From:	Brian.F.Madigan@frb.gov
To:	Bair, Sheila C.
Cc:	Alvarez, Scott
Subject:	Memorandum
Date:	Monday, September 29, 2008 7:42:35 AM
Attachments:	wb memo board.docm

Chairman Bair,

Chairman Bernanke asked me to send you the attached staff memorandum regading Wachovia.

Please note that the memo is confidential and should not be released without the permission of the Federal Reserve.

Brian Madigan
Division of Monetary Affairs
Federal Reserve Board

(See attached file: wb memo board.docm)

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BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Date: September 28, 2008

To: Board of Governors

From: Staff[1]

Subject: Considerations regarding invoking the systemic risk exception for Wachovia Bank, NA

Background

Wachovia Corporation ("Wachovia"), a financial holding company, provides commercial and retail banking services and other financial services in the United States and internationally. The company has a very large retail operation, offering households and businesses deposit and credit products. The company also provides a wide range of investment banking, private banking, and asset management services. The company is headquartered in Charlotte, North Carolina.

At the end of the second quarter, Wachovia Corp. had assets of $812 billion, making it the fourth largest banking organization in the United States in terms of assets.[2] Its main bank subsidiary is Wachovia Bank, NA, which had assets of $671 billion. Total assets of the insured depository institution subsidiaries of Wachovia Corp. are about $782 billion (about 95 percent of the holding company), with two thrift subsidiaries comprising about $105 billion. Wachovia's depository institution subsidiaries have more than 27 million deposit accounts. As of September 24, 2008, deposits of Wachovia's depository institution subsidiaries totaled $439 billion, including nearly $30 billion of foreign deposits.

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[1] Monetary Affairs (Madigan, English, Nelson), Research and Statistics (Parkinson and Kwast), Banking Supervision and Regulation (Bailey, Stefansson, Wassom), Reserve Bank Operations (Marquardt, Stehm), and Legal (Alvarez, Fallon).

[2] All asset, deposit and capital data are as of June 30, 2008, unless otherwise stated. As of September 24, 2008, Wachovia Corp. had assets of $805 billion.

Wachovia reported tier 1 capital of $49 billion and tier 2 capital of $29 billion. The consolidated tier 1 capital ratio of Wachovia was 8.0 percent and the total risk-based capital ratio was 12.7 percent. The company reports a tangible net capital ratio of 5.1 percent. Wachovia Bank, NA reported tier 1 capital of $39 billion and tier 2 capital of about $23 billion, resulting in a tier 1 ratio of 7.3 percent and a total risk-based capital ratio of 11.6 percent.

Wachovia owns a very large retail-oriented broker-dealer network through Wachovia Securities and the recently acquired AG Edwards, Inc. Combined, these firms have more than 3,500 brokerage locations and employ approximately 15,000 registered representatives throughout the United States.

Recent difficulties

Over the first half of this year, Wachovia posted losses of $9.6 billion, reflecting writedowns on available-for-sale securities and high provisions for loan losses. In part the high provisions reflect losses on option ARM mortgages acquired in the 2006 purchase of Golden West Financial Corporation, a $125 billion OTS-regulated thrift holding company based in California.

Investors have become increasingly concerned about Wachovia's prospects in recent months as the outlook for home prices and mortgage credit quality has deteriorated. These concerns were reportedly reinforced last week by the FDIC's resolution of Washington Mutual, under which senior and subordinated debt holders at both the holding company and the insured depositories were not supported and face large losses. Market sentiment was bolstered for a time last week by the prospect of quick agreement and passage of legislation authorizing Treasury's Troubled Asset Relief Program (TARP). But as the legislative outlook for the TARP became uncertain late in the week, Wachovia's stock price tumbled and CDS spreads on five-year Wachovia debt surged to more than 1500 basis points on Friday. Wachovia reported that it was finding it difficult to obtain funding and was running down its liquidity reserves. It seems likely that very soon, possibly tomorrow, the firm will not be able to fund its operations.

Interdependencies

The firm is the third largest deposit holder in the United States. As of September 24, 2008, Wachovia reported $439 billion of domestic and foreign deposits including almost $12 billion from state and other political subdivisions. Total deposits include $30 billion of sweep accounts that are swept into accounts that are insured by the FDIC and $40 billion of other sweep accounts. Uninsured deposits total $183 billion, including $4 billion to foreign governments and central banks. Wachovia Bank, NA has $12.5 billion of borrowings outstanding in the Term Auction Facility (TAF) program and $57.4 billion in FHLB borrowings. Debt issued by Wachovia's depository institution subsidiaries is $68.9 billion, of which $19.6 billion is subordinated debt. The holding company has $56.3 billion of debt, of which $13 billion is subordinated debt. Commercial paper outstanding is $3 billion. Senior debt issued by the holding company is rated A1, while that of Wachovia Bank, NA is rated Aa2. Subordinated debt issued by the holding company is rated A2, and subordinated debt of Wachovia Bank, NA is Aa3.

The main financial entities exposed to Wachovia are given in table 1. Mutual funds are prominent among these counterparties; they hold $35 billion of notes among other obligations. The amount held by money market mutual funds is not clear.

In addition to being a market maker in the debt and equity markets, the firm is a large correspondent banker in Latin America and Asia. Wachovia's bank in Hong Kong is considered critically important by Hong Kong authorities. In the United States, Wachovia clears significant values over CHIPS and Fedwire and is a participant in the full range of systemically important clearing and settlement systems. Wachovia Bank, NA settles foreign exchange transactions through CLS as a third party and is a direct participant in the Fixed Income Clearing Corporation (FICC) for settling U.S. government securities, and is a settlement bank and participant in the Depository Trust Company (DTC). Its securities affiliates directly participate in FICC, DTC, NSCC and various derivatives clearing organizations. In addition, Wachovia processes the most trade-related SWIFT messages, significant ACH volumes, and as much as 30 percent of

Table 1
TOP 5 FUNDS PROVIDERS BY PRODUCT
$ MILLIONS

Top 5 Total Funding Counterparties	
Dreyfus Investment Advisors, Inc.	6,485
State Street Global Advisors, Inc.	5,840
Federated Investors	4,389
PIMCO	4,380
BlackRock Financial Management, Inc.	3,978
	25,072
Top 5 VRDN Counterparties	
Federated Investors	1,400
The Dreyfus Corporation	1,032
The Vanguard Group, Inc.	755
BlackRock Financial Management, Inc.	679
Wells Fargo Bank NA	664
	4,530
Top 5 TOB Counterparties	
The Vanguard Group, Inc.	2,110
JP Morgan Investment Management, Inc.	2,081
Fidelity Management and Research Company	1,271
Federated Investors	1,110
Charles Schwab and Co.	659
	7,231
Top 5 ABCP Counterparties	
Morgan Stanley	2,057
Lehman	1,938
Columbia Management Advisors, LLC	1,510
Morgan Stanley Investment Advisors, Inc.	984
Infiniti SPC Limited	969
	7,458
Top 5 CD Counterparties	
The Dreyfus Corporation	6,335
Morgan Stanley Investment Advisors, Inc.	985
FHLB San Francisco	980
Western Asset Management Co.	975
Garban Capital Markets LLC	670
	9,945

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all checks drawn on the U.S. east coast. Thus, staff would expect some payment and settlement concerns with a Wachovia failure.

The firm's retail brokerage is the second largest in the United States in terms of client assets, with $1.12 trillion in client assets and $259 billion of assets under management. The firm's mutual fund company, Evergreen, is the 22nd largest in the US with $113 billion of fund assets.

Least-cost resolution

The FDIC has conducted a planning exercise for the failure of a bank much like Wachovia Bank, NA. The conclusion of the exercise was that the FDIC could likely resolve Wachovia Bank, NA through a least-cost resolution at zero cost to the Deposit Insurance Fund because there are sufficient uninsured obligations (including foreign deposits, senior debt, and subordinated debt) to absorb all of the bank's losses. Potential least-cost resolution options that would be available to the FDIC under the FDI Act would include a liquidation and deposit payoff. In addition, because of the substantial franchise value associated with Wachovia' businesses, there almost surely would be other least-cost resolution methods – such as an assisted acquisition after appointment of a receiver – that would satisfy the least-cost test and be less disruptive than a liquidation.

Nevertheless, given the forecasted size of the losses at Wachovia Bank, NA, it appears likely that any assisted transaction effected by the FDIC under a least-cost framework would require that the FDIC impose significant haircuts on subordinated debtholders of the bank and quite possibly senior note holders as well. In addition, absent invocation of the systemic risk exception, the FDIC is prohibited from using deposit insurance funds to benefit the senior or secured debtholders of the holding company.

Staff believes that a least-cost resolution of Wachovia Bank, NA would have significant adverse effects on financial markets. Term funding markets have been under considerable stress for more than a year, and these pressures increased greatly following the failure of Lehman Brothers, the difficulties at AIG, and the closing of WaMu. Libor rates have jumped more than 100 basis points since early September. Commercial paper

rates have also risen dramatically, and the volume of financial paper outstanding has declined sharply. In both of these markets, the maturity of new issues has shortened a great deal as investors have become much less willing to lend beyond overnight. Concerns about actual and potential losses on financial institutions' obligations caused outflows from prime money market mutual funds (MMMFs) totaling nearly $400 billion over the past two weeks. Since these funds are normally substantial purchasers of commercial paper and short-term bank obligations, these outflows added to the pressures in those markets. More generally, investors appear to have become more concerned about the outlook for a number of U.S. banking organizations, putting downward pressure on their stock prices and upward pressure on their CDS spreads.

In this environment, a least-cost resolution of Wachovia Bank, NA, with no assistance provided to creditors of Wachovia and the potential for meaningful losses imposed on the debt of the bank, would almost surely have significant systemic consequences. A default by Wachovia and a partial payout to debtors of Wachovia Bank, NA would intensify liquidity pressures on other U.S. banks, which are extremely vulnerable to a loss of confidence by wholesale suppliers of funds. Investors would be concerned about direct exposures of other financial firms to Wachovia or Wachovia Bank, NA. Furthermore, the failure of Wachovia would lead investors to doubt the financial strength of other institutions that might be seen as similarly situated. Market participants are already concerned about National City Corp. Like that of Wachovia, National City's stock price fell sharply late last week, and its CDS spreads widened to levels higher than those of Wachovia. Other financial institutions that are seen as potentially weak – perhaps SunTrust or PNC– could also come under considerable pressure, particularly if the failure of Wachovia led to even greater dislocations in funding markets. Wachovia's sudden failure despite its solid regulatory capital position could also lead investors to reassess the riskiness of U.S. commercial banks more broadly, particularly given the current fragility of financial markets generally and the term funding markets for financial institutions.

In addition, if a least-cost resolution did not support foreign depositors (who are considered nondeposit, general creditors under the FDI Act), the resolution would imperil

this significant source of funding for many major U.S. financial institutions.[3] More generally, given Wachovia's international presence, global liquidity pressures could increase and confidence in the dollar could decline. Moreover, losses on Wachovia and Wachovia Bank, NA paper could lead more money market mutual funds to "break the buck," accelerating runs on those and other money funds. The resulting liquidations of fund assets along with the further loss of confidence in financial institutions might well lead short-term funding markets to virtually shut down. Moreover, the individuals and businesses whose deposits have been swept into non-deposit investments or foreign deposits (e.g., at a Cayman branch) would find all or part of their funds unavailable and likely face losses. In the current environment, such an event could well shake the public confidence in bank deposits. All of these effects would likely cause investors to raise sharply their assessment of the risks of investing in similar (albeit smaller) regional banks, making it much less likely that those institutions would be able to raise capital and other funding.

Staff believes the consequences of a least-cost resolution would extend to the broader economy. The worsening of the financial turmoil that would result from a least-cost resolution of Wachovia Bank, NA would further undermine business and household confidence. In addition, with the liquidity of banking organizations further reduced and their funding costs increased, banking organizations would become even less willing to lend to businesses and households. These effects would contribute to weaker economic performance, higher unemployment, and reduced wealth, in each case materially.

Benefits and costs of using the systemic risk exception

If the systemic risk exception were invoked, staff believes that a resolution method could be designed that would avoid all or most of the adverse impacts discussed above. In particular, if all uninsured creditors of the insured depositories were fully

[3] Citibank, NA, for example, reported having approximately $478.8 billion in deposits in its foreign offices (including deposits held through Edge and Agreement corporations and international banking facilities).

protected and similar protections were provided to holding company creditors, the adverse effects would be mitigated substantially. While extending the protection only to senior creditors would presumably have some beneficial effect, allowing material losses on the subordinated debt of the bank or the holding company could still result in significant adverse effects in financial markets.

Use of the systemic risk exception, however, would involve some perhaps substantial costs.[4] The FDIC would suffer some direct losses from its protection of uninsured creditors at both the bank and, if desired, the holding company level. The size of these losses is unknown at this time, as is the potential impact of such losses on the FDIC's resources. In addition, moral hazard would be exacerbated and the potential for market discipline in the future reduced for the very largest depository institutions, especially if all holding company creditors were protected. Finally, if the systemic risk exception is invoked and used, the FDIC must "expeditiously" recover any losses incurred as a result of the use of the exception through one or more special assessments on insured depository institutions. Unlike normal deposit insurance assessments, these special assessments would be allocated across institutions based on average total assets (rather than deposits) and, thus, would hit larger banks proportionally harder than smaller depository institutions.

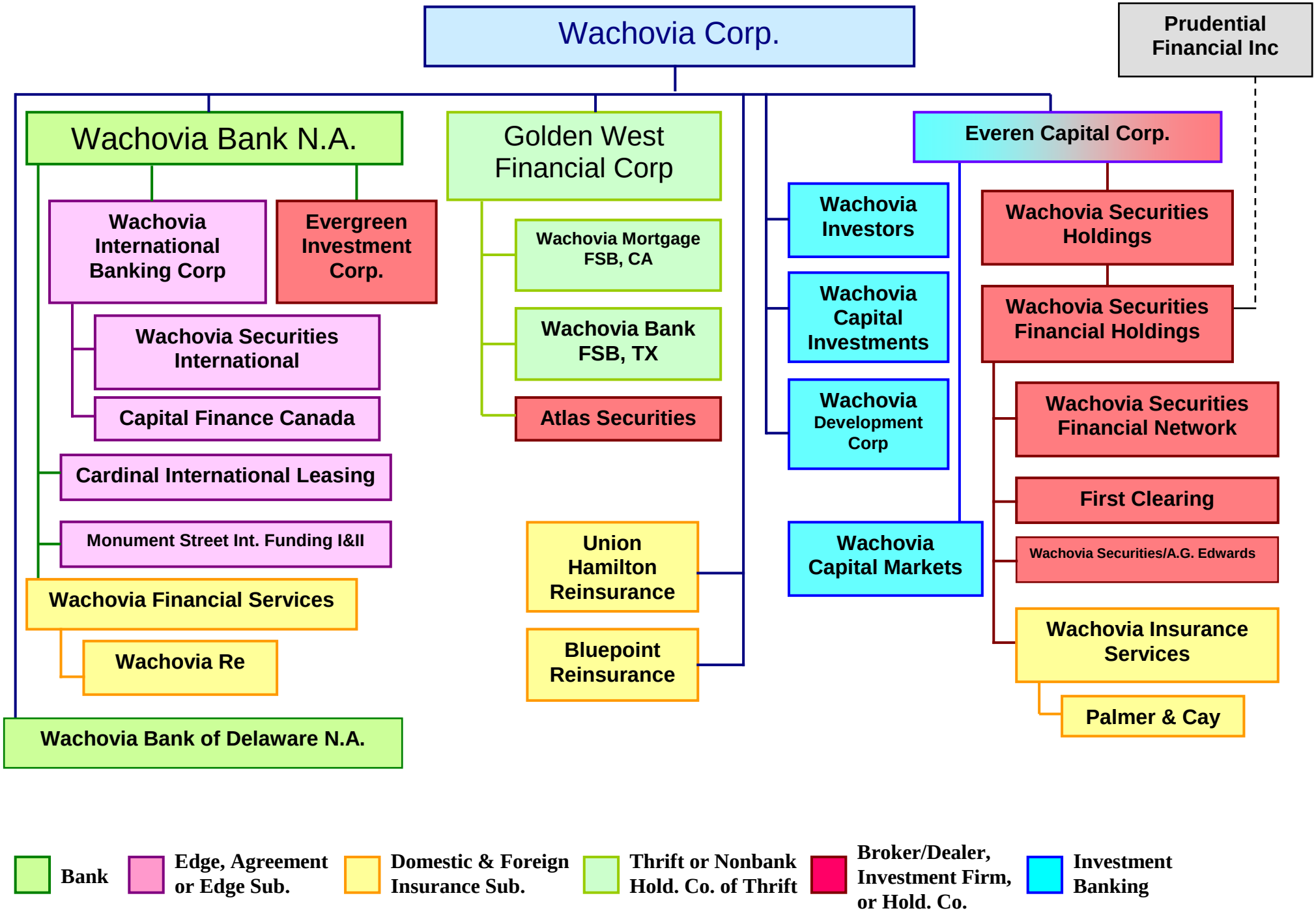
Conclusion

Staff believes that imposition of a least-cost resolution on Wachovia would almost surely have major systemic effects. Both financial stability and overall economic conditions would likely be adversely affected for the reasons discussed above. A non-least-cost resolution that protects all depository institution and holding company creditors would best ameliorate the adverse effects of the failure on financial markets and the real economy. At a minimum, senior creditors of the depository institutions and the bank holding company should be protected.

In creating the systemic risk exception, the Congress clearly envisioned that circumstances could arise in which the exception should be used. In view of the current

intense financial strains which have already seriously impaired the functioning of the financial system, and the likely consequences for the financial system and the economy of a least-cost resolution of the fourth-largest commercial bank in the United States, the staff believes that circumstances such as the Congress envisioned are clearly present and that invocation of the systemic risk exception can readily be justified.

[4] Invoking the systemic risk exception does not lift the guidelines on discount window lending to troubled institutions established by the Federal Deposit Insurance Company Act (1991).


Wachovia Corp.
Prudential Financial Inc
Wachovia Bank N.A.
Golden West Financial Corp
Everen Capital Corp.
Wachovia International Banking Corp
Evergreen Investment Corp.
Wachovia Securities International
Capital Finance Canada
Cardinal International Leasing
Monument Street Int. Funding I&II
Wachovia Financial Services
Wachovia Re
Wachovia Bank of Delaware N.A.
Wachovia Mortgage FSB, CA
Wachovia Bank FSB, TX
Atlas Securities
Union Hamilton Reinsurance
Bluepoint Reinsurance
Wachovia Investors
Wachovia Capital Investments
Wachovia Development Corp
Wachovia Capital Markets
Wachovia Securities Holdings
Wachovia Securities Financial Holdings
Wachovia Securities Financial Network
First Clearing
Wachovia Securities/A.G. Edwards
Wachovia Insurance Services
Palmer & Cay
Bank
Edge, Agreement or Edge Sub.
Domestic & Foreign Insurance Sub.
Thrift or Nonbank Hold. Co. of Thrift
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