Invested in America

October 22, 2012

The Honorable Ben S. Bernanke, Chairman
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
Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, DC 20429
Attention: Comments, Federal Deposit Insurance Corporation
FDIC RIN 3064-AD96

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-2012-0009 / 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 request comment on the proposed treatment of exposures to PSEs.

The Securities Industry and Financial Markets Association ("SIFMA") is pleased to provide comments on "Regulatory Capital Rules: Standardized Approach for Risk-weighted Assets; Market Discipline and Disclosure Requirements**."** The Securities Industry and Financial Markets Association (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 Standardized Approach NPR”, proposing to revise and harmonize the Agencies’ rules for calculating risk-weighted assets to enhance risk sensitivity and address weaknesses identified over recent years, including incorporating certain international capital standards of the Basel Committee on Banking Supervision (BCBS) set forth in BCBS128 (standardized approach). On pages 25 through 27, the Agencies discuss “Exposures to Public Sector Entities” and define “PSE” as a state, local authority, or other governmental subdivision below the level of a sovereign and further clarify that in the United States this would include a state, county, city, town or other municipal corporation, a public authority, and generally any publicly owned entity that is an instrument of a state or municipal corporation, stating:

“Under the proposal, a banking organization would assign a 20 percent risk weight to a general obligation exposure to a PSE that is organized under the laws of the United States or any state or political subdivision thereof and a 50 percent risk weight to a revenue obligation exposure to such a PSE. A general obligation would be defined as a bond or similar obligation that is backed by the full faith and credit of a PSE. A revenue obligation would be defined as a bond or similar obligation that is an obligation of a PSE, but which the PSE is committed to repay with revenues from a specific project financed rather than general tax funds…. The risk weights assigned to revenue obligations are higher than the risk weight assigned to general obligations because repayment of revenue obligations depends on specific projects, which present more risk relative to a general repayment obligation of a state or political subdivision of a sovereign.”

We respectfully submit that the Agencies’ proposal for U.S. Public Sector Entities, as written, will neither enhance risk sensitivity nor will it clearly harmonize the definition of *general obligation* in the Code-of-Federal Regulations.

<u>Improving Risk Sensitivity</u>:

The proposal made by the US Agencies for US PSE exposures could be easily and efficiently modified to better align with stated objectives and actual US PSE credit experience by using the existing rules contained in the Code-of-Federal-Regulations[1] (“CFR”) Title 12 part 1. These rules were updated by the Department of Treasury/OCC in June 2012 to meet the ratings removal requirements of section 939A of the Dodd-Frank Act. US PSE exposures that meet the Investment Grade definition, per CFR Title 12 part 1, should be assigned to the 20% risk-weight category and US PSE exposures that do not should be assigned to a higher risk-weight category (such as 50%). Dividing US PSE exposures this way better aligns objectives of the BCBS[2] and the Agencies to create “more risk-sensitive capital requirements” and a safe and sound financial system.

In addition to defining “Investment Grade” in the Standard Approach NPR, the Agencies also used it in the joint final rule regarding “Risk-Based Capital Guidelines: Market Risk” issued in June 2012,

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[1] Department of the Treasury, Office of the Comptroller of the Currency, Docket ID OCC-2012-0005, Final Rule.
[2] Basel Committee on Banking Supervision, International Convergence of Capital Measurement and Standards, #128

referencing the recently revised CFR Title 12 definitions. In that joint final rule, the Agencies segregated the corporate debt market into Investment Grade and non-Investment Grade categories. This reduced the risk capital associated with Investment Grade corporate debt positions and increased the risk capital associated with non-Investment Grade corporate debt positions. The same logic should be applied to US PSE exposures in the Standard Approach NPR.

Past performance in the municipal debt market supports an Investment Grade/non-Investment Grade bifurcation. As recently noted by members of the Federal Reserve Bank of New York[3], defaults on PSE Debt that generally does not meet the Investment Grade definition are far more frequent than on PSE Debt that generally does meet the definition (which implies that most defaults are on non-Investment Grade debt and/or non-rated debt). To illustrate, from 1970 through 2011, the cumulative 41-year total percentage of defaulting US PSE Obligors which would have been very likely to meet the Investment Grade definition was less than a quarter of one percent (0.25%); whereas the total cumulative default rate on US PSE exposures that would generally not have met the definition was over four percent (4%).

Market pricing for PSE Obligations also supports an Investment Grade/non-Investment Grade risk-weighting division rather than a *general obligation*/*revenue obligation* division. For instance, the market does not make a price distinction between New York City Municipal Water Finance Authority Revenue Bonds and New York City General Obligation Bonds, nor does it make a distinction between Massachusetts' School Building Authority Revenue Bonds and Commonwealth of Massachusetts General Obligation Bonds.

<u>Harmonizing Agency Rules</u>:

The proposal made by the US Agencies does not clearly reconcile what constitutes a public sector entity *general obligation*. Specifically, there is a portion of the municipal bond market (approximately 10%[4]) that is neither dependent on repayment from "*revenues from a specific project financed rather than general tax funds*" as the Agencies describe revenue obligations; nor backed by "*the full-faith and credit of a PSE*." For example, several U.S. states bond finance the building of schools, and pledge to repay the bonds specifically from state-wide income taxes, sales taxes or property taxes; however, they do not give a "full-faith and credit pledge." We refer the Agencies to a letter dated February 13, 2012 from the State of New York responding to questions from the Agencies concerning the Dodd-Frank Act. This letter describes New York State Personal Income Tax Bonds created by the State of New York and backed by New York's personal income taxing-power, to fund public purpose projects; however a Full Faith and Credit pledge is not given. Based on a direct reading of the existing US Agency capital rules contained in the CFR, Federal Reserve language would tend to place Municipal Bonds like the NY Personal Income Tax Bonds into the 50% risk-weighting category (CFR Title 12 part 208, Appendix A) while the OCC rules, depending on facts-and-circumstances, would place the NY Personal Income Tax Bonds into the 20% risk-weighting category (CFR Title 12 part 167, with reference to CFR Title 12 1.2(b), CFR Title 12 1.110 "Taxing powers of a State or political subdivision" & OCC Interpretative Letter #907).

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[3] "The Untold Story of Municipal Bond Defaults" – Jason Appleson, Eric Parsons, and Andrew Haughwout, August 2012
[4] Based on JJKenny and Bloomberg sector identifications. 10% represents approximately $306bn of state and local municipal debt.

The US Agencies should take this opportunity to harmonize and clarify their definition of *general obligation* throughout all of the regulatory capital rules, including the NPR's released in June 2012. The Agencies could accomplish this by relying on CFR Title 12 part 1.110, and incorporate into that definition subsequent guidance given in interpretative letters. It should be made explicitly clear for regulatory capital purposes that *general obligation* includes not only full faith and credit bonds, but also bonds where a State promised repayment out of the general fund or legislative action or via an assignment of other material taxing power.

Summary:

The suggested proposals in this letter create no additional burden on Regulators or Banks. The rules from the June 2012 CFR Title 12 part 1 final amendments already will require Banks to make "Investment Grade" determinations for Investment Security holdings, including US PSE Bonds. Harmonizing the definition of "General Obligation" only requires that the Agencies all rely on the definitions contained in CFR Title 12 part 1; which could be further easily clarified by amending the CFR definition to include subsequent interpretative guidance given.

Additionally, the proposed 20% risk-weighting of both *general obligation* and *revenue obligation* that meet the Investment Grade definition is within the parameters of BCBS guidance, which offered the option for National Regulators to assign all PSE exposures to the 20% risk-weight category.

Most importantly, the suggestions in this letter better reflect the credit risk and credit structures that exist in the market, thereby better achieving both BCBS & Agencies' objectives.

We appreciate the opportunity to comment on the Agencies' NPR and are happy to furnish any additional information requested.

Sincerely,

Michael Decker
Managing Director and Co-Head of Municipal Securities