BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

DIVISION OF BANKING
SUPERVISION AND REGULATION

July 14, 2005

Mr. Mark J. Welshimer, Esq.
Sullivan & Cromwell LLP
125 Broad Street
New York, NY 10004-2498

Dear Mr. Welshimer:

This letter is in response to your initial memorandum of November 18, 2004, as well as to subsequent memoranda and other communications, requesting approval of a proposed risk-based capital ("RBC") treatment for a synthetic securitization of margin loans proposed by **[redacted]** that is intended to reduce the RBC requirements assessed against margin loans maintained on the bank holding company's balance sheet. You base your requested RBC treatment on the Federal Reserve Board's ("Board") SR letter 99-32, "Synthetic Collateralized Loan Obligations," the federal banking agencies' joint final rule entitled "Capital Treatment of Recourse, Direct Credit Substitutes and Residual Interests in Asset Securitizations" (2001 Recourse Rule), as well as additional guidance set forth in a letter from the Board and the Office of the Comptroller of the Currency (OCC) to a banking organization dated July 28, 2003 (2003 Interpretive Letter).[1]

In your memorandum to Board staff of May 6, 2005, you describe the final version of the proposed transaction in which **[redacted]** will synthetically securitize margin loans originated by an SEC-registered broker-dealer subsidiary. While the proposed transaction is similar to a specific transaction discussed in the 2003 Interpretive Letter, it differs in two respects. First, the underlying assets of the synthetic securitization are margin loans that are revolving credits payable on demand. Second, **[redacted]** has proposed to retain a mezzanine position that would be externally rated the equivalent of "BB" by two nationally recognized statistical rating organizations (NRSROs). As we understand it, **[redacted]** would like Board staff to confirm the appropriate RBC treatment for the various risk positions that arise from the synthetic securitization. As you know, Board staff has discussed this transaction with our colleagues at the other federal banking agencies and they are aware of the RBC treatment that is outlined below.

[1] The 2003 Interpretive Letter is posted on the OCC's public web site as Interpretive Letter #988.

Background

In the proposed transaction, **[redacted]** would synthetically securitize margin debit balances originated by [redacted], an SEC-registered broker-dealer and an indirect subsidiary of **[redacted]** (**[redacted]**), in accordance with the Board's Regulation T (Reg T margin loans).[2]

As we understand the transaction, **[redacted]** will select and isolate a group of **[redacted]** margin accounts with a notional principal amount of approximately **[redacted]** of Reg T margin loans (i.e., the notional reference portfolio), which will remain on **[redacted]**'s consolidated balance sheet. The credit risk of the notional reference portfolio will be stratified into notional positions that are expected to consist of equity (first loss), mezzanine, and senior positions.

[Redacted] will retain the unrated first loss equity position and a mezzanine position, which is expected to be externally rated "BB." Two mezzanine positions externally rated "BBB" and "A" will be issued to a third-party OECD bank using two unfunded credit default swaps (CDS). The notional amount of the aggregate mezzanine CDS is expected to be fixed between 1 percent and 2 percent of the notional reference portfolio. **[Redacted]** will also retain a super senior position which will be divided into a "AA" externally-rated position and a "AAA" externally-rated position. All of the positions above the unrated first loss equity position, including **[redacted]**'s retained "BB," "AA," and "AAA" positions, will be rated by at least two NRSROs.

We understand that any losses that arise on the Reg T margin loans will be allocated first to the unrated equity position and then to the "BB" mezzanine position, both of which are retained by **[redacted]**. After these two risk positions have been exhausted, losses would then be allocated sequentially to the "BBB" and "A" mezzanine positions held by the OECD bank, and finally to the "AA" and "AAA" senior positions retained by **[redacted]**.

According to your memorandum of May 6, 2005, the initial maturity of the synthetic securitization will be two years from the date of issuance of the mezzanine CDS positions to the OECD bank. However, on an annual basis **[redacted]** may extend the transaction's maturity by another year so that the effective maturity would be reset to two years. We understand that this extension of the transaction's maturity only would be permitted if each NRSRO that has rated the positions in the synthetic securitization confirms its initially assigned external rating of the mezzanine CDS positions issued to the OECD bank. Such a confirmation must be based on **[redacted]**'s retained unrated equity and "BB"-rated mezzanine positions maintaining their initial size and with no change in the premium of the mezzanine CDS positions. If the initial external ratings of the mezzanine CDS positions are not confirmed, whether due to losses eroding the value of **[redacted]**'s retained positions or for other reasons, then the maturity of the synthetic securitization will not be extended.

---

[2] **[Redacted]** owns **[redacted]** through an intermediate holding company, **[redacted]**

During the life of the synthetic securitization, **[redacted]** will have the ability to add margin accounts to the transaction so that newly originated Reg T margin loans will have access to the credit protection provided by the mezzanine CDS positions. Since the aggregate balance of Reg T margin loans in the initial identified set of margin accounts will vary over time, the ability to add new accounts to the transaction helps to ensure that the purchased credit protection is effectively utilized by always having the maximum amount of margin loans covered by the transaction. The selection of new margin accounts will be subject to criteria that will ensure that the risk profile of the new accounts will be essentially identical to the existing accounts in the notional reference portfolio -- i.e., there will be no favorable or adverse selection. These criteria will be developed in conjunction with the NRSROs that will rate the various risk positions in the transaction.

[Redacted] has indicated that the aggregate amount of Reg T margin loans arising under the margin accounts designated to the synthetic securitization may exceed the size of the initial notional reference portfolio. In this instance, the banking organization would consider the amount of Reg T margin loans that exceeds the initial size of the notional reference portfolio as outside the scope of the synthetic securitization and subject to the existing 8 percent RBC requirement.

At the end of each month during the synthetic securitization, losses on individual margin accounts will be determined and allocated to the transaction based on the "Issuer's Percentage."[3] The Issuer's Percentage is the ratio of 1) the initial notional reference portfolio, which is the outstanding principal amount of Reg T margin loans at the inception of the transaction (e.g., approximately **[redacted]**), divided by 2) the average daily balance of the actual outstanding principal amount of Reg T margin loans associated with the accounts designated to the synthetic securitization during the relevant month. The Issuer's Percentage is capped at 100 percent. The amount of the monthly loss will be multiplied by the Issuer's Percentage to determine the amount of the loss to be allocated to the synthetic securitization. Thus, if the actual amount of the Reg T margin loan portfolio increases relative to the initial notional reference portfolio, the percentage of monthly losses from the portfolio allocated to the transaction declines. The cumulative amount of allocated monthly losses aggregated over the life of the synthetic securitization will be allocated to the various risk positions of the transaction at its maturity.

Under the terms of the synthetic securitization, **[redacted]** has retained the right to terminate the two CDS issued to the OECD bank prior to the transaction's maturity in the event that the Board's RBC treatment of Reg T margin loans is revised so that the regulatory capital benefit of the transaction is eliminated or the synthetic securitization no longer provides the expected RBC relief.

Risk-Based Capital Treatment

1. As indicated in your December 29, 2004 memorandum describing the transaction, Board staff agrees that [redacted] must maintain a full dollar-for-dollar RBC charge on the retained, unrated equity position absorbing first losses in the transaction. With respect to the retained

[3] The term "Protection Seller Percentage" may be substituted for the term "Issuer Percentage" once the transaction is consummated.

"BB" position, **[redacted]** may assign this tranche to the 200 percent risk weight category. This treatment is subject to the requirements set forth in the 2001 Recourse Rule for rated, untraded positions, including that the position must have external ratings assigned by at least two NRSROs in order to be assigned to a risk weight based on an external rating. (See 12 CFR parts 208 and 225, appendix A, section III.B.3.c.ii.)

2. The portion of the notional reference portfolio where the credit risk is covered by the mezzanine CDS positions issued to a third-party OECD bank may be considered to be guaranteed by the OECD bank and assigned to the 20 percent risk weight category as set forth in the Board's RBC guidelines. (See 12 CFR parts 208 and 225, appendix A, section III.C.2.)[4]

The retained senior positions that are externally rated "AA" and "AAA" may be assigned to the 20 percent risk weight category, subject to the restrictions in the 2001 Recourse Rule.

Beginning with the date one year prior to the maturity date of the transaction (i.e., the extension date if the maturity of the synthetic securitization is not extended), **[redacted]** may recognize only a portion of the credit protection provided by the OECD bank counterparty. The recognized portion of the credit protection would decrease during the last year of the transaction, effectively increasing the banking organization's RBC requirements, so that one quarter prior to the maturity date the full 100 percent RBC charge will be assessed against the notional reference portfolio.

Specifically, during the fourth quarter prior to the effective maturity of the synthetic securitization only 75 percent of the credit protection provided by the mezzanine CDS position would be recognized when determining **[redacted]** risk-weighted assets. The remaining 25 percent of the assets protected by the mezzanine CDS tranche would no longer be considered guaranteed and this portion of the notional reference portfolio generally would be assigned to the 100 percent risk weight category consistent with the Board's RBC requirements for Reg T margin loans. During the third, second, and final quarters prior to the transaction's effective maturity date, the amount of recognized credit protection would be 50 percent, 25 percent, and 0 percent, respectively. The amortization of the credit protection provided by the synthetic securitization would reduce the RBC relief initially granted to both the mezzanine and the retained senior risk positions. Regardless of the amortization approach described in this paragraph, however, **[redacted]**'s maximum RBC charge on the notional reference portfolio would be 8 percent. With respect to the amount of Reg T margin loans that exceed the initial notional reference portfolio, **[redacted]** must assign these loans to the 100 percent risk weight category during the life of the transaction.

In providing this interpretation, Board staff considered the high credit quality of Reg T margin loans, which is due to the combination of initial margin requirements under the Board's Regulation T, daily margin maintenance requirements under NYSE and NASD regulations, the high liquidity of the collateral, the lender's right to terminate the loan at any time, and protection

---

[4] **[Redacted]** is not booking the CDS as a hedge for purposes of FAS No. 133 and will book the CDS in its trading account. Accordingly, apart from the RBC requirements applicable to the margin loans and any related relief resulting from the transfer of risk under the CDS, **[redacted]** must maintain RBC against the CDS itself in accordance with the market-risk measure in Appendix E to Regulation Y.

from bankruptcy autostay provisions. In addition, staff considered the ability of **[redacted]** to adequately monitor and manage the risks of the margin loans, which should assist in minimizing the risk to the synthetic securitization. It should be noted that because the Reg T margin loans remain on the bank holding company's balance sheet, there will be no benefit to the institution for purposes of calculating its Tier 1 leverage ratio.

The RBC treatment outlined above only applies to transactions that meet the description contained in this letter and satisfy the modified criteria for synthetic securitizations set forth in the Annex of the 2003 Interpretative Letter. Board staff will continue to review and issue RBC interpretations on synthetic securitizations using credit derivatives on a case-by-case basis. If you have any further questions, please contact Tom Boemio (202-452-2982), Anna Lee Hewko (202-530-6260), or Mark Van Der Weide (202-452-2263).

Sincerely,

(signed)

Barbara Bouchard
Associate Director