Keys to Capital in 2012

“Capital is King” (New Rules – Old Challenges)

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School of Law | Center for Banking and Finance

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Introduction – Basics
Capital Requirements – History

- **Increasingly Sophisticated Approach**
  - 1983 capital rules
  - Market risk recognized in 1986
  - 1987 Basel risk-based capital guidelines capture off-balance sheet items
  - Basel II proposal to capture more types of risk
  - Basel III (2012) > more capital & more tangible common capital

- **Rules include Regulations and Guidelines**
How Important is Capital?

- **CAMELS rating: depository institutions**
  - Capital
  - Assets
  - Management
  - Earnings
  - Liquidity
  - Sensitivity to risk

- **RFI/C(D): holding companies**
  - Risk
  - Financial condition
  - Impact on the subsidiary bank(s)
  - Composite for the FHC and rating of each insured (D) depository
Capital Ratio Requirements

- **Capital Ratios – Current Rules**
  - Leverage Capital Ratio – Tier 1 Capital/Total average assets
  - Tier 1 Risk-based Capital Ratio – Tier 1 Capital/Total risk-weighted assets
  - Total Risk-based Capital Ratio – Qualifying Total Capital (Tier 1 and Tier 2)/Total risk-weighted assets

- **Minimum Requirements – Current Rules**

<table>
<thead>
<tr>
<th></th>
<th>Adequately Capitalized</th>
<th>Well Capitalized</th>
</tr>
</thead>
<tbody>
<tr>
<td>Leverage Capital Ratio</td>
<td>3% / 4%</td>
<td>5%</td>
</tr>
<tr>
<td>Tier 1 Risk-based Capital</td>
<td>4%</td>
<td>6%</td>
</tr>
<tr>
<td>Total Risk-based Capital</td>
<td>8%</td>
<td>10%</td>
</tr>
</tbody>
</table>

- **Ratios improve if you Increase Capital or Decrease Assets**
Capital Ratio Requirements (continued)

- **Basel III – New Rules**
  - Focus on quality of capital (Tier 1 Common Equity Capital – T1 CE)
  - Deduction for goodwill and other intangibles (other than MSBs), DTAs, investments in stock of unconsolidated subsidiaries, etc.
  - Table below does not include “counter-cyclical capital buffer” of up to 2.5% or additional capital ranging from 1% to 2.5% required for G-SIBs

<table>
<thead>
<tr>
<th></th>
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</tr>
</thead>
<tbody>
<tr>
<td>Common Equity Capital Ratio</td>
<td>2.0%</td>
<td>2.0%</td>
<td>3.5%</td>
<td>4.0%</td>
<td>4.5%</td>
<td>4.5%</td>
<td>4.5%</td>
<td>4.5%</td>
<td>4.5%</td>
</tr>
<tr>
<td>Capital Conservation Buffer</td>
<td>0%</td>
<td>0%</td>
<td>0%</td>
<td>0%</td>
<td>0%</td>
<td>0.625%</td>
<td>1.25%</td>
<td>1.875%</td>
<td>2.5%</td>
</tr>
<tr>
<td>Common Equity plus Capital Conservation Buffer</td>
<td>2.0%</td>
<td>2.0%</td>
<td>3.5%</td>
<td>4.0%</td>
<td>4.5%</td>
<td>5.125%</td>
<td>5.75%</td>
<td>6.375%</td>
<td>7.0%</td>
</tr>
<tr>
<td>Phase-in of deductions</td>
<td>0%</td>
<td>0%</td>
<td>0%</td>
<td>20%</td>
<td>40%</td>
<td>60%</td>
<td>80%</td>
<td>100%</td>
<td>100%</td>
</tr>
<tr>
<td>Tier 1 Capital/RWAs</td>
<td>4.0%</td>
<td>4.0%</td>
<td>4.5%</td>
<td>5.5%</td>
<td>6.0%</td>
<td>6.0%</td>
<td>6.0%</td>
<td>6.0%</td>
<td>6.0%</td>
</tr>
<tr>
<td>Total Capital/RWAs</td>
<td>8.0%</td>
<td>8.0%</td>
<td>8.0%</td>
<td>8.0%</td>
<td>8.0%</td>
<td>8.0%</td>
<td>8.0%</td>
<td>8.0%</td>
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</tr>
<tr>
<td>Total Capital plus Capital Conservation Buffer</td>
<td>8.0%</td>
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<td>8.0%</td>
<td>8.0%</td>
<td>8.625%</td>
<td>9.25%</td>
<td>9.875%</td>
<td>10.5%</td>
</tr>
</tbody>
</table>
Capital Ratio Requirements (continued)

- **Basel III – Key Provisions**
  - Components of capital
  - Risk coverage
  - Leverage ratio
  - Liquidity coverage requirements
  - Pillar 2—risk management and supervision
  - Pillar 3—market discipline
### Capital Ratio Requirements (continued)

#### Basel Committee on Banking Supervision reforms - Basel III

Strengthens micro-prudential regulation and supervision, and adds a macro-prudential overlay that includes capital buffers.

<table>
<thead>
<tr>
<th>Capital</th>
<th>Pillar 1</th>
<th>Containing leverage</th>
<th>Pillar 2</th>
<th>Pillar 3</th>
<th>Liquidity</th>
</tr>
</thead>
<tbody>
<tr>
<td>Quality and level of capital</td>
<td>Greater focus on common equity. The minimum will be raised to 4.5% of risk-weighted assets, after deductions.</td>
<td></td>
<td></td>
<td></td>
<td>Global liquidity standard and supervisory monitoring</td>
</tr>
<tr>
<td>Capital loss absorption at the point of non-viability</td>
<td>Contractual terms of capital instruments will include a clause that allows – at the discretion of the relevant authority – write-off or conversion to common shares if the bank is judged to be non-viable. This principle increases the contribution of the private sector to resolving future banking crises and thereby reduces moral hazard.</td>
<td></td>
<td></td>
<td></td>
<td>Liquidity coverage ratio</td>
</tr>
<tr>
<td>Capital adequacy buffer</td>
<td>Composition adequate to 2.5% of risk-weighted assets, bringing the total common equity ratio to 7%. Constraint on a bank’s discretionary distributions will be imposed when banks fall into the buffer range.</td>
<td></td>
<td></td>
<td></td>
<td>Notional funding ratio</td>
</tr>
<tr>
<td>Counterparty credit risk</td>
<td>Substantial strengthening of the counterparty credit risk framework. Includes: more stringent requirements for measuring exposure; capital incentives for banks to use central counterparties to mitigate operational risk; and capital for inter-financial sector exposures.</td>
<td></td>
<td></td>
<td></td>
<td>Principles for sound liquidity risk management and supervision</td>
</tr>
<tr>
<td>Bank exposures to counterparties (CCPs)</td>
<td>The Committee has proposed that trade exposures to a qualifying CCP will receive a 2% risk weight and default fund exposures to a qualifying CCP will be capitalised according to a risk-based method that consistently and simply estimates risk arising from such default.</td>
<td></td>
<td></td>
<td></td>
<td>Supervisory monitoring</td>
</tr>
</tbody>
</table>

In addition to meeting the Basel III requirements, global systemically important financial institutions (GSIBs) must have higher loss absorbency capacity to reflect the greater risks that they pose to the financial system. The Committee has developed a methodology that includes both quantitative indicators and qualitative elements to identify global systemically important banks (GSIBs). The additional loss absorbency requirements are to be met with a progressive Common Equity Tier 1 (CET1) capital requirement ranging from 1% to 2.5%, depending on a bank’s systemic importance. For banks facing the highest SIB surcharge, an additional loss absorbency of 1% could be applied as a disincentive to increase materially their global systemic importance in the future. A consultative document was published in cooperation with the Financial Stability Board, which is coordinating the overall set of measures to reduce the moral hazard posed by global SIBs.

Chart prepared by BCBS and available at [http://www.bis.org/publ/bcbs207.pdf](http://www.bis.org/publ/bcbs207.pdf).
Capital Ratio Requirements (continued)

- **Dodd-Frank and Basel III Implementation**
  - Basel III is expected to refine G-SIB requirements during late 2011 or early 2012 (additional T1 CE of 1% to 2.5% of RWAs)
  - Section 939A of Dodd-Frank requires that regulators review references to NRSROs in regulations
  - Section 171 of Dodd-Frank (Collins Amendment) requires the exclusion of cumulative preferred and trust preferred from Tier 1
    - Applies to institutions with consolidated assets of greater than $15 billion
    - Three-year phase-in starting in 2013
    - Technically applies to intermediate bank holding companies that are subsidiaries of non-U.S. organizations
  - December 15 Federal Reserve rulemaking regarding capital standards for trading activities is not fully consistent with Basel III
Dodd-Frank and Basel III Implementation (continued)

- Current U.S. regulatory intentions with respect to implementation of Basel III:
  - Adoption of 6-year transition period for Basel III requirements
  - U.S. banking organizations would not be expected to meet fully phased-in Basel III requirements prior to their effective times, but would be expected to:
    - take affirmative steps to increase capital levels in order to meet applicable deadlines, and
    - improve their capital ratios through prudent earnings retention policies
- U.S. may look to progress towards Basel III in evaluating capital adequacy for various purposes
Special and Practical Considerations

- Basel III and Dodd-Frank Implementation
- Capital funding at the holding company is typically contributed to the depository institution as Tier 1 common equity capital
- Special capital rules for TARP issuers, SBLF issuers and small bank holding companies (under $500 million in total assets)
- Enforcement actions which may increase minimum requirements
- Financial holding company status
- Application of FDIC Statement of Policy
- Prior commitments to regulators
- Covenants in commercial agreements
  - Loan and other financing documents
- Special rules in the capital regulations
  - Direct credit substitutes – risk weighting adjustment
  - Non-financial equity investments – deduction from core capital elements (Tier 1 capital)
  - Others
Tier 1 Capital (core capital elements)

- **General requirements (pre-Basel III)**
  - Tier 1 capital must represent at least 50% of total capital
  - Voting common stock must be the “dominant” element within Tier 1
  - All capital instruments must be fully paid-up and effectively unsecured
  - Banking organization may not provide funding for its own capital instruments
  - In general, Tier 1 and Tier 2 capital must be subordinate to senior indebtedness and, if issued by depository institution, depositors

- **Components (pre-Basel III)**
  - Common stockholders’ equity
  - Non-cumulative preferred stock (including any related surplus); includes TARP preferred
  - Minority interests – issuances by consolidated depository institutional (non-cumulative perpetual preferred)
  - Restricted core capital elements
    - Qualifying cumulative perpetual preferred stock
    - Minority interests – issuances by consolidated depository institutions (cumulative perpetual preferred)
    - Minority interests – issuances by non-depository institutions (common or perpetual preferred)
    - Trust preferred securities for institutions with total assets of less than $15 billion
Tier 1 Capital (calculation)

- **Sum of core capital elements**

- **Reduced by:**
  - Goodwill
  - Other intangibles
  - Interest-only strip receivables
  - Deferred tax assets
  - Non-financial equity investments
  - Other items

- **Pre-Basel III**
Tier 2 Capital (supplementary capital)

- **General requirements (pre-Basel III)**
  - May not exceed 100% of Tier 1 capital

- **Components (pre-Basel III)**
  - Allowance for loan and lease losses (limited to 1.25% of risk-weighted assets)
  - Perpetual preferred stock
    - Excess amounts of cumulative and non-cumulative
    - Auction-rate preferred stock
  - Hybrid capital instruments; perpetual debt; mandatorily convertible debt securities
  - Term subordinated debt; intermediate term preferred stock (limited to 50% of Tier 1 and amortized during 5-year period immediately prior to maturity)
Total Capital (calculation)

- Sum of Tier 1 and Tier 2 capital
- Reduced by:
  - 50% of capital investments in unconsolidated banking and finance subsidiaries
  - Reciprocal holdings of other banking organizations
  - Other deductions (case-by-case)
- Pre-Basel III
Total Assets

- **Leverage Ratio**
  - Use book assets, no conversion or weighting is necessary
  - Use average over the quarter rather than quarter-end
  - Look to call report or FRY-9
Risk-weighted Assets

- **Currently for Risk Weighting (modified Basel I):**
  - 0% includes cash, claims on governments of OECD countries, agencies of U.S. with full faith and credit of U.S. government
  - 20% includes claims against U.S. depository institutions and OECD banks, general obligation municipal bonds, U.S. agencies, World Bank
  - 50% includes 1-4 family mortgage loans, certain multifamily mortgage loans, municipal revenue bonds
  - ABS (optional): ratings dependent
  - 100% includes all else
  - Other assets
    - Non-financial equity interests
    - Direct credit substitutes
    - Subordinated interest
    - Sub-prime assets
Risk-weighted Assets – Off-balance Sheet Assets

- Off-balance sheet items are converted at four different rates and then placed into one of the four risk-weighted categories (modified Basel I):
  - 0% conversion factor for unused portions of commitments of less than a year; right to cancel (more recently changed to 10% in U.S.)
  - 20% conversion factor for short-term, self-liquidating trade contingencies, commercial letter of credit
  - 50% conversion for bid bonds, performance bonds, standby letter of credit for a particular transaction; commitments of more than a year (home equity lines)
  - 100% conversion for guarantees, financial standby letter of credit
# Risk-weighted Assets – Unsecuritized Exposures

<table>
<thead>
<tr>
<th></th>
<th>Wholesale</th>
<th>Retail</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>IRB</strong></td>
<td>Risk adjusted amounts determined by bank inputs (PD, LGD, EAD and M) for individual exposures</td>
<td>Risk adjusted amounts determined by bank inputs (PD, LGD, EAD) for retail segments (e.g., residential mortgage loans, qualifying revolvers, other)</td>
</tr>
<tr>
<td><strong>Modified Basel I</strong></td>
<td>100% for everything except governments, banks and international organizations</td>
<td>50% for residential mortgage loans; 100% for everything else</td>
</tr>
<tr>
<td><strong>Standardized</strong></td>
<td>RBA for most wholesale exposures</td>
<td>LTV scale for residential mortgages; 75% for “regulatory” retail and 100% for other retail</td>
</tr>
</tbody>
</table>
Risk-weighted Assets – Securitization Exposures

- IRB hierarchy
  - Ratings Based Approach - mandatory if external rating, else inferred rating (if available)
    - “Inferred rating” refers to external rating of another securitization exposure to subordinated obligation of same issuer with same underlying assets, having no credit enhancement that is unavailable to unrated exposure and having a remaining maturity equal to or longer than the unrated exposure. This rating (if available) must be imputed to the unrated exposure
  - Supervisory Formula (if all data available)
  - Otherwise deduction from capital (exception for IAA applicable to certain conduit exposures)
## Ratings Based Approach

<table>
<thead>
<tr>
<th>Long Term Ratings*</th>
<th>Current Risk Weights</th>
<th>Risk Weights Under US Final Rules</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>Granular Pool</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Senior Exposure</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Non-Senior Exposure</td>
</tr>
<tr>
<td>AAA</td>
<td>20%</td>
<td>7%</td>
</tr>
<tr>
<td></td>
<td></td>
<td>12%</td>
</tr>
<tr>
<td></td>
<td></td>
<td>20%</td>
</tr>
<tr>
<td>AA</td>
<td>50%</td>
<td>10%</td>
</tr>
<tr>
<td></td>
<td></td>
<td>18%</td>
</tr>
<tr>
<td>A+</td>
<td>12%</td>
<td>20%</td>
</tr>
<tr>
<td>A</td>
<td>20%</td>
<td>35%</td>
</tr>
<tr>
<td>A-</td>
<td></td>
<td>35%</td>
</tr>
<tr>
<td>BBB+</td>
<td>100%</td>
<td>35%</td>
</tr>
<tr>
<td></td>
<td></td>
<td>50%</td>
</tr>
<tr>
<td>BBB</td>
<td>60%</td>
<td></td>
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<tr>
<td></td>
<td></td>
<td>75%</td>
</tr>
<tr>
<td>BBB-</td>
<td></td>
<td>100%</td>
</tr>
<tr>
<td>BB+</td>
<td>200%</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>250%</td>
</tr>
<tr>
<td>BB</td>
<td></td>
<td>425%</td>
</tr>
<tr>
<td>BB-</td>
<td></td>
<td>650%</td>
</tr>
<tr>
<td>B, below or unrated</td>
<td>RBA Not Available</td>
<td>Deduct from tier 1 and tier 2 capital</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Short Term Ratings</th>
<th>Current Risk Weights</th>
<th>Risk Weights Under US Final Rules</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>Granular Pool</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Senior Exposure</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Non-Senior Exposure</td>
</tr>
<tr>
<td>A-1</td>
<td>20%</td>
<td>7%</td>
</tr>
<tr>
<td></td>
<td></td>
<td>12%</td>
</tr>
<tr>
<td></td>
<td></td>
<td>20%</td>
</tr>
<tr>
<td>A-2</td>
<td>50%</td>
<td>12%</td>
</tr>
<tr>
<td></td>
<td></td>
<td>20%</td>
</tr>
<tr>
<td></td>
<td></td>
<td>35%</td>
</tr>
<tr>
<td>A-3</td>
<td>100%</td>
<td>60%</td>
</tr>
<tr>
<td></td>
<td></td>
<td>75%</td>
</tr>
<tr>
<td></td>
<td></td>
<td>75%</td>
</tr>
</tbody>
</table>

* For investing banks, one rating is sufficient. If there are multiple ratings on a particular position, the lowest solicited rating governs.
Securitization Capital Charges

- The SFA capital requirement for a securitization exposure is $UE$ (underlying exposure) multiplied by $TP$ multiplied by the greater of (i) $0.0056 \times T$; or (ii) $S[L+T] - S[L]$, where:

\[
S\{Y\} = \begin{cases} 
Y & \text{when } Y \leq K_{IRB} \\
K_{IRB} + K\{Y\} - K[K_{IRB}] + \frac{d \cdot K_{IRB}}{1000} \left(1 - e^{\frac{-K_{IRB} - Y}{K_{IRB}}}ight) & \text{when } Y > K_{IRB}
\end{cases}
\]

\[
K\{Y\} = (1 - h) \cdot \left(1 - \beta[Y; a, b]\right) \cdot Y + \beta[Y; a + 1, b] \cdot c
\]

\[
h = \left(1 - \frac{K_{IRB}}{EWALGD}\right)^N
\]

\[
g = \frac{(1 - c) \cdot c}{f} - 1
\]

\[
f = \frac{v + K_{IRB}^2}{1 - h} - c^2 + \left(1 - K_{IRB}\right) \cdot K_{IRB} - v
\]

\[
v = K_{IRB} \cdot \left(\frac{EWALGD - K_{IRB}}{K_{IRB}} + 0.25 \cdot (1 - EWALGD)\right)
\]

\[
d = 1 - (1 - h) \cdot (1 - \beta[K_{IRB}; a, b])
\]
Resecuritzation Issues

“Resecuritization” (or “Resecuritisisation”) under IRB Appendix is defined as (in Section 541(i)):

- “A resecuritization exposure is a securitization exposure in which the risk associated with an underlying pool of exposures is tranched and at least one of the underlying exposures is a securitization exposure. In addition, an exposure to one or more resecuritization exposures is a resecuritization exposure.”
Analytical Approach to Addressing Capital Needs
Initial Considerations

- Review detailed capital calculation at holding company and at insured depository institutions
- Review call reports, reports of examination, SEC filings, enforcement actions, agreements with change of control provisions, etc.
- Determine whether capital need is at depository institution or holding company
- Make realistic assessment of timeline if regulatory issues exist
- Determine whether need can be addressed by Tier 1 or Tier 2 capital
- Determine whether significant changes in asset composition or asset levels will occur prior to, or in connection with, capital formation
- Evaluate alternatives based on current market conditions
- Evaluate limitations or requirements relating to TARP or SBLF participation
- Determine whether insiders and current shareholders will participate
Initial Considerations (continued)

- Determine whether fairness opinion will be required or may be prudent
- Determine whether it is realistic to approach professional investors
- Determine whether shareholder approvals will be required
- Evaluate limitations based on characteristics of the organization and its current equity capital platform and debt obligations
- Evaluate alternatives to sell business divisions or to create “joint venture” arrangements (capital treatment for minority interests at subsidiaries)
- Consider challenges created by trust preferred securities
- Consider challenges created by regulatory developments
## Market/Investor Perspective

<table>
<thead>
<tr>
<th>Institution Characteristics</th>
<th>Growth</th>
<th>Combination</th>
<th>Survival</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>• Finance an opportunity</td>
<td>• Public market access uncertain</td>
<td>• New capital “fills the hole” in the balance sheet and limits risk of failure</td>
</tr>
<tr>
<td></td>
<td>• Trading at a premium valuation</td>
<td>• Valuation reflects market uncertainty – and offers significant upside</td>
<td>• Typically trading at a significant discount to tangible book value</td>
</tr>
<tr>
<td></td>
<td>• Adequate capital and reserves as stand alone</td>
<td>• Material asset quality issues</td>
<td>• Distressed asset quality, operational issues and management issues</td>
</tr>
<tr>
<td></td>
<td>• Limited exposure to higher risk asset classes</td>
<td>• Attractive core franchise value</td>
<td>• Franchise value sufficient to attract capital</td>
</tr>
<tr>
<td></td>
<td>• Strong core franchise</td>
<td>• Respected management team with opportunity to upgrade</td>
<td></td>
</tr>
<tr>
<td></td>
<td>• Respected management team</td>
<td>• New capital assures survival</td>
<td></td>
</tr>
<tr>
<td></td>
<td>• Survival assured, position for long term success</td>
<td>• New capital facilitates pursuit of core strategy</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Use of Proceeds</th>
<th>“Offensive” use of capital – repay TARP and strategic acquisitions</th>
<th>Lead investor due diligence must create credibility</th>
<th>Lead investor requires improvements in management and operations</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>• Lead investor must offer support for strategic direction</td>
<td>• Lead investor must address identified weaknesses and offer credible path to improvements</td>
<td>• Lead investor must interact with regulators to address regulatory intervention</td>
</tr>
</tbody>
</table>
## Capital Instruments

<table>
<thead>
<tr>
<th></th>
<th>Advantages</th>
<th>Disadvantages</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Common Stock</strong></td>
<td>• Tier 1 Capital</td>
<td>• Highest Cost of Capital</td>
</tr>
<tr>
<td></td>
<td>• Foundation of Capital Base</td>
<td>• Most Dilutive to Earnings</td>
</tr>
<tr>
<td></td>
<td>• Increase Float/Exposure</td>
<td>• Difficult During Periods of Market Volatility</td>
</tr>
<tr>
<td></td>
<td>• May Be Accretive to Book Value</td>
<td>• Offering May Pressure Price</td>
</tr>
<tr>
<td><strong>Non-Cumulative Convertible Preferred</strong></td>
<td>• Tier 1 Capital</td>
<td>• Dividend Not Tax-Deductible</td>
</tr>
<tr>
<td></td>
<td>• Equivalent to Common</td>
<td>• Dilutes Existing Common Shares Upon Conversion</td>
</tr>
<tr>
<td></td>
<td>• Over Time Increases Float</td>
<td>• Structure can be Complex</td>
</tr>
<tr>
<td></td>
<td>• More Attractive Dividend Rate</td>
<td></td>
</tr>
<tr>
<td><strong>Non-Cumulative Perpetual Preferred</strong></td>
<td>• Tier 1 Capital</td>
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<td>• Increases Capacity for Trust Preferred</td>
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<td><strong>Bank or BHC Tier 2 Subordinated Debt</strong></td>
<td>• Lowest Cost of Capital</td>
<td>• Tier 2 Treatment at Issuer</td>
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<td>• Tier 2 Treatment at Issuer</td>
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<td>• Can be Tier 1 at Bank if BHC is Issuer</td>
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<td><strong>Cumulative Perpetual Redeemable Preferred</strong></td>
<td>• Tier 2 Treatment at Issuer</td>
<td>• Cash Flow Requirement</td>
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<td>• No Dilution to Shareholders</td>
<td>• Dividend Not Tax-Deductible</td>
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Institutional Capital Products

- Lending/investing by money-center banks, insurance companies and other institutions
- Senior holding company debt (secured or unsecured)
- Capital-qualified subordinated debt
  - Depository institution level (accounting consolidation can create holding company capital)
  - Holding company level
- Risk mitigation arrangements to facilitate financing
  - Repurchase and liquidity arrangements
  - Other support from significant shareholders
# Typical Transaction Timeline

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* Closing would be delayed for between 60-120 days if a Notice under the Change in Bank Control Act is required or if a non-control determination under the Bank Holding Company Act is requested.
Transaction Issues – Public Offering

- Valuation and tax analysis
  - Third-party loan review
  - Application of Section 382 limitations

- Investment banks/underwriters
  - Size of the offering
  - Access to institutional investors
  - Ability to execute within appropriate time frame

- Equity or debt instrument

- Disclosure issues
  - Regulatory developments
  - Asset quality trends
  - Impact of Dodd-Frank and Basel III

- Coordinate with required shareholder and other approvals
  - SEC review of proxy materials
Transaction Issues – Public Offering (continued)

- Coordinate with the U.S. Treasury
- Dilution to current shareholders
  - Rights offerings
  - Shareholder approvals
  - Shareholder communications
- Banking regulator involvement
  - FRB, OCC, FDIC, state authorities
  - Applications, notices and other submissions
- Coordinate with sale of non-performing loans and other assets
- Implementation
  - Registration statement
  - SEC review of registration statement
Transaction Issues – Private Placement

- Valuation and tax analysis
  - Third-party loan review
  - Application of Section 382 limitations
- Anti-dilution protection
- Indemnification rights
- Transaction fees; expense reimbursement
- Minority investor rights
  - Registration rights
  - Tag-along and drag-along rights
  - Board/committee representation
  - Board observation rights
- Disclosure issues
Transaction Issues – Private Placement (continued)

- **Post-investment covenants**
  - Capital formation
  - Information rights
  - Operational and strategic matters
  - Executive compensation

- **Coordinate with the U.S. Treasury**

- **Coordinate with sale of non-performing loans and other assets**

- **Coordination with FRB and FDIC statements of policy and passivity and non-association commitments**
Implementation – Private Placement

- Determine number of investors and amount of the aggregate investment
- Confirm exemption from registration requirements
- Transaction documents
  - Investment Agreement or Stock Purchase Agreement
  - Registration Rights Agreement
  - Documents that create the security
  - Other documents
    - Offering memorandum
    - Shareholder agreement
    - Subscription agreement
- Coordinate necessary shareholder and other approvals
- Coordinate fairness opinion
- Coordinate with sale of non-performing loans and other assets
- Banking regulator involvement
  - FRB, OCC, FDIC, State Authorities
  - Applications, notices and other submissions
Discussion

- Common Stock Transaction
- Preferred Stock Transaction
- Senior or Subordinated Debt Transaction
Long Term Impact

- **Small/mid-sized institutions will continue to encounter challenges in raising capital**
  - From 2005 to 2010, institutions over $100 billion grew by 49%; institutions between $10 billion and $100 billion shrank by 30%
  - Dividends will continue to be limited as these institutions retain earnings to comply with enhanced capital requirements

- **Only publicly traded companies will be successful acquirers**
  - Transaction funding for small/mid-sized institutions has disappeared
  - Pricing multiples for small/mid-sized institutions will diverge from regionals and large institutions

- **Consolidation will be slower than anticipated as healthy mid-sized institutions and regionals build capital**

- **Regulatory policies will continue to make investments by private equity difficult**
Long Term Impact (continued)

Note: Data reflects bank and thrift operating units. Assets have been adjusted for inflation by translating prior years to the level of the consumer price index at December 2010. Source: Federal Deposit Insurance Corp.
Appendices:

APPENDIX A – Capital Markets Environment
APPENDIX B – Overview of Regulation and Regulators
APPENDIX C – Control, FRB and FDIC Policy Statements
APPENDIX D – Regulatory Reform

Special Notes:

The presenter(s) acknowledge and thank Allen G. Laufenberg and Stifel Nicolaus for their contribution to, and assistance with, the preparation of the materials in APPENDIX A – Capital Markets Environment.

APPENDIX D – Regulatory Reform was prepared and contributed by Charles M. Horn of Morrison & Foerster LLP.
Capital raising activity for banks and thrifts declined significantly in 2011 as compared to the prior three years.

SBLF funded approximately $4 billion out of a potential $30 billion dedicated to the program.
APPENDIX A – Capital Markets Environment

Bank and Thrift Common Offerings

Bank & Thrift Public Common Stock Offerings

Source: SNL Financial.

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US debt downgrade in August 2011 had a significant impact on momentum that had built off March 2009 lows:

- S&P Bank Index is up 138%
- NASDAQ Bank Index is up 37%; smaller banks continue to lag large banks
- S&P 500 is up 86%
APPENDIX A – Capital Markets Environment

Valuation Levels Near Historical Lows

Valuations have remained depressed after bottoming out in early 2009 and are well below the 20-year norm

There are currently 88 institutions with assets greater than $1 billion trading below tangible book value.

Shading in the above chart references periods of economic recession.

Source: SNL Financial as of 3/9/12. Includes institutions with assets greater than $1 billion as of the most recently reported quarter (includes acquired & defunct institutions).

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APPENDIX A – Capital Markets Environment
Trust Preferred

- No longer an option as a result of the Collins Amendment to Dodd-Frank
- Investors’ focus is now on tangible common equity levels with appropriate amounts of leverage
- Leverage is unavailable to the vast majority of the community banking industry

TruPS Offerings – Banks & Thrifts ($B)

Source: SNL Financial.

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APPENDIX A – Capital Markets Environment

Historical Bank and Thrift Failures

- Compelling FDIC-assisted transactions have become more scarce, increasing competition for attractive franchises and prompting some buyers to begin looking to traditional M&A for growth.
- FDIC “Problem List” has declined to 813 from a high of 884 institutions.

Source: SNL Financial and FDIC.
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APPENDIX B
Overview of Current Regulation


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APPENDIX B
Regulators – Regulations

- Federal Reserve (Reserve Banks and the Reserve Board)
  - 12 CFR 225 (Appendix C) – state member banks and bank holding companies
  - 12 CFR 567 – thrift holding companies

- General information
  - Created by Congress with the passage of the Federal Reserve Act in 1913
  - Consists of 12 Federal Reserve Banks located throughout the country
  - Run by seven member Board of Governors that is appointed by the President for 14-year terms (President appoints Chairman and Vice Chairman for 4-year terms)
  - Primary federal regulator of all bank holding companies
  - Effective July 21, 2011, primary federal regulator of all thrift holding companies
  - Primary federal regulator for state-chartered banks that choose to become Federal Reserve members (approximately 845)

Source: The 96th Annual Report 2009, Board of Governors of the Federal Reserve System
APPENDIX B

Regulators – Regulations

- **Office of the Comptroller of the Currency**
  - 12 CFR 3 (Appendix C) – national banks
  - 12 CFR 567 – federal thrifts

- **General information**
  - Created by the National Bank Act in 1863
  - Bureau of the Treasury Department
  - Comptroller is appointed by the President, with the advice and consent of the Senate, for a five-year term
  - Charters, regulates and supervises all national banks (approximately 1,485)
  - Effective July 21, 2011, primary federal regulator of all federal savings and loan associations and federal savings banks (approximately 800)

APPENDIX B

Regulators – Regulations

- **Federal Deposit Insurance Corporation – state non-member banks and state chartered thrifts**
  - 12 CFR 325 (Appendix C)

- **General information**
  - Created in 1933
  - Independent federal agency managed by a five-member board of directors appointed by the President and confirmed by the Senate (includes Comptroller (OCC))
  - Funds its operations and its insurance activities from deposit insurance premiums paid by insured depository institutions
  - Insurer of all federally insured depository institutions including almost all banks and thrifts
  - Receiver or conservator for all failed federally insured depository institutions
  - Primary federal regulator of state non-member banks (approximately 4,475)
  - Effective July 21, 2011, primary federal regulator of state chartered thrifts (approximately 60)

Avoiding “Control”

- A company that directly or indirectly “controls” a bank (or a bank holding company) becomes a bank holding company (BHC). BHC status has significant adverse consequences that would typically be unacceptable for most professional investors, including:
  - Limitations on activities and investments
  - Significant regulation
  - Supervision and examination by the Federal Reserve
  - Capital requirements
  - Restrictions on the ability to incur debt
The FRB has taken a very expansive view of what constitutes “controlling influence” and “control” and considers the following factors:

- Percentage of voting securities
- Percentage of equity
- Operational or other covenants
- Business relationships
- Right to appoint directors or officers
- Right to appoint board observers
APPENDIX C
Avoiding “Control” (continued)

- **Control is broadly defined and difficult to avoid if investor:**
  - Acquires direct or indirect control of 25% or more of any class of voting securities of a bank or BHC
  - Controls the election of a majority of the board of directors of the bank or BHC
  - Has the power to directly or indirectly exercise a controlling influence over the management or policies of the bank or BHC
APPENDIX C
FRB Policy Statement

- On September 22, 2008, the Federal Reserve Board (FRB) issued a Policy Statement that relaxes certain long-standing policies on minority equity investments, including allowing investors:
  - To make passive minority investments of up to 33% of total equity without being considered in control, if certain conditions are met;
  - To have one board seat [and up to two board seats on the target’s board under certain conditions];
  - To obtain updates from the target’s management on key issues and to participate in discussion of these issues with the target’s management and board of directors; and
  - To have additional business relationships than previously allowed, if the investment is closer to 10% than to 25% of the total voting securities of the organization.
The Policy Statement relaxes limitations imposed on investors by:

- Allowing total passive investments in banks and BHCs of up to 33% (from 24.9%) of total equity. The FRB will permit an investor to acquire a combination of voting and non-voting shares that aggregate less than 1/3 of the total equity of the target bank or BHC, provided that the investor does not acquire 15% or more of any class of voting securities (assuming all convertible non-voting shares held by the investor were converted).

  - Note that, as in the past, non-voting convertible shares held by a passive investor must remain non-voting in the hands of that investor and may only be transferred (i) to an affiliate of the investor or to the target; (ii) in a widespread public offering; (iii) in transfers in which no transferee (or group) would receive 2% or more of any class of voting securities, or (iv) to a transferee that already controls more than 50% of the voting securities of the target.

  - Note also that any passive investor would continue to be restricted to acquiring only up to 24.9% of any class of voting securities without being considered in control of the target bank or BHC.
APPENDIX C
FRB Policy Statement (continued)

- The Policy Statement relaxes limitations imposed on investors by:
  - Allowing a private equity investor to have director representation. A minority investor may name one director regardless of the size of its minority investment, [and may name up to two directors total, if: (i) the board has at least eight voting members; (ii) the investor’s board representation is proportionate to its total interest in the target; and (iii) another shareholder of the target is a BHC that controls the target].
  - In addition, the investor’s representative may not chair the board or any committee of the board, and may serve as a board committee member only if the representatives of the minority investor do not account for more than 25% of the committee members and do not have the authority or practical ability unilaterally to bind the board or management.
The Policy Statement relaxes limitations imposed on investors by:

- Allowing input from investors into bank or BHC business decisions. The FRB in the past limited the ability of a passive investor to have any influence over the business or operations of the target bank or BHC. The FRB now permits non-controlling minority investors to communicate with management about (and advocate for) changes in the target’s policies and operations, including changes to dividend policies, debt and equity financing strategies, business line operations, mergers or other acquisitions transactions, and even management. However:
  - Investors subject to any passivity agreement with the FRB may not solicit proxies against management or threaten to sell shares as part of any attempt to influence management, and
  - Minority investors may not obtain covenants from the target that would limit the target management’s discretion over major policies and decisions.
    - Generally not permitted:
      Covenants regarding hiring, firing and compensation of executive officers, engaging in new lines of business, merging or consolidating entities, raising additional capital, selling or acquiring assets
    - Generally permitted:
      Prohibitions on issuing senior securities, modifying terms of investor’s securities, or liquidating the target, or information and consultation rights.
The Policy Statement relaxes limitations imposed on investors by:

- Allowing the Federal Reserve to permit additional business relationships between investors and a target bank and bank holding company. The Federal Reserve continues to require that business relationships between the minority investor and the banking organization be quantitatively limited and qualitatively nonmaterial, although it may allow more and different types of business relationships between a non-controlling investor and the banking organization where the investor’s ownership of voting securities is closer to 10% than 25%.
APPENDIX C

Issues Introduced by Acquisitions from the FDIC

- Need to coordinate with the FDIC
- Need to review updates to FDIC FAQs
- Possible application of the 2009 FDIC Statement of Policy (“SOP”)
  - 10% Tier 1 equity at the insured depository institution
  - Cross support for institutions with common ownership of 80% or greater
  - Limitations on transfer of ownership interest for three years
  - No prior affiliation with a failed depository institution
  - Limitations on transactions between the investors and the insured depository institution
Generally the SOP applies prospectively to:

- Private investors in a company, including any company acquired to facilitate bidding on failed banks or thrifts that is proposing to, directly or indirectly, (including through a shelf charter) assume deposit liabilities, or such liabilities and assets, from the resolution of a failed insured depository institution; and
- Applicants for insurance in the case of de novo charters issued in connection with the resolution of failed insured depository institutions (hereinafter “Investors”).
  - This SOP does not apply to acquisitions of failed depository institutions completed prior to its approval date
  - The SOP will not apply to an Investor in a bank or thrift, or bank or thrift holding company where the bank or thrift has maintained a composite CAMELS 1 or 2 rating continuously for seven years
In order to provide guidance about the standards for more than *de minimis* investments in acquirers of deposit liabilities and the operations of failed insured depository institutions, the FDIC has adopted the SOP.

- The SOP applies to investors and is not intended to interfere with or supplant the pre-existing regulation of holding companies.
- The FDIC will review the operation and impact of this SOP within six months of its approval date and will make adjustments, as it deems necessary.
APPENDIX C
FDIC Statement of Policy (continued)

- **Capital Commitment:** The resulting depository institution shall maintain a ratio of Tier 1 common equity to total assets of at least 10% for a period of three years from the time of acquisition. Thereafter, the depository institution shall maintain no lower level of capital adequacy than “well capitalized” during the remaining period of ownership of the investors.
APPENDIX C
FDIC Statement of Policy (continued)

- **Cross Support**: If one or more investors own 80% or more of two or more banks or thrifts, the stock of the banks or thrifts commonly owned by these investors shall be pledged to the FDIC, and if any one of those owned depository institutions fails, the FDIC may exercise such pledges to the extent necessary to recoup any losses incurred by the FDIC as a result of the bank or thrift failure.
  - The FDIC may waive this pledge requirement where the exercise of the pledge would not result in a decrease in the cost of the bank or thrift failure to the Deposit Insurance Fund.
Continuity of Ownership: Investors subject to this policy statement are prohibited from selling or otherwise transferring their securities for three years following the acquisition, absent the FDIC’s prior approval.

- Such approval shall not be unreasonably withheld for transfers to affiliates provided the affiliate agrees to be subject to the conditions applicable under this policy statement to the transferring Investor.
- These provisions shall not apply to mutual funds defined as an open-ended investment company registered under the Investment Company Act of 1940 that issues redeemable securities that allow investors to redeem on demand.
APPENDIX C
FDIC Statement of Policy (continued)

- **Prohibited Structures:** Complex and functionally opaque ownership structures in which the beneficial ownership is difficult to ascertain with certainty, the responsible parties for making decisions are not clearly identified, and ownership and control are separated, would be so substantially inconsistent with the principles outlined above as not to be considered as appropriate for approval for ownership of insured depository institutions.

- **Special Owner Bid Limitation:** Investors that directly or indirectly hold 10% or more of the equity of a bank or thrift in receivership will not under any circumstances be considered eligible to be a bidder.

- **Transactions With Affiliates:** All extensions of credit to Investors, their investment funds, and any affiliates of either, by an insured depository institution acquired by such Investors under this SOP would be prohibited.
Secrecy Law Jurisdictions: Investors employing ownership structures utilizing entities that are domiciled in bank secrecy jurisdictions would not be eligible to own a direct or indirect interest in an insured depository institution unless:

- the Investors are subsidiaries of companies that are subject to comprehensive consolidated supervision as recognized by the Federal Reserve Board,
- they agree to provide information to the primary federal regulator about the non-domestic Investors’ operations and activities and
- maintain their business books and records (or a duplicate) in the United States
APPENDIX D – Regulatory Reform

Basel III – Capital

- Capital quality
- Level of capital
- Capital conservation buffer
- Countercyclical buffer
- Loss absorption at the point of non-viability
In practical terms, three types of qualifying capital

- Tier 1 common equity
- Tier 1 additional equity
- Tier 2 capital

The emphasis of Basel III plainly is on Tier 1 common equity
Tier 1 common equity
- Bank’s common shares meeting criteria for such classification (or equivalent for non-joint stock companies)
- Stock surplus/share premium on common equity Tier 1 instruments
- Retained earnings and other disclosed reserves
- Common shares issued by bank’s consolidated subsidiaries and held by third parties (as minority interests) that meet certain additional criteria for inclusion in common equity Tier 1 after regulatory adjustments (deductions)
Criteria for common equity

- The most subordinated claim in liquidation of the bank
- Entitled to a claim on the residual assets that is proportional with its share of issued capital, after all senior claims have been repaid in liquidation (i.e., has an unlimited and variable claim, not a fixed or capped claim)
- Principal is perpetual and never repaid outside of liquidation (other than discretionary repurchases or other allowable discretionary capital reductions under relevant law)
- No expectation is created at issuance that the instrument will be bought back, redeemed or cancelled nor do the statutory or contractual terms provide any feature which might give rise to such an expectation
Criteria for common equity

- Distributions paid out of distributable items and not tied or linked to the amount paid in at issuance and not subject to a contractual cap
- No circumstances under which the distributions are obligatory (no event of default for non-payment)
- Distributions paid only after all legal/contractual obligations have been met (including payments on more senior capital instruments). Therefore no preferential distributions
APPENDIX D – Regulatory Reform
Basel III – Capital Quality

- **Criteria for common equity**
  - It takes the first and proportionately greatest share of any losses as they occur and absorbs losses on a going concern basis proportionately and *pari passu* with all the other instruments within the Tier 1 common category.
  - The paid-in amount is recognized as equity capital (i.e., not as a liability) for determining balance sheet insolvency.
  - The paid-in amount is classified as equity under the relevant accounting standards.
  - It is directly issued and paid-in and the bank cannot directly or indirectly have funded the purchase of the instrument.
APPENDIX D – Regulatory Reform
Basel III – Capital Quality

- **Tier 1 additional capital – hybrids**
  - To qualify as Tier 1 capital, hybrid instruments must be:
    - subordinated to all depositors and all creditors
    - not secured or guaranteed
    - perpetual, with no incentives to redeem and no investor put option
    - fully discretionary non-cumulative dividends/coupons
    - callable by bank only after 5 years
    - any return of capital only with prior supervisory authorisation
    - capable of principal loss absorption on a going concern basis

- **Several hybrid Tier 1 instruments will be phased out, including step-up instruments, cumulative preferred stock, and trust preferred stock**
New deductions from Tier 1 capital:
- Minority interests in consolidated subsidiaries of banks
- Banks’ own non-controlling, minority investments in financial institutions
- Deferred tax assets up to a limit
- Shortfall in reserves
- Mortgage serving rights
- Goodwill and other intangibles
- Gains on sale in securitization transactions
- Gains and losses due to changes in banks’ own credit risk
- Defined benefit pension fund assets and liabilities
APPENDIX D – Regulatory Reform
Basel III – Capital Quality

- **Tier 2 Capital Requirements**
  - Original maturity of at least 5 years, with no incentive to redeem
  - Callable only by the issuer and only after 5 years, with prior supervisory approval
  - Dividends/Coupons – may not have a credit-sensitive dividend feature
  - In liquidation, subordinated to all non-subordinated creditors
Minimum common equity
- Current Basel requirement is 2%
- New requirement of 3.5% will take effect January 1, 2013, rising to 4.5% by January 1, 2015

Minimum Tier 1 capital
- Current requirement is 4%
- Requirement of 4.5% will take effect January 1, 2013, rising to 6% by January 1, 2015

Minimum total capital requirement
- Remains at 8%

New ratios based on more stringent definition of capital
APPENDIX D – Regulatory Reform

Basel III – Conservation Buffer

- Requires banks to build up capital outside periods of stress which can be drawn down as losses are incurred

- Ratio of Tier 1 common equity to risk-weighted assets

- Buffer is phased in in equal increments over three year period, beginning with 0.625% on January 1, 2016

- On January 1, 2019, permanent buffer of 2.5% takes effect

- Restraints on dividends and discretionary bonuses if buffer falls below 2.5%
As part of the capital conservation buffer for 29 global systemically important banks (G-SIBs), BCBS has established an “additional loss absorbency” surcharge.

- G-SIBs will be allocated initially to four buckets, from 1.0% to 2.5%
- A fifth bucket of 3.5% has been created as a “penalty box”
- Allocations depend on scoring system that takes into account several factors, including levels of cross-border activity, size, interconnectedness, substitutability, and complexity
- General supervisory judgment is also a factor
- G-SIBs may use certain instruments in addition to Tier 1 to satisfy surcharge requirement
- Surcharge phases in between 2016 and 2019
APPENDIX D – Regulatory Reform
Basel III – Countercyclical Buffer

- Buffer is to be employed when “excess credit growth is judged to be associated with a build-up of system-wide risk”
- Buffer is an extension of the capital conservation buffer
- Buffer is set on a national basis; buffers will not be internationally uniform
- Buffer requirement should be announced 12 months in advance of effective date
- Phase-in along the same time frame and in the same amounts as conservation buffer
- Ceiling will be 2.5% as of January 1, 2019
- Requirements higher than the phase-in amounts presumably could not be imposed
APPENDIX D – Regulatory Reform
Basel III – Loss Absorption

- Contractual terms of instruments should allow for either the permanent write-down of principal or conversion to common equity when a bank is viewed as non-viable

- Non-viability is when a public sector injection or the equivalent is needed, without which the bank would become non-viable, or a write-off is required, without which the firm would become non-viable

- Local regulators would have discretion to specify a conversion rate and also whether to implement either a write-off or a conversion

- EU regulators are considering more onerous “bail-in” measures

- U.S. position on bail-in capital is not fully developed
Securitizations and credit ratings

- BCBS believes aspects of existing capital framework encouraged investors to place too much reliance on external credit ratings
- Requirements:
  - Issue-specific rating assessment may only be applied to unrated issues by the same issuer that ranks pari passu or senior to rated issue
  - Banks must develop methodologies to assess credit risk of securitization exposures even if rated
  - Eligibility criteria for entities providing credit protection have been amended
  - Banks should use ratings of credit rating agencies consistently for both risk weighting and risk management purposes
APPENDIX D – Regulatory Reform

Basel III – Leverage

- Leverage ratio new to Basel process but well-established in U.S.
- U.S. requirement already at 4%; 3% for very highly rated banks
- Lengthy phase-in of 3% ratio; fully effective January 1, 2018
- Capital Measure: *numerator* of the leverage ratio (capital) would consist of only high quality capital that is generally consistent with the revised definition of Tier 1 capital
- Total Exposure Measure: generally, *denominator* of the leverage ratio (the total exposures) would be determined in accordance with applicable accounting rules
APPENDIX D – Regulatory Reform

Basel III – Leverage Ratio

- Tier 1 leverage ratio to be set at 3% during parallel run period between 2013 and 2017
- Bank level disclosure of leverage ratio and components to start in January 2015
- Supervisory monitoring period to commence on January 1, 2011
- Leverage ratio not to become binding until early 2018
- Current proposal is to base leverage ratio on banks’ capital (the numerator) compared to their exposure (the denominator) on new definition of Tier 1 capital
- Exposure should follow accounting standards
APPENDIX D – Regulatory Reform
Basel III – Leverage Ratio

- High quality liquid assets include cash and cash-like instruments in the measure of exposure
- Securitisation exposures will be counted in a manner generally consistent with accounting treatment
- Derivatives exposures will either follow the applicable accounting treatment or use the current exposure method
- Other off-balance sheets are included:
  - Commitments
  - Unconditionally cancellable commitments
  - Direct credit substitutes
- 10% credit conversion factor for any commitments that are unconditionally cancellable at any time by the bank
Liquidity requirements under Basel II consist of two key liquidity ratios:

- Liquidity Coverage Ratio, which is a short term measure of liquidity
- Net Stable Funding Ratio, which is a medium term measurement of liquidity
APPENDIX D – Regulatory Reform
Basel III – Liquidity

- Liquidity Coverage Ratio

- Ratio:
  - Ratio of high quality liquid assets to total net cash outflows over next 30 days
  - Must be equal to or greater than 100%
  - Inflows capped at 75% of outflows
  - Builds on traditional internal methodologies used by banks to assess exposure to contingent liability events
  - Defined as stock of high quality liquid assets divided by total net cash outflows for next 30 days

- Certain high quality liquid assets (“level 1 assets”) to be included on asset side on an unlimited undiscounted basis

- Level 2 assets must comprise no more than 40% of the overall stock and must have a minimum 15% haircut

- Observation period for liquidity coverage ratio commences in 2011 and ratio to be introduced at start of 2015
Net Stable Funding Ratio

- “Final” version has been published but still under discussion
- Net stable funding ratio:
  - Ratio of available amount of stable funding ("ASF") to required amount of stable funding ("RSF")
  - Must exceed 100%
  - Designed to promote resilience over a period of one year
  - Builds on net liquid asset and cash capital methodologies used by internationally active banks
- Ratio should be reported at least quarterly
- Minimum standard will be required by January 1, 2018
APPENDIX D – Regulatory Reform
Basel III – U.S. Implementation

- Basel III tasks for U.S. regulators
  - Capital surcharges for systemically important financial firms
  - Coordination with Basel Committee on identification of, and surcharges for, G-SIBs
  - More stringent capital requirements for large U.S. banking organizations consistent with the requirements of the Dodd-Frank Act

- Impact of Basel III on the larger U.S. banking community
  - Will there be a “trickle-down” effect from Basel III to the U.S. banking system in general?
  - Most likely trickle-down effect: components of Tier 1 and Tier 2 capital
APPENDIX D – Regulatory Reform
Dodd-Frank – Capital

- The Dodd-Frank Act does not expressly address Basel II or Basel III capital requirements, but it contains several provisions that (i) impose requirements that either are harmonious with the Basel Committee regime, or (ii) create capital requirements that are greater than those imposed by Basel III

- Issues addressed under Dodd-Frank:
  - Quality of capital
  - Contingent capital
  - Capital levels
  - Leverage
Primary but by no means the only Dodd-Frank provision affecting regulatory capital is the Collins Amendment

- Requires the establishment of new minimum leverage and risk-based capital requirements for bank and thrift holding companies
- The floor for the new standards is the current set of rules applicable to insured banks and thrifts under the “prompt corrective action” rules
- Effectively disqualifies trust preferred and other hybrid capital securities from treatment as Tier 1 primary capital
- But unclear how the U.S. regulators will treat new holding company instruments that are modeled on earlier capital instruments
Collins Amendment rules will exclude trust preferreds and other hybrids from the numerator of Tier 1, subject to limited exceptions:

- Exclusion applies to all hybrid securities issued on or after May 19, 2010
- Mutual holding companies and thrift and bank holding companies with less than $15 billion in total consolidated assets may include hybrids issued before May 19, 2010, until they mature
- Bank holding companies with assets of $50 billion or more and systemically important nonbank financial companies must phase out from Tier 1 hybrids issued before May 19, 2010 from January 2013 to January 2016
- Intermediate U.S. holding companies of foreign banks have a five-year transition period to phase out pre-May 19, 2010, hybrid securities from Tier 1 capital
New capital-related requirements under Section 165 for bank holding companies with more than $50 billion in consolidated assets and nonbank financial companies deemed systemically important (“SIFIs”)
- Higher capital levels than required for other banks
- Stress testing
- Capital and resolution planning
APPENDIX D – Regulatory Reform
Dodd-Frank – Capital Quality

- Hybrids
  - Within 18 months of enactment, GAO must conduct a study of the use of hybrid capital instruments as a component of Tier 1, which shall consider, among other things:
    - the benefits and risks of allowing instruments to be used to comply with Tier 1 requirements
    - the economic impact of prohibiting the use of hybrids
    - possible specific recommendations for legislative or regulatory actions regarding the treatment of hybrids
Within two years of enactment, the Financial Stability Oversight Council (“FSOC”) must conduct a study on contingent capital that evaluates, among other things:

- the effect on safety and soundness of a contingent capital requirement
- the characteristics and amounts of contingent capital that should be required
- the standards for a triggering requirement