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

DIVISION OF BANKING
SUPERVISION AND REGULATION

October 31, 2005

Mark J. Welshimer, Esq.
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FAX: (212) 558-3353

Dear Mr. Welshimer:

This is in response to your inquiry on behalf of Wachovia Corporation ("Wachovia"), Charlotte, North Carolina, regarding the appropriate risk-based capital treatment for Wachovia's indirect equity investment in a consolidated financial guarantee reinsurance subsidiary, BluePoint Re Limited ("BluePoint"), a Bermuda-based company. Specifically, you have requested that the Board permit Wachovia to deconsolidate BluePoint for risk-based capital purposes and to deduct Wachovia's equity investment in BluePoint 50 percent from tier 1 capital and 50 percent from tier 2 capital.

Wachovia has made an equity investment of $300 million in BluePoint and is BluePoint's only equity investor. BluePoint is a consolidated subsidiary of Wachovia for purposes of U.S. generally accepted accounting principles ("GAAP"). BluePoint engages in the business of reinsuring financial guarantees issued principally by the major U.S. monoline insurance companies to support municipal bonds and asset-backed securities.

Under the Board's existing risk-based capital adequacy guidelines for bank holding companies ("Capital Guidelines"), a bank holding company ("BHC") generally must hold risk-based capital against the assets and relevant off-balance-sheet items of the parent BHC and each GAAP consolidated subsidiary of the BHC.[1] The Capital Guidelines apply to BHCs on a GAAP consolidated basis because the Board believes that a BHC generally would support its GAAP consolidated subsidiaries as if the exposures of the subsidiaries were direct exposures of the parent BHC. The Capital Guidelines contain an exception, however, for "subsidiaries that, while consolidated for accounting purposes, are not consolidated for certain specified supervisory or regulatory purposes, such as to facilitate functional regulation."[2] The Capital Guidelines require a BHC to deconsolidate the assets of such a subsidiary for risk-based capital purposes and to deduct the BHC's capital investments in such a subsidiary 50 percent from tier 1 capital and

[1] 12 CFR part 225, App. A, § I.

[2] 12 CFR part 225, App. A, § II.B.2.b.

50 percent from tier 2 capital. Wachovia is requesting an interpretation of the existing risk-based guidelines that would allow it to apply such a treatment to its BluePoint subsidiary.

Wachovia has offered a number of arguments and commitments in support of its request. Wachovia has argued that the risk-based capital requirements imposed by the Capital Guidelines on the types of financial guarantee reinsurance transactions that BluePoint engages in vastly exceed the economic capital requirements for the transactions. In this regard, Wachovia has indicated that at least 98 percent of the municipal bonds and asset-backed securities underlying BluePoint's reinsurance transactions will be externally rated at least investment grade and, on average, the underlying securities will have external ratings of A+/A1. Wachovia also has represented that historical losses incurred on the financial guarantees that BluePoint reinsures have been minimal.

In addition, BluePoint's financial condition and operations will be subject to review by Moody's and S&P. BluePoint currently has a Aa3 stand-alone financial strength rating from Moody's and a AA stand-alone financial strength rating from S&P, and Wachovia has committed that BluePoint's stand-alone financial strength rating will always be at least A.[3] BluePoint also would be subject to governmental supervision and review (beyond the umbrella supervision exercised by the Board) in its licensing jurisdiction. BluePoint would be regulated by the Bermuda Monetary Authority, a regulator of a significant number of global reinsurance companies. Wachovia argues that this supervision and review should significantly limit the amount of risk BluePoint may incur, and, hence, should limit the ability of Wachovia to abuse the deconsolidate-and-deduct approach.

To alleviate any supervisory concern that Wachovia's ultimate exposure to BluePoint might exceed its current equity investment in BluePoint, Wachovia has indicated that it does not intend to make available any additional financial support to BluePoint in the event BluePoint were to be in troubled financial condition. Wachovia may desire to provide additional capital to BluePoint if BluePoint's operations are profitable, but Wachovia has committed that it would not invest additional capital in, or extend credit to, BluePoint without obtaining the approval of the Board.

Wachovia also has separated BluePoint from the rest of the Wachovia organization in other significant ways. Importantly, unlike most of Wachovia's other major subsidiaries, BluePoint is not branded with the Wachovia name. In addition, three members of BluePoint's nine-member board of directors do not have any positions with Wachovia (outside of BluePoint). Moreover, although BluePoint and Wachovia will have some dual employees, BluePoint's chief executive officer, President, and chief underwriting officer do not hold any positions with Wachovia (outside of BluePoint). Wachovia also has indicated that BluePoint employees, when they interface with customers or other third parties on behalf of BluePoint, will be identified only as BluePoint employees and will act only on behalf of BluePoint.

[3] Although Wachovia believes Moody's and S&P generally have assessed the financial strength of BluePoint on a stand-alone basis, both Moody's and S&P have considered Wachovia's ownership of BluePoint as part of their rating process.

Wachovia also has provided information about the relationships between the business operations of Wachovia and BluePoint. Wachovia proposes to provide tax, accounting, legal, and other support services to BluePoint and may provide limited cross-marketing services for BluePoint. In addition, BluePoint has and will continue to reinsure financial guarantees supporting (i) municipal bonds or asset-backed securities underwritten by a securities broker-dealer subsidiary of Wachovia; and (ii) asset-backed securities the underlying assets of which were originated by Wachovia (collectively, "Wachovia-connected exposures"). Wachovia has indicated to the Board, however, that BluePoint would be able to limit its Wachovia-connected exposures to (a) 12 percent of total exposures during 2005; (b) 10 percent of total exposures during 2006; and (c) 7.5 percent of total exposures after 2006. BluePoint would not provide financial guarantees directly to Wachovia.

Wachovia has indicated that at least one European bank regulator has permitted one of its banks to deconsolidate and deduct equity investments in a consolidated financial guarantee subsidiary for risk-based capital purposes. Wachovia also contends that none of the 1988 Basel Capital Accord, the Revised Basel Capital Accord, or the Capital Guidelines are designed to address the insurance or reinsurance operations of banking organizations. Notably, the most recent version of the Revised Basel Capital Accord specifically provides for a deconsolidate-and-deduct approach to risk-based capital requirements for insurance subsidiaries of internationally active banking groups.[4] Although BluePoint's reinsurance operations primarily reinsure credit risk, they are subject to insurance regulation by the Bermuda Monetary Authority and would be subject to insurance regulation in the United States if BluePoint were domiciled in the United States.

Based on all the facts of record in this case – including in particular the nature of BluePoint's business, BluePoint's external credit ratings, and the general independence of BluePoint from the remainder of the Wachovia organization – staff has determined that Wachovia may deconsolidate BluePoint for purposes of the Capital Guidelines so long as Wachovia deducts its equity investment in BluePoint 50 percent from tier 1 capital and 50 percent from tier 2 capital.[5] Staff believes that such a treatment is a reasonable interpretation of the existing risk-based capital guidelines. This determination is based on the specific facts and circumstances of Wachovia's investment in BluePoint described in your correspondence with Board staff and this letter, including all the commitments and representations made by Wachovia and BluePoint in connection with this request. Any material change in those facts and circumstances or any failure by Wachovia or BluePoint to observe any of its commitments or representations may result in a different determination. Moreover, staff notes that the risk-based

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[4] Basel Committee on Banking Supervision, International Convergence of Capital Measurement and Capital Standards: A Revised Framework, ¶ 30. The deconsolidate and deduct approach for insurance subsidiaries set forth in the Revised Basel Capital Accord may or may not be available to U.S. banking organizations under any U.S. implementation of the Revised Basel Capital Accord.

[5] The deduction from tier 1 capital will be taken not only for purposes of the Capital Guidelines, but also for purposes of the tier 1 leverage measure. In accordance with the rules governing that measure, Wachovia may deduct from the total assets used in the denominator of that measure the amount of its investment in Bluepoint that it has deducted from its tier 1 capital (12 CFR part 225, App. D, § II.b.).

capital treatment set forth in this letter may not be available to Wachovia at such time as the Revised Basel Capital Accord is implemented in the United States.

If you have any questions about this letter, please direct them to Norah Barger, Associate Director in the Division of Banking Supervision and Regulation, at (202) 452-2402, or to Mark E. Van Der Weide, Senior Counsel in the Legal Division, at (202) 452-2263.

Sincerely yours,

Richard Spillenkothen
Director