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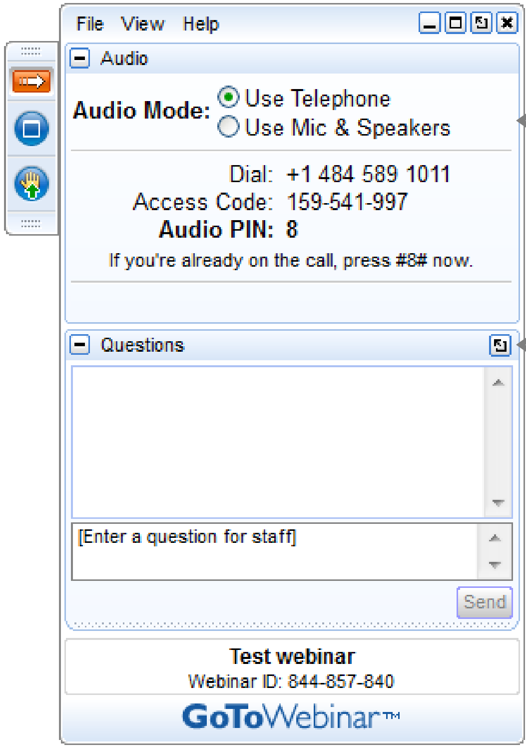

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Will the Volcker Rule Impact You?

Speakers

Corrie Wagner, *Moderator*
Product Manager

George Friedlander
Citigroup

Scott Lilienthal
Hogan Lovells US LLP

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Will the Volcker Rule Impact You?

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Senior Product Manager
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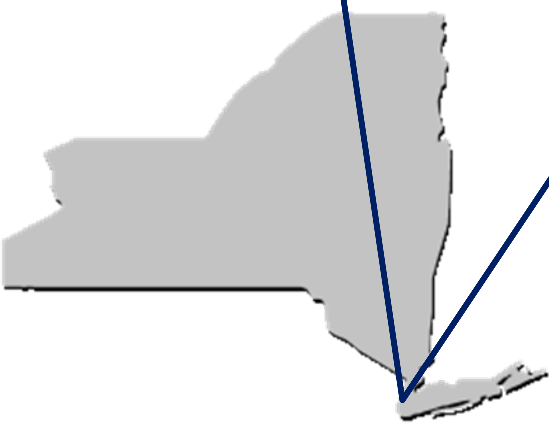

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Will the Volcker Rule Impact You?

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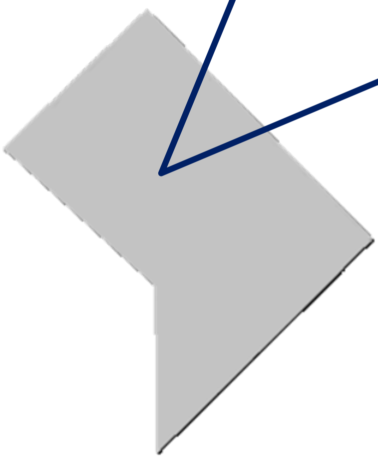

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Volcker Rule

- Part of Dodd-Frank Wall Street Reform and Consumer Protection Act

- Intended purpose: To limit the scope and size of risks taken by banking entities

Volcker Rule

- Notice of proposed rulemaking issued on November 7, 2011, comments were due January 13, 2012

- Scheduled to go into effect on July 21, 2012, but banking entities will have until July 21, 2014 to bring their activities into compliance (possibly longer through Federal Reserve Board extensions)

Aspects of the Volcker Rule Affecting Municipal Securities

- Restricts the ability of banking institutions from engaging in proprietary trading activities, subject to specific exceptions

- Restricts banking entities from investing in or sponsoring “hedge funds” or “private equity funds”

Exception for "obligations of any State or any political subdivision thereof"

- Compare to exception for "obligations of the United States **<u>or any agency thereof</u>**" (emphasis added)

- Footnote in proposed rule indicates that omission of State or local agencies was intentional

- Proposed rule specifically requests comment on whether exception should cover State agencies

Primary objections to proposed exclusion being limited to States and political subdivisions

- Proposed exclusion would not cover approximately 60% of municipal market (i.e, agency obligations)

- Would bifurcate municipal market, resulting in confusion and increased costs

Primary objections to proposed exclusion being limited to States and political subdivisions

- Would restrict ability of banking entities to perform important market-making function

- No basis in legislative history for narrow interpretation

- No credit quality basis for distinguishing between direct and agency debt

- Contrary to interpretations of other similar laws

Tender Option Bonds (TOBs)

- Generally consist of fixed-rate tax-exempt bonds deposited into a trust, which issues short-term floating rate interests and residual interests

- Holders generally have put right, supported by remarketing agent and liquidity facility

- Use of trust allows tax-exempt nature of interest to pass-through to investors

Tender Option Bonds (TOBs)

- Volcker Rule would generally prohibit banking entities from having an ownership interest in or becoming a sponsor of a “private equity fund” or “hedge fund”

- “Private equity fund” and “hedge fund” defined broadly as any fund that qualifies under certain specified exceptions under the Investment Company Act, which are the exemptions relied upon for TOBs

Consequences of Proposed Rule for TOBs

- Would effectively eliminate TOBs

- TOBs serve important market function in addressing mismatch of supply and demand in the municipal market for short-term debt

Argument for Exempting TOBs

- TOBs do not create the kind of risks for banking entities that the Volcker rule was intended to eliminate

- Comparable to securities lending and repurchase agreements

Will the Volcker Rule Impact You?

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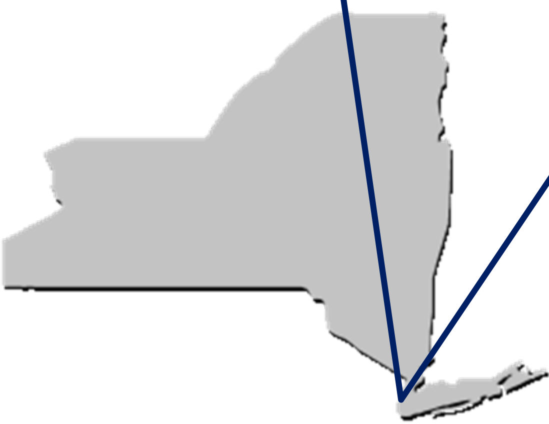

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Citi Municipal Strategy

Volcker Proposal – Potentially Negative Implications for Municipals

February 21st, 2012

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Published: January 31, 2012

Framing the Issues

- I. Hurry up and wait: interested parties must comment to the agencies by 2/13, but the full impact would not be until 2 years from the 7/21 effective date.

- II. Potential good news #1: the proposal is raising serious alarm in Japan, the EU, and Canada, all concerned about the impact of the market-making restrictions on sovereign debt. Mary Schapiro at the SEC has stressed the case for exempting all munis from the proposed restrictions.

- III. The bad news #1: a) They are all correct about how damaging the proposed restrictions would be, but it is not yet clear that the agencies involved will take the industry objections seriously. b) The muni market would be particularly hard hit by the restrictions if not modified. That is why we believe it is essential that muni institutional investors and issuers generate their own letters expressing concern by the 2/13 deadline.

- IV. Potential good news #2, the fix for municipals is relatively easy, and logically powerful: simply expand the exemptions from direct obligations, as defined, to all munis.

- V. Potential bad news #2: the restrictions on market making are so severe for the non-exempt sectors, that capital formation and cost of borrowing in the bond markets would be severely damaged. The need to modify the restrictions to something that works better for all capital markets is an urgent one, in our view.

Limitations That Appear To Be The Most Severe For Capital Markets

- Intentions of the Volcker Rule--limit scope and size of risks taken by banks or financial institutions that contain a bank.

  - I. Limits on Proprietary Trading

  - II. Limits on Market-Making

  - III. Exempt Sectors: US Treasuries and Agencies, "Direct Obligation" munis, but not agencies.

  - IV. Exceptions that do not appear to be adequate--for hedging, underwriting, narrowly defined market-making.

  - V. Why the market-making exceptions appear to be inadequate--restrictions on the ability to benefit from profits that come from price change rather than bid/offer spread. As a consequence, we believe banks will be forced to limit risk-taking to an extreme degree.

  - VI. The muni-specific concern: The agencies, in their draft, propose to exempt direct obligations of state and local governments, but not "agency securities." As we discuss below, we view this as an awkward and unnecessary bifurcation that would affect the entire municipal bond market.

An Academic Perspective: Dr. Darrell Duffie Professor at Stanford GSB

- I. The rule would discourage the provision by market of "immediacy"--the capacity of a bank to put its own capital at risk to absorb a client's demand or supply of an asset into its own inventory.

- II. Under this view, the intent of Congress to exempt market-making would be thwarted, and financial market liquidity would suffer.

- III. Banks would retain the ability to retain only limited demand for immediacy. It is only through meeting this demand that banks mitigate the most significant price distortions and execution costs.

- IV. Market making banks that absorb such costs would experience deterioration in the proposed metrics for market-making risk, and would face the threat of regulatory sanction.

- V. Imbalances in the supply or demand of immediacy would cause larger and more persistent distortions in market prices. This would mean higher direct financing costs, and liquidity and volatility premia in thinner and more volatile markets. The quality and capacity of market making services would decline.

- The conclusion: limitations on market making would be so severe as to drive market-making activities from banks to non-bank third parties such as hedge funds or non-bank broker-dealers.

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Implications of Migration of Market-Making to Third Parties

- I. A massive distortion resulting from the disparity between these third-party market-makers and the underwriting and distribution functions. Third parties such as hedge funds cannot underwrite, and non-bank broker-dealers do not have sufficient capital, market knowledge or distribution capabilities to fill the chasm between market-making and underwriting/distribution.

- II. A variety of the roles currently played by banks as market makers would suffer. Price discovery would diminish. Volatility would increase. Yields required to clear the market would increase sharply, especially during periods of market distress.

- III. The split between exempt and non-exempt municipal sectors would be problematic.

- IV. Municipal market specifically: given the vast number of distinct credits and the vast number of small blocks that are traded, it is not clear at all that third parties could fill the gap to provide the needed credit knowledge, distribution capabilities or willingness to work with small issuers and small blocks needed to support liquidity and limit price volatility, in a sector with 50% of bonds owned by the Household sector and a vast number of smaller issuers.

- V. In municipal bonds specifically, the impact of the migration of market-making to third parties would not be limited to the non-exempt sectors. Banks currently take on existing blocks of both exempt and non-exempt sectors, in order to provide investors with the capacity to purchase new deals.

Implications Migration Of Market-Making To Third Parties (Cont.)

- VI. New issue agency debt yields would also be affected if underwriter capacity to hold unsold balances is impaired. This would also spill over to pricing of exempt sectors.

- VII. Wyman study on corporates also applies to munis: borrowing costs would rise, investors would face a substantial mark-to-market loss, and transaction costs would rise sharply.

Other Factors Supporting Case For Full Exemption For Municipals

- I. Inconsistency between the direct obligation/agency dichotomy in the proposal and all other definitions of municipals in Federal law.

- II. Vastly disparate definitions of direct obligations and "agency securities" from one state to the next and one issuer to the next, that have no parallel with the definition used in the Volcker proposal.

- III. Lack of value in the direct obligation/agency dichotomy as a measure of risk.

- IV. Spillover impact to exempted municipals as the entire market functions less effectively. Despite a likely two-tiered market, the sharply higher illiquidity, volatility and transaction-related costs would not “stay home” entirely.

- V. The case for exemption of TOBs.

Appendix A-1

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