BANK FOR INTERNATIONAL SETTLEMENTS

Adjusting to the New Basel III Capital Order

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Citi Corporate & Investment Banking

"Men wanted for hazardous journey. Low wages, bitter cold, long hours of complete darkness. Safe return doubtful. Honour and recognition in event of success."

- Sir Ernest Henry Shackleton

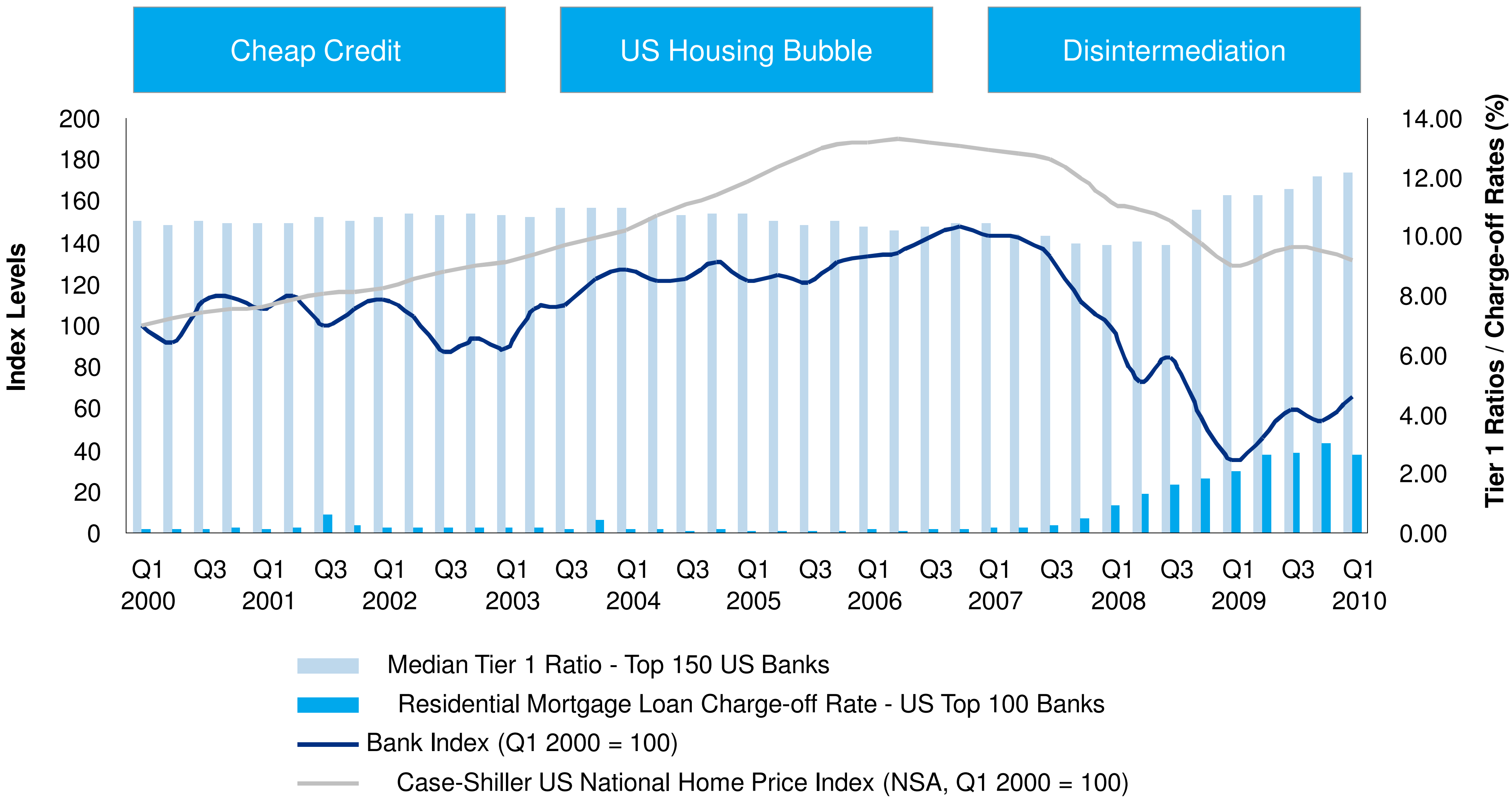
Approaching a Common Capital Regime for Banks

It has been a long road to this point …

Agenda

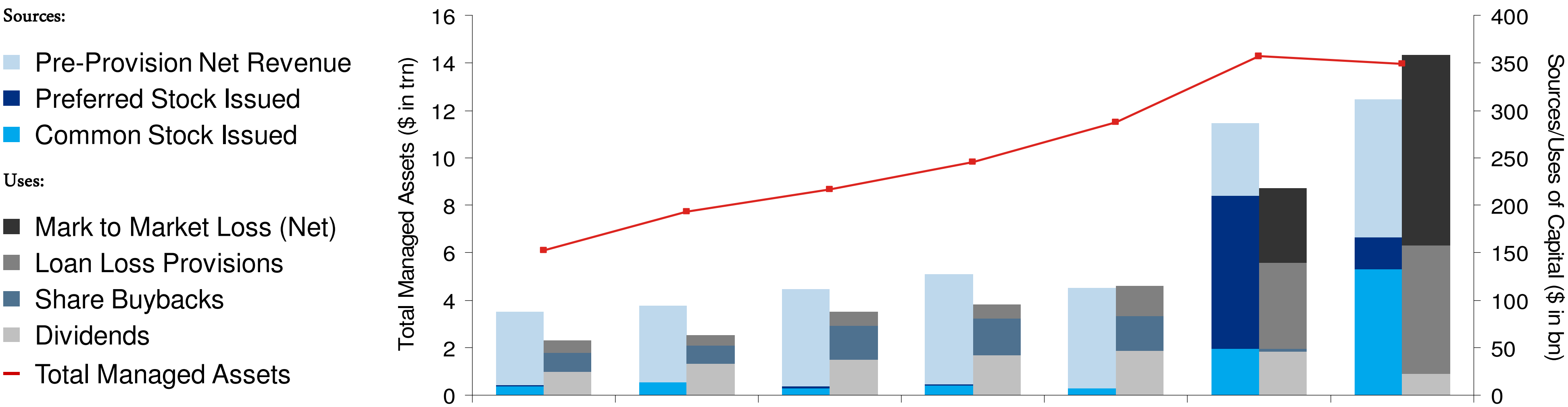
- Pre-Crisis to Post-Crisis
- Digesting the New Capital Framework
- Much Cleared / Many Question Remain
- Business Model and Valuation
- The New Securities & The Capital Markets
- Conclusions

The Root Causes of the Crisis: Looking at the U.S.



 Sources: SNL, Factset, and Citi.

Compounded by the Old Approach to Capital Optimization: Maximize Leverage



% Change in:	2003	2004	2005	2006	2007	2008	2009
Tier 1 Common Equity	12%	25%	8%	15%	(3%)	(2%)	58%
Tier 1 Capital	13%	25%	10%	16%	3%	43%	9%
Total Managed Assets	4%	28%	12%	14%	17%	24%	(3%)

Massive Distributions

Aggressive Balance Sheet Growth

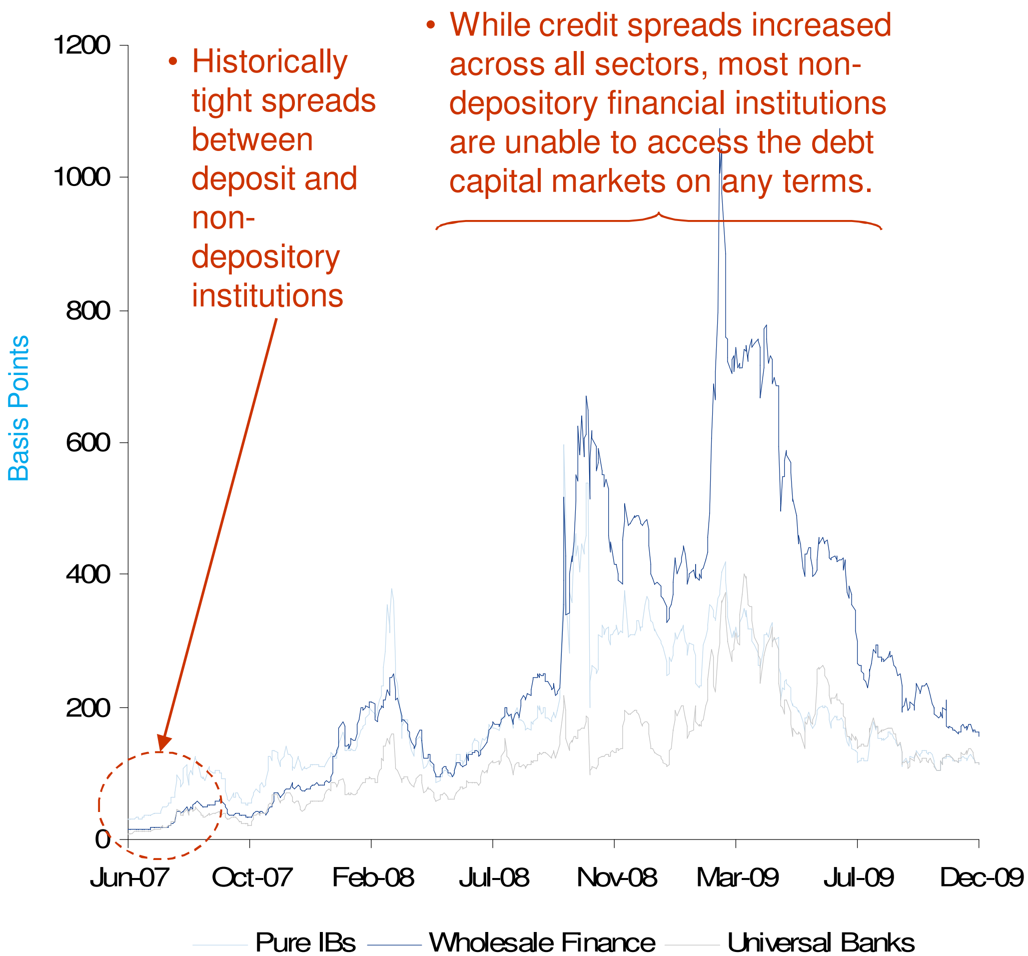
Subsequent Losses

Sources: SNL, Factset, and Citi.

Why Liquidly Measures Matters / Wholesale Funding Challenges

5-Year CDS

	Pre-Crisis Jun-07	Crisis Dec-08	Today Dec-09
Pure IBs	29 bps	291 bps	114 bps
Wholesale Finance	14 bps	366 bps	158 bps
Universal Banks	10 bps	119 bps	114 bps



Impacted the Mighty

northern rock	• Nationalized in August 2007 • Losses stemming from portfolio of retail mortgages and over-reliance on ST wholesale funding
BEAR STEARNS	• Give to JPM in March 2008 • US Fed supported
LEHMAN BROTHERS	• Failed in September 2008
Merrill Lynch	• Required rescuing by Bank of America following Lehman collapse
Goldman Sachs	• Converted to a bank • Received systemic support
Morgan Stanley	• Converted to a bank • Received systemic support
GE	• Participated in Gov't systemic support programs
CIT	• Converted to a bank; other systemic support • Still failed in late 2009

Source: Yieldbook. Bloomberg.

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Agenda

Pre-Crisis to Post-Crisis

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Many of the Concerns are Regional

US

- New hybrids
- Limitation on DTAs
- Wholesale funding
- Systemic classifications
- Derivatives/clearing houses

Europe

- Leverage ratio
- New liquidity requirements
- SIFI's
- New hybrids

Asia (Ex-Japan)

- Minority stakes in non-consolidated FIs as well as minority interests in consolidated subsidiaries
- SIFI's – *Global, Regional, Local*

Japan

- Minority stakes in non-consolidated FIs
- Limitation on DTAs
- New hybrids

Australia

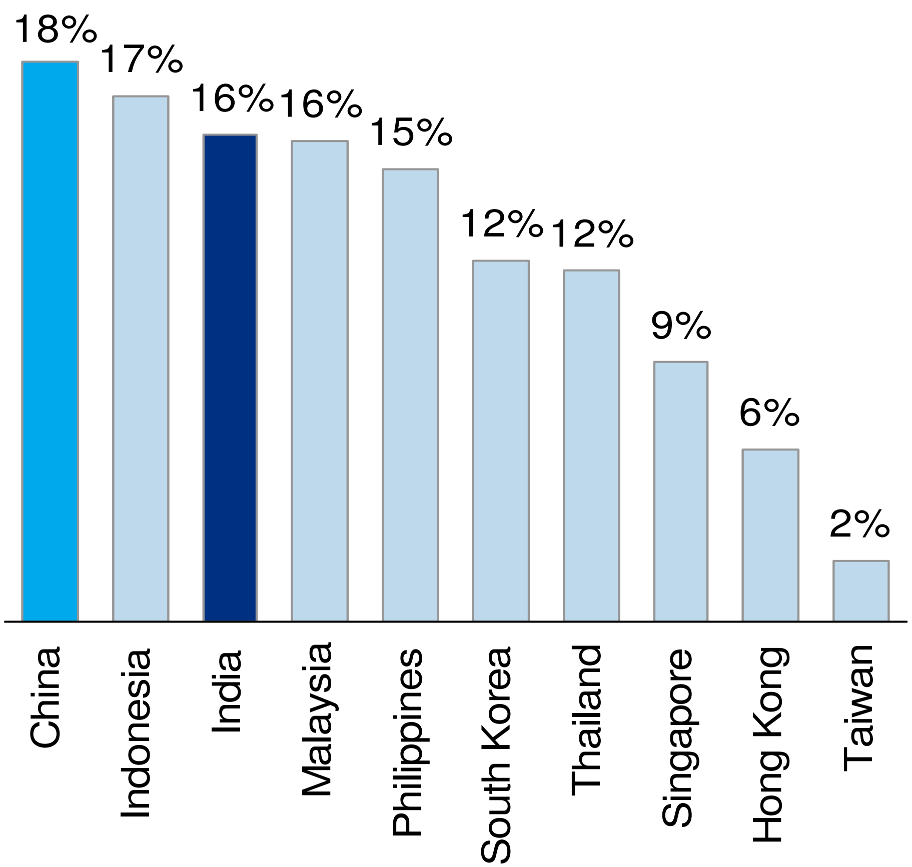
- Wholesale funding
- New liquidity requirements
- New hybrids
- SIFI's

Each region has its own set of considerations

Asset Growth in Asia Continues…

Expected System-wide Loan Growth

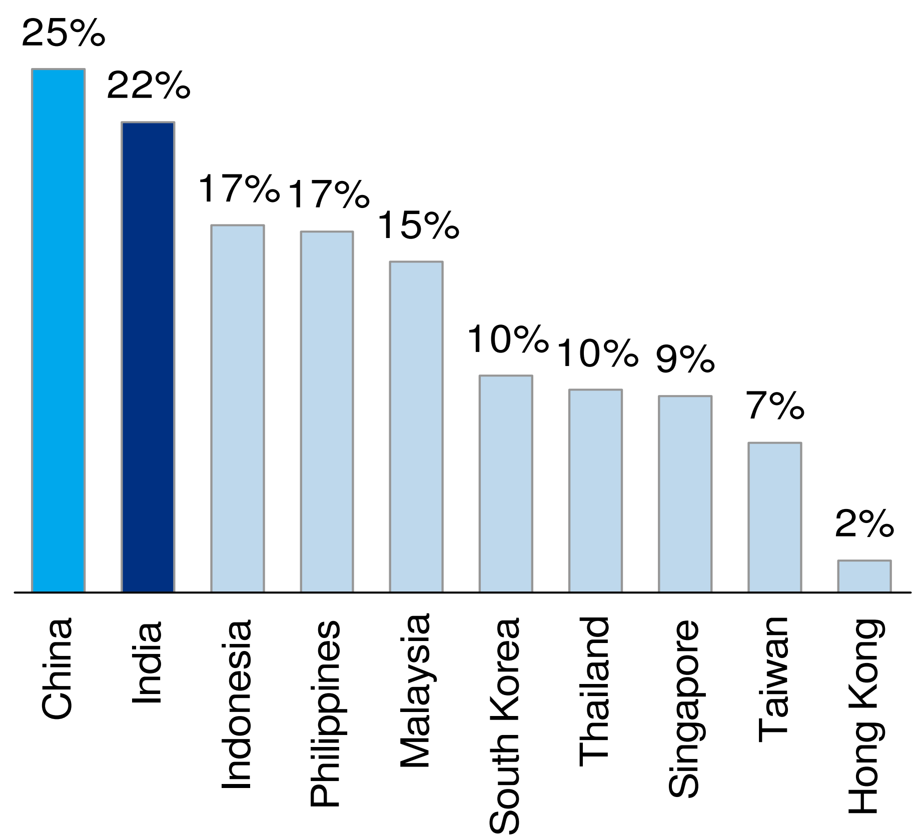
(2010 – 2013E CAGR %)



Source: EIU 2011.

Research Analyst Bank Asset Growth Analysis

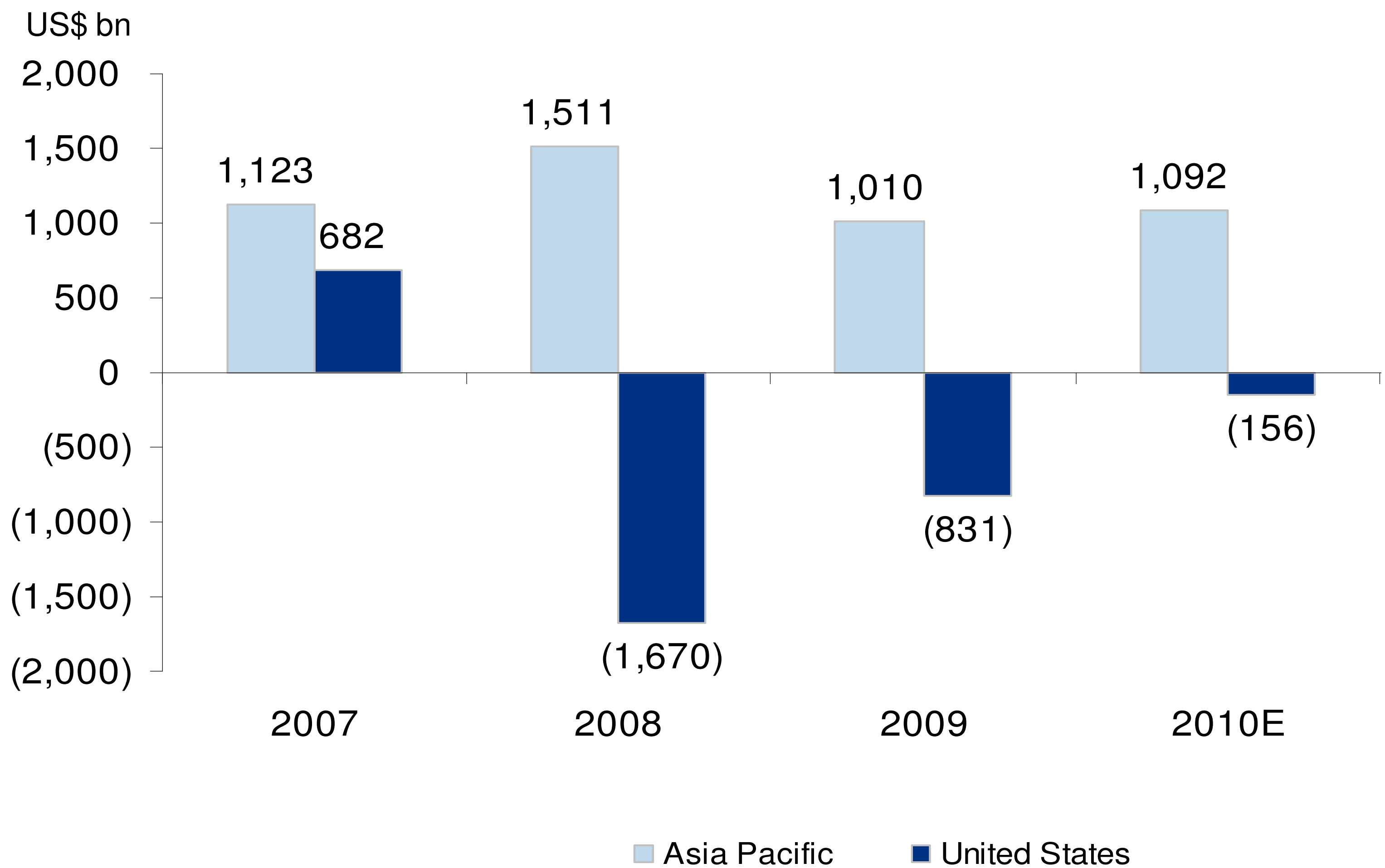
(2010 – 2013E CAGR %)



Source: EIU 2011.

…In Contrast to the US

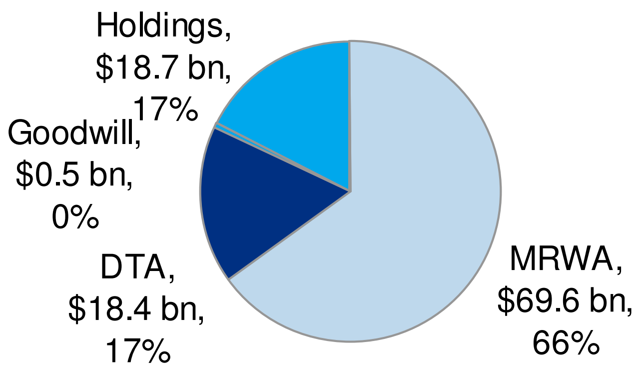
Net New Loan Issuance – Asia Pacific vs. US



Source: EIU.
Note: Asia Pacific number is the aggregate of the following countries: Australia, China, Hong Kong, India, Indonesia, Japan, Malaysia, Philippines, Singapore, South Korea, Taiwan, Thailand and Vietnam

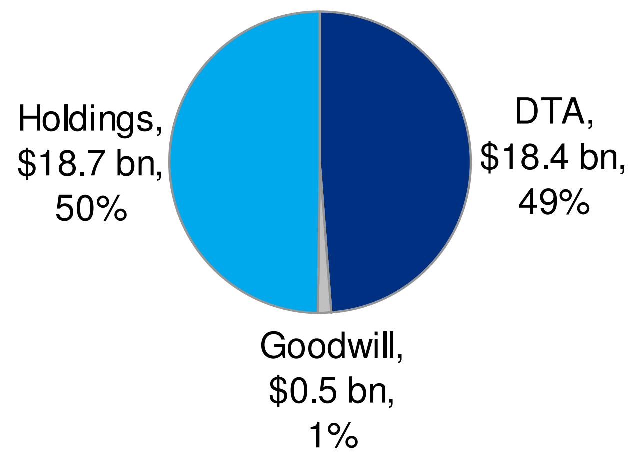
Capital Needs from Basel III's Impact …

Asia Pacific Banks with MRWA Impact



Total Impact = US$107 bn

Asia Pacific Banks Without MRWA Impact



Total Impact = US$37 bn

US$37–$110 bn of Estimated New Equity Capital Needed for New Capital Regime

Sources: Company filings, Citi estimates.

APAC Perspective on Basel III

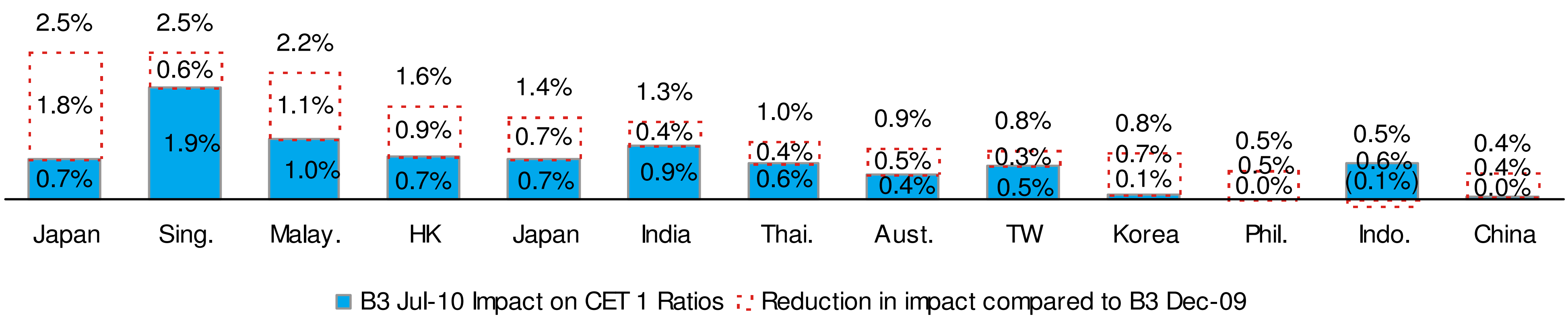
Expected Impact (%) of Core T1 Ratio – From Dec ’09 to July/Dec ‘10

Estimated Regional Capital Needs for Basel III

December ’09 — **+US$100 billion** → **July-Dec ’10** — **+US$37 billion(1)**

+

Over US$110 billion in Growth Capital in China and India

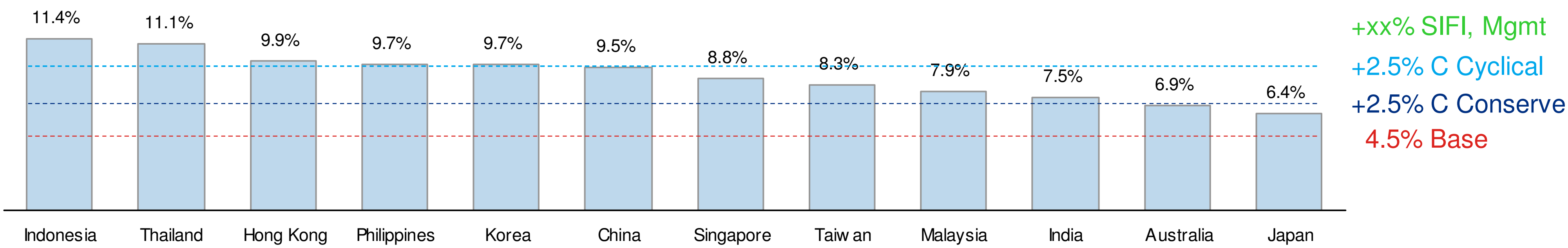


Reduction in CET1 Ratio (Percentage Points)

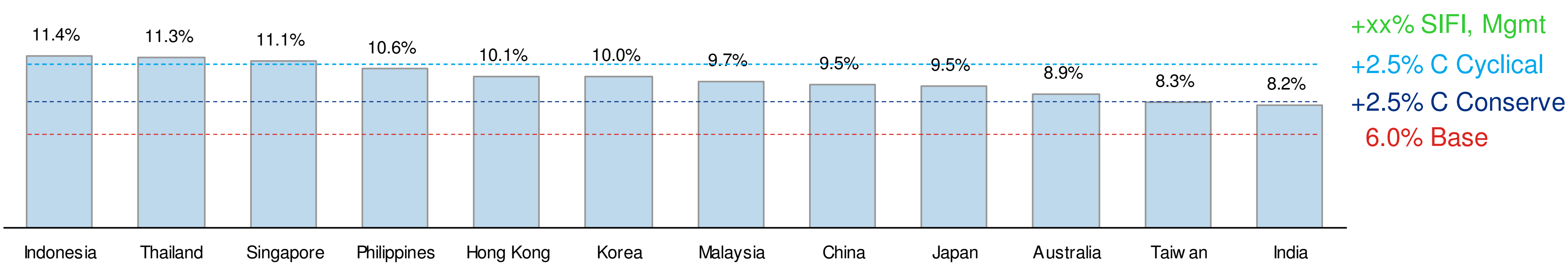
Source: Company filings. Basel III estimated needs based on an analysis of the largest listed banks in the region.
(1) Excludes estimated increase in Market RWA (“MRWA”) from changes in parameters of definition (BIS QIS of Oct-2009)

APAC Perspective on Basel III

Core Equity Tier 1 (Post-Adjustment)



Tier 1 (Post-Adjustment)



Source: Company filings and EIU. Basel III and Growth Capital estimated needs based on an analysis of the largest listed banks in the region.

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More to go…

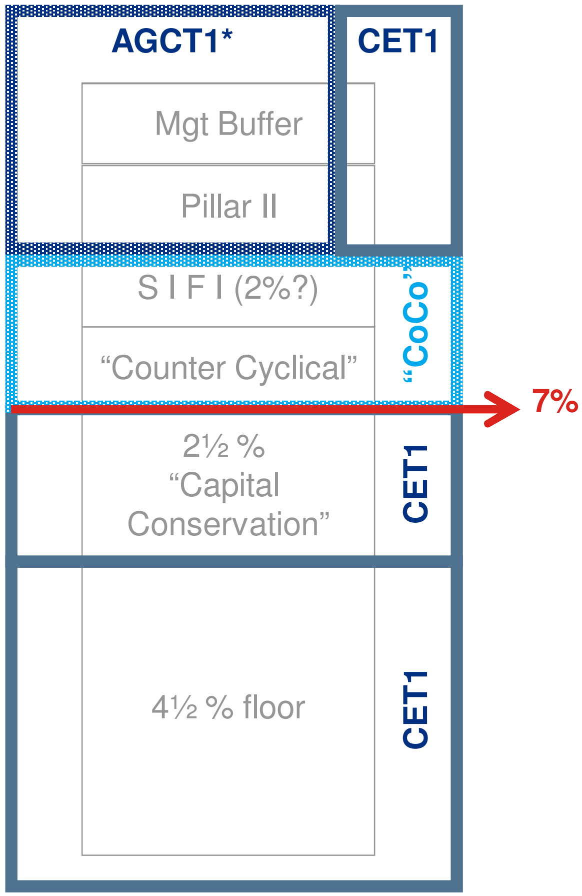
Uncertainties remain regarding hybrid capital issuance and 'new world' non-equity capital

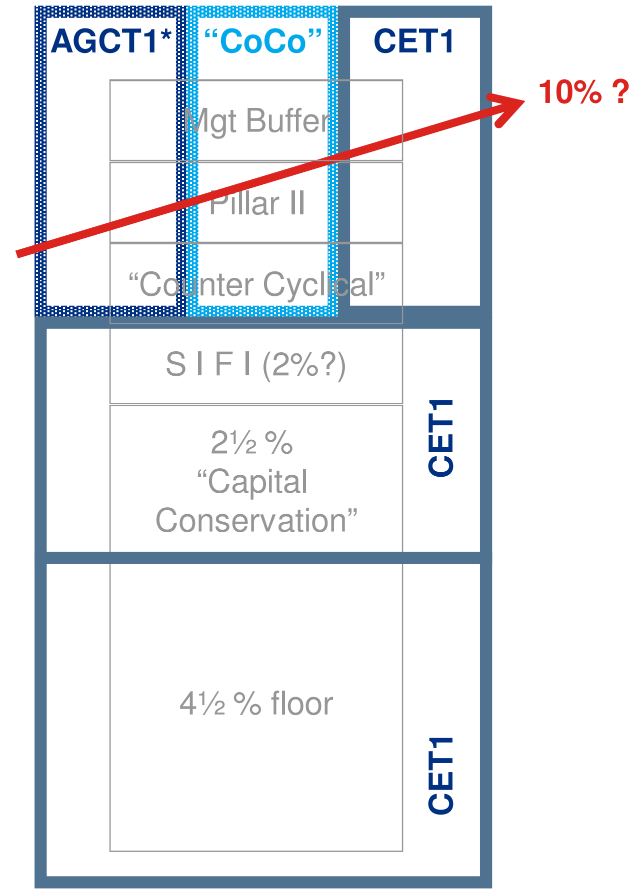
Clarity in some but not all areas

Basel III's 6 Questions	Basel III Components	Clarity?
• How much Common Equity do we need?	**Raise Quality of Capital** / **Stronger Risk Coverage** / **Leverage Ratio (any calibration)** / **Address Cyclicality**	✓
• How much highly liquid stock?	**Set Global Minimum Liquidity Standards** / **Liquidity Coverage Ratio ("LCR")**	½
• How much maturity transformation?	**Leverage Ratio (high calibration)** / **Set Global Minimum Liquidity Standards** / **Net Stable Funding Ratio ("NSFR")**	½
• How much more capital for counterparty risk?	**Strengthen Risk Coverage**	✓
• What's the purpose of non-equity capital?	**Leverage Ratio (Other T1)** / **Raise Quality of Capital** / Emphasis on **equity** New Hybrid: **Additional Going-Concern Capital**	✗
• What's the main Solvency test? – Day–to–day "pinch" ratio: CET1% – Stress Testing? – Different for SIFI and non-SIFI?	**Contingent Capital?**	✗

Buffers, and more buffers, and a few more

Regulatory View (maybe)	Market View – for now …



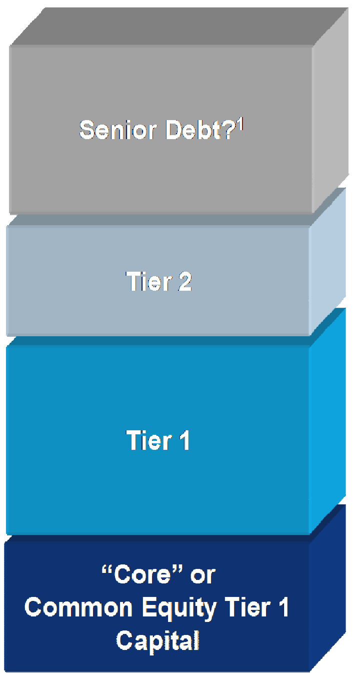


- Just make sure you have enough…

“Gone Concern” Loss Absorption and “Bail-In” senior debt?

In January 2011, the Basel Committee issued a press release detailing the minimum requirements to ensure loss absorbency at the point of non-viability; meanwhile, debate continues on the potential role of ‘bail-in’ senior debt

Potential Capital Structure:



All with principal write-off OR conversion into ordinary shares (or equivalent) at the point of non-viability

Gone Concern Loss Absorption Feature in Tier 1 and Tier 2

- Scope and Requirement: All Additional Tier 1 and Tier 2 instruments issued by an internationally active bank must provide for permanent write down or conversion into common equity at the point of non-viability (can be contractual or statutory)
- Non-Viability is the earlier of:
  - a decision that a write-off, without which the firm would become non-viable, is necessary, as determined by the relevant authority, and
  - the decision to make a public sector injection of capital, without which the firm would become non-viable, as determined by the relevant authority
- Issuance of any new shares must occur immediately and prior to any public sector injection (to avoid dilution)
- The bank must maintain at all times sufficient authorised but unissued capital to cover any conversion
- Transitional Arrangements: Must be included from 1 January 2013.

Senior debt as part of a potential capital resolution structure

- Debate continues over bank resolution / bail-ins of senior unsecured debt and is intensifying, with the adoption of various national resolution regimes and EU Recovery/Resolution proposals

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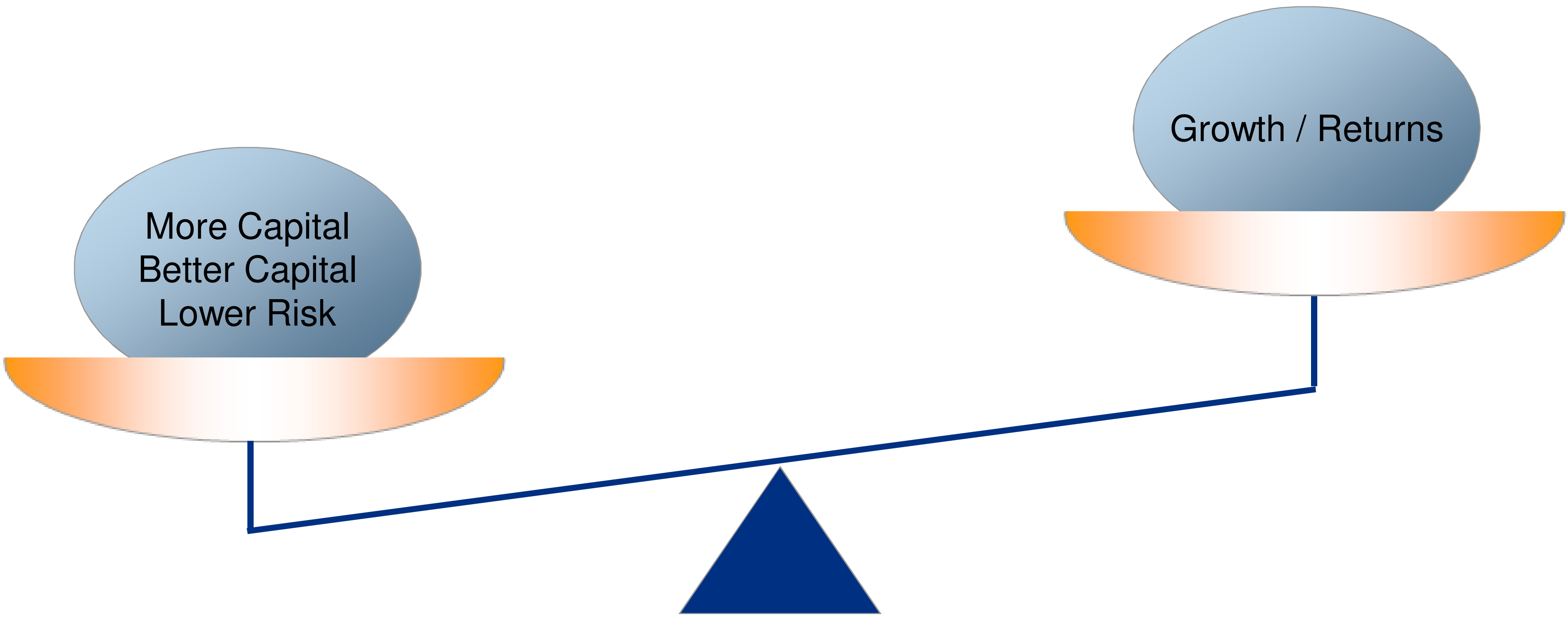
Bank Management Teams Face a Challenging Dynamic

New Regulatory Regime
Hostile Political Environment

Same Investor Requirements



A tough balancing act: Political pressure to both reduce risk and expand access to credit, while meeting investor demands for returns

Valuation Parameters for Turnaround Banking Stocks

Valuation Metric Over Time

Discount to Book Value

- Investor focus on the balance sheet, both funding and asset quality
- Limited evidence of franchise value or implementation of a strategic plan
- Lack of earnings visibility

Book Value

- Continued investor focus on the balance sheet
- Beginning progress on strategic plan, including realization of key fee income and earnings from new business initiatives
- Earnings visibility

Book Value Plus a Premium

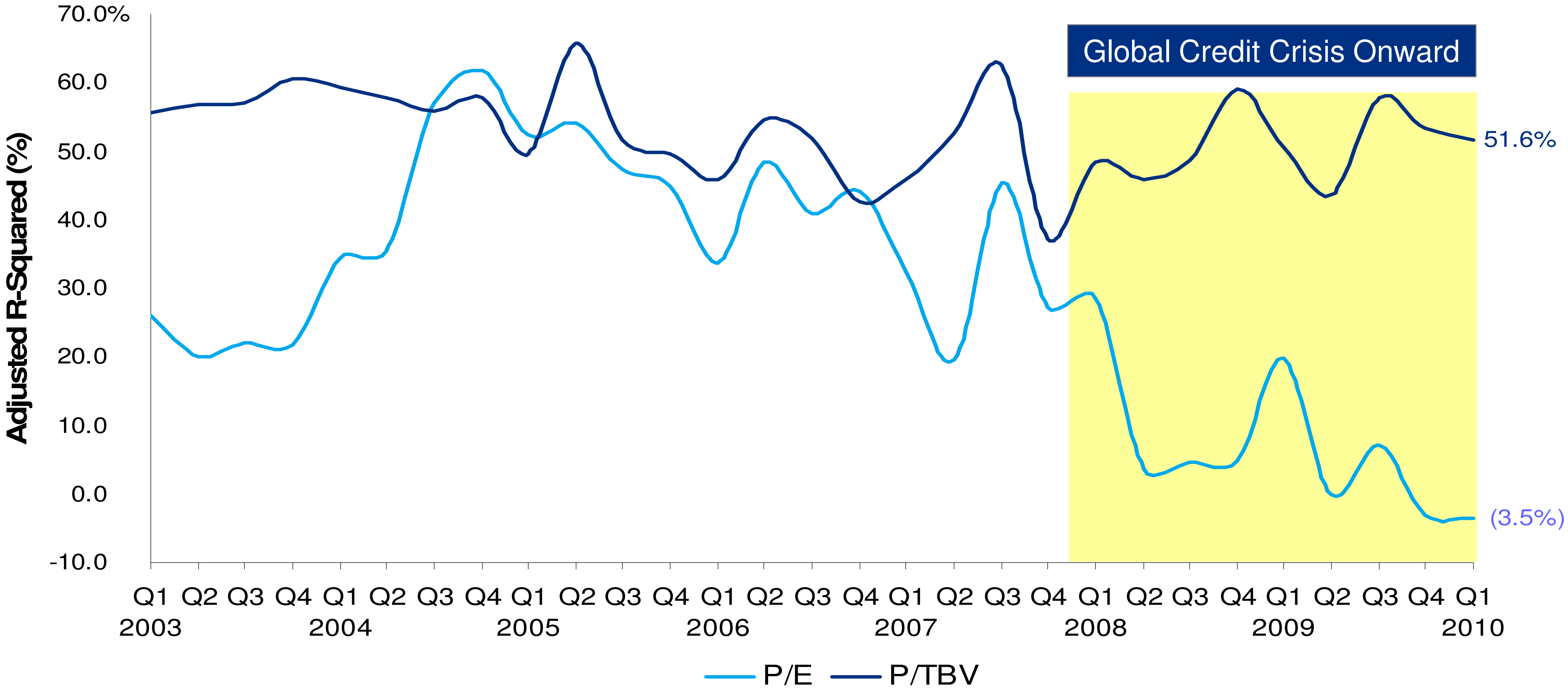
- Balance sheet quality now a given
- Clear progress on strategic plan—sales of new products and services at meaningful levels
- Ability to project growing earnings into the future

Multiple of Earnings

- Balance sheet much less an investor focus
- Phase I of strategic plan implemented, Phase II underway. Focus on gaining market share
- Investors debate growth rate and metrics

Eras of Bank Valuation

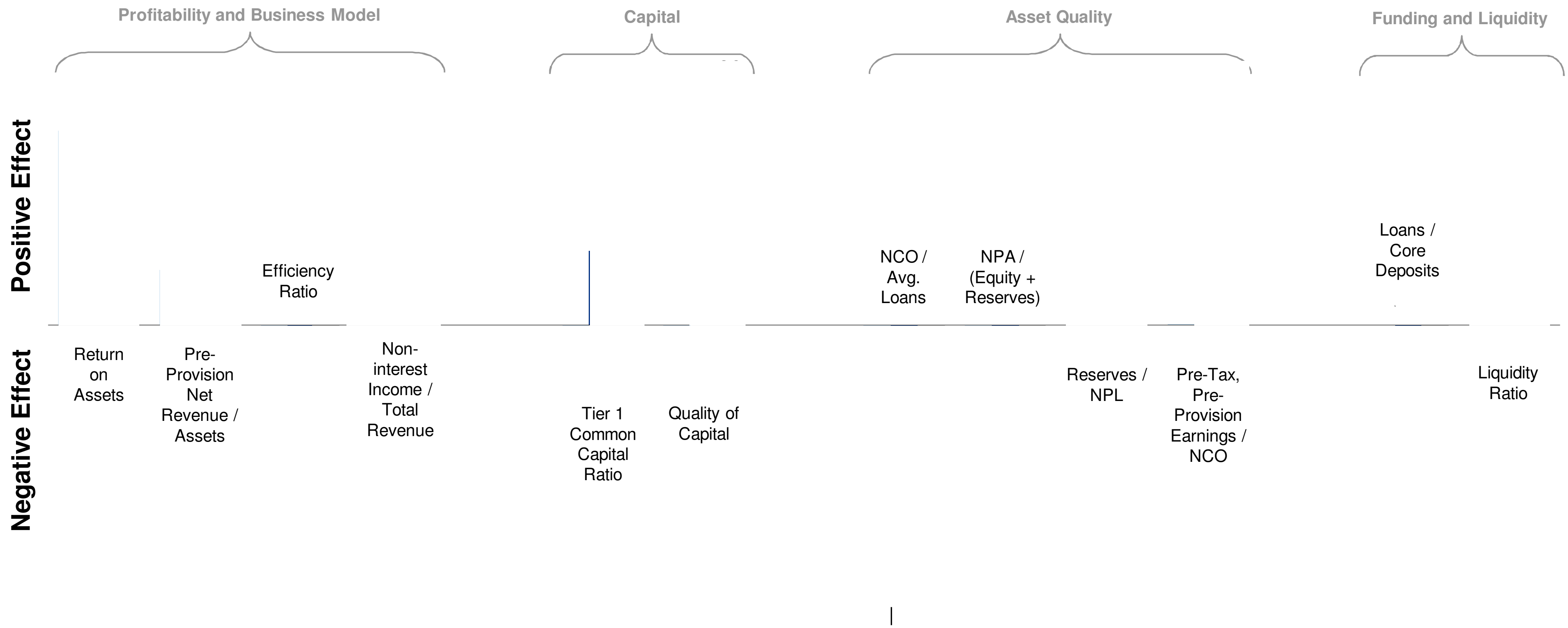
Multiple Regression Model R-Squared by Quarter



Source: Citi Financial Strategy Group analysis.

Interpreting the Market Drivers

Univariate R-Squared – P / TBV on Explanatory Variables

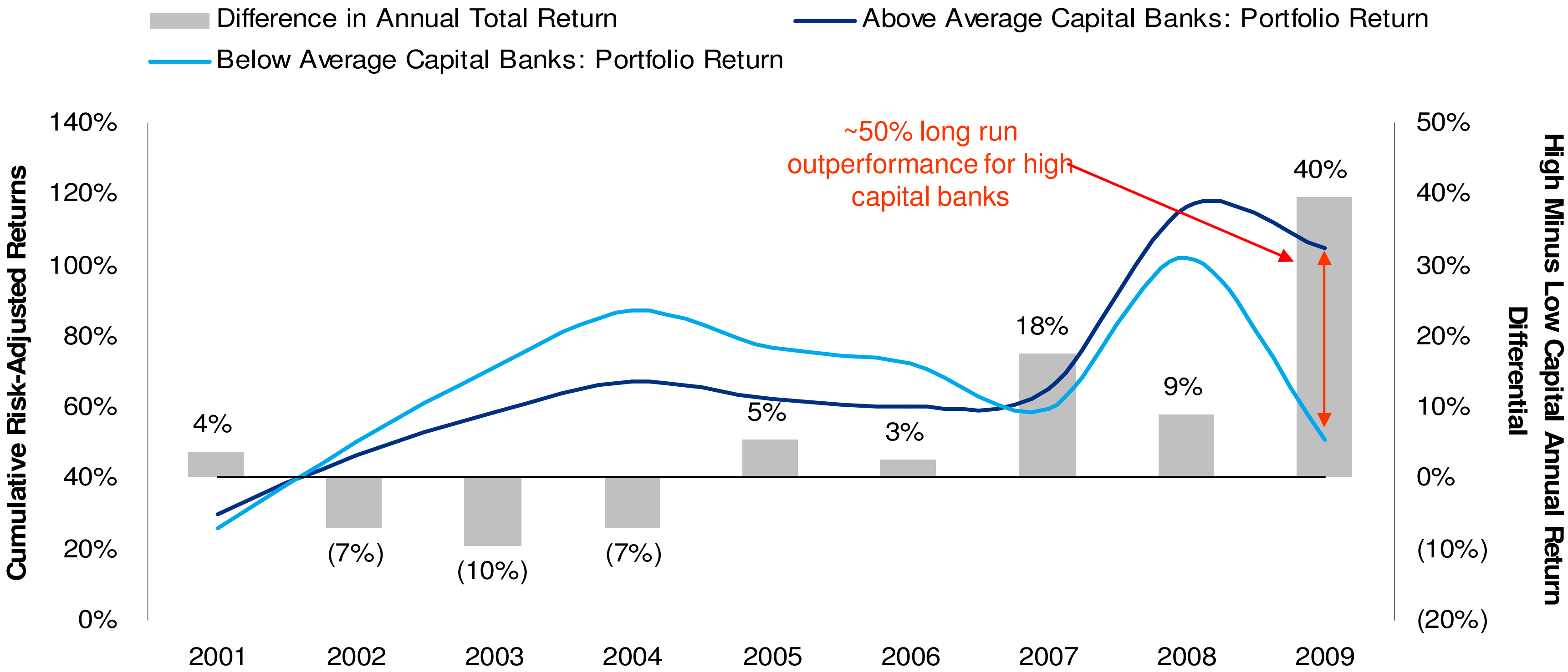


- During the crisis, bank valuations placed a premium on asset quality and capital adequacy and away from leveraged growth
- Other concerns such as funding, liquidity, and business mix are now emerging

Source: Citi Financial Strategy Group analysis.

Significant Value Destruction from Holding Inadequate Capital

The market rewarded those with countercyclical capital management policies



 Source: Citi Financial Strategy Group analysis.

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Non-Equity Capital: Key Issues for Asia-Pacific Banks

Our discussions with banks across the region have highlighted many points of clarification for structuring and issuing Tier 1 and Tier 2 capital moving forwards.

General concerns	
Treatment of SIFIs	• Will additional buffers need to be in core equity or can it be in Tier 1 hybrids? • What are the level of additional buffers?
Countercyclical buffer	• Less concerned due to unlikely application in the medium-term
Portfolio approach to amortisation of capital instruments	• Confirmation of portfolio treatment will greatly impact how banks manage Tier 1 / Tier 2 capital instruments
What is an internationally active bank?	• Critical particularly in emerging markets – is there a level playing field?
"Write-Off" vs write-down	• Size of write-off – is it temporary or permanent?
Temporary vs Permanent Write-Down	• For strong banks, worth at least 25-50bps for Tier 1 • For weaker banks, worth 50-100bps for Tier 1
Conversion vs Write-down	• OSFI (Canadian regulator) has required Tier 2 to be a conversion into ordinary shares
Conversion mechanics	• Where is the conversion floor price set? Credit Suisse suggests 50% of today's share price (Lloyds was 100%)
Legal framework (conversion)	• Is share issue approval required at issue or also at conversion? • Changes to constitution and issued share capital?

Tier 1 Capital: Key Issues for Asia-Pacific Banks

Key issues for Tier 1 "Hybrid" capital are tax deductibility and notching from rating agencies.

Tier 1 Additional Going Concern	
Earlier trigger than non-viability	• Will this occur? Some clarity better than none? • Market / pricing need for separation to differentiate Tier 1 and 2
SPV usage and tax deductibility	• Will there be some leeway? Is that the intention to allow deductibility? Stapled structures? • Change in tax laws?
Accounting	• What about perpetual bonds that are accounted for as equity? Will these need conversion / write-down? • Will vanilla preference shares need conversion / write-down?
Preference Shares	• Some jurisdictions (e.g. China) are restricted from this form of funding
Cost	• Rabobank set very high precedent • Buyer and investor universe?
Rating agency treatment	• Moody's has substantially increased notching for Tier 1 • S&P has proposed substantially increased notching (and revised country outlooks) • Fitch also has significantly reduced equity treatment of bank capital • Ability to rate the product will be critical – only Fitch and potentially S&P can rate conversion / write-down thus far

Tier 2 Capital: Key Issues for Asia-Pacific Banks

Tier 2 issuance is likely to be a key focus for banks across the region for the next 6-12 months whilst Tier 1 uncertainty remains and to take advantage of the issuance window for "old-style" Tier 2.

Tier 2 Gone Concern	
Definition of non-viability	• Are there local laws applicable • Is this the minimum AND maximum standard
Write-off vs Conversion	• Which one? What is the mechanics
Tax deductibility	• Conversion / write-down may impact tax deductibility in many jurisdictions • Critical to address this issue for banks • Swiss suggesting change in tax laws
Cost	• Undertaking lots of cost analysis of old-style vs new-style • Likely that 50bps+ difference from old to new • Seems to make sense to continue
Liability Management	• Exchange offers and buybacks
Products	• Allowance to vary terms / substitute / exchange • Exchangeable products (into senior or Basel III complying)
Rate and Redemption Structure	• Preference for fixed to fixed, with discrete call dates • Callable structures strongly preferred if price of option is minimal
Rating agencies	• Currently notched off issuer rating, but will this change to fall more in line with Tier 1?
Contingent capital	
Who will it apply to?	• Unknown
What are the product features?	• Unknown
Ratings	• Only Fitch thus far can rate the instruments (e.g. Credit Suisse)
Index inclusion	• Potentially not included so that investors are not forced to acquire

Products and Markets

There are two key market concerns for bank issuers in the medium term: 1) Oversupply of capital products and 2) buyer universe and impact on cost.

Key themes

- Focus on private bank markets (especially Asian markets) – most likely to fund based more on credit than product
- Very heavy pipeline into Asian markets with European banks testing demand
- Cocos most likely with hedge funds, sovereign funds and employee plans (Credit Suisse US$6bn+ issue) to Qatar Holding and Olayan
- Institutions slow to change mandates though some have started (e.g. PIMCO)

Supply Concerns

- US$30 billion + equivalent in Swiss Cocos from UBS and Credit Suisse
- Top 35 US banks needing US$100-150 billion in equity capital
- Equity research suggest Coco requirement in European market is over €500-700bn
- ~US$300 billion (equivalent) of old-style European hybrid Tier 1 to replace by ~2015-2016

Products

- Write-down structure preferred (temporary better than permanent) – most likely for fixed income institutions
- Rating agencies inability to rate products will have significant impact
- Tier 2 product essentially not much different from Tier 1 products – in near default, investors are in similar situation unless there are different trigger points

Tier 1		Tier 2		Cocos	
Write-Down	**Conversion**	**Write-Down**	**Conversion**	**Write-Down**	**Conversion**
• Most broadly marketable • Similar to some existing European Tier 1 • Most likely institutional product • Preference for temporary write-down	• Private bank focused, though institutions will increasingly shift towards being able to buy • Ability to monetise shares is critical – resale facility?	• Many variations being explored • Callable structures preferred • Preference for temporary write-down	• Private bank focused, though institutions will increasingly shift towards being able to buy • Ability to monetise shares is critical – resale facility?	• Private bank and some institutional investors • Sovereign wealth funds, employee plans, hedge funds	• Sovereign wealth funds, employee plans, hedge funds • Private bank • Limited fixed income institutional interest

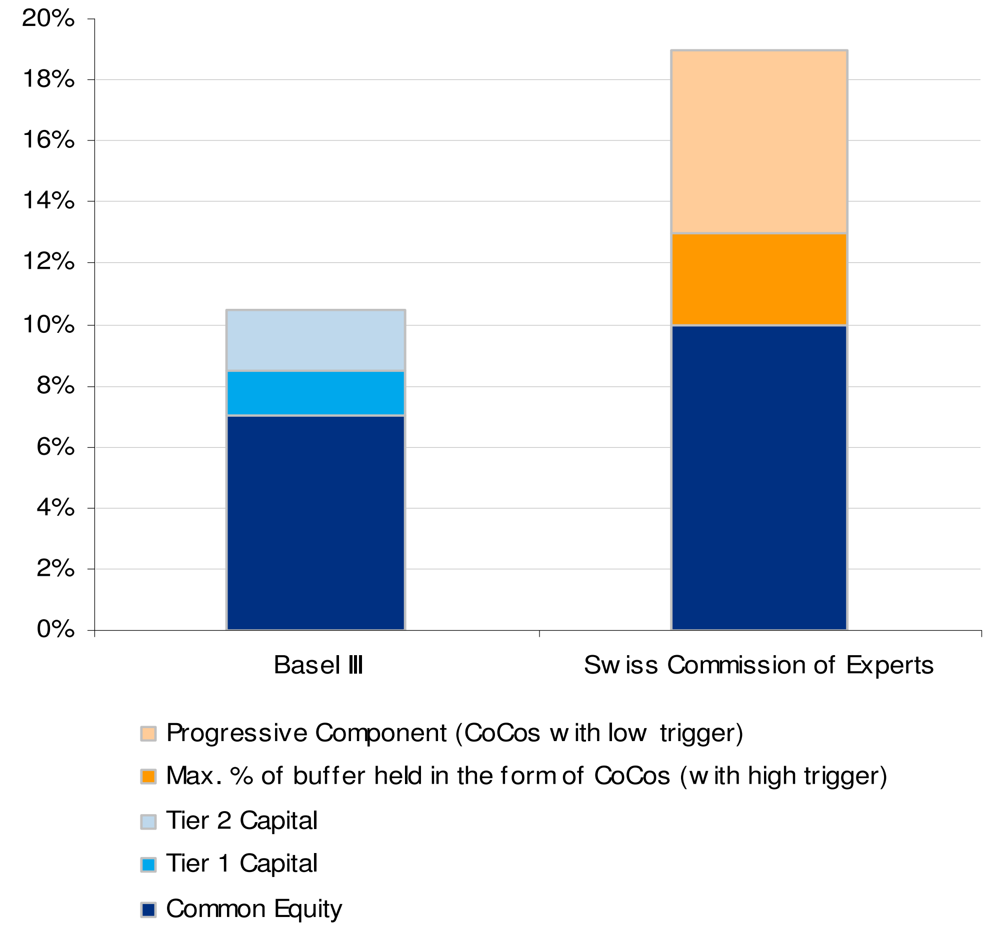
Dual Triggers: Cocos

On 4 October 2010, the Swiss Commission of Experts published proposals under which systemically important banks are subject to supplementary capital requirements, which may include significant amounts of contingent capital.

Overview of new proposals compared to Basel III*

	Basel III	Swiss Commission of Experts
Timing	Valid from 2013, with transition through 2018	
I. Minimum requirements	• 8% total capital, of which – 6% Tier 1, of which ▪ 4.5% Common Equity	• Same • *Note: total capital and Tier 1 requirements may be met with CoCos in component II and III*
II. Buffer	• 2.5% Common Equity	• 8.5%, of which – Min. 5.5% Common Equity – Max. 3% CoCos (trigger at 7% of Common Equity)
III. Progressive Component	• Surcharge for systemically important banks (TBD)	• 6% of CoCos (trigger at 5% of Common Equity)
Total	• 10.5% total capital, of which – 7% Common Equity	• 19% of total capital of which – min. 10% Common Equity

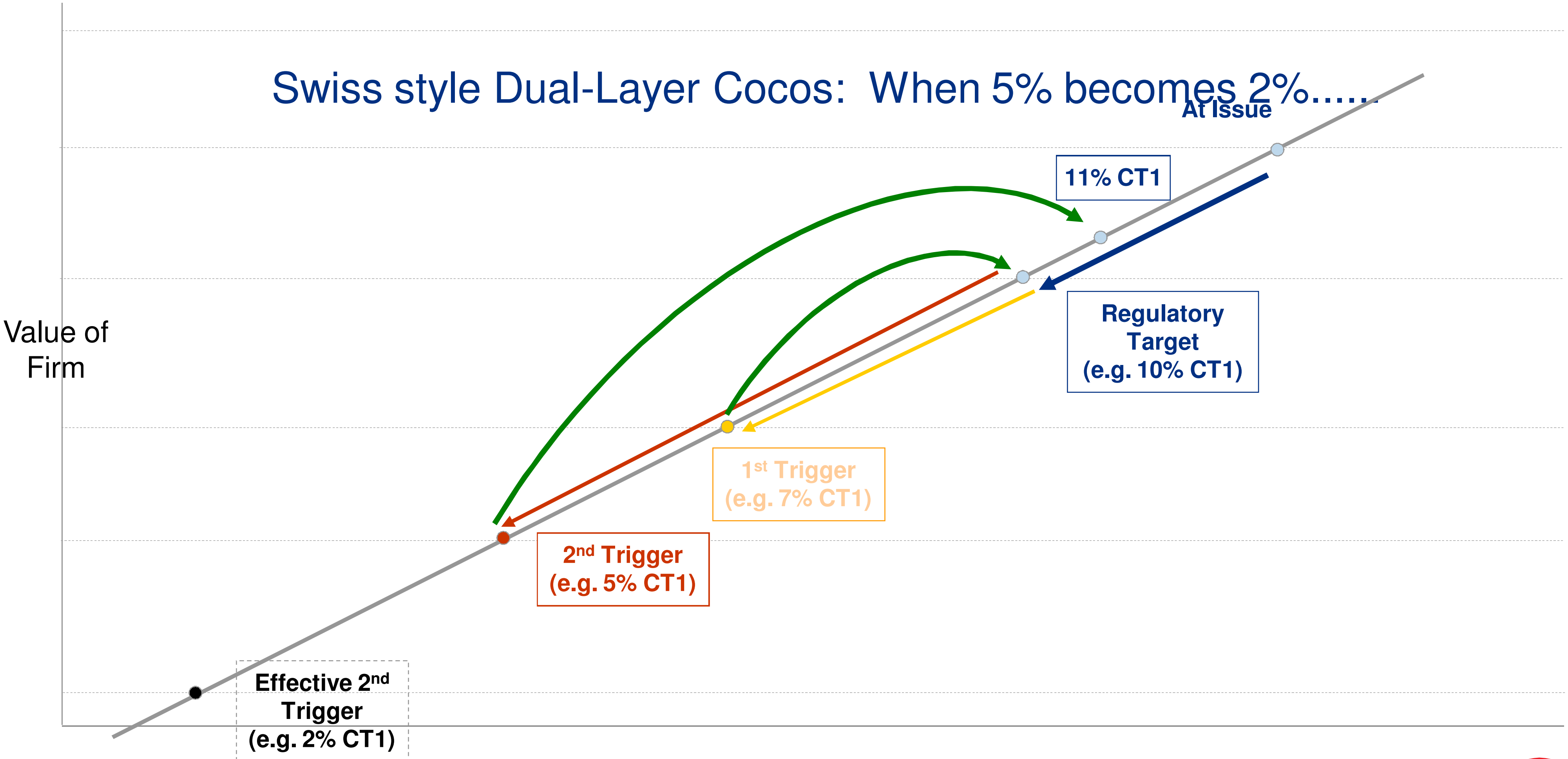
Overview of Capital Requirements*



Source: Final report of the Commission of Experts for limiting the economic risks posed by large companies

Dual Layer Theory – Separating Tier 1 and Tier 2

- A key concern for Tier 1 and Tier 2 capital is that in distress, they would potentially
- It is therefore also important from a markets standpoint to have a separate and higher trigger point for Tier 1 – differentiation is important
- This means the non-viability for Tier 2 becomes a far more remote trigger point and will allow more differentiated pricing



Minimum Tier 1 And Total Capital Requirements under Basel III

Having established Tier 1 and Total Capital ratio, the recent announcements indicate a continuing commitment to non-equity capital instruments (or at least a realization that the equity markets alone will not be able to meet global banks' capital needs). The key unanswered question is these instruments' design.

Total Capital Ratio Breakdown (1)

Hybrid Tier 1 Shortfall

Minimum T1 ratio (6.0%) – US$0 bn

+ Conservation buffer (8.5%) – US$9.4 bn

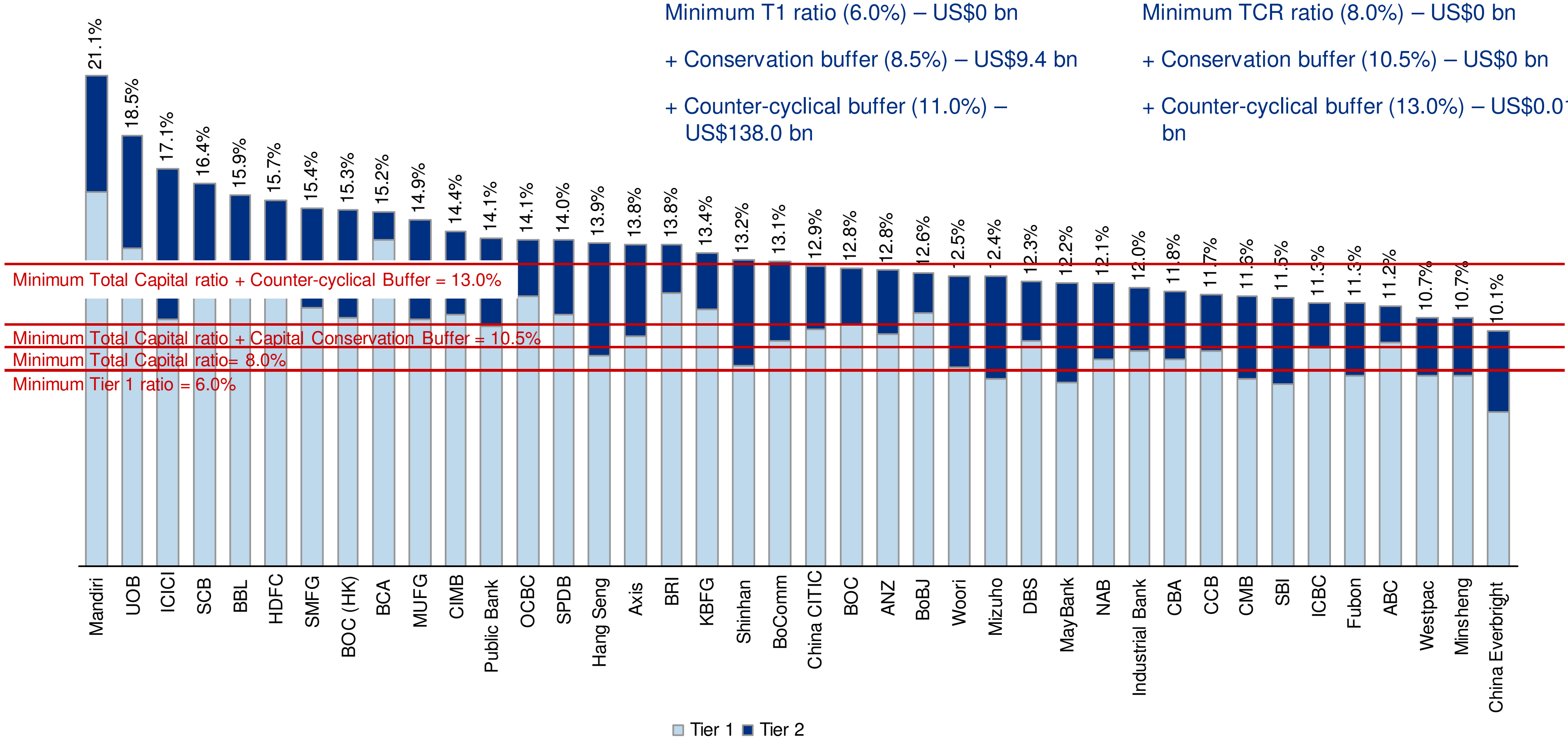
+ Counter-cyclical buffer (11.0%) – US$138.0 bn

Tier 2 Shortfall

Minimum TCR ratio (8.0%) – US$0 bn

+ Conservation buffer (10.5%) – US$0 bn

+ Counter-cyclical buffer (13.0%) – US$0.01 bn



Source: Company filings, Citi estimates, based on financials as of June 30, 2010, adjusted for recently announced capital raisings.
(1) Includes top 40 APAC banks by market cap as of September 14, 2010.

Selected Bank Capital Deals

Issuer	Lloyds TSB Group	Rabobank	Credit Suisse	Rabobank
Market Conditions	• Exchange Offer (Nov 2009)	• New Issue (March 2010)	• New Issue and Exchange (Feb 2011)	• New Issue (January 2011)
Issue Size	• £8.4 bn (equiv.)	• € 1.25 bn	• US$3.5bn + CHF2.5bn to Qatar Holding and Olayan Group • Reg S tranche TBD	• $2 bn
Issue Rating	• Guaranteed by Lloyds TSB Bank: (Ba2/BB/BB) • Guaranteed by Lloyds Banking Group (Ba3/BB-/BB)	• Unrated	• BBB+ (Fitch)	• A (Fitch)
Description	• Lower Tier 2 contingent convertible (Enhanced Capital Notes)	• 10 year senior contingent permanent write-down	• Tier 1 for the Qatar tranche • 30 yr NC 5.5 subordinated debt for Reg S	• Perpetual Tier 1 capital securities
Maturity	• Ranging from 2019 to 2032 depending on series	• 19 March 2020	• 2041	• Perpetual
Coupon	• The rate of interest of each series will be set at a fixed premium of between 1.5%-2.5% above the respective distribution rate Non-deferrable	• 6.875% (Euribor + 343bps)	• 9.50% for USD, 9.0% for CHF until call date • Fixed rate reset every 5 years	• 8.375% fixed for first 5 years, reset every 5yrs • Optional non-cumulative • Mandatory non-cumulative upon breach of ratios including 8% Equity Capital Ratio • Dividend stopper until next Interest is paid in full or redemption
Redemption	• Tax event or capital disqualification event	• N/A	• Call at year 5.5 • Also calls at Tax Event and Capital Event • Right to substitute and vary terms	• Call at year 5.5 • Tax or capital disqualification (other than Basel III event) call at prevailing Face Value • Can substitute or vary terms to meet Basel III criteria (but no redemption)
Conversion / Exchange Trigger	• Core Tier 1 < 5%	• Equity capital ratio[1] < 7%	• Core Tier 1<7% (quarterly test) unless not required by regulator • Also upon non-viability	• Equity Capital Ratio < 8% in the most recent accounts, or likely to fall below 8% in the near term (issuer or regulatory discretion)
Conversion Price / Write down Redemption Price	• Conversion into fixed number of ordinary shares i.e price of £0.592093	• Upon trigger, immediate repayment of Write Down Redemption Price required equal to 25% of the original principal amount plus accrued interest	• Variable number of common shares, but with conversion floor (maximum number of shares) set at 50% of current share price • Sale facility for conversion is set-up	• Coupons are automatically cancelled • Face Value is written down based on formula – pro-rata write-down with all capital securities based on amount required to improve to 8% or the amount of losses • Once written-down, cannot write-back. More than one write-down can occur
Basel III Expected Treatment	• Pre Conversion: Lower Tier 2 / Upper Tier 2 • Post Conversion: Core Tier 1	• Pre Write-Down : None • Post Write-Down : Core Tier 1 for 75% permanent write-down of principal)	• Pre-Conversion: Tier 2 (Basel), "Buffer Capital" under FINMA • Post-Conversion: Core Tier 1	• Tier 1 • Ability to substitute or vary terms to meet Basel III criteria
Ranking	• *Pari passu* with Lower Tier 2	• Senior Unsecured – ranking senior to all subordinated capital	• Subordinated, senior to undated Tier 1 and 2	• Junior subordinated debt, pari passu with other capital securities
Conversion period	• Until maturity	• Until maturity	• Until maturity	• Until maturity

[1] Defined as membership certificates divided by RWA and retained earnings

Recent Asian FIG Capital Deals

There have now been 5 deals globally that are Tier 2 with an exchange option to senior at a "stepped-down" coupon. These have all been 10 year bullet structures.

Date	Issuer	Volume	Product	Issue Rating	Pricing	Comment
Jan 2011	Rabobank	US$2bn	Perp NC 5	NR/NR/A	8.375%	• Perp Tier 1 instrument, non-cumulative, no step-up, permanent principal write-down upon breach of 8% equity capital ratio (pari passu with other capital)
Jan 2011	Prudential plc	US$550m	Perp NC 5.5	Baa1 / A- / BBB+	7.75%	• Perp Tier 1 instrument, cumulative (ACSM), no step-up, exchangeable into Non-Cumualtive Preference Shares
Nov 2010	Macquarie Bank	US$400mm	Perp NC 5	Baa3/BBB/BBB	8.375%	• Perp Tier 1 instrument, non-cum, no step-up, exchangeable into Non-Cumulative Preference Shares
Nov 2010	Fubon Bank	US$200mm	10 year bullet – step-down notes	NR/BBB/NR	6.125% (334bps over UST)	• Issuer option to exchange into senior with 50bps coupon step-down after Jan 2013 if lose regulatory treatment
Nov 2010	ICBC	US$500mm	10 year bullet	A3/NR/BBB+	5.125%	• No regulatory call
Nov 2010	ICICI Bank	US$150mm	10 year bullet – step-down notes	Baa3/NR/NR	7.00%	• Issuer option to exchange into senior with 50bps coupon step-down after Jan 2013 if lose regulatory treatment
Nov 2010	OCBC	US$500mm	12 NC 7	Aa2/A	3.75% (275bps over UST)	• Callable at par at year 7
Oct 2010	SMBC	€750mm	10 year bullet	Aa3/A	4.00% (130bps over m/s)	• Citi joint bookrunner
Oct 2010	Chong Hing Bank	US$225mm	10 year bullet – step-down notes	Baa3/NR/BBB	6.00% (338bps over UST)	• Issuer option to exchange into senior with 50bps coupon step-down after Jan 2013 if lose regulatory treatment • PBs 21%, funds 51%; HK 56%, Asia 38%
Oct-Nov 2010	DBS	SGD1.7bn and SGD800mm	Perp NC 10 pref	A3/A/A	4.70%	• Perpetual non-cumulative preference shares
Sept 2010	HSBC	US$750mm	10 year bullet	A2/A+	5.00%	• One time regulatory call in Sept 2015 at 101% • Interest can be deferred until maturity (cumulative) or when ordinary dividends are paid and principal can be deferred for up to 6 months after maturity
Sept 2010	Macquarie	€600mm	10 year bullet	A1 / A / NR	340bps over m/s	• Final book €1.6bn, 180 accounts • Received Tier 2 approval prior to Sept 12 Basel release
Aug 2010	HSBC Bank USA	US$1.25 bn	10 year bullet	A1/AA-/AA-	4.875% (225bps over UST)	• NA
July 2010	Bank of East Asia	US$600mm	10 year bullet	A3/BBB+	6.125% (320bps over UST)	• Regulatory call at par

Agenda

Pre-Crisis to Post-Crisis

Digesting the New Capital Framework

Much Cleared / Many Question Remain

Business Model and Valuation

The New Securities & The Capital Markets

Conclusions

Strategic Considerations and Concluding Remarks

(1) CAPITAL MANAGEMENT

- Leverage and dividend / buy-back policies need to be re-thought
- 'Missing pieces' prevent capital optimisation at this point in time
- Rate of capital formation matters now more than ever
- A more integrated approach to Capital / ALM / Funding may arise over time

(2) REGULATORY IMPACTS ON STRATEGY

- Banks are redefining what are "core" businesses
- Most strategic options will in future require more capital
- Risk aversion reflected in composition of assets
- Retained funding capital

(3) CAPITAL MARKETS PERSPECTIVE

- Valuation drivers have shifted
- Financial engineering out of favor
- Potential flood of issuers to come to market
- Question-marks over the market for new instruments
- Value proposition of banks not fully brought into focus at present