Katz Capital Advisory LLC

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To The Federal Housing Finance Agency

Response to Notice of Proposed Rulemaking on Enterprise Capital Requirements
RIN-2590-AA95

Introduction

On July 17, 2018, FHFA published in the Federal Register a Proposed Rule on Enterprise Capital, proposing new capital requirements for Fannie Mae and Freddie Mac (together, "the GSEs"). We welcome the opportunity to provide comments on:

Question 36: FHFA is soliciting comments on the capital treatment of outstanding perpetual, noncumulative preferred stock. Given that FHFA cannot change the definition of core capital as provided in the statute, what modifications should FHFA consider and why?

1. FHFA must ensure the definition of noncumulative preferred stock is no less than the same as Additional Tier 1 Capital as defined by the Federal Reserve System. The final revised criteria for additional tier 1 capital are set forth in section 20(c)(1) of the final rule:

    - FEDERAL RESERVE SYSTEM - 12 CFR Parts 208, 217, and 225 [Docket No. R–1442; Regulations H, Q, and Y] RIN 7100–AD 87

    - V. Definition of Capital

      A. Capital Components and Eligibility Criteria for Regulatory Capital Instruments

      2. Additional Tier 1 Capital

    The proposed criteria were designed to ensure that additional tier 1 capital instruments would be available to absorb losses on a going-concern basis. Most relevant of the 14 proposed criteria to each of the Enterprises' issued and outstanding noncumulative preferred stock is the following two criteria

    (4) The instrument has no maturity date and does not contain a dividend step-up or any other term or feature that creates an incentive to redeem.

    (5) (i) The banking organization must receive prior approval from its primary Federal supervisor to exercise a call option on the instrument.

2. As noted above, the Federal Reserve's final revised criteria for additional tier 1 capital are set forth in section 20(c)(1) of the final rule:

- FEDERAL RESERVE SYSTEM - 12 CFR Parts 208, 217, and 225 [Docket No. R–1442; Regulations H, Q, and Y] RIN 7100–AD 87

The final rule limits Additional Tier 1 Capital to 1.5 percent of risk-weighted assets, the difference between 6 percent and 4.5 percent.

- IV. Minimum Regulatory Capital Ratios, Additional Capital Requirements, and Overall Capital Adequacy

  Minimum Risk-Based Capital Ratios and Other Regulatory Capital Provisions Consistent with Basel III, the proposed rule would have required banking organizations to comply with the following minimum capital ratios: a common equity tier 1 capital to risk weighted assets ratio of 4.5 percent; **a tier 1 capital to risk-weighted assets ratio of 6 percent;**

Given that FHFA cannot change the definition of core capital as provided in the statute, FHFA is not able to include a 1.5 percent noncumulative preferred stock or Additional Tier 1 Capital limit. The lack of prudent limit 1.5 percent limit will enable the Enterprises to over rely on less loss absorbing preferred stock Tier 1 core capital relative to common stock Tier 1 core capital.

3. Addressing the Point of Non-Viability Requirements Under Basel III

U.S. law as it pertains to the Enterprises is NOT consistent with the Basel non-viability standard.

Consistent with the Basel nonviability standard, under the proposal, additional tier 1 and tier 2 capital instruments issued by the Enterprises after the date on which such organizations would have been required to comply with any final rule should be required to include a disclosure that the holders of the instrument may be fully subordinated to interests held by the U.S. government in the event that the banking organization enters into a conservatorship, receivership, insolvency, liquidation, or similar proceeding.

During the recent financial crisis, the United States and foreign governments lent to, and made capital investments in, banking organizations. These investments helped to stabilize the recipient banking organizations and the financial sector as a whole. However, because of the investments, the recipient banking organizations' existing tier 2 capital instruments, and (in some cases) tier 1 capital instruments, did not absorb the banking organizations' credit losses consistent with the purpose of regulatory capital. At the same time, taxpayers became exposed to potential losses.

On January 13, 2011, the BCBS issued international standards for all additional tier 1 and tier 2 capital instruments issued by internationally-active banking organizations to ensure that such regulatory capital instruments fully absorb losses before taxpayers are exposed to such losses (the Basel nonviability standard). Under the Basel non-viability standard, all non-common stock regulatory capital instruments issued by an internationally-active banking organization must include terms that subject the instruments to write-off or conversion to commented equity at the point at which either:

(1) The write-off or conversion of those instruments occurs; or
(2) A public sector injection of capital would be necessary to keep the banking organization solvent.

Alternatively, if the governing jurisdiction of the banking organization has established laws that require such tier 1 and tier 2 capital instruments to be written off or otherwise fully absorb losses before taxpayers are exposed to loss, the standard is already met. If the governing jurisdiction has such laws in place, the Basel non-viability standard states that documentation for such instruments should disclose that information to investors and market participants, and should clarify that the holders of such instruments would fully absorb losses before taxpayers are exposed to loss.

4. At a minimum, to the extent the final rule as it pertains to noncumulative preferred stock does not include both a risk based capital limit and operational nonviability bail-in mechanism, FHFA should consider strengthening the loss absorption of noncumulative preferred stock terms and conditions to include the following two terms and conditions:

A. FHFA should consider full implementation of the penny dividend criteria pursuant to a cost benefit analysis. Yes, this feature will require a very minimal incremental cost for a very meaningful incremental benefit. At this time, there are a very large number of market precedents to determine the minimal incremental cost of a penny dividend feature.

In the preamble to the proposed rule RIN 7100–AD 87, the agencies included a discussion regarding whether criterion (7) should be revised to require banking organizations to reduce the dividend payment on tier 1 capital instruments to a penny when a banking organization reduces dividend payments on a common equity tier 1 capital instrument to a penny per share. Such a revision would increase the capacity of additional tier 1 instruments to absorb losses as it would permit a banking organization to reduce its capital distributions on additional tier 1 instruments without eliminating entirely its common stock dividend.

Commenters asserted that such a revision would be unnecessary and could affect the hierarchy of subordination in capital instruments.

Commenters also claimed the revision could prove burdensome as it could substantially increase the cost of raising capital through additional tier 1 capital instruments.

In light of these comments the agencies have decided to not modify proposed criteria (7) to accommodate the issuance of a penny dividend as discussed in the proposal.

B. FHFA should consider requiring noncumulative preferred stock to include a term to require mandatory conversion to common stock upon the occurrence of pre-defined events. For example, all European ECB regulated banks require conversion to common equity when common equity Tier 1 capital falls below a predefined going concern level.
Yes, this feature will require a well established market based minimal incremental cost for a very meaningful incremental benefit. One such meaningful incremental benefit is the potential to include the noncumulative preferred stock as common equity Tier 1 capital for stress test purposes. At this time, there are a very large number of market precedents to determine the minimal incremental cost of a contingent capital feature. Also, inclusion of a contingent capital feature makes redundant the incremental cost of a penny dividend feature as a penny dividend feature is a subset of a contingent capital feature.

There is much precedent and discussion of contingent capital instruments. For example:

- The Board recently considered contingent capital instruments within the context of determining the eligibility of TLAC bail-in instruments; Regulations YY; Docket No. R-1523 RIN 7100-AE37,

and some time ago the Board considered contingent capital instruments in response to:

- **REPORT TO CONGRESS ON STUDY OF A CONTINGENT CAPITAL REQUIREMENT FOR CERTAIN NONBANK FINANCIAL COMPANIES AND BANK HOLDING COMPANIES**

  FINANCIAL STABILITY OVERSIGHT COUNCIL

  Completed pursuant to Section 115(c) of the Dodd-Frank Wall Street Reform and Consumer Protection Act July 2012

  - IV. Conclusions

  "The issuance of contingent capital instruments could provide a useful tool for strengthening financial institutions' capital positions and ability to withstand losses during times of financial stress. Contingent capital issuances have the potential to provide these benefits at a lower cost of capital than additional common equity issuances, although contingent capital instruments are generally not as loss absorbing as common equity.

The United States experience with instruments similar to contingent capital is quite limited and, as discussed above, there are a range of potential issues that could be associated with contingent capital instruments, depending on their structure and, in particular, the structure and timing of conversion triggers.

Therefore, at this time, the Council recommends that contingent capital instruments remain an area for continued private sector innovation. ***The Council encourages the Federal Reserve and other financial regulators to continue to study the advantages and disadvantages of including contingent capital and bail-in instruments in their regulatory capital frameworks***.*“*

5. FHFA should follow the same transitional provisions as that followed by the Federal Reserve and as it pertains to Question 36 for non-qualifying noncumulative preferred stock capital instruments.

As noted above, the Federal Reserve's final revised criteria for additional tier 1 capital are set forth in section 20(c)(1) of the final rule:

- FEDERAL RESERVE SYSTEM - 12 CFR Parts 208, 217, and 225 [Docket No. R–1442; Regulations H, Q, and Y] RIN 7100–AD 87

  VII. Transition Provisions

  The proposal established transition provisions for: (i) Minimum regulatory capital ratios; (ii) capital conservation and countercyclical capital buffers; (iii) regulatory capital adjustments and deductions; (iv) non-qualifying capital instruments; and (v) the supplementary leverage ratio. Most of the transition periods in the proposal began on January 1, 2013, and would have provided banking organizations between three and six years to comply with the requirements in the for the phase-out of non-qualifying capital instruments from regulatory capital under either a three- or ten-year transition period based on the organization's consolidated total assets. The proposed transition provisions were designed to give banking organizations sufficient time to adjust to the revised capital framework while minimizing the potential impact that implementation could have on their ability to lend. The transition provisions also were designed to ensure compliance with the Dodd- Frank Act. As a result, they would have been, in certain circumstances, more stringent than the transition arrangements set forth in Basel III.

VII. Transition Provisions (cont'd)

Depository Institution Holding Companies With $15 Billion or More in Total Consolidated Assets as of December 31, 2009 That Are Not 2010 Mutual Holding Companies Under the final rule, consistent with the proposal and with section 171 of the Dodd-Frank Act, debt or equity instruments that do not meet the criteria for additional tier 1 or tier 2 capital instruments in section 20 of the final rule, but that were issued and included in tier 1 or tier 2 capital, respectively, prior to May 19, 2010 (non-qualifying capital instruments) and were issued by a depository institution holding company with total consolidated assets greater than or equal to $15 billion as of December 31, 2009 (depository institution holding company of $15 billion or more) that is not a 2010 MHC must be phased out as set forth in Table15 below.

TABLE 15—PERCENTAGE OF NON-QUALIFYING CAPITAL INSTRUMENTS INCLUDABLE IN ADDITIONAL TIER 1 OR TIER 2 CAPITAL

Transition period (calendar year)	Percentage of non-qualifying capital instruments includable in additional tier 1 or tier 2 capital for depository institution holding companies of $15 billion or more
Calendar year 2014 (advanced approaches banking organizations only)	50
Calendar year 2015	25
Calendar year 2016 And thereafter	0