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The Volcker Rule's Impact on Regional and Community Banks:

Significantly Limits Bank Investment in Structured Products
Restricts Hedging Activities to Risk Mitigation

Thomas W. Killian, Principal
(212) 466-7709
tkillian@sandleroneill.com

On December 10th, the final Volcker Rule was approved by the Office of the Comptroller of the Currency (OCC), the Board of Governors of the Federal Reserve System (Fed), the Federal Deposit Insurance Corporation (FDIC), the Securities and Exchange Commission (SEC), and the Commodities Futures Trading Commission (CFTC) (collectively, the Agencies).[1] The Volcker Rule attempts to reduce risk and banking system instability by restricting U.S. banks from investing in or engaging in proprietary trading and speculation and imposing a strict framework to justify exemptions for underwriting, market making and hedging activities. U.S. banks will be restricted from investing in funds with collateral comprised of less than 100% loans that are not registered with the SEC and from engaging in hedging activities that do not hedge a specific identified risk. As a result, we expect to see a number of changes in bank investment and hedging strategies including:

- Significant reduction in bank investments in the debt tranches of Covered Funds (as defined below) of collateralized debt obligations (CDOs) and possibly collateralized mortgage obligations (CMOs);
- Significant reduction in bank investments in the debt tranches of collateralized loan obligations (CLOs) and a shift in focus to transactions with 100% loan collateral; and
- Hedging activities will be restricted to risk-mitigating hedges of quantifiable risk.

The complexity of translating the Volcker Rule's simple risk reduction guidelines into actionable regulation caused it to morph from an 11-page insertion (Section 619) in the Dodd-Frank Act (DFA) passed by Congress in July of 2010 into a 963-page opus that imposes by regulation boundaries between commercial and investment banking that were lost when parts of the Glass-Steagall Act were repealed in 1999 through

[1] See Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds, OCC, Fed, FDIC, December 10, 2013 and Text of the Final Common Rules, OCC, Fed, FDIC, SEC and CFTC. December 10, 2013.

the Gramm-Leach-Bliley Act.[2] The more than 18,000 letters[3] received during the comment period reinforce the complexity of this task and the stakes for all industry participants as the Volcker Rule moves towards implementation on April 1, 2014 with a conformity period for divesting impermissible investments and activities by July 21, 2015.

This note will focus on the key factors that determine whether a fund is a Covered Fund, the determination of an Ownership Interest, the permissibility of hedging activities, and the potential implications for market participants.

For a more detailed discussion of these issues, Sandler O'Neill will be hosting a webinar on Thursday, December 19th at 4 p.m. to discuss the impact of the Volcker Rule and potential strategies that industry participants may consider in response to these changes.

OVERVIEW

Simply stated, the Volcker Rule prohibits any U.S. banking organization from owning, sponsoring, or having certain relationships with a hedge fund or private equity fund that is a Covered Fund (defined below), subject to certain exemptions and qualifications. Banking organizations are also restricted from engaging in proprietary trading of securities, derivatives, commodity futures and options for their own account. There are limited exemptions from these restrictions for market making, underwriting, risk-mitigating hedging, trading in government securities transactions, and organizing and offering a hedge fund or private equity fund. These exemptions are most relevant for the systemically important financial institutions (SIFIs) and national banks that are active in those lines of business. These exemptions are also subject to limits based on safety and soundness, conflict of interest, and material exposure to high risk assets or trading strategies.

While banks are generally not permitted to sponsor Covered Funds, there is an allowance for a *de minimis* investment amount of up to 3% of the banking organization's tier 1 capital (which is deducted from the banking organization's tier 1 capital). The 5% credit risk retention required under Section 15G of the Securities Exchange Act of 1934 is not included in this 3% limitation. A banking organization that serves as a sponsor, investment manager, or investment adviser is also subject to "super 23A" covered transaction restrictions[4] that limit the other services it can provide to a Covered Fund.

[2] Gramm-Leach-Bliley Act, November 12, 1999.

[3] Board of Governors of the Federal Reserve System, Summary of Comment Letters Received as of December 10, 2013.

[4] For purpose of section 23A of the BHC, the term "covered transaction" means with respect to an affiliate of a member bank: a loan or extension of credit, a purchase of or investment in securities owned by the affiliate, a purchase of assets from the affiliate, the acceptance of securities or other debt obligations issued by the affiliate as collateral security for a loan or extension of credit, the issuance of a guarantee, acceptance or letter of credit, a transaction with an affiliate that

While most community and regional banks are not engaged in market making, underwriting, proprietary trading and risk taking, many of these banks make investments in the debt tranches of collateralized debt obligations (CDOs), collateralized mortgage obligations (CMOs), and/or collateralized loan obligations (CLOs) that may be significantly impacted by Volcker Rule restrictions on investments in Covered Funds. Similarly, most community and regional banks are not actively involved in proprietary trading but they do use hedges to manage their exposures to interest rate risk. The Volcker Rule will now require that hedging activity be restricted to risk-mitigating hedges of quantifiable risk. This will require that community and regional banks identify the specific risks they are hedging and monitor the effectiveness of those hedges as consistent with their policies and procedures.

COVERED FUND

While the Volcker Rule was intended to limit bank investments in hedge funds and private equity funds, Section 13 broadly defines hedge funds and PE funds to include any issuer that relies on one of the following exemptions under the Investment Company Act (ICA) of 1940:

- Funds sold to 100 or fewer investors (referred to as the Section 3(c)(1) exemption); or
- Funds sold only to Qualified Purchasers (QPs) (referred to as the Section 3(c)(7) exemption).

The Volcker Rule also defines Covered Funds to include commodity funds and certain foreign funds organized and operated outside the U.S. but sponsored by a U.S. bank.

Transactions that rely on different exemptions from the ICA such as the Section 3(c)(5) exemption for REITS, the Rule 3a-7 exemption for non-managed fixed income funds, and the Section 3(c)(3) exemption for trust funds maintained by a trustee or fiduciary would not be subject to the Volcker Rule. As a result, the same type of collateral could be sold in a securitization with the same waterfall structure but if that transaction relied on a different exemption from the ICA, then it would not be viewed as a Covered Fund and would not be subject to the Volcker Rule.

In addition to exclusions for issuers that relied on other exemptions from the ICA, the final Volcker Rule specifically excludes securitizations consisting ***solely*** of loans as collateral. This is consistent with Section 13(g)(2) of the BHC Act pursuant to the DFA. These securitizations would include:

- Residential mortgage-backed securities (RMBS);
- Commercial mortgage-backed securities (CMBS);
- Auto securitizations;
- Credit card securitizations; and
- Asset-backed commercial paper.

involves the borrowing or lending of securities, a derivative transaction with an affiliate that causes the bank or subsidiary to have credit exposure to the affiliate.

In addition to these exclusions for loan assets as collateral, the Volcker Rule also excludes other entities from the definition of Covered Fund including: wholly owned subsidiaries, joint ventures, acquisition vehicles, insurance company separate accounts (including bank owned life insurance), public welfare and tax credit funds such as Small Business Investment Companies (SBICs), registered investment companies (RICs) such as Business Development Companies (BDCs), and entities formed on behalf of the FDIC to facilitate the disposal of assets. These exclusions may provide some potential flexibility for banks to restructure their operations to either rely on a different exemption from the ICA or shift some assets or business activity to a wholly-owned subsidiary or joint venture such as a SBIC or RIC that is specifically excluded from being a Covered Fund.

OWNERSHIP INTEREST

When the Volcker Rule was proposed, many bankers, lawyers and industry professionals assumed that an investment in a debt security of a securitization with a fixed interest rate or return tied to a third party index would not be considered an Ownership Interest. But the Volcker Rule defines an Ownership Interest in a fund to mean any equity, partnership, or other similar interests. Section 10 (6)(i) specifically defines "other similar interests" as interests that include ***any*** of the below characteristics:

- Right to participate in the selection or removal of a partner;
- Right to receive a share of income on the Covered Fund;
- Right to receive the underlying assets of the Covered Fund after all other interests have been retired;
- Right to receive excess spread;
- Losses arising from the underlying assets of the Covered Fund reduced by payments from the Covered Fund;
- Right to receive income on a pass through basis from the Covered Fund; ***or***
- Any derivative exposure that provides similar rights as above.[5]

The typical cash flow waterfall of a securitization transaction includes certain of these elements. As a result, we understand that the Agencies have indicated that debt tranches of securitization transactions would be considered Ownership Interests. Since we understand that the Agencies characterize any investment in a debt or equity tranche of a CDO, CMO or CLO securitization transaction as an Ownership Interest, to the extent such transactions are Covered Funds, they would be subject to divestiture before the end of the conformity period of July 21, 2015, unless extended by the Fed.

[5] Text of the Final Common Rules, OCC, Fed, FDIC, SEC and CFTC. December 10, 2013, pg. 32.

IMPACT ON U.S. BANK INVESTMENT IN STRUCTURED PRODUCTS

U.S. banks will need to carefully review their investment portfolios to identify those issuers of securitizations that relied on the Section 3(c)(1) or 3(c)(7) exemptions. Other than REITs and certain non-managed ABS transactions, many private securitizations have relied on these two exemptions. For example, in the pooled trust preferred CDO market, there were approximately 104 securitization transactions aggregating about $57 billion in original issuance amount of trust preferred securities by banking organizations, insurance companies and REITs.[6] Of this amount, about $41 billion is still outstanding as of September 30, 2013. Roughly 90% of the outstanding balance of pooled TPS deals relied upon the 3(c)(1) or 3(c)(7) exemptions. At the extreme, U.S. banks would not be permitted to own roughly $38 billion of such pooled TPS CDO investments. These investments will have to be divested during the conformity period ending July 21, 2015. The overall credit quality of the banking industry has improved significantly since the time of the financial crisis in 2007 to 2010 and this could be an interesting entry point for non-bank investors to focus on the market for these pooled TPS CDO investments.

The CLO market has substantially recovered from the market collapse in 2007 with a total market size of approximately $270 billion as of September 30, 2013.[7] Typically, CLOs have the right to supplement their investment in loans with other non-agency securities to bolster overall returns. To the extent that a CLO actually holds securities, those holdings would cause the CLO to become a Covered Fund and subject to divestiture by banks during the conformity period. To avoid this outcome, we expect that certain structural modifications will be applied to existing CLOs. For instance, the CLO manager could agree to only invest in loans. Because of these complications, we expect to see the CLO market evolve to focus on either “bank eligible” or “not bank eligible” collateral with corresponding pricing adjustments. We may also see some CLO assets migrate to a RIC or BDC structure which is excluded from being a Covered Fund due to registration with the SEC.

We expect that investors will also be reviewing their investments in CMO transactions to determine if any would be considered Covered Funds. As of November 30, 2013, the total CMO market was estimated by Bloomberg to be approximately $1.8 trillion in outstanding securities with roughly $700 billion in non-agency securities collateral and $1.1 trillion in agency securities collateral. CMOs that relied on 3(c)(1) or 3(c)(7) exemptions would be viewed as Covered Funds unless such funds are collateralized 100% by loans. If banks have invested in CMOs that are Covered Funds, then they will be forced to divest such investments during the conformity period. The underlying real estate collateral for these loans could provide some potential to restructure transactions to potentially rely on the 3(c)(5) exemption as a REIT and avoid classification as a Covered Fund.

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[6] Based on review of all pooled TPS transactions completed between 2000 and 2007 by Sandler O’Neill.

[7] Based on Moody’s CLO Interest, September 30, 2013, pg. 5

PROPRIETARY TRADING

U.S. Banks are prohibited from engaging in proprietary trading including the purchase or sale of any security, derivative, commodity future or option for the purpose of short term gain. There are a number of exemptions for underwriting, market-making, risk mitigating hedging, trading in certain government securities, and transactions entered on behalf of other clients.

Under the terms of the final Volcker Rule, community banks with less than $10 billion in total consolidated assets are exempt from trading restrictions and compliance requirements with respect to trading in U.S. Treasuries, GSE Agencies, Municipals and FDIC obligations. In addition, certain other activities are exceptions to the limits on trading activities including: trading activities where the bank is solely acting as a broker, transactions through a deferred compensation or pension plan, transactions to satisfy a debt previously contracted, certain repurchase and securities lending arrangements, transactions pursuant to liquidity management plan, and risk mitigating hedging activity.

RISK-MITIGATING HEDGING

The Volcker Rule explicitly permits U.S. banks to engage in risk-mitigating hedges but requires that those hedges:

- Must be subject to internal compliance;
- Must hedge or mitigate a specific risk;
- Cannot create a significant exposure that is not hedged;
- Must be subject to continuing review, monitoring and management;
- Must not reward proprietary risk taking; and
- Must document the transaction at the time of execution

The requirement that a hedge be designed to mitigate a specific risk does not mean that a bank would be required to hedge each incremental loan. The bank would be permitted to hedge aggregate portfolio risk that results from an analysis of the characteristics of the loan pools and required to monitor and manage the effectiveness of the hedge in addressing this aggregate risk.

CONFORMITY PERIOD AND TIMING

As shown in the chart below, all banking organizations will be required to implement the Volcker Rule on April 1, 2014 and divest impermissible bank activities and investments by the end of the conformity period at July 21, 2015. The timeline for quantitative methods reporting varies by asset size as follows:

Consolidated Trading Assets and Liabilities	Implementation Date	Conformity Date	Quantitative Methods Reporting
$50 Billion or more	1-Apr-14	21-Jul-15	30-Jun-14
$25 Billion but less than $50 B	1-Apr-14	21-Jul-15	30-Apr-16
$10 Billion but Less than $25 B	1-Apr-14	21-Jul-15	31-Dec-16
Less than $10 Billion	1-Apr-14	21-Jul-15	None Required

During the conformity period, banking entities should engage in "good faith planning efforts, appropriate for their activities and investments, to enable them to conform their activities and investments to the requirements of section 619 and the final implementing rules by no later than the end of the conformance period."[8] Practically speaking, this means that all banking organizations will be required to identify the investments and operations that will be impacted by the Volcker Rule and develop a credible plan to divest these assets and comply with the reporting and record keeping requirements by the end of the conformity period.

A banking entity's interest in a hedge fund or private equity fund qualifies for the extended transition period for illiquid funds only if the banking entity's retention of that ownership interest in the fund, or provision of additional capital to the fund, is necessary to fulfill a contractual obligation of the banking entity that was in effect on May 1, 2010.

The Volcker Rule permits banking entities to request extensions of the conformity period. For each additional extension of one year, a banking entity must submit a request to the Fed: (1) in writing at least 90 days prior to the expiration of the applicable time period; (2) provide the reasons why the extension should be granted; and (3) provide a detailed explanation of the banking entity's plan for divesting or conforming the investment(s). Once the request is submitted, the Fed must determine that the extension is consistent with the purposes of the Volcker Rule and would not be detrimental to the public interest. If an extension is granted, the Volcker Rule would allow the Fed to impose any additional conditions on the extension that the Fed deems appropriate.

[8] Federal Register. Volume 77, NO. 111, Friday, June 8, 2012, pg. 33949

SUMMARY

The task of translating the 11-page insertion of Section 619 in the DFA into actionable regulation approvable by five regulatory agencies was finally completed on December 10th. This final rule effectively accomplishes by regulation what was lost by legislation with the repeal in 1999 of certain parts of the Glass-Steagall Act. The general principles of reducing risk and banking system instability by restricting U.S. banks from investing in or engaging in proprietary trading and speculation and imposing a strict framework to justify exemptions for underwriting, market making and hedging activities certainly make sense in light of the financial crisis of 2007 to 2010. Overall, community banks with less than $10 billion in assets will face the same Volcker Rule requirements but with no quantitative methods reporting and greater flexibility on trading activities in U.S. government Treasuries, GSE agencies, municipals and FDIC securities.

The complications of imposing general principals of risk reduction on complicated securitization and hedging transactions required many simplifying assumptions. In the securitization market, the decision was made to base determination of Covered Fund status solely on the exemption from the ICA rather than the substance of the transaction or the risk profile of the collateral. Similarly, for the definition of ownership interest, the Agencies appear to have included any debt or equity tranche in the securitization of non-loan collateral rather than trying to differentiate which tranches would be more equity-like. This broad definition of ownership interest has certainly surprised industry participants and will cause U.S. banking organizations to significantly alter their investments in structured products. The narrow window in timing to divest impermissible activities and assets before July 21, 2015 may cause losses on portfolio sales due to liquidity rather than credit concerns.

Thomas W. Killian is a Principal of Sandler O'Neill + Partners, L.P. His 35-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 21 years with Sandler O'Neill, advising banks, thrifts, and insurance companies on a variety of capital markets, strategic advisory and M&A assignments.

At Sandler O'Neill, Mr. Killian has managed the successful execution of 13 M&A transactions representing over $2.4 billion in deal value and $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 that raised over $7 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.

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 represented Sandler O'Neill in conferences with the Federal Financial Institutions Examination Council, the Federal Reserve, the Federal Deposit Insurance Corporation, and SNL Financial to discuss capital structure, Dodd-Frank and Basel III related issues. 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.

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