Loan Hedging Within A Fair Value Option Framework

Program Overview

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Loan Hedging Prior to 2007

Bank of America created the Global Portfolio Strategies (“GPS”) group in January 2004 to implement and manage an active credit portfolio management process. GPS is a public-side unit which, prior to 2007, reported through the Risk Management organization. GPS is not active within the origination and risk management approval process, but augments these functions through the following objectives:

- Improve credit portfolio diversification by reducing obligor, sector, industry, and correlated credit risk concentrations – i.e., reduce concentrated exposures using credit derivatives, etc.
- Actively rebalance the credit portfolio in line with forward looking and market-based views
- Actively monitor and address credit migration, separately from the origination/approval unit
- Facilitate growth opportunities through freeing of loan capacity where exposure is hedgeable
- Improve risk adjusted returns of the credit portfolio

Loan Hedging Prior to 2007

Hedging Decisions

GPS created a model which identified concentrated exposures. Output from the model generally was the starting point and formed the basis for hedge evaluation and execution. In instances where actual GPS hedging deviated from the model, GPS would articulate a fundamental, market, and/or optimization rationale for the variance. This rationale is based on fundamental analysis which includes individual GPS Manager research conducted at the obligor and sector levels.

- Protection was purchased to reduce concentrated exposures to a more acceptable level or protect against a borrower's default.
- Protection was written (i.e., long positions were initiated) to defray CDS protection premium costs and increase portfolio diversification.

Program Issues

- Asymmetric accounting treatment of loan vs hedges.
- Hedging costs incurred at the corporate level rather than the origination level – i.e., origination behavior did not always correspond to the risk underwritten.

The Fair Value "Option"

Background

Current Accounting Options

- Accrual Accounting: Loans booked in the accrual book are hedged with credit derivatives. Loans are not mark-to-market whereas credit derivatives are mark-to-market, resulting in accounting asymmetry.
- Lower Of Cost Or Market (LOCOM) Accounting: Loans are intended to be distributed within twelve months.

Fair Value Option

- FASB has approved an accounting change, Fair Value Option (FASB 159), which allows banks the option to mark certain financial assets and liabilities to market, with changes in fair value recognized in earnings. This allows banks to hold and hedge excess concentrations while eliminating some of the accounting asymmetry.

Fair Value Option (FVO) - Some Highlights

- Option to adopt either on January 1, 2007 or January 1, 2008.
- Adoption of FVO is linked to the adoption of a Fair Value Measurement (FVM) program. FVM requires detailed disclosure of the valuation approach for all market-based instruments on three levels.
  - A one-time election to move existing assets to a MTM valuation is available at adoption of FVO, with any cumulative unrealized gains and losses on existing contracts recorded as an adjustment to retained earnings.
  - Implementation is prospective and will not require financial restatements for prior periods.
  - Irrevocable FVO election must be made at the origination of new assets, with the associated mark impacting current P&L.

Fair Value Option Portfolio

Program Overview

Portfolio Scope / Selection

A formulaic approach for portfolio selection, for both existing and new transactions, is used. Created by private side Risk Management personnel, the formula is not shared with public side associates.

- Day 1 FVO portfolio selection from existing (prior to 12/31/06) client commitments.
- Ongoing FVO portfolio selection from new commitments.
- Limited to borrowers with a liquid CDS or bond market – i.e., public entities or private entities with publicly traded debt.
- Borrowers deemed to have “concentrated exposures” – i.e, in excess of “house guidelines”.
- Facilities limited to entire contracts of Revolvers, Term Loans and Letters of Credit.
- Breadth of borrowers and facilities may increase over time.

Contract definition

Any single lender's assignment of a portion of the loans or loan commitments created under a combined or single credit agreement. For example, separate and distinct revolvers or term loans, each having different credit terms, structure, tenor/maturity, repayment terms, lenders and/or collateral, etc. Any tranche in a single credit agreement would constitute a separate contract. Only entire contracts can be moved into the FVO book, and contracts cannot be bifurcated between FVO and non-FVO treatments.

Fair Value Option

Program Overview

Relationship Management

- The client relationship will continue to be managed by the Client Team / Risk Management.
- Revenue associated with FVO assets flows to the GPS unit and not the Client Team.
- There are no significant changes to Risk Management activities.
- The FVO book exposure is *excluded* from "relationship" exposure aggregation calculations but is *included/aggregated* as a trading risk asset with all other traded asset groups.
- The exposure in the FVO book will be a mandated hold position. Disposal of FVO assets is expected to be limited in the early stages of the program and require prior approval of the Client Team.

Loan Hedging within the FVO Framework

GPS is now integrated within Bank of America's Global Credit Products ("GCP"), the revenue unit specializing in credit, to optimize information flows, execution, and risk management. Loans and associated hedges are managed as a proprietary portfolio, but with a primary goal to manage risk (mark-to-market and jump-to-default) and secondarily, to generate positive returns.

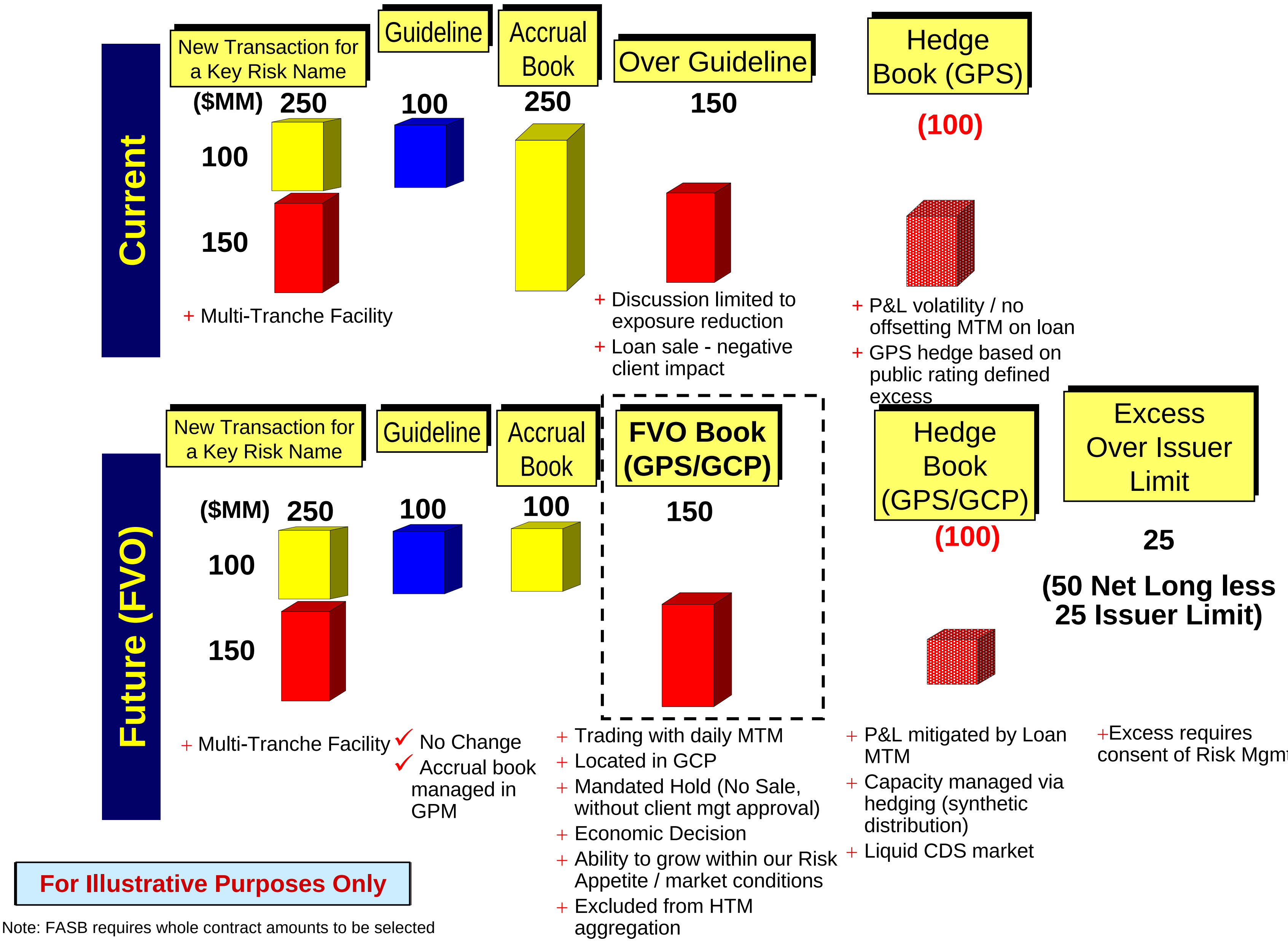
- Loan accruals and fees are credited to GPS/GCP for all FVO assets – i.e., akin to a third party investor – as are all hedging/overhead costs.
- Hedging is designed to mitigate the impacts in negative loan MTM and loss associated with a borrower's default.
- FVO loans are aggregated by family and are subject to the existing Risk Management infrastructure and governance currently supporting the GCP platform.
  - Portfolio VAR limit – a risk adjusted limit at the portfolio level calculated net of all hedges.
  - Single name (issuer) limit – Limits are applied to all FVO loan facilities net of hedges with limit exceptions requiring the appropriate Risk Management approval. Where excesses occur and approval is not granted, GPS must reduce exposure (via hedges) to comply with the appropriate limit. Where excesses are approved, triggers (e.g., issuer CDS prices) are established for each borrower requiring GPS and Risk Management to revisit hedging strategies for the particular borrower.

GPS will continue to manage a smaller, more focused portfolio of hedges for some accrual loans through a transition period.

Critical Characteristics

- Dynamic MTM and “just-in-time” hedging (i.e., to prevent jump-to-default losses and avoid systemic premium costs).
- Credit research based culture.
- Bottoms-up orientation - “not macro”.
- Profit driven – treat CDS as an asset class in addition to a risk mitigation tool.
- Product-informed and sector-oriented, market facing.

Example – High Grade



Note: FASB requires whole contract amounts to be selected

Competitive Advantages / Landscape

Competitive Advantages

- Attract the best talent and culture with market facing expertise.
- Command better coverage from the Street due to larger profile.
- Sharpen performance by emphasizing revenue accountability and active market-based risk coverage.
- Integrate research and other credit product areas to foster better information flow.
- Improve culture, teamwork, information flow, and management by rationalizing geography.
- Increase intensity, innovation and creativity in hedging BAC risk.

Competitive Landscape

2007 implementation of FVO appears limited at this time:

- Bank A (domestic) is deciding not to adopt FVO for the loan portfolio – operational reasons.
- Bank B (domestic) – plans to adopt FVO but for limited number of names (those that are fully hedged) – volatility reasons.
- Bank C (European) – new assets only – operational and MTM reasons.

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Key Benefits

Client Impact

- FVO book will allow us greater flexibility in managing to requested relationship holds.
- FVO allows excess loan exposures to be held to maturity <u>and</u> be marked-to-market.
- Relationship will continue to be managed on the private side, maintaining client coverage stability.

Risk Management

- Loans will be marked-to-market, with the eligible FVO exposure excluded from subsequent relationship exposure aggregation calculations, but would be subject to trading unit issuer and portfolio limits.
- Provides an improved alignment of CDS and underlying loan assets, reducing accounting asymmetry
- Better positions the bank to meet client needs through credit cycles.
- Market continuing to demand aggressive underwriting, with excess exposures more suited for a MTM platform vs. accrual book.

Market Facing Discipline

- Market pricing should drive better economic transparency in origination and hedging decisions, resulting in a more objective assessment of relationship value, risk and reward.
- Day 1 portfolio mark flows through equity.
- Marks associated with new originations post 1/1/07 will flow through P&L.