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October 19, 2012

Jennifer J. Johnson
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, N.W.
Washington, D.C. 20551
Docket No. R-1442

Robert E. Feldman
Executive Secretary
Attention: Comments/Legal ESS
Federal Deposit Insurance Corporation
550 17th Street, N.W.
Washington, D.C. 20429
RIN 3064-AD95

Office of the Comptroller of the Currency
250 E Street, S.W., Mail Stop 2-3
Washington, DC 20219
Docket ID OCC-2012-0008

Re: Basel III Regulatory Capital Rules -- REIT Preferreds as Additional Tier-1 or Tier-2 Capital

Madam and Sirs:

Brigade Capital Management, a credit asset management firm based in New York with over $10 billion under management and an active fixed-income and equity investor across multiple industries including banking and financial organizations, appreciates the opportunity to comment on the Basel III Capital Proposals issued by the Federal Reserve Board, Office of the Comptroller of the Currency, and the Federal Deposit Insurance Corporation (the "Agencies") on June 7, 2012.[1] Our comments focus on Question 27 regarding Real Estate Investment Trust Preferred Securities (REIT Preferreds) and also briefly address Question 21 and the applicability of Tier-2 Capital eligibility for REIT Preferreds.

We support providing REIT Preferreds very limited Additional Tier-1 Capital treatment, subject to the limitations on minority interest, under the proposed rules. We believe REIT Preferreds undermine the objective of providing complex banking organizations the ability to absorb losses in periods of stress. While the proposed rules will significantly limit the issuance of REIT Preferred securities, we respectfully suggest that the Agencies take the proposal one step further and give the securities no Additional Tier-1 or Tier-2 Capital treatment since they are not loss

[1] The proposal is titled: Regulatory Capital, Implementation of Basel III, Minimum Regulatory Capital Ratios, Capital Adequacy, Transition Provisions, and Prompt Corrective Action. 77 F.R. 52791, Part II (August 30, 2012)

absorbing capital on a going concern basis nor are we aware that any of the existing bank REIT subsidiaries that issue REIT Preferred Securities would be an "operating entity" as defined by the NPR. Further, as described below, we do not believe the existence of a consent dividend provides sufficient deferral flexibility in a period of stress to satisfy criterion 7 in the proposed rule for Additional Tier-1 Capital.

The banking industry is at critical juncture and a key tenet of financial reform is that banking organizations hold proper levels and forms of capital. Our opinion that REIT preferred securities should not be treated as Additional Tier-1 or Tier-2 Capital is based on extensive analysis of the existing structures coupled with an understanding of the precedents of Washington Mutual and Colonial Bank. Less than $10 billion in REIT Preferreds were issued historically and only about $3 billion remain outstanding, when excluding defaulted securities.

What is a REIT Preferred? In the most basic form, a REIT is created by a bank as a Delaware Corporation with the sole purpose of issuing preferred stock and buying assets from the bank. The entity is not set up to transact business with clients or earn a profit in its own right. In fact, one of the Bank REIT Preferred structures notes in its offering material that a principal objective is simply to "maintain desired Treatment under the Internal Revenue Code."

Since a REIT itself cannot adequately absorb losses on a going concern basis, a REIT Preferred structure includes a "Conditional Exchange" provision whereby the bank's regulator can require a conversion of the preferred issued by the REIT into holding company perpetual preferred shares under certain stressed situations. The Conditional Exchange can occur if a regulator believes the bank is about to (i) become undercapitalized under the PCA regulations; (ii) be placed into conservatorship or receivership; or (iii) become undercapitalized in the near term. Upon a Conditional Exchange, the REIT Preferred obligation would become perpetual preferred stock of the holding company even though the securities are originally accounted for as minority interest on the issuing entity's (bank holding company's) balance sheet. Highlighted below are two precedents involving Conditional Exchanges that remain the subject of litigation years after the failure of the relevant banks.

Structural Weaknesses of REIT Preferreds

In addition to the complexity of REIT Preferreds, the following structural weaknesses show that the securities are unfit to support a stressed bank:

1. **A Conditional Exchange creates a negative signal to the market and occurs at a point of non-viability**. As discussed above, REIT Preferreds contain a stipulation whereby the securities may become Basel III compliant capital upon a Conditional Exchange. A Conditional Exchange under such stressful events likely occurs at a point of non-viability for a bank. And the precedents of Washington Mutual and Colonial Bank highlight that the Conditional Exchange can be contested legally while also occurring at a point of non-viability. Plainly, the Conditional Exchange generally occurs after the bank has failed and ambiguity around the process leaves both regulators and all parties subject to litigation risk.

2. **The bank does not have immediate access to deferred dividend payments on REIT Preferreds.** The ability for a banking organization to defer dividends on subordinated capital can provide critical capital and liquidity when under stress. However, if a bank elects to defer a REIT Preferred dividend in order to harvest precious liquidity, neither the bank nor the bank holding company have immediate access to that cash. Through a series of complex inter-company transactions, the bank gets access to cash from a deferred REIT Preferred dividend via a deposit in the bank. Furthermore, the deferral of the dividend can cause the REIT structure to unwind, which endangers the tax benefit of the bank owning the REIT in the first place. The complexity of deferability of REIT Preferred dividends runs in stark contrast to criterion 7 for Additional Tier-1 Capital where a "banking organization has full discretion at all times to cancel dividends" without "other restrictions on the banking organization except in relation to any capital distributions to holders of *common* stock." In reality, a deferral of REIT Preferred dividends blocks payments of both *common* equity dividends *and* holding company perpetual *preferred* dividends. A recently issued bank holding company perpetual preferred stock offering memorandum highlights this structural weakness where it notes: "our REIT preferred securities prohibit us from declaring or paying any dividends or distributions on the *Preferred* Stock.... at any time when we have deferred interest thereunder or at any time full dividends have not been paid on our REIT preferred securities".

3. **A Consent Dividend could be challenged from a legal perspective.** According to the proposed rules, the existence of a "consent dividend" could provide more favorable capital treatment to some REIT Preferred Securities. We think a consent dividend does little to simplify the process of deferring a dividend on a REIT Preferred. Traditional holding company preferred stock can be deferred with ease from a legal perspective even though it can send a negative signal to the marketplace. Deferring a REIT Preferred dividend in a period of stress with the only protection of a consent dividend may leave a bank at risk of litigation when they should be focused on solvency. We further highlight that a consent dividend on a REIT Preferred has never been used in practice and tested from a legal perspective for a stressed bank. Traditional bank holding company perpetual preferred stock has been deferred in many instances. Any potential litigation awards arising from challenges to a consent dividend on REIT Preferreds could ultimately impair recoveries on other parts of a bank's capital structure, including taxpayer funds.

4. **REIT Preferreds are extremely complex from a financial reporting perspective.** Most bank capital securities appear on a financial statement in relatively simple terms: subordinated debt or preferred stock. However, Bank REIT Preferreds are recorded as minority interest on the balance sheet, which we think masks the debt-like characteristics of the structure since dividends are not as easily deferrable as those on traditional preferred stock. Furthermore, traditional bank credit analysis based on public financial statements can often overlook REIT Preferreds when calculating leverage, capital, and debt service given the minority interest accounting for the securities.

5. **None of the REITs are an "operating entity"**. Bank REIT Preferred issuing subsidiaries are set up to simply issue preferred shares and hold assets. Based on our extensive analysis of REIT Preferreds, none of the existing structures are designed to

conduct business with clients with the intention of earning a profit in their own right. We again highlight our earlier example where an objective of one of the REITs is to simply maintain preferential tax treatment under the Tax Code.

On top of these structural weaknesses, we highlight two troublesome precedents that accounted for a material share of Bank REIT Preferred issuance historically. These two cases involved litigation after a bank failure and are illustrative of why REIT Preferreds are not loss-absorbing on a going concern basis:

Washington Mutual. With over $300 billion of assets, Washington Mutual was the largest bank failure in U.S. history. The company had issued approximately $4 billion of REIT Preferred securities according to its final plan of reorganization. These REIT Preferreds ultimately received a litigation windfall following the attempted Conditional Exchange into holding company preferred stock.

Litigation directly related to the Conditional Exchange continued for years after failure due to the complicated mechanics of the Conditional Exchange. Importantly, Washington Mutual announced the exchange of the REIT Preferred to holding company preferred shares on September 26, 2008, one day *after* JPMorgan announced the acquisition of the bank, creating ambiguity as to which entity was responsible for the security. JPMorgan, as successor to Washington Mutual Bank, ultimately made a $50 million payment offer in an attempt to put an end to litigation by holders of the original REIT Preferreds who claimed the Conditional Exchange was not properly executed. The Washington Mutual precedent highlights that the complexity of the Conditional Exchange and resultant ambiguity leads to additional (and otherwise unnecessary) litigation during a regulatory or bankruptcy process.

Colonial Bank. Colonial Bank failed in 2009 with $25 billion of assets at an estimated cost to the FDIC of $3.8 billion, according to recent reports. In 2007, Colonial Bank issued $300 million of REIT Preferreds. Despite well-documented stress at the bank throughout the credit crisis, the bank continued to service its obligations on REIT Preferreds and its attempted Conditional Exchange of the REIT Preferreds occurred after the company had announced a significant net loss, issued a statement about the substantial doubt concerning its ability operate as a going concern, and the likelihood of being placed into receivership by the FDIC.

Litigation filed in 2011 highlights the risk that regulators of failed banks can face in a capital structure that includes Bank REIT Preferreds. Colonial's holding company has sued the buyer of the bank (BB&T Corporation) and the FDIC, and certain aspects of the case are still pending years after Colonial's failure. Both the Conditional Exchange required to convert REIT Preferreds into holding company preferred stock and subsequent downstreaming of proceeds to the bank have been points of contention throughout the litigation and bankruptcy process. The Conditional Exchange was disclosed in a Colonial 8-K on August 12, 2009, roughly two weeks after Colonial announced a $606 million net loss and management "concluded that there is substantial doubt about Colonial's ability to continue as a going concern." The Conditional Exchange also occurred after the company said on August 7, 2009 that "Colonial Bank will be asked to consent to the Superintendent's exercise of his statutory authority to appoint the FDIC as receiver or conservator for the Bank." We do not have an opinion on the ultimate outcome of

any litigation but emphasize that aspects of the Conditional Exchange that occurred over three years ago are still being challenged.

Concluding Comments

The Bank REIT Preferred universe is now approximately $3 billion and nearly $5 billion of defaulted securities remain subject to litigation or some form of settlement windfall. Several well-capitalized issuers of REIT Preferreds have already made public statements that the securities will no longer receive Additional Tier-1 Capital treatment. We view no prospective issuance of REIT Preferreds as a positive development for the banking sector because it will remove a complex, uncertain form of capital from bank balance sheets.

We think REIT Preferreds are not loss absorbing on a going concern basis. We encourage the Agencies to explicitly state that REIT Preferred securities will not count as Additional Tier-1 or Tier-2 Capital under Basel III guidelines. With regard to the Tier-2 standards referenced in "Question 21" in the proposal, we note that REIT Preferreds should not be eligible for Tier-2 status because the instruments are not issued out of an "operating entity" and the structure of the REIT does not allow the proceeds to be "immediately available without limitation to the banking organization or the banking organization's top-tier holding company" and therefore do not meet criterion 9 for Tier-2 Capital.

In sum, we believe the proposed rules will materially limit the issuance of REIT Preferred Securities (Question 27), we believe that REIT Preferreds should not receive Tier-2 Capital treatment (Question 21) and, for the reasons stated above, we also recommend that such securities receive no Additional Tier-1 or Tier-2 Capital treatment.

We thank you for your consideration of this matter and would welcome the opportunity to discuss our comments with the respective Agencies.

Sincerely,

Donald E. Morgan III
Managing Partner

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Partner – Head of Financial Institutions Investments