
0.00%	\$0
0.25%	\$1,145
0.50%	\$2,291
0.75%	\$3,436
1.00%	\$4,581

<u>Credit Spread Change</u>	<u>Rate Change</u>						
	<u>-3%</u>	<u>-2%</u>	<u>-1%</u>	<u>Unchanged</u>	<u>+1%</u>	<u>+2%</u>	<u>+3%</u>
-1.00%	(\$19,177)	(\$14,052)	(\$9,192)	(\$4,581)	(\$205)	\$3,949	\$7,894
-0.75%	(\$18,031)	(\$12,907)	(\$8,047)	(\$3,436)	\$940	\$5,094	\$9,039
-0.50%	(\$16,886)	(\$11,762)	(\$6,902)	(\$2,291)	\$2,085	\$6,240	\$10,184
-0.25%	(\$15,741)	(\$10,617)	(\$5,756)	(\$1,145)	\$3,231	\$7,385	\$11,330
0.00%	(\$14,596)	(\$9,471)	(\$4,611)	(\$0)	\$4,376	\$8,530	\$12,475
0.25%	(\$13,450)	(\$8,326)	(\$3,466)	\$1,145	\$5,521	\$9,675	\$13,620
0.50%	(\$12,305)	(\$7,181)	(\$2,321)	\$2,291	\$6,667	\$10,821	\$14,765
0.75%	(\$11,160)	(\$6,035)	(\$1,175)	\$3,436	\$7,812	\$11,966	\$15,911
1.00%	(\$10,014)	(\$4,890)	(\$30)	\$4,581	\$8,957	\$13,111	\$17,056

- As the above table shows, changes in credit spreads on the bank's debt will have a material impact on its fair value
- That change in fair value will go through earnings, creating income volatility, if the debt is fair-valued
- When you combine the impact of spread changes on the debt's fair value with the impact of changes in fair value of the swap due to interest rates, the impact on Tier 1 Common Equity is quite unpredictable
- This volatility to Tier 1 Common Equity and to earnings will likely be considered unacceptable by most banks, leading them to reduce the use of derivatives to hedge interest rate risk

Balance Sheet Considerations: Unrealized Gains and Losses

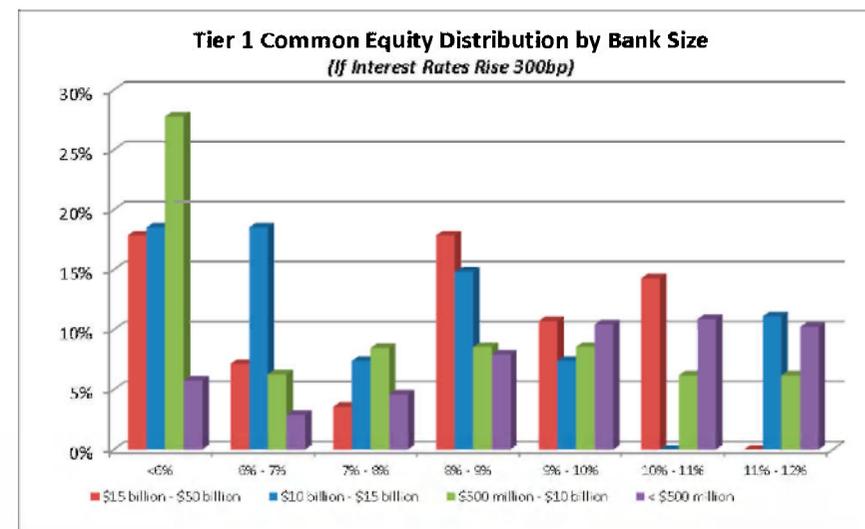
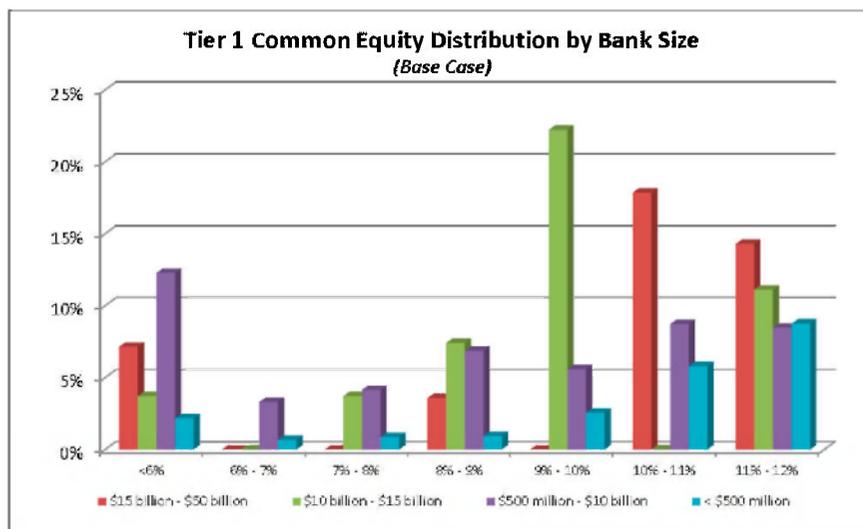
- ❑ Currently, unrealized gains and losses of AFS securities are EXCLUDED from regulatory capital, but INCLUDED in GAAP and tangible equity
- ❑ However, under Basel III, unrealized losses would now be deducted from Tier 1 Common Equity, but unrealized gains would not be added
- ❑ This would create material periodic volatility to capital ratios due to changes in market interest rates, even though securities that are temporarily underwater would “pull to par” as they near maturity regardless of interest rates
- ❑ A strict interpretation / application of this requirement would have disastrous results for most banks as well as for the banking system and the mortgage market, as the following would likely result:
 - Some banks would reclassify securities to Held-To-Maturity (“HTM”) to avoid this, reducing liquidity in the process (Note that pending revisions to the HTM rules being contemplated by FASB may severely limit banks’ ability to use the HTM classification).
 - Some banks would sell their longer duration securities (which have more interest rate-related price risk), and shorten the duration of any future bond purchases. This would significantly reduce earnings in the banking system.
 - In order to maintain earnings, some banks would replace longer duration securities backed by the U.S. government and / or agencies with shorter duration credit-risky securities, introducing additional credit risk into the balance sheet. **WE ARE ALREADY SEEING THIS**
 - The curtailment of purchases of longer duration securities, particularly in Mortgage-Backed Securities (“MBS”) would have a materially adverse effect on the U.S. mortgage market, since banks are a vitally important investor in MBS.

Balance Sheet Considerations: Unrealized Gains and Losses

- We can readily measure the potential impact of this rule on bank capital ratios if interest rates rise:

Asset Size	Total Number of Banks	Total Assets	Total Risk-Weighted Assets	Total AFS Securities	Total Tier 1 Common Equity	Tier1 Common Equity Ratio	Change in MV of Securities +300	+300 Tier 1 Common Equity	+300 Tier 1 Common Equity Ratio	Change in Tier 1 Common Equity Ratio
\$15 billion - \$50 billion	28	758,061,259	503,292,556	129,797,098	61,540,429	12.2%	(13,628,695)	47,911,734	9.5%	-2.7%
\$10 billion - \$15 billion	27	338,907,132	216,887,606	73,169,159	32,171,022	14.8%	(7,682,762)	24,488,260	11.3%	-3.5%
\$500 million - \$10 billion	1,181	1,803,660,765	1,206,645,226	344,915,689	155,816,335	12.9%	(36,216,147)	119,600,188	9.9%	-3.0%
< \$500 million	5,767	875,182,864	577,738,399	168,048,296	88,715,908	15.4%	(17,645,071)	71,070,837	12.3%	-3.1%
Total	7,003	3,775,812,020	2,504,563,787	715,930,242	338,243,694	13.5%	(75,172,675)	263,071,019	10.5%	-3.0%

- We assume a duration of 3.5 years for the AFS securities portfolio, based on empirical evidence
- Using this assumption, the aggregate Tier 1 Common Equity Ratio for all banks less than \$50 billion in assets would decline by 3% if interest rates rise 300bp – not unlikely given that we are at historic lows in rates



Balance Sheet Considerations: Non-reliance on Credit Rating

- ❑ **Dodd-Frank Act – Section 939A**

U.S. financial institutions are subject to DFA Section 939A which requires amendment of the FDIC Act to purge regulations of references to credit rating entities and substitute other standards of credit-worthiness for securities and money market instruments.

- ❑ **Basel III**

G20 banks subject to Basel III may rely upon credit ratings to determine risk weighting of assets for capital ratio calculation purposes.

- ❑ **DFA rulemaking process must create “safe harbor” for other standards of credit worthiness**

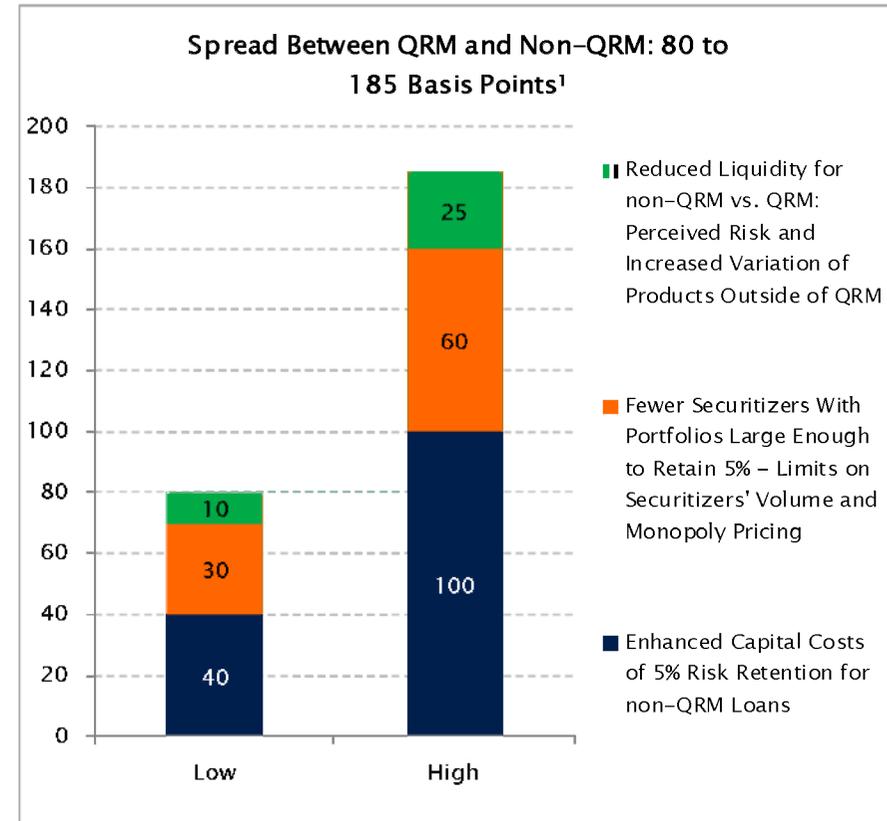
Until rulemaking is completed, U.S. banks believe they can still rely on credit ratings to determine permissibility of investment and risk-weighting of investments. Depending on how extensive the other standards of credit worthiness become through the rule-making process, mid-size and smaller financial institutions may have to create a separate credit function within the bank to validate credit or refrain from making credit intensive investments. The formation of a separate credit function would be very expensive and inefficient for mid-size and smaller banks.

Alternatively, by creating a “safe harbor” for qualification of investments and risk-weighting that permits the use of ratings as supplemented by additional non-intrusive research and support, mid-size and smaller financial institutions could continue to make appropriate investments with enhanced assessment of credit-worthiness.

Balance Sheet Considerations: QRM vs. non-QRM Assets

- ❑ **Large Asset Class:** Residential mortgage backed securities represent one of the largest asset classes on many U.S. financial institution balance sheets
- ❑ **DFA Section 941–15G:** Requires securitizers of residential mortgages that do not meet QRM standards to retain 5% risk unless the mortgage is guaranteed by FNMA or FHLMC
- ❑ **Increased Cost:** Some economists and analysts have estimated that the cost of the retained risk, the reduction in qualified securitizers who can accommodate the 5% retained interest requirement, and the potential for reduced liquidity for NQRM vs. QRM product may add 80 to 185 BP to mortgage rates for NQRM

Qualified Residential Mortgage (QRM)	
Borrower Qualifications	
Down Payment	20%
Debt - Income	
Housing debt	28%
Total debt	36%
Borrower 60 day delinquencies	None in previous 2 years
Product Characteristics	
Loan Type	1st lien, 1-4 single family loan to purchase or refinance
Documentation	Verified, ability to repay documented
Written Appraisal	Required
Points/Fees	3% Maximum
Full Amortization	Required
Loan to Value	
Home purchases	80%
Refinance	75%
Cash out refinance	70%
Mortgage Insurance	Cannot be used for LTV calcs.
Maximum Term	30 years



(1) QRM: Higher Mortgage Rates on the Horizon, Economists' Outlook, June 2011

III. Liquidity Considerations

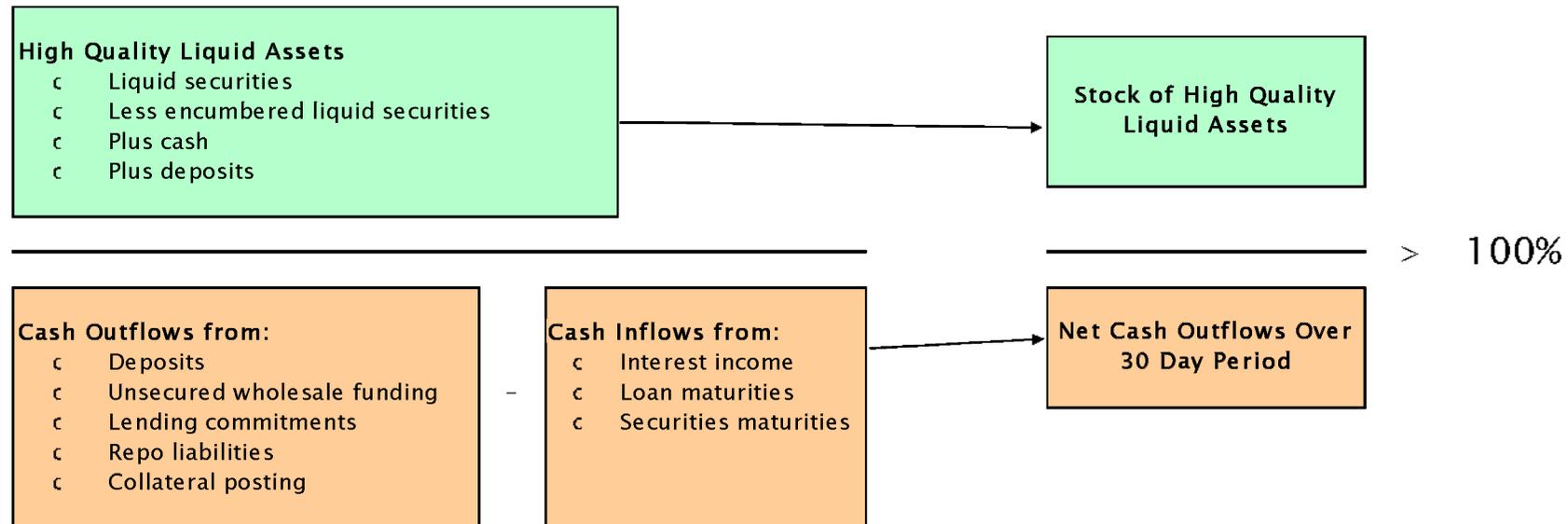
Overview of Liquidity Considerations

- ❑ **LCR:** Will the liquidity coverage ratio apply to regional and smaller banks?
- ❑ **FHLB Funding:** Most regional and community banks get a substantial portion of their term funding from FHLB advances. The Basel III liquidity coverage ratio proposes a 25% haircut on funding secured by non-liquid assets and 15% haircut on borrowings secured by Level 2 assets. This may disproportionately impact the liquidity of small and mid size banks that do not otherwise have access to efficiently priced term funding.
- ❑ **FNMA and FHLMC Securities:** Many regional and community banks have substantial portfolios of FNMA and FHLMC mortgage backed securities. The Basel III liquidity coverage ratio proposed a 15% haircut of such securities and limits their inclusion in the liquidity coverage ratio to Level 2 assets which are limited to 40% of total liquid assets. This may disproportionately impact the liquidity of small and mid size banks that have historically invested in such assets. In response, these banks will likely sell their existing holdings and/or curtail future purchases, putting systemic pressure on the mortgage markets given how important banks are as MBS investors.

Liquidity Considerations: Application of LCR to Mid-size and Smaller Banks

Observation Period Begins in January 2011 with Required Compliance in 2015

- ❑ **Basel III vs DFA Liquidity:** DFA includes no specific requirements for amount or composition of liquidity but does call for regulators to set prudential standards regarding the types of liabilities and amount and degree of reliance on short term funding that is appropriate

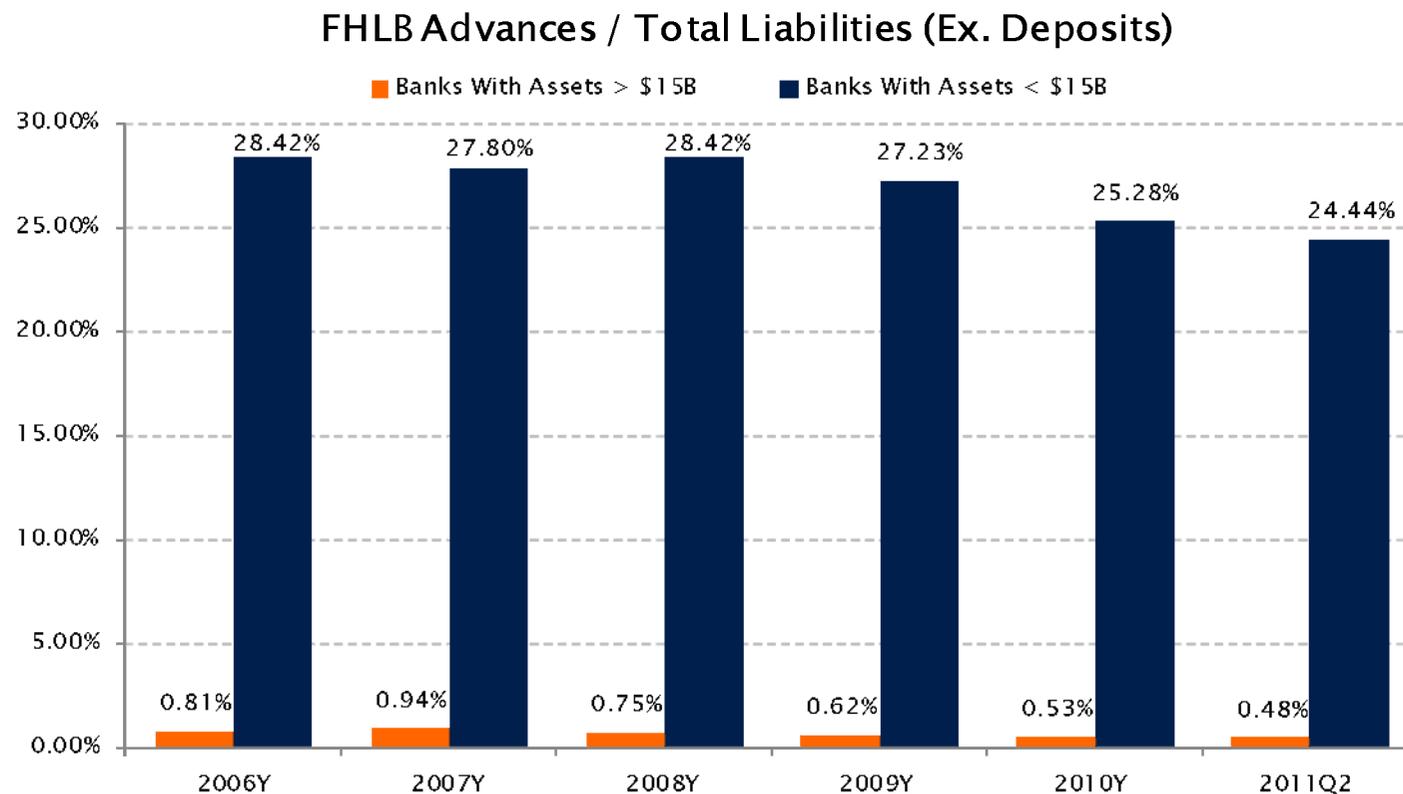


LCR Surprises

- c 15% haircut for FNMA and FHLMC securities in LCR calculation
- c 15% haircut for AA- or higher rated corporate bonds
- c 40% limitation of Level 2 assets as a component of total liquid assets
- c 100% run off of other liabilities
- c 25% run off of deposits with operational relationships
- c 15% haircut on funding secured by Level 2 assets
- c 25% haircut on funding secured by non liquid assets
- c 100% coverage of liquidity facilities and contingent funding liabilities

Liquidity Considerations: FHLB Advances Key Funding Source

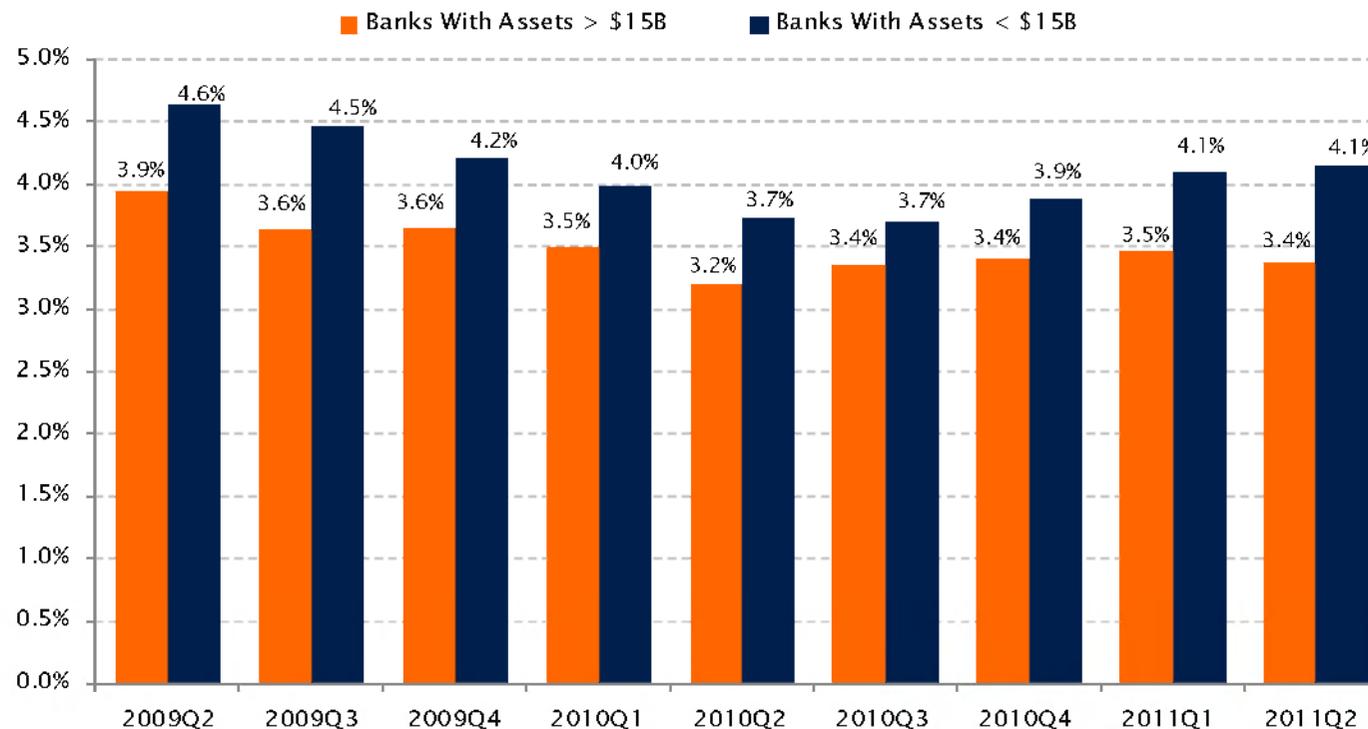
- ❑ **FHLB Advances Critical Funding Tool for Mid-Size and Smaller Banks:** Mid-size and smaller banks (<\$15B) are highly dependent upon FHLB borrowings for non-deposit funding
- ❑ **LCR Haircuts May Disproportionately Impact Smaller Banks:** The 25% haircut on borrowings secured by non-liquid assets and 15% haircut on borrowings secured by Level 2 assets may disproportionately impact smaller banks



Liquidity Considerations: FNMA and FHLMC Investments

- ❑ Mid-size and smaller banks (<\$15B) have significant holdings of FNMA and FHLMC securities
- ❑ Basel III LCR proposes a 15% haircut of such securities and limits their inclusion in the liquidity coverage ratio to Level 2 assets which are limited to 40% of total liquid assets.
- ❑ This may impact the liquidity of small and mid size banks that have historically invested in such assets. In response, these banks will likely sell their existing holdings and/or curtail future purchases, putting systemic pressure on the mortgage markets given how important banks are as MBS investors.

FNMA and FHLMC Security Holdings / Total Assets



IV. Capital Considerations

Overview of Capital Considerations

Capital Considerations

- ❑ **Bank Size Applicable to Basel III Capital Rules:** What size banks will the Basel III capital rules apply to? If broadly applied to all banks > \$500 million, will there be exemptions/exclusions to the application of the capital definitions such as the forward loan loss provisioning deduction from tier 1 common.
- ❑ **Timing Difference on TPS Phase out for Banks > \$15 billion:** the DFA phase out period for tier 1 capital treatment for TPS ranges from 2013 to 2016 but for Basel III this ranges from 2013 to 2022. This 6 year difference in phase out period represents a potentially important capital advantage that will be available for G20 banks relative to US banks > \$15 billion in assets. How can this be reconciled to avoid this unlevel playing field for US banks? To the extent that DFA rules hold, this would likely trigger a regulatory event redemption for the bank issuers which could cause large scale restructuring of bank capital for US banks impacted by this change.
- ❑ **Timing Difference on TPS Phase out for Banks < \$15 billion:** Conversely, US banks < \$15 billion are not subject to the TPS phase out of tier 1 capital under DFA but would be subject to the Basel III phase out from 2013 to 2022. To the extent that the Basel III rules are applied to smaller banks in the US and this phase out of the tier 1 treatment of TPS begins in 2013, this could trigger a regulatory event redemption for the bank issuers which could cause a restructuring of the bank capital issued by these banks.
- ❑ **Deduction for Cross Holdings of Hybrid Capital:** Since 1996 over \$500 billion of bank capital securities have been issued in the form of trust preferred securities (\$214 billion), subordinated debt (\$131 billion) and non-cumulative perpetual preferred (\$161 billion). Banks were significant buyers of the TPS and sub debt issued and we believe still own a substantial amount of this paper. Our trading desk at Sandler O'Neill believes that the "market" has not focused on the deduction from capital of the cross holdings of capital securities. Once this becomes more clear, such securities may reprice downward creating further balance sheet losses. In addition, this will exacerbate the difficulty of raising hybrid capital for the banking industry.

Overview of Capital Considerations

Capital Considerations

- ❑ **Deduction for Cross Holdings of TPS CDOs:** In addition to direct investment in TPS and sub debt, many banks have purchased rated tranches of CDOs that have as their primary underlying collateral TPS and sub debt. Will such investments be viewed as the same as a direct investment in bank TPS and sub debt? If so, how will the equity ownership test be met? There is approximately \$38 billion of this paper in the market and a substantial amount was originally purchased by regional and community banks.

- ❑ **“Gone Concern” Capital Considerations:** Basel III requires that hybrid capital securities explicitly acknowledge “gone concern” capital treatment in order to be considered as regulatory capital. If the “gone concern” capital treatment is not explicitly acknowledged then the instrument would only get tier 1 or tier 2 treatment if current laws require that the hybrid capital instrument fully absorbs loss before taxpayers are exposed or a peer group confirms that the bank’s jurisdiction conforms with the “gone concern” provision. There is much confusion in the market as to what this means and how it will be applied. For example, if a sub debt instrument has to explicitly convert to common upon a triggering event, many debt-only funds cannot purchase. Will sub debt instruments have to have this conversion language going forward? How will this impact the overall market for hybrid capital paper?

- ❑ **Stress Test Impact on Timing for Basel III Compliance:** Basel III capital and liquidity ratio compliance is phased in over 6 years. But based on the market reception to the recent Comprehensive Capital Analysis and Review (CCAR) results in April, it is clear that bank stock investors will reward banks for earlier compliance. This will place market pressure on publicly traded banks for earlier compliance than would otherwise be required by Basel III.

Capital Considerations: Bank Size Applicable to Basel III Capital Rules

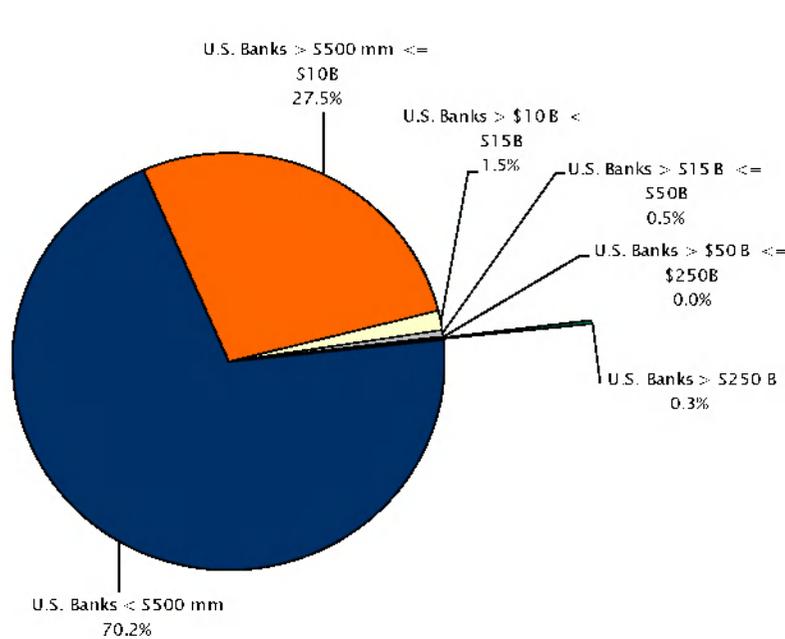
Basel III rules primarily designed for large, internationally active banks

(\$Millions)	U.S. Banks							G20 Banks excluding U.S.
	< \$500 mm	> \$500 mm <= \$10B	> \$10 B <= \$15B	> \$15 B <= \$50B	> \$50 B <= \$250B	> \$250 B	Total	
Total Bank Universe								
Total Assets	\$876,066	\$1,803,742	\$338,907	\$758,061	\$2,749,973	\$11,934,640	\$18,461,388	\$92,159,624
# of Inst.	5,772	1,181	27	28	26	12	7,046	5,483
% Institutions	81.92%	16.76%	0.38%	0.40%	0.37%	0.17%	100.00%	
% Assets	4.75%	9.77%	1.84%	4.11%	14.90%	64.65%	100.00%	
High Assets	\$500	\$9,978	\$14,796	\$49,893	\$199,753	\$2,264,436	\$2,264,436	\$2,679,394
Low Assets	\$0	\$500	\$10,007	\$15,683	\$51,364	\$263,260	\$0	
Mean	\$152	\$1,527	\$12,552	\$27,074	\$105,768	\$994,553	\$304,952	\$146,985
Median	\$119	\$911	\$12,648	\$23,165	\$86,871	\$801,115	\$152	\$21,520

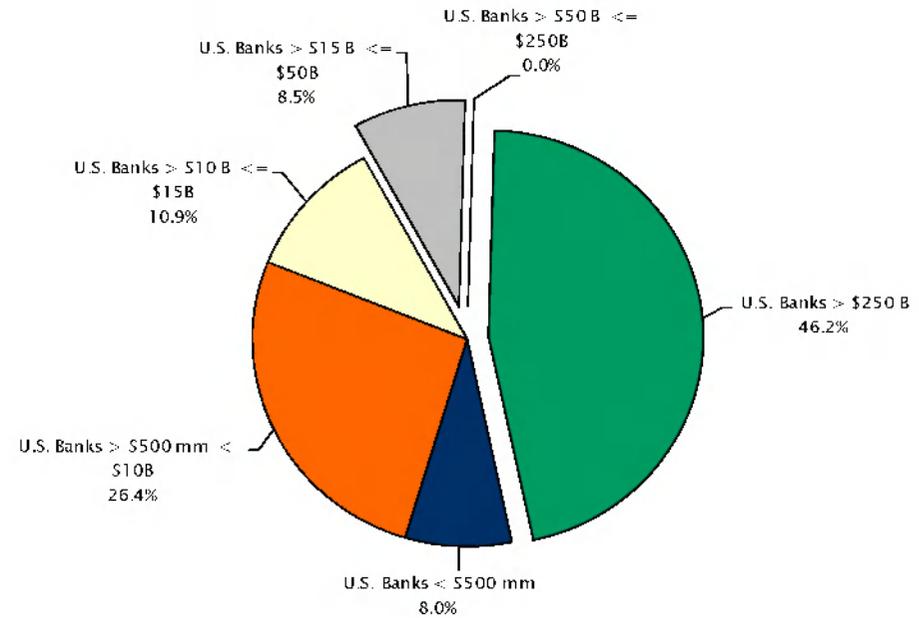
- ☐ > \$50 B SIFIs subject to stress test, greater regulatory scrutiny and CCARs test
- ☐ > \$15 B subject to DFA Collins Amendment and TPS phase out of Tier 1 capital
- ☐ > \$10 B subject to DFA stress test
- ☐ < \$5 B subject to GAO study of impact of DFA on access to capital for smaller banks

Capital Considerations: Bank Size Applicable to Basel III Capital Rules

But smaller banks comprised significant number and dollar amount of losses in most recent crisis



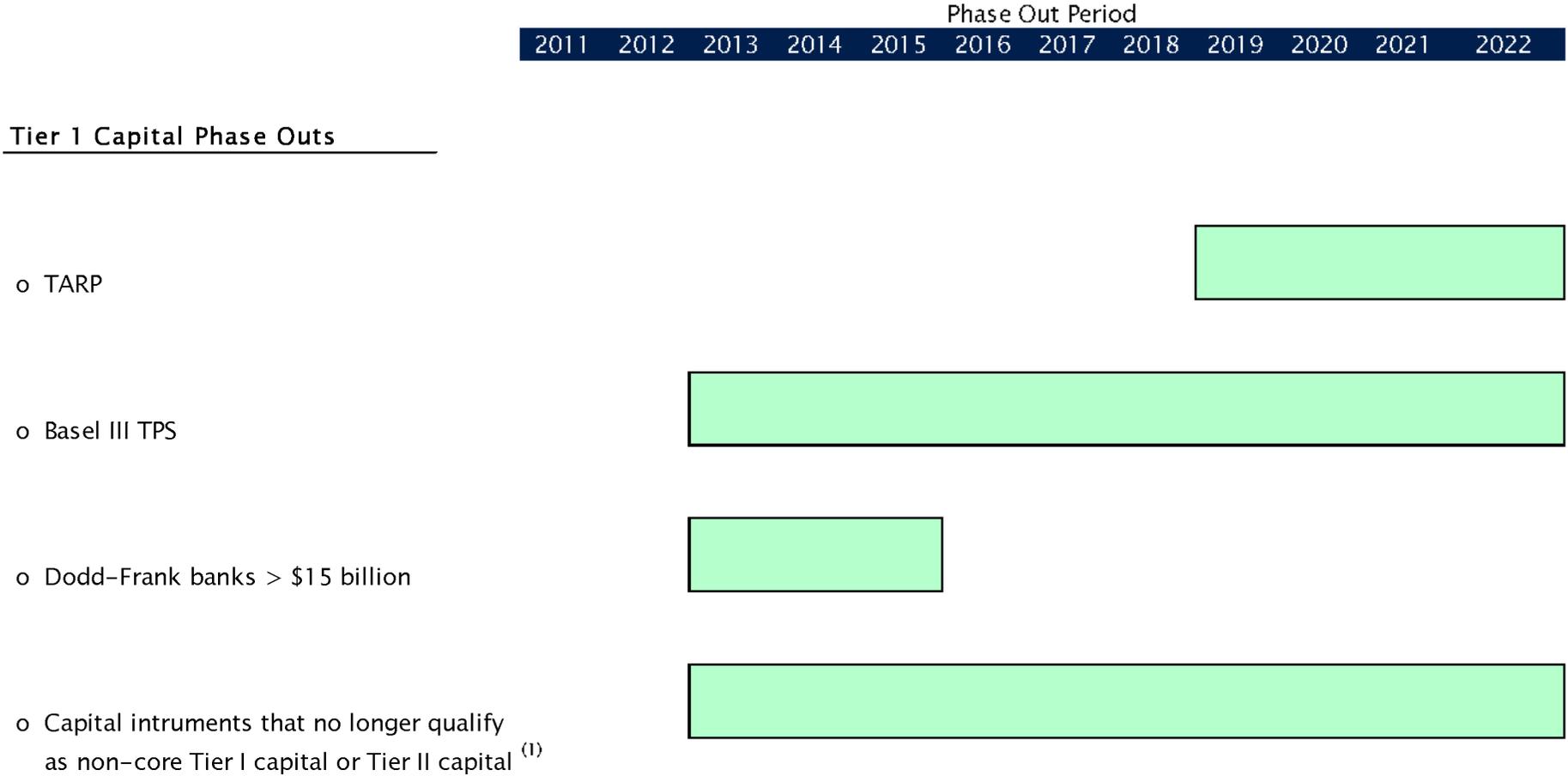
□ 99% of # of bank failures between 2008 and 2011 banks <\$15 billion



□ 45% of \$ value of failed bank assets between 2008 and 2011 <\$15 billion

Data as of October 3, 2011
Source: FDIC

Capital Considerations: Timing Differences on TPS Phase out for Banks



(1) Including instruments that no longer qualify due to “gone-concern” capital phase out

Capital Considerations: Regulatory Event Call Potential from TPS Phase Out

Regulatory Event Call Most Relevant During Non-Call Period

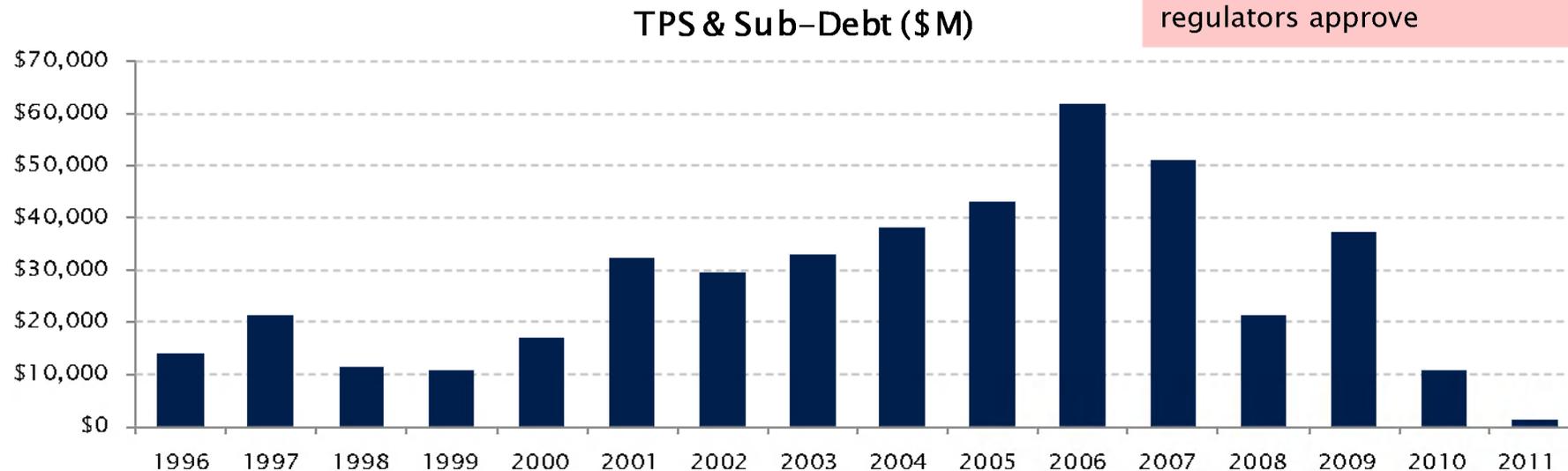
Initial stand alone deals had 10 year non-call period other than under special event redemption

Calls after non-call period subject to optional call premium schedule

Pooled deals transitioned market to 5 year non-call period with limited or no call premium

Calls after non-call period subject to optional call premium which was generally limited for floating rate issuers

Recent issuers still in no-call period could trigger regulatory event call to redeem hybrid capital at par. They may do this to retire expensive capital if have surplus Tier 1 or Tier 2 and regulators approve



Capital Considerations: Deductions from Cross Holdings of Hybrid Capital

- ❑ For banks owning **LESS THAN 10%** of an issuer's issued common shares:
 - For all investments of **MORE THAN 10%** of the investing bank's common equity (after standard deductions) in capital instruments of other unconsolidated financial institutions outside the regulatory scope of consolidation, the investing bank will be required to deduct from capital the amount in excess of 10% using the corresponding deduction approach summarized below
 - For all investments of **LESS THAN 10%** of the investing bank's common equity (after standard deductions) in capital instruments of other unconsolidated financial institutions, the investing bank will be required to risk weight the amount of such investment using the schedule of risk weighted assets

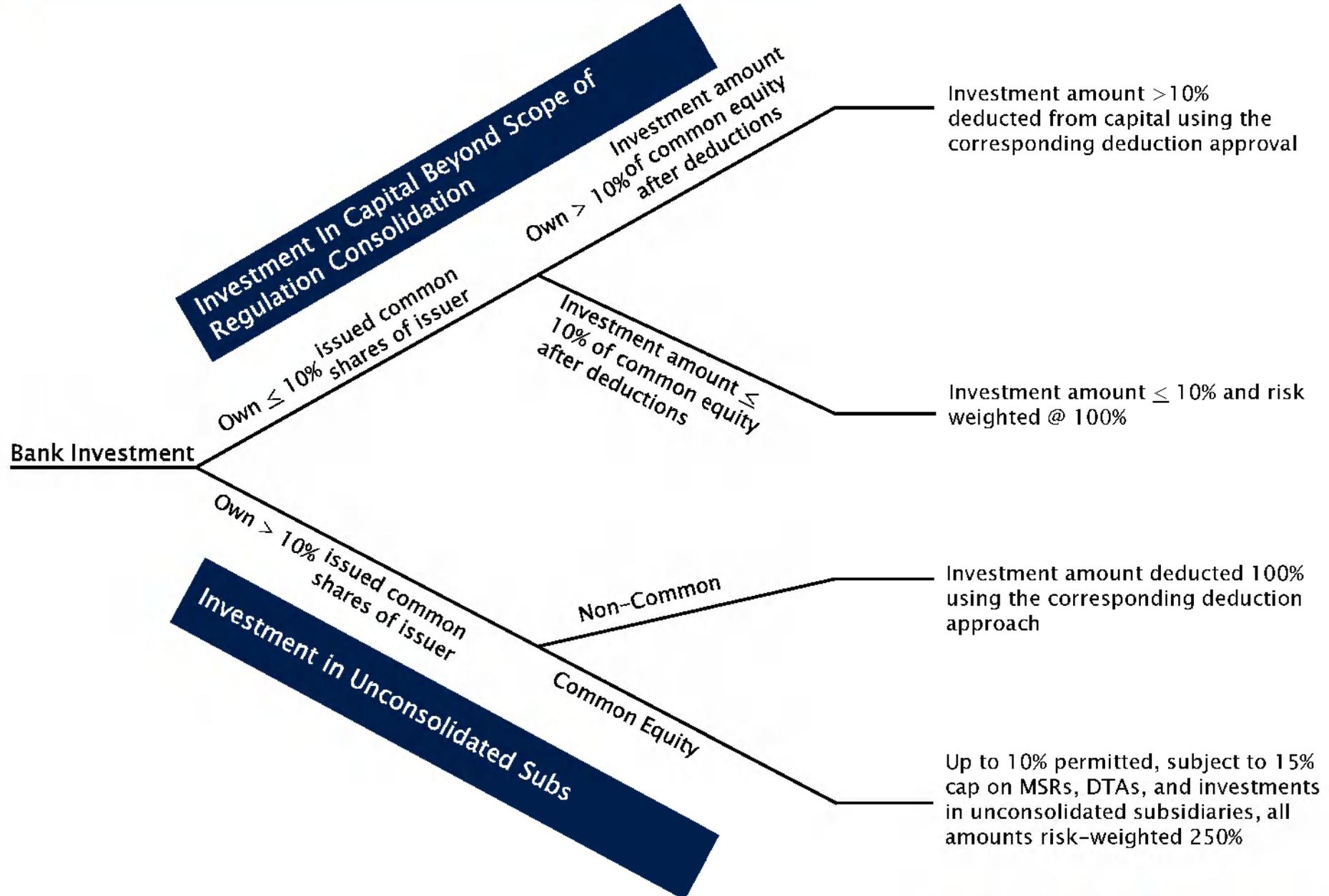
- ❑ For banks owning **MORE THAN 10%** of an issuer's issued common shares:
 - For all investments in non-common capital instruments, such investments are deducted 100% using the corresponding deduction approach highlighted above
 - For all common equity investments, a bank is permitted to invest up to 10% of its common equity in the common equity of another financial institution with that investment subject to 250% risk-weighting. Any investment in unconsolidated subsidiary in excess of 10% of the investing bank's common equity (after standard deductions) will be deducted from the investing bank's common equity, and beginning January 1, 2013, will also be subject to a 15% aggregate limit for a basket including deferred tax assets, mortgage servicing rights and this investment in unconsolidated subsidiary

- ❑ Corresponding Deduction Approach:

Investments in excess of 10% are fully deducted using the corresponding deduction approach for the same component of capital. If a bank does not have enough of that form of capital then the shortfall would be deducted from the next higher tier of capital

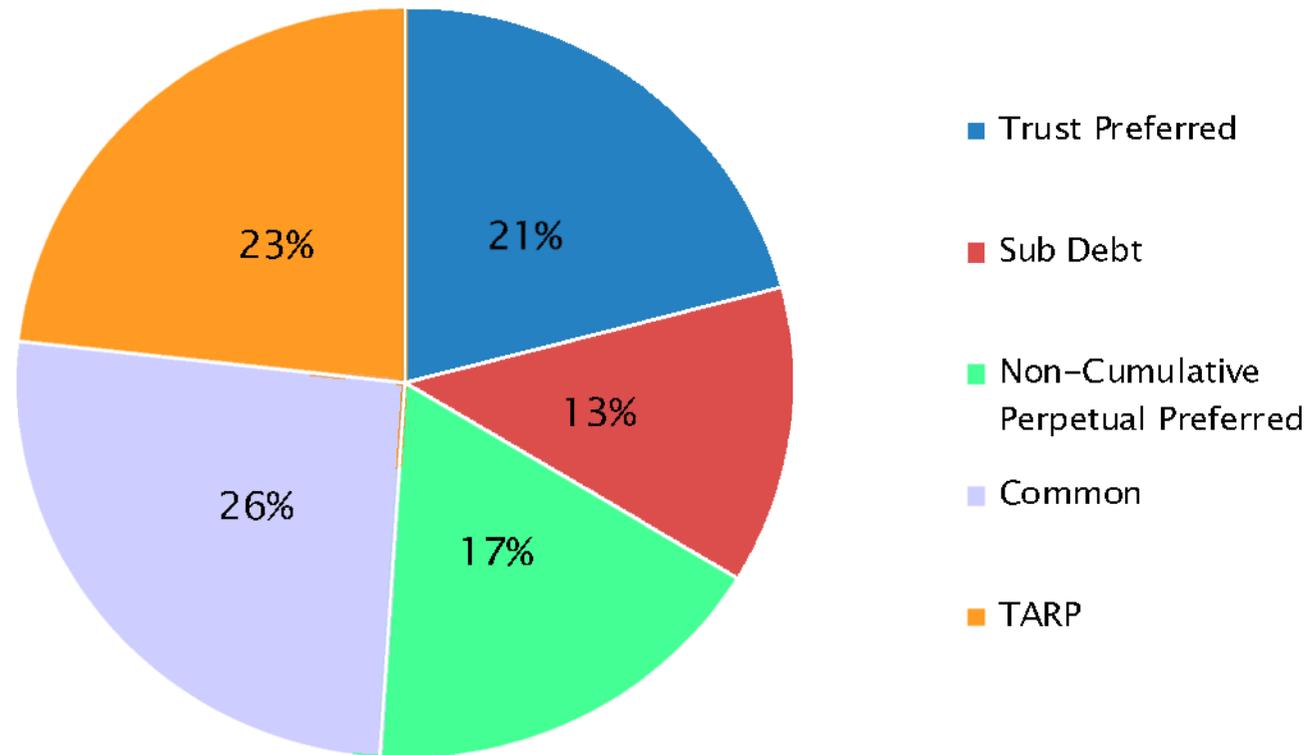
I.	Total holdings	x	Common equity holdings / total capital holdings
II.	Total holdings	x	Additional Tier 1 capital holdings / total capital holdings
III.	Total holdings	x	Tier 2 capital holdings / total capital holdings

Capital Considerations: Deductions from Cross Holdings of Hybrid Capital



Capital Considerations: Deductions from Cross Holdings of Hybrid Capital

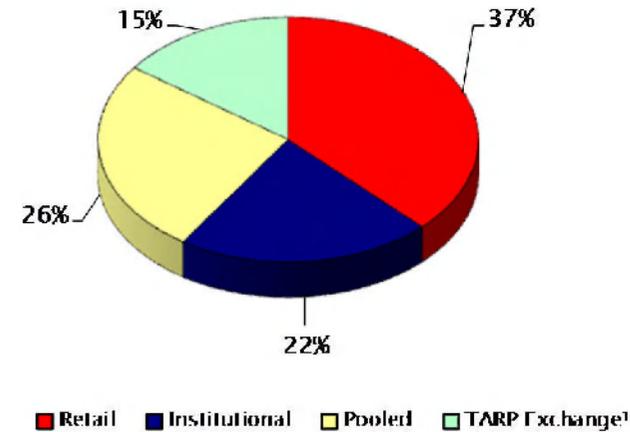
- Since 1996, there has been approximately \$506 billion in non-common Tier 1 and Tier II capital issued consisting of \$214 billion of trust preferred securities, \$131 billion of subordinated debt and roughly \$161 billion of non-cumulative perpetual preferred



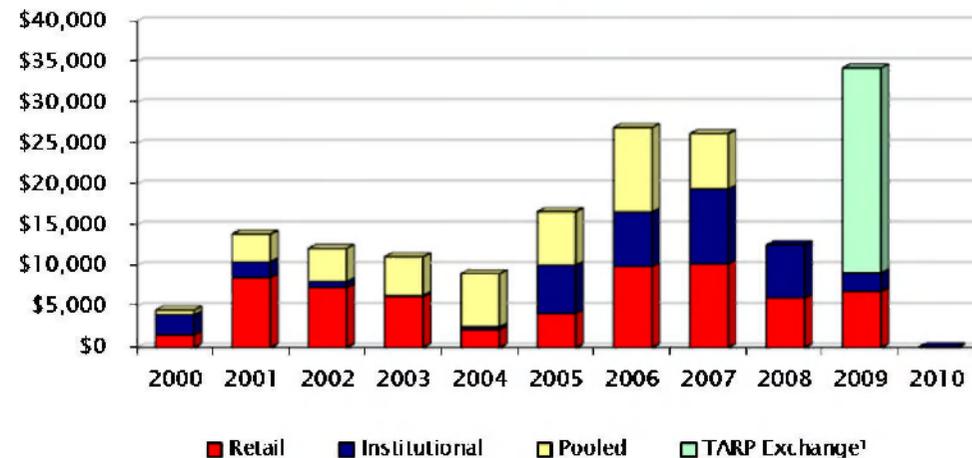
Capital Considerations: Deductions from Cross Holdings of TPS CDOs

- ❑ TPS CDO market consists of approximately \$39 billion of rated liabilities in 541 tranches from 94 bank and insurance TPS CDOs⁽³⁾
- ❑ Banks were originally attracted to invest in the A and BBB rated tranches of the TPS CDOs due the investment grade rating and the attractive yield relative to other credit alternatives
- ❑ Of the \$39 billion of rated liabilities, roughly \$15 billion or about 38% was originally rated A or BBB; this amount has now been reduced to about \$10.8 billion due to repayments, defaults and downgrades ⁽³⁾
- ❑ As of June 30, 2011, SNL securities reports that TPS CDO investments by banks and thrifts totaled \$3.025 billion with 48 institutions investing more than 10% of their tangible equity in TPS CDOs and 35 institutions each owning more than \$20 mm in TPS CDO exposure

Issuance by Type (2000-2010)⁽²⁾



Issuance by Type (\$M)⁽²⁾



¹ Includes \$27 billion of Citigroup's TARP funds that were converted to Trust preferred securities

² Source: SNL Securities, Bloomberg Financial and Sandler O'Neill calculation

³ Source: Fitch ratings, U.S. Bank Trups CDOs Experience Ongoing Pressure, July 2009

Capital Considerations: Deductions from Cross Holdings of TPS CDOs

Deductions for TPS CDOs Will Have a Significant Impact on Capital Ratios for 48 Banks

- Investments in TPS CDOs > 10% of tangible common equity (after adjustments) will be deducted from the common equity component of Tier I capital annually beginning in January 2014 to January 2018 and subject to an aggregate restriction of 15% of tangible common equity for DTA, MSR and Significant Investments

As of 06/30/2011		Balance Sheet				
		Total Assets (\$mm)	Tier 1 Capital (\$mm)	Cost Basis of TPS CDO Exposure (\$mm)	TPS CDO / Tier 1 Capital (%)	Excess TPS CDO Exposure (\$mm)
Company						
1	Zions First National Bank	16,343	1,885.8	633.1	33.6	444.5
2	Amboy Bank	2,328	299.5	89.7	30.0	59.8
3	California Bank & Trust	10,781	1,136.5	162.9	14.3	49.2
4	Citizens National Bank of Meridian	1,135	119.5	38.5	32.2	26.6
5	Vectra Bank Colorado, National Association	2,268	279.2	47.7	17.1	19.8
6	Commerce Bank of Washington, National Association	886	92.8	21.4	23.0	12.1
7	United Texas Bank	152	18.5	13.3	71.7	11.4
8	Parkvale Savings Bank	1,803	120.4	20.9	17.4	8.9
9	Eastern Bank (MHC)	7,628	660.2	74.8	11.3	8.8
10	Cortland Savings and Banking Company	481	40.4	11.7	29.0	7.7
11	Bank 21	54	5.3	6.1	115.6	5.6
12	Nova Bank	549	16.6	6.7	40.5	5.1
13	First National Bank of Shelby	949	95.7	14.4	15.1	4.9
14	Brentwood Bank (MHC)	433	41.2	8.9	21.6	4.8
15	First & Farmers National Bank, Inc.	461	39.0	8.6	22.2	4.8
16	Newton County Bank	152	19.3	6.6	34.0	4.6
17	Affinity Bank	364	14.4	6.0	41.5	4.5
18	Citizens Bank & Trust Company	122	12.1	5.7	46.6	4.4
19	1st National Bank of South Florida	309	29.2	6.7	22.9	3.8
20	First Fidelity Bank, National Association	1,131	92.7	13.0	14.0	3.7
	High	16,343	1,885.8	633.1	115.6	444.5
	Low	54	5.3	5.7	11.3	3.7
	Mean	2,416	250.9	59.8	32.7	34.7
	Median	717	66.9	13.1	26.0	6.6
	Total For All 48	64,227	6,302.3	1,360.4		730.2

- Overall there are about 300 banks with TPS CDO investments totaling \$3.025 B

Source: SNL Financial

Capital Considerations: “Gone Concern” Capital Focus

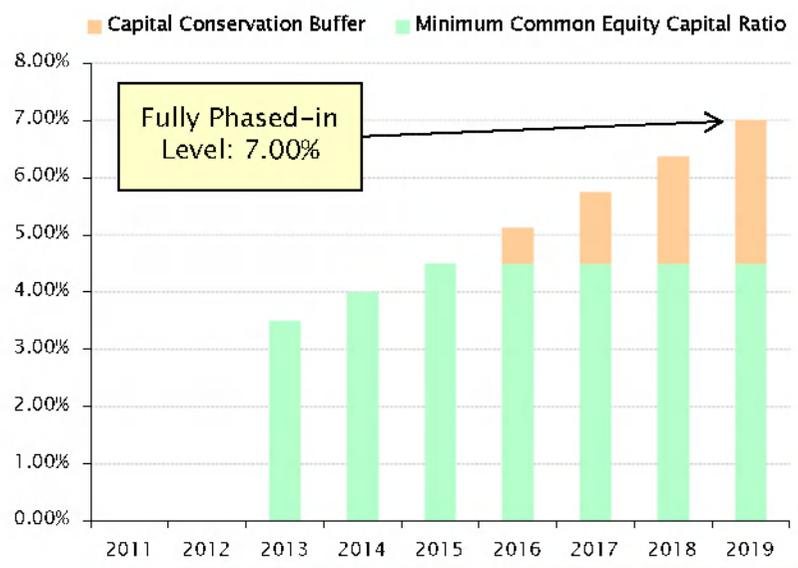
- ❑ **DFA – Title II (Sections 201 – 217) Provide details on orderly liquidation authority for banks for “covered financial institutions”**
 - Provides authority to liquidate failing financial companies that pose a significant risk to the financial stability of the US
 - Mandates that shareholders of covered financial companies receive no payment until other claims paid
 - Clarifies potential disposition procedures in bankruptcy process for financial institutions

- ❑ **Basel III – “Gone Concern” Capital Focus**
 - “Gone Concern” treatment of capital must be explicitly acknowledged in the terms and conditions of the capital instrument
 - If “Gone Concern” treatment is not explicitly acknowledged then the instrument would only get tier 1 or tier 2 treatment if:
 - ✓ Current laws require that non-common Tier 1 and Tier 2 capital instruments be written off upon a triggering event or otherwise require such instruments to fully absorb losses before taxpayers are exposed to loss
 - ✓ Peer group review confirms that the bank’s jurisdiction conforms with the “Gone Concern” provision Relevant regulator and issuing bank include reference to this gone-concern feature in issuance documents going forward

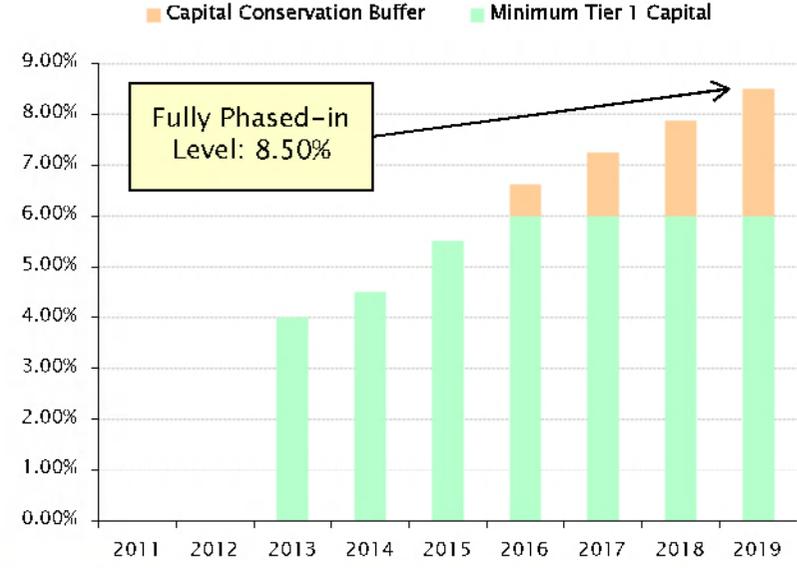
There have been no issuances of Subordinated debt by U.S. banks since HBAN 7.0%’s issued in December 2010

Capital Considerations: Stress Test Acceleration of Basel III Timing

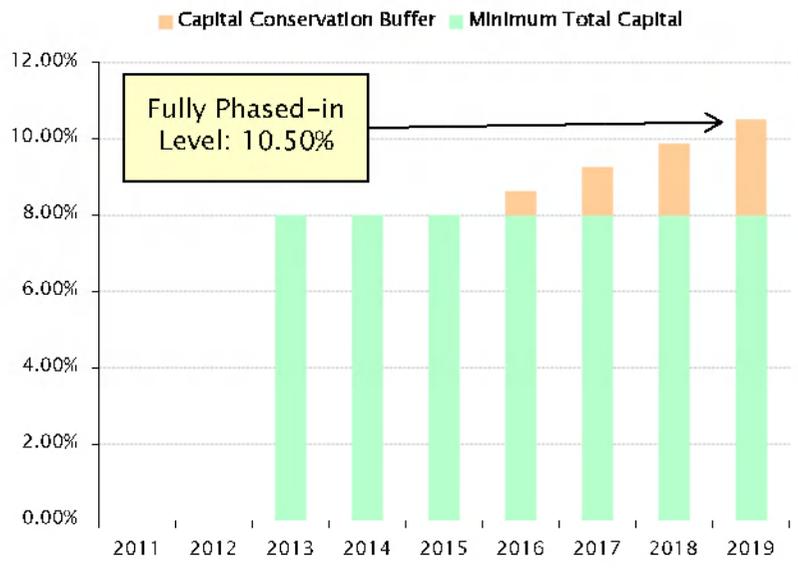
Common Equity



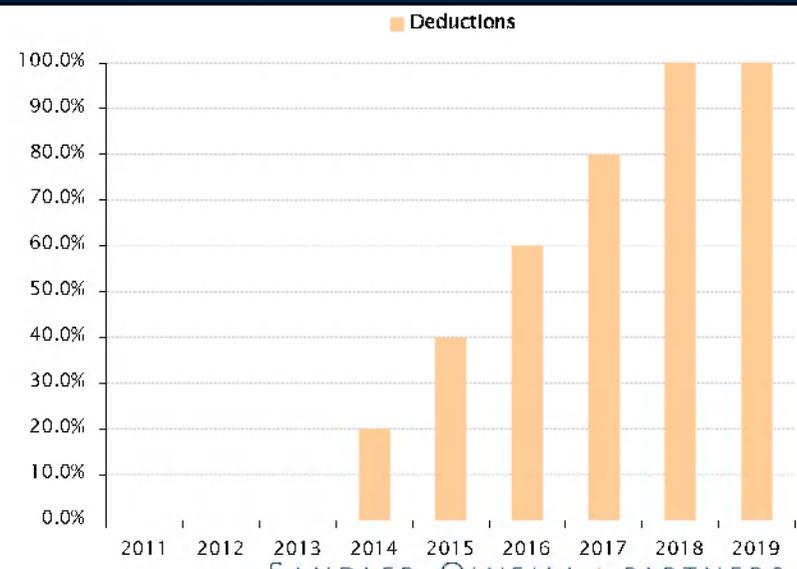
Tier 1 Capital



Total Capital



Phase-in of deductions from Tier 1 Common Equity (including amounts exceeding the limit for DTAs, MSRs and financials)



Capital Considerations: Stress Test Acceleration of Basel III Timing

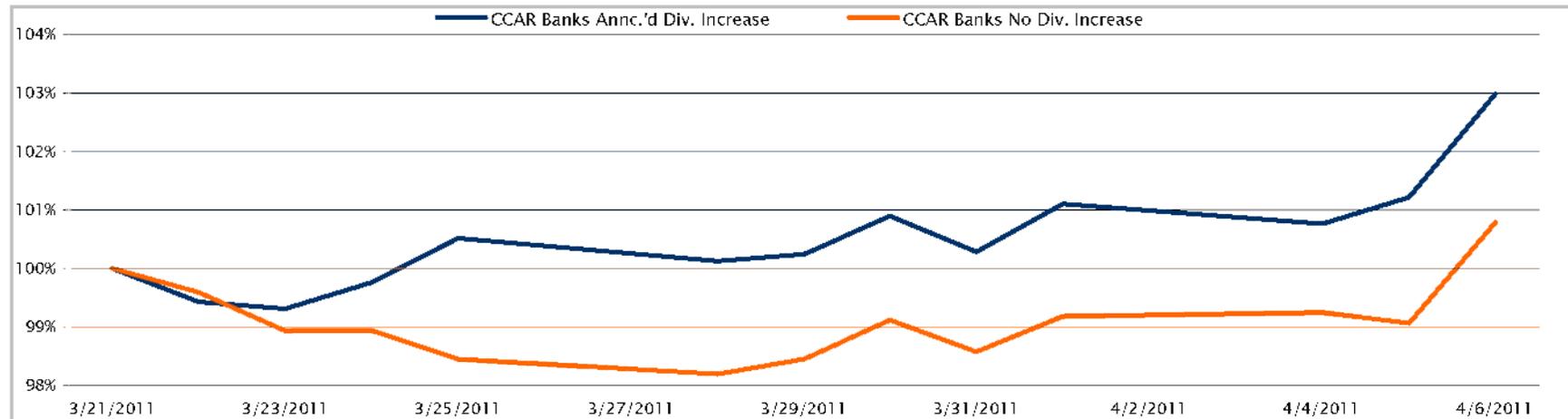
- ❑ DFA requires at least annual stress tests for BHCs > \$10 billion in assets and non-banks >\$50 billion using 3 stress scenarios
- ❑ Comprehensive Capital Analysis and Review (CCAR) tests required before any capital actions taken by top 19 U.S. banks
- ❑ CCAR plan submitted at least annually should cover:
 - Capital adequacy processes
 - Capital distribution policy
 - Government investment repayment
 - Stress scenario analysis
 - Basel III and Dodd-Frank Act compliance plan
- ❑ Stress scenarios and government capital repayment plans required
 - 9 quarterly projections under 3 stressed scenarios (baseline, adverse, and severely adverse) showing impact on capital ratios
 - BHCs expected to maintain adjusted Tier 1 common ratio in excess of 5% in all stress scenarios
 - Government capital repayment before capital distributions
- ❑ Reasonable plans to comply with Basel III and DFA required:
 - BHCs expected to show plans for fully phased in Basel II capital requirements
 - Strategies to account for all deductions and limitations of the DFA and Basel III must be shown
 - BHCs requested to show DFA and Basel III compliance using baseline conditions through the sooner or 2012 when reach compliance

Capital Considerations: Stress Test Acceleration of Basel III Timing

CCAR Bank Dividend Increases Triggered Stock Price Appreciation

	Company	Old Quarterly Div.	Old Annualized Div.	New Quarterly Div.	New Annual Div.	% Increase	2011 EPS Estimate	Dividend as a % of 2011 EPS
1	BBT	\$0.15	\$0.60	\$0.16	\$0.64	6.7%	\$1.75	34%
2	JPM	\$0.05	\$0.20	\$0.25	\$1.00	400.0%	\$4.95	4%
3	WFC	\$0.05	\$0.20	\$0.12	\$0.48	140.0%	\$2.88	7%
4	USB	\$0.05	\$0.20	\$0.125	\$0.50	150.0%	\$2.19	9%
5	BK	\$0.09	\$0.36	\$0.13	\$0.52	44.4%	\$2.70	13%
6	C ⁽¹⁾	\$0.00	\$0.00	\$0.001	\$0.004	NA	\$0.54	NA
7	KEY	\$0.01	\$0.04	\$0.03	\$0.12	200.0%	\$0.80	5%
8	FITB	\$0.01	\$0.04	\$0.06	\$0.24	500.0%	\$1.17	3%

⁽¹⁾ Effective 2Q11



V. Bios

Bios



FRED D. PRICE, *Managing Principal*
Sandler O'Neill + Partners, L.P.
212-466-7765 / fprice@sandleroneill.com

Fred D. Price, Managing Principal, is a Founding Principal of Sandler O'Neill + Partners, L.P., and a member of the firm's Executive Committee. Mr. Price is extensively involved in the firm's capital markets activities and provides senior oversight to the firm's client support services and other business affairs.

Mr. Price initially developed and managed the asset/liability, financial strategy and balance sheet management client support services for the firm. He was previously Director of Equity Research and was instrumental in expanding the firm's research coverage universe.

Prior to founding Sandler O'Neill, Mr. Price was a Managing Director at Bear Stearns & Co. Inc., where he was responsible for product development and client support in the Financial Services Group. Mr. Price has also worked as an independent consultant specializing in asset/liability management for financial institutions and held senior management positions in the banking industry. He is a frequent guest on business television, speaking about financial industry issues.

Mr. Price attended the University of California at Bakersfield and The Graduate School of Business at the University of Southern California.

Bios



THOMAS W. KILLIAN, *Principal, Capital Raising*
Sandler O'Neill + Partners, L.P.
212-466-7709 / tkillian@sandleroneill.com

Thomas W. Killian is a Principal of Sandler O'Neill + Partners, L.P. His 32-year career in commercial and investment banking includes seven years of commercial banking experience with NationsBank, structuring and arranging leveraged finance transactions; two years with Salomon Brothers, transacting capital markets and advisory assignments for a variety of major corporations; five years with J.P. Morgan, managing financial advisory and capital raising activities for banks and thrifts in the Western region of the United States; and 19 years with Sandler O'Neill, advising banks, thrifts, and insurance companies, a variety of capital markets, strategic advisory and M&A assignments.

At Sandler O'Neill, Mr. Killian has managed the successful execution of over \$8.5 billion of capital raising transactions. He has co-managed the Sandler O'Neill team responsible for successfully completing 17 pooled trust preferred transactions, raising over \$7.0 billion for approximately 650 financial institutions. Included in Mr. Killian's capital raising transactions are eight recapitalization and restructuring transactions that involved complex capital structures designed to preserve tax benefits for the issuing institutions. He functions as a primary resource in structuring and implementing complex capital markets transactions for financial institutions. Some of these transactions include the first ever NYSE listed closed-end fund designed to invest in middle market bank preferred stock that was completed in 2005 and the firm's sale-leaseback effort with American Realty Capital.

Mr. Killian holds a Bachelor of Science from the University of North Carolina at Chapel Hill, where he was a John Motley Morehead Merit Scholar, and a Masters in Business Administration from Northwestern University's J.L. Kellogg Graduate School of Management. He has spoken at industry and regulatory conferences (including the Federal Reserve Bank, FDIC, Western Independent Bankers and the China Banking Regulatory Commission) on issues impacting financial institutions and capital markets. His articles have appeared in *Bank Accounting & Finance*, *U.S. Banker* and *Modern Bankers*, a publication of the Peoples Bank of China.

Mr. Killian is also a founding board member of Students Bridging the Information Gap, a 501(c)(3) charity that provides computers, books and other support to African schools and orphanages.

Bios



RAYMOND E. CHANDONNET, *Principal, Fixed Income Sales*

Sandler O'Neill + Partners, L.P.

212-466-7816 / rchandonnet@sandleroneill.com

Ray Chandonnet is a Principal of Sandler O'Neill + Partners, L.P. and is the firm's Chief Balance Sheet Strategist. In that capacity, Mr. Chandonnet works extensively with the firm's clients on a range of tactical balance sheet issues related to earnings, capital, liquidity, investments, funding and interest rate risk.

Mr. Chandonnet has primary responsibility for overseeing the firm's asset-liability and quantitative analysis team. He also built and runs the firm's businesses in wholesale funding and interest rate derivatives.

Mr. Chandonnet has been involved in the banking industry since 1986. Prior to joining Sandler O'Neill, he was head of Bank Strategy for JPMorgan Securities for two years, and founder and head of the Bank Specialist Group at Lehman Brothers for five years. Mr. Chandonnet's background also includes four years as head of Bank Strategies for First Union Capital Markets, five years as a bank strategist and advances specialist at the Federal Home Loan Bank of Boston, and five years as asset/liability and financial analyst for a community bank in the Boston area.

Mr. Chandonnet is a frequent publisher and speaker on a wide range of issues related to bank financial management. He holds a MS in Finance from Bentley College Graduate School of Business and a Bachelor of Science in Computer Science from Merrimack College.



ADAM R. MANDEL, *Principal, Fixed Income Trading*

Sandler O'Neill + Partners, L.P.

212-466-7873 / amandel@sandleroneill.com

Adam R. Mandel is a Principal of Sandler O'Neill + Partners, L.P., where he is responsible for credit trading, including corporates, trust preferreds and CDOs.

Mr. Mandel joined Sandler O'Neill in 2001 from Goldman Sachs, where he worked in the Fixed Income Division trading corporate bonds, specializing in financial institutions.

Mr. Mandel spent six years at Merrill Lynch in various capacities including: Fixed Income Corporate Syndicate, where he worked with investment grade, emerging markets and high yield securities. He later went on to trade investment grade corporate bonds.

Mr. Mandel holds a Bachelor of Arts in Economics from Union College.