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.

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[1]" 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.

[1] 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[2] 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

[2] 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.[3] 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.[4] 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.

Flaherty & Crumrine Incorporated
September 30, 2010

[3] The Committee should solicit comments from the major rating agencies, if it has not already.

[4] 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.

Flaherty & Crumrine Incorporated

Appendix

Basel III Loss Absorbency Proposal — **Flaherty & Crumrine Inc.**

Sample Recovery Waterfall At Varying Regulatory Trigger Points — September 29, 2010

	Initial	Scenario 1	Scenario 2	Scenario 3	Scenario 4	Scenario 5
Common Shares Outstanding	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%
Tier 2 Pfd Outstanding	$ 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%
Tier 1 Pfd Outstanding	$ 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)

	Initial	Scenario 1	Scenario 2	Scenario 3	Scenario 4	Scenario 5
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%
Required Additional Share Authorization	20,000,000,000

<-- Needed to determine maximum additional share authorization. Sould be as close to 100% as possible.

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.