

October 22, 2012

Board of Governors of the Federal Reserve System  
20<sup>th</sup> Street and Constitution Avenue, NW  
Washington, DC 20551

Office of the Comptroller of the Currency  
250 E Street, SW  
Washington, DC 20219

Federal Deposit Insurance Corporation  
550 17<sup>th</sup> Street, NW  
Washington, DC 20429

Re: Response to NPR on “Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Minimum Regulatory Capital Ratios, Capital Adequacy, Transition Provisions, and Prompt Corrective Action”

FRB Docket No. R-1442, RIN 7100-AD87  
OCC Docket ID: OCC-2012-0008  
FDIC RIN 3064-AD95

To Whom It May Concern,

Flaherty & Crumrine Incorporated respectfully offers the following responses to Questions 18 and 19 of the above Notice of Proposed Rulemaking (NPR). Flaherty & Crumrine is an independent investment advisory firm, established in 1983, specializing in the management of preferred, hybrid and capital securities. We manage approximately \$4.9 billion for closed- and open-end investment companies, endowments, corporations, and trusts. We thank the Board of Governors of the Federal Reserve, the Office of the Comptroller of the Currency and the Federal Deposit Insurance Corporation for the opportunity to comment on the NPR.

*Excerpt of Relevant Proposal:*

Additional criterion regarding certain institutional investors’ minimum dividend payment requirements

Some banking organizations may want or need to limit their capital distributions during a particular payout period, but may opt to pay a penny dividend instead of fully cancelling dividends to common shareholders because certain institutional investors only hold *stocks that do not pay a dividend*. [Emphasis added. Presumably this should read “stocks that pay a dividend.”] The agencies believe that the payment of a penny dividend on common stock should not preclude a banking organization from canceling (or making marginal) dividend payments on additional tier 1 capital instruments. The agencies are therefore considering a revision to criterion (7) of additional tier 1 capital instruments that would require a banking organization to have the ability to cancel or substantially reduce dividend payments on additional tier 1 capital instruments during a period of time when the banking organization is paying a penny dividend to its common shareholders.

**Flaherty & Crumrine Incorporated**

301 E. Colorado Blvd., Suite 720  
Pasadena, California 91101  
(626) 795-7300

47 Maple Street, Suite 403  
Summit, New Jersey 07901  
(908) 918-0300  
www.flaherty-crumrine.com

The agencies believe that such a requirement could substantially increase the loss-absorption capacity of additional tier 1 capital instruments. To maintain the hierarchy of the capital structure under these circumstances, banking organizations would have the ability to pay the holders of additional tier 1 capital instruments the equivalent of what they pay out to common shareholders.

---

**Question 18:** What is the potential impact of such a requirement on the traditional hierarchy of capital instruments and on the market dynamics and cost of issuing additional tier 1 capital instruments?

*Response to Question 18:*

As a starting point, we believe that the long-standing and well-understood principles of priority of payments and claims with respect to preferred and common equity capital should be changed only for good reasons, supported by compelling evidence that the proposed change enhances the safety and soundness of banks and the financial system. We have not seen such evidence. We also reject the idea that paying a dividend to preferred shareholders that is equal to any common dividend payment eliminates any problem with the proposal. Payments to preferred shareholders are senior in their entirety compared to payments to common shareholders; they are not *pari passu*.

We ask two questions. Would the proposal assist a financial company in rebuilding Tier 1 capital in a crisis? And would it make a crisis less likely in the first place?

We do not believe the proposal would meaningfully assist a financial company in rebuilding Tier 1 capital in a crisis. First and most obviously, dividend payments to common shareholders reduce Tier 1 capital. Although the dollars may be relatively small in the case of a one cent per share common dividend, allowing those payments when a bank needs Tier 1 capital can be justified only if they help the bank raise other forms of Tier 1 capital. Eliminating or nearly eliminating noncumulative preferred dividends would make it impossible for the bank to raise Tier 1 preferred capital. This means the bank would need to raise common equity capital.

We do not believe the proposal would allow the bank to raise common equity capital more readily. Allowing the bank to pay a penny dividend to common might improve the stock price, but the impact would likely be very small as the minimal dividend payment would be viewed by investors as temporary. That is, if the bank recovered, markets would expect substantially higher dividends in the future, and almost all of the value placed on the shares would come from those higher future dividends. If the bank did not recover, payment of a few quarters' dividends at the rate of one cent would add trivially to the value of the common stock. Investors simply would not put much value on the penny dividend.

More importantly, even if the payment of a penny dividend were to boost the common share price, this would not eliminate (in fact, it would modestly increase) the need for Tier 1 capital at a troubled bank. The bank would still need to sell common shares, either outright or via exchanges, and common shareholders would still suffer dilution as those shares were issued. The main benefit of the slightly higher stock price is that common shareholders would suffer less dilution than if the stock price were lower. In effect, preferred investors would be forced to surrender some seniority to allow common shareholders to reduce their dilution, despite the fact that common shareholders own the company and hire its management.

Preferred investors accept the risk that dividends can be eliminated. Maintaining current standards that prevent payments to common shareholders when preferred dividends are being deferred or eliminated would still permit a troubled bank to bolster its common equity capital through common share offerings or liability management exercises involving preferred securities. Maintaining current standards would only prevent management from appeasing a subset of common shareholders who say they value a common dividend. We do not believe preferred shareholders should bear the burden of this, and we do not think regulators should put the interests of preferred shareholders behind those of common shareholders.

Turning to the second question, we do not believe the proposal would make a crisis less likely in the first place. In fact, it probably runs in the other direction. By allowing a bank to pay a penny common dividend while largely eliminating preferred dividends, regulators would make it a little less painful for management to eliminate preferred dividends. Regulators should want current shareholders to suffer substantial dilution if a bank gets in trouble. Doing so promotes better management throughout the business cycle, which should help avoid a crisis in the first place. Regulators have pushed for more common equity capital and more compensation in the form of deferred equity to help drive better risk and capital management at banks. We think this proposal runs counter to those objectives.

Finally, the proposal would disrupt the entire existing bank preferred securities market, as all issues have contractual terms that prevent payment of common dividends if preferred dividends are deferred or reduced. The proposal would be inconsistent with otherwise-qualifying Tier 1 and Tier 2 preferred issues that are currently in the market. Nearly all of them would need to be refinanced, which would be disruptive to both issuers and investors.

If regulators incorporate the proposal into final regulations, then investors in additional Tier 1 capital securities will charge more for the reductions in seniority and management discipline that would result from the proposal. The incremental cost to an issuer would depend upon its overall credit standing, with very strong banks with relatively high common dividends paying only marginally higher rates on preferred instruments and shaky banks (especially those with high share counts and/or low dividends) paying much more.

We respectfully recommend that regulators drop the proposal to allow banks to pay a penny dividend on common stock while substantially eliminating dividends on alternative Tier 1 instruments. It upsets long-standing seniority arrangements, would result in measurably lower Tier 1 capital with uncertain (but likely small) impact on a bank's ability to raise additional Tier 1 capital, would reduce discipline on bank management that is a fundamental objective of regulatory reform, and would disrupt the market for existing preferred securities.

**Question 19:** What mechanisms could be used to ensure, contractually, that such a requirement would not result in an additional Tier 1 capital instrument being effectively more loss absorbent than common stock?

*Response to Question 19:*

Current contractual mechanisms and bankruptcy/receivership law already ensure that common stock is more loss absorbing than preferred stock and other additional Tier 1 capital instruments. If the proposal is not included in the final regulations, no changes would be needed to current or future preferred securities' documents.

Despite our recommendation to the contrary, if regulators decide to allow the payment of common dividends while preferred dividends are reduced, then preferred shareholders should gain some additional contractual rights.

First, in addition to making equivalent current payments to preferred shareholders as suggested in the NPR, the amount of dividends paid to common shareholders when preferred dividends are reduced should be added to the liquidation preference of preferred shares on a pro-rata basis, up to the amount by which preferred dividends were reduced.<sup>1</sup> The additional liquidation preference amounts would be repaid (reducing liquidation preference back to its prior par value) after full preferred dividends have been restored over a period not longer than the number of quarters over which preferred dividend payments were reduced. This would allow preferred shareholders to regain their priority in bankruptcy or liquidation over amounts paid to common shareholders during periods when preferred dividends were reduced. In addition, it would allow preferred shareholders to recover payments made to common shareholders during the period of preferred dividend reduction while imposing no interim burden on a bank that manages to rehabilitate itself. This would (i) reestablish the priority of payments (preferred before common) on payments made to common shareholders that should have been made to preferred shareholders and (ii) still allow the bank to accumulate Tier 1 capital during the period of reduced dividends.

Second, although it is not specific to this proposal, regulators should make it clear in any resolution authority that preferred securities will be converted to equity at a rate that closely mirrors what would happen in bankruptcy, with substantial dilution to common shareholders. In other words, preferred securities should not be written down while leaving common shareholders' interests intact. Each layer of a bank's capital structure should absorb losses according to its seniority under the resolution framework. Since regulators do not and cannot know recovery amounts at the time of resolution, any write-down of a preferred capital instrument should come with recovery rights (up the amount of liquidation preference or par value) that should be paid prior to recoveries by common equity shareholders. The same mechanism should apply for senior debt holders, should their claims be impaired or potentially impaired at the point of regulatory intervention.

We have commented previously on this concept to the Basel Committee on Banking Supervision and include that comment as an Addendum here.<sup>2</sup>

Thank you for the opportunity to express our views on Questions 18 and 19 of the NPR. Should you wish to discuss any of these points in greater detail, please contact Bradford Stone by telephone at (908) 918-0300 or via email at [stone@pfdincome.com](mailto:stone@pfdincome.com).

Respectfully Submitted,

Flaherty & Crumrine Incorporated  
October 20, 2012

*Addendum*

---

<sup>1</sup> For example, if a bank paid \$1 million in common dividends during a period when preferred dividends were reduced by \$1 million or more, and the bank had \$100 million (liquidation preference) in preferred securities that were affected, then the liquidation preference would increase by \$1 million to \$101 million.

<sup>2</sup> The comment is also available on the BIS website at <http://www.bis.org/publ/bcbs174/fac.pdf>

**Comment on “Proposal to ensure the loss absorbency of regulatory capital at the point of non-viability,” Basel Committee on Banking Supervision, August 2010**

We are writing to offer our comments on the Committee’s “Proposal to ensure the loss absorbency of regulatory capital at the point of non-viability,” dated August 2010.

Flaherty & Crumrine Incorporated specializes in the management of preferred and related securities. We have focused on preferred securities portfolios for institutional clients and investment funds since our inception in 1983, and currently manage over US\$4 billion for four public U.S. closed-end funds, one Canadian closed-end fund and multiple other institutional accounts.

We understand the Committee’s desire to force capital providers to bear losses on their securities prior to public sector assistance of a troubled systemically important bank. We also agree that a well understood, legally sound, and internationally consistent resolution regime for systemically important international banks is the better way to force loss absorbency across a bank’s capital structure than the August proposal. In particular, we are concerned that excluding senior unsecured debt from the loss absorbency process significantly increases the moral hazard with respect to senior unsecured debt. This could lead systemically important international banks to rely more heavily on senior unsecured debt (because the cost is lower than it would be otherwise) and carry smaller amounts of non-common Tier 1 and Tier 2 capital, thereby reducing financial flexibility and increasing systemic risk. Accordingly, we second the Committee’s desire for a resolution framework for all banks and we hope that the Committee makes that effort a priority.

That being said, and in light of the adoption of the Committee’s higher minimum capital standards for all banks, we do not see any pressing need for addition of loss absorption language. Bank preferred and hybrid securities absorbed losses during the recent financial crisis for both gone concerns (in the bankruptcy or receivership process) and going concerns (through dividend deferrals on non-cumulative securities and preferred-to-common exchanges). In the United States, Dodd-Frank financial reform legislation gives bank regulators substantial new powers to resolve failing institutions and impose losses on all (or even selected) capital providers. Adding specific loss absorbency language to bank capital securities in the U.S. might conflict with the requirements of Dodd-Frank and actually *reduce* regulatory discretion.

Nonetheless, the Committee may decide that there are some jurisdictions where the addition of a loss absorption mechanism for non-common Tier 1 and Tier 2 securities is appropriate. Although we do not know whether the market would be receptive to either of the two loss absorption mechanisms contemplated by the Committee, we offer the balance of our comments to express our view on the relative merits of each mechanism.

The part of the proposal that most concerns us as investors in hybrid capital instruments is the requirement to write-off non-common Tier 1 and Tier 2 instruments upon a defined trigger event. The proposal states that either a full write-off of the instruments or their conversion into common equity (prior to any public capital injection) would be acceptable forms of loss absorbency. We agree that both mechanisms perform the same function from the regulator’s perspective, and we recognize that the Committee is not mandating a particular mechanism. However, they are very different from an investor’s perspective.

**Flaherty & Crumrine Incorporated**

301 E. Colorado Blvd., Suite 720  
Pasadena, California 91101  
(626) 795-7300

47 Maple Street, Suite 403  
Summit, New Jersey 07901  
(908) 918-0300  
[www.flaherty-crumrine.com](http://www.flaherty-crumrine.com)

As an investor in hybrid securities, we believe we can tolerate a well-designed conversion mechanism, but a write-off mechanism likely would prevent us from investing in such issues. We think the **write-off approach** – whereby hybrid instruments would be written down to zero without compensation upon the trigger event – is neither appropriate nor prudent.

- A write-off mechanism would assign losses to preferred security investors ahead of common stock investors. This is contrary to the long-understood concept of preferreds as senior equity.
- The write-off approach would result in lower recovery for preferred investors (zero) than likely would be the case in receivership or bankruptcy, where there might be some recovery. Since the proposal is meant to address loss absorbency at the point of non-viability, losses should be absorbed as if the bank had failed. The write-off mechanism violates that in all cases other than when there is a total loss for all capital providers.
- It would expose preferred investors to significant risk of “early exercise<sup>1</sup>” by regulators. For example, if the regulator determined a bank was undercapitalized but still solvent, it might (properly) declare a trigger event to bolster the bank’s capital. In that case, preferred investors would be wiped out while common stock investors would benefit from the extinguishment of the preferred liability and potential recovery in the bank’s prospects. Since regulators would have full discretion to declare such an event – indeed they would have an incentive to act early to avoid a crisis in the first place – preferred investors would be exposed to a significant new risk. Investors would either avoid these issues entirely or need to charge high rates to compensate for that additional risk.
- The existence of the write-off mechanism would create a perverse incentive for banks in a crisis period. If preferred claims might be eliminated by regulatory fiat, a struggling bank might wait for its regulator to trigger the write-off before raising private capital. So rather than moving sooner to raise capital, the bank would have an incentive to wait, increasing the risk that the bank ultimately might fail. We do not think it is prudent to incorporate a regulatory mechanism that might actually promote risky behavior in a crisis, however unlikely that behavior might appear today.
- Rating agencies may refuse to rate securities with a write-off mechanism, given the regulatory discretion necessary in determining a write-off trigger event. Agency ratings remain an important component of the investment guidelines used by investors in preferred and hybrid securities.
- We believe a write-off mechanism would fundamentally change the nature of preferred and hybrid securities. *As investors, we would not buy them if they incorporate a write-off feature.* In fact, many of our underlying clients would prohibit us from buying them. Many other investors would exit the market as well, especially if the rating agencies refused to rate them. Investors that remained in the market would charge substantially higher rates to accept the risk of write-off. The higher cost of capital would encourage banks to carry a smaller capital cushion above regulatory minimums, increasing systemic risk.

---

<sup>1</sup> By early exercise we refer to, “a decision that a write-off, without which the firm would become non-viable, is necessary, as determined by the relevant authority.”

In contrast, we believe a well-designed **conversion mechanism** would be more acceptable to most prospective investors in preferred securities. There are a variety of approaches to setting conversion terms, but we believe they should be structured such that, to the greatest extent possible, the historical priority of claims among various classes of preferred and common equity investors is preserved. The table in the Appendix illustrates how the conversion feature might work.

- Conversion of preferred or hybrid securities should have the following features:
  - The formula for conversion should be established upon issuance, not at the discretion of the regulator or anyone else at the time of the trigger event.
  - The formula should attempt to provide 100% of liquidation preference to Tier 1 and Tier 2 instruments in the form of common stock.
  - If the value of the available common stock is insufficient to satisfy those liquidation preferences in full, common stock should be allocated according to the priority of claims on those instruments.
- A conversion feature would protect preferred investors from the risk of early exercise by regulators (as described above). If a bank was undercapitalized (at least at the core common equity level) but still solvent, and the regulator decided to exercise its right to convert preferred to common, preferred investors would receive common stock worth liquidation preference<sup>2</sup> while common shareholders would see their holdings diluted. Losses brought about by the activities that led to undercapitalization would be borne by the common shareholders, while preferred investors would absorb losses post-conversion. This seems a fair way to allocate losses among capital providers, and it makes much more sense than eliminating preferred ahead of common interests.
- These outcomes are similar to current resolution regimes. In the first scenario where the bank would have failed without regulatory action, preferred investors receive (largely worthless) common stock. In the second scenario where the bank is still solvent but needs more common equity, preferred capital is converted to common equity and prior common shareholders absorb the dilution of their ownership stake due to conversion. This is essentially what happened in preferred-to-common exchanges at a number of banks during the financial crisis. In both scenarios, preferred liabilities are eliminated, paving the way for the bank to raise new public or private capital. Moreover, none of this would prevent banks from pursuing their own capital-raising activities in a stress scenario. In fact, the possibility that regulators could trigger significant dilution of common equity via preferred conversion would incentivize banks to seek additional capital earlier, thus reducing the severity of any crisis.
- Conversion upon the above terms would be similar to the result in bankruptcy and receivership. Since investors in preferred securities already face the risk of bankruptcy or receivership, such a conversion mechanism should not significantly change pricing on preferred instruments. Moreover, the rating agencies should continue to rate bank capital

---

<sup>2</sup> According to the conversion formula; the actual market value of common stock issued to preferred holders might be worth more or less than the liquidation preference value. Of course, there might not be sufficient stock to cover 100% of liquidation preference. In those cases, common stock would be allocated according to the normal priority of claims.

issues that include the conversion feature.<sup>3</sup> That is because bank capital securities already face the prospect of receiving common equity upon bankruptcy or receivership, and the rating agencies rate those securities. Having agency ratings will greatly facilitate banks' ability to raise non-common forms of capital.

- We believe that a conversion mechanism would represent a relatively modest change for preferred investors in terms of potential future payoffs compared to the write-off approach, so many investors should remain in the market. As a result, pricing on preferred issues that included regulatory conversion would not be as unreasonably high as the write-off mechanism, encouraging banks to carry more capital than they would if the cost of preferred capital were higher.

If the Committee determines that loss absorption is necessary in certain jurisdictions, we strongly urge the Committee and national regulators to adopt the conversion approach to loss absorbency for hybrid and preferred capital wherever possible.

Naturally, any decision to change regulatory capital eligibility for existing Tier 1 and Tier 2 securities should allow a reasonable transition period, as virtually all outstanding issues would eventually need to be replaced. We estimate that bank preferred securities represent about 60% of total preferreds outstanding. Banks will need some time to replace them to avoid disrupting the market. We think the Committee's timetable for the phase out of TruPS (10-year phase out beginning 1 January 2013) is a reasonable one.

Finally, we have a comment on **item 6 of the Explanation**, "*The relevant jurisdiction in determining the trigger event is the jurisdiction in which the capital is being given recognition for regulatory purposes.*" We believe this provision is acceptable as long as it is part of the terms and conditions of the note (i.e., as long as it is a disclosed risk factor and provides for the conversion by each regulatory authority). There is a caveat, however. The provision could contribute to contagion across banking systems. For example, suppose the Group parent is in country A and the operating bank subsidiary is in country B; the Group consolidates bank B's capital at the parent level. The banking system in country A comes under strain, prompting regulators to exercise the conversion or write-down trigger on the Group, which in turn would affect the bank in country B. At a minimum, this would be disruptive, and it could put strain on country B's banking system, increasing contagion risk.<sup>4</sup> If this provision is included, regulators should be selective in the use of cross-border triggers and not be required to trigger conversion or write-down across *all* Group entities.

Thank you for the opportunity to express our views on the Committee's proposal. Should you wish to discuss any of these ideas in greater detail, please contact Bradford Stone by telephone at +1 908-918-0300 or via email at [stone@pfdincome.com](mailto:stone@pfdincome.com).

**Flaherty & Crumrine Incorporated**  
September 30, 2010

---

<sup>3</sup> The Committee should solicit comments from the major rating agencies, if it has not already.

<sup>4</sup> If the regulatory trigger resulted in the write-off of preferred instruments, the losses would be totally unrelated to the health of the bank in country B, yet those preferred investors would be wiped out. If the trigger resulted in conversion, preferred investors would receive Group stock worth (approximately) liquidation preference. Since the bank in country B is healthy, this seems appropriate. We think this is another reason why the conversion mechanism is superior to the write-off mechanism.

## Appendix

### Basel III Loss Absorbency Proposal

Sample Recovery Waterfall At Varying Regulatory Trigger Points

Flaherty & Crumrine Inc.

September 29, 2010

	Initial	Scenario 1	Scenario 2	Scenario 3	Scenario 4	Scenario 5
<b>Common Shares Outstanding</b>	1,000,000,000	3,000,000,000	21,000,000,000	21,000,000,000	21,000,000,000	21,000,000,000
Common Share Price	\$ 30.00	\$ 5.00	\$ 0.40	\$ 0.15	\$ 0.10	\$ 0.00
Market Cap	\$30,000,000,000	\$ 15,000,000,000	\$ 8,400,000,000	\$ 3,150,000,000	\$ 2,100,000,000	\$ 0
Loss on Common (as % of orig price)		83.3%	98.7%	99.5%	99.7%	100.0%
<b>Tier 2 Pfd Outstanding</b>	\$ 3,000,000,000	\$ -	\$ -	\$ -	\$ -	\$ -
Common Shares Owned by T2 Pfd	-	600,000,000	7,500,000,000	20,000,000,000	20,000,000,000	20,000,000,000
Value of Common Owned by T2 Pfd	\$ -	\$ 3,000,000,000	\$ 3,000,000,000	\$ 3,000,000,000	\$ 2,000,000,000	\$ 0
Loss on T2 Pfd (as % of orig face)		0.0%	0.0%	0.0%	33.3%	100.0%
<b>Tier 1 Pfd Outstanding</b>	\$ 7,000,000,000	\$ -	\$ -	\$ -	\$ -	\$ -
Common Shares Owned by T1 Pfd	-	1,400,000,000	12,500,000,000	-	-	-
Value of Common Owned by T1 Pfd	\$ -	\$ 7,000,000,000	\$ 5,000,000,000	\$ -	\$ -	\$ -
Loss on T1 Pfd (as % of orig face)		0.0%	28.6%	100.0%	100.0%	100.0%

#### Common Equity Ownership (by Original Holders)

Common Equity	100%	33%	5%	5%	5%	5%
Tier 1 Pfd	0%	47%	60%	0%	0%	0%
Tier 2 Pfd	0%	20%	36%	95%	95%	95%
Total	100%	100%	100%	100%	100%	100%

Maximum Common Equity Dilution	95%	<-- Needed to determine maximum additional share authorization. Should be as close to 100% as possible.
Required Additional Share Authorization	20,000,000,000	

#### Key to Scenarios:

- 1 - Solvent but undercapitalized; sufficient equity value to pay off 100% of liquidation preference to both Tier 1 and Tier 2 capital securities.
- 2 - Solvent but severely undercapitalized; sufficient equity value to pay off 100% of liquidation preference Tier 2 capital securities and partial repayment on Tier 1 capital securities.
- 3 - Solvent but severely undercapitalized; sufficient equity value to pay off 100% of liquidation preference Tier 2 capital securities only.
- 4 - Nearly insolvent; insufficient equity value to pay off 100% of liquidation preference of either Tier 1 or Tier 2 capital securities; Tier 1 takes total loss and Tier 2 takes partial loss.
- 5 - Insolvent; no recovery for Tier 1 or Tier 2 capital providers.