

Proposal: 1655 (AF43) Reg Q- Regulatory Capital Treatment for Investments (GSIBs)

Description:

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From: R Street Institute, Alex J. Pollock

Proposal: 1655 (AF43) Reg Q- Regulatory Capital Treatment for Investments (GSIBs)

Subject: R-1655; RegulationQ - Regulatory Capital Treatment for Investments (GSIBs)

Comments:

NONCONFIDENTIAL // EXTERNAL

ALEX J. POLLOCK

R Street Institute

Washington, DC

April 5, 2019

Via e-mail to:

Office of the Comptroller of the Currency

Board of Governors of the Federal Reserve System

Federal Deposit Insurance Corporation

Re.: Comments on the Proposed Joint Rule on "Regulatory Capital Treatment for Investments in Certain Unsecured Debt Instruments of Global Systemically Important U.S. Bank Holding Companies, Certain Intermediate Holding Companies, and Global Systemically Important Foreign Banking Organizations"

OCC: Docket ID OCC-2018-0019; RIN 1557-AE38

Board: Docket No. R-1655; RIN 7100-AF43

FDIC: RIN 3064-AE79

Dear Sirs and Mesdames:

Thank you for the opportunity to comment on this proposed joint rule.

In my view, the logic of the proposal is impeccable. Because it is, it should be applied to another, parallel situation, as discussed below. The proposal's objective, "to reduce interconnectedness and contagion risk among banks by discouraging banking organizations from investing in the regulatory capital of another financial institution," makes sense, but might be improved by adding, "or if such investments are made, to ensure

that they are adequately capitalized."

I believe another rule with exactly the same logic and exactly the same objective is required to address a key vulnerability of the U.S. banking system. That is to apply the logic of the proposed rule to any investments made by U.S. banks in the equity securities of Fannie Mae and Freddie Mac, two of the very largest and most systemically risky of American financial institutions. As you know, hundreds of American banks took steep losses on their investments in the preferred stock of Fannie and Freddie when those institutions collapsed, and such investments caused a number of banks to fail. That banks were able to make these investments on a highly leveraged basis was, in my judgment, a serious regulatory, as well as management, mistake. On top of this, U.S. regulations allowed banks to own Fannie and Freddie securities without limit.

Banks were thus encouraged by regulation to invest in the equity of Fannie and Freddie on a hyper-leveraged basis, using insured deposits to fund the equity securities. Hundreds of banks owned about \$8 billion of Fannie and Freddie's preferred stock. For this disastrous investment, national banks had a risk-based capital requirement of a mere 1.6%, since changed to a still inadequate 8%. In other words, they owned Fannie and Freddie preferred stock on margin, with 98.4%, later 92%, debt. (With due respect, your broker's margin desk wouldn't let you do that.)

In short, the banking system was used to double leverage Fannie and Freddie, just as the investments in TLAC debt addressed by the proposal would otherwise double-leverage big banks. To analogously correct the systemic risk, when banks own Fannie and Freddie equities, they should have a dollar-for-dollar capital requirement, so that it really would be equity from a consolidated system point of view.

I respectfully recommend, true to the principle and the logic of the proposed joint rule, that any investments by a bank in the preferred or common stock of Fannie and Freddie should be deducted from its Tier 1 regulatory capital. I believe this should apply to banks of all sizes.

These are my personal views. It would be a pleasure to provide any further information or comments which might be helpful.

Thank you for your consideration.

Respectfully,

Alex J. Pollock

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