Invested in America

October 22, 2012

The Honorable Ben S. Bernanke, Chairman
and Jennifer J. Johnson, Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20051
Docket No. R-1442 / RIN 7100 AD-87

The Honorable Martin J. Gruenberg, Acting Chairman
and Robert Feldman, Executive Secretary
Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, DC 20429
FDIC RIN 3064-AD97; Attention: Comments, Federal Deposit Insurance Corporation

Mr. Thomas J. Curry, Comptroller of the Currency
Office of the Comptroller of the Currency
250 E Street, SW., Mail Stop 2-3
Washington, DC 20219
Docket ID OCC-2012-0010
RIN 1557-AD46

MEMORANDUM TO THE BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, THE FEDERAL DEPOSIT INSURANCE CORPORATION AND THE OFFICE OF THE COMPTROLLER OF THE CURRENCY (the "Agencies")

Re: Question 4: The agencies solicit comments on the proposed CVA capital requirements, including the simple CVA approach and the advanced CVA approach.

The Securities Industry and Financial Markets Association ("SIFMA") is pleased to comment on "Regulatory Capital Rules: Advanced Approaches Risk-Based Capital Rule; Market Risk Capital Rule." SIFMA brings together the shared interests of hundreds of securities firms, banks and asset managers. SIFMA's mission is to support a strong financial industry, investor opportunity, capital formation, job creation and economic growth, while building trust and confidence in the financial markets. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association (GFMA). For more information, visit www.sifma.org. This letter supplements other comments provided by SIFMA on this proposal.

<u>Background</u>:

In June 2012, the Agencies issued a joint notice of proposed rulemaking, "the Advanced Approaches NPR," proposing to revise the advanced approaches risk-based capital rule to incorporate certain aspects of "Basel III: A Global Regulatory Framework for More Resilient Banks and Banking Systems" (Basel III) that the Agencies would apply only to advanced approach banking organizations (referred to herein as "Banks").

On pages 17 and 23 of the Advanced Approaches NPR, the Agencies solicit comments on the proposed CVA capital requirements including the simple CVA approach and the advanced CVA approach. For the reasons described below, we believe that the CVA capital requirement should not apply to OTC derivative contracts with US PSEs (as defined in the Agencies' notice of proposed rulemaking entitled "Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Minimum Regulatory Capital Ratios, Capital Adequacy, Transition Provisions, and Prompt Corrective Action") and United States-based non-profit borrowers of tax-exempt bond proceeds[1] ("Non-Profit Borrowers" and together with US PSEs, "Borrowers") when such Borrowers execute OTC derivatives to hedge or mitigate commercial risk related to tax-exempt debt and energy purchase prices.

<u>Discussion</u>:

For more than 25 years, Borrowers in the municipal securities market have entered into swaps in connection with, or to offset payment obligations on, related debt obligations, utilizing such swaps to hedge or lower their borrowing costs on new, outstanding or anticipated debt. As a result of certain limitations unique to the tax-exempt bond market, Borrowers would be disproportionately disadvantaged, relative to other asset classes, by the CVA capital requirements as currently proposed.

As set forth in the Advanced Approaches NPR, Banks can mitigate CVA requirements by purchasing credit default swaps ("CDS")[2]. The effectiveness of utilizing CDS to mitigate CVA relies on the existence of a robust and liquid CDS market. It is expected that, for many markets, this will be an effective tool for Banks to reduce the impact of the CVA requirement. However, due to structural and regulatory constraints unique to the tax-exempt market, the CDS market for this asset class is illiquid and thinly-traded[3]. As a result, Banks will be unable to purchase CDS in this market to offset the CVA, resulting in inordinately high CVA capital allocated to this particular market.

We further note that these structural and regulatory constraints, unique to the tax-exempt market, make it unlikely that a robust market in related CDS will develop in the foreseeable future, even given the potential increased appetite for such products among Banks seeking to reduce their CVA requirements, as tax considerations related to the allocation of tax-exemption interfere with the ability

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[1] Such borrowers typically include non-profit healthcare institutions, non-profit higher educational institutions and other similar non-profit organizations.

[2] <u>See</u> Section II.A.4 of the Advanced Approaches NPR.

[3] <u>See</u> Nicole Bullock and Aline van Duyne, "Hedge funds go in search for way to short munis," *Financial Times*, February 8, 2011; Dan Seymour, "Hedging Munis: It Ain't Easy," *The Bond Buyer*, July 22, 2010; Cate Long, "There is no municipal CDS market," *Reuters*, January 12, 2012.

to "short-sell" tax-exempt debt on a regular basis.[4] Furthermore, the non-bank institutional investors who are familiar with municipal credit and would be the natural sellers of protection to Banks via CDS, and have wanted to sell CDS, have been unable to do so because the tax-exempt nature of their bond funds creates a disincentive for them to receive the taxable interest income stream that would be created by such transactions.

Although the proposed rules would also allow Banks to offset, to a lesser degree, CVA by holding collateral posted by counterparties, most Borrowers, while highly credit-worthy, would not be in a position to post collateral at levels required to significantly impact the related capital charges. US PSEs generally do not carry large cash balances, thereby minimizing taxes, and Borrowers borrowing on a "revenue" basis are also similarly frequently constrained in the size of their cash balances, as their financing structures typically, by design, produce limited amounts of excess cash. For some US PSEs, the posting of collateral would be prohibited by law[5] and for many Borrowers, the posting of collateral is subject to the limitations of pre-existing indenture or credit agreement lien covenants.

The factors described above, unique to the tax-exempt debt market, will result in untenable capital requirements for CVA generated by swaps with Borrowers that do not reflect the true economic risk of the transactions as demonstrated by the last 25 years. The cost of such capital will necessarily be borne by those Borrowers and may even be prohibitive, interfering with Borrowers' ability to effectively hedge exposures and manage their risk.

Summary:

The Agencies should exempt derivative transactions with Borrowers from both the standard and advanced approach CVA methods. Excluding derivative transactions with Borrowers who are hedging or mitigating commercial risk related to tax-exempt debt and energy purchase prices would avoid the unintended consequences described above and serve the best interests of Borrowers.

We note, as a related matter, that European lawmakers, in their efforts to incorporate the Basel III terms into the European Union's regulations, are considering various proposals to exclude transactions with certain counterparties from the CVA capital requirements, including a proposal to exclude transactions with "non-financial counterparties" under certain circumstances[6]. Any disparity between US and EU regulations on this point could put US Banks at a significant competitive disadvantage.

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[4] *Ibid*.
[5] See State ex rel Kane v. Goldschmidt, 308 Ore. 573 (discussing the creation of debt within the meaning of Or. Const. art XI, § 7); See also Brown v. City of Stuttgart, 312 Ark. 97 (discussing the creation of debt within the meaning of Ark. Const., art. 16 § 1).
[6] Matt Cameron, "New CRD IV draft exempts sovereign trades from CVA capital charge," *Risk.net*, March 6, 2012.

We appreciate the opportunity to provide the Agencies with these comments. If you have any questions or wish to discuss the above comments further, please do not hesitate to contact us.

Sincerely,

Michael Decker
Managing Director and Co-Head of Municipal Securities