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July 24, 2015

Robert de V. Frierson, Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue NW
Washington, DC 20551

Transmitted via regulations.gov

Docket ID: FRS-2015-0182

Dear Mr. Frierson,

SIFMA is pleased to comment on the Federal Reserve System's (the "Fed") proposal published on May 28, 2015 (the "Proposal") related to Treatment of U.S. Municipal Securities as High-Quality Liquid Assets under the Fed's Liquidity Coverage Ratio rule. SIFMA is the voice of the U.S. securities industry, representing the broker-dealers, banks and asset managers whose 889,000 employees provide access to the capital markets, raising over $2.4 trillion for businesses and municipalities in the U.S., serving clients with over $16 trillion in assets and managing more than $62 trillion in assets for individual and institutional clients including mutual funds and retirement plans. 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.

SIFMA's Municipal Securities Division includes all major banks and securities firms that underwrite and trade municipal securities. SIFMA's membership also includes nearly all banks that are subject to the Liquidity Coverage Ratio ("LCR") Rule as well as those that are subject to the modified LCR Rule. As such, we take a strong interest in the issues raised in the Proposal. When the LCR Rule was being considered in 2014, SIFMA's Municipal Securities Division submitted comments on the then-proposed LCR Rule. At the request of the Fed, the Office of the Comptroller of the Currency ("OCC") and the Federal Deposit Insurance Corporation ("FDIC") (the "Agencies"), we subsequently also provided supplementary market data as well as full set of responses to municipal-market specific questions. In our comments, we argued that investment-grade municipal securities generally satisfy the Agencies' own liquidity criteria, as described in the proposed rule, and should, therefore, be made High Quality Liquid Asset ("HQLA") eligible under the final LCR Rule approved by the Agencies. As such, we were disappointed that the final LCR Rule, approved in September 2014, explicitly excluded all municipal securities from the definition of HQLA.

We therefore applaud the Fed for recognizing the HQLA value of certain municipal securities in their proposed amendment to the LCR Rule. We are seriously concerned that this amendment was not also jointly proposed by the OCC and FDIC. The lack of unified regulatory action and a consistent rule set for all firms that are subject to the LCR will bifurcate participation in the market by placing firms on uneven playing fields for reasons wholly unrelated to underlying liquidity risk and its prudent management. We are hopeful that the OCC and FDIC will also amend their LCR rules in order to include investment grade municipal securities as HQLA-eligible assets.

Furthermore, while the Fed's proposal would make certain municipal securities eligible for inclusion as HQLA, it would both significantly limit the municipal securities to which such eligibility applied and the ability of banks to include eligible municipal securities in their stock of HQLA. First, we believe that these restrictions and limitations are unfounded. Second and more important, we are concerned that these constraints will discourage bank investment in the U.S. municipal securities market, thereby negatively affecting the ability of state and local governments to finance vital investment in domestic infrastructure. We therefore urge the Fed to move forward with an amended Proposal which includes investment-grade municipal securities generally, including both general obligation and revenue obligations bonds, as HQLA-eligible assets, with no additional asset specific concentration limitations.

We continue to strongly believe investment grade municipal securities should be eligible for inclusion as Level 2A HQLA. We have enumerated the reasons in our earlier letters,[1] as have many other market participants.[2] For the sake of brevity, we will not reiterate those points here, but instead will focus on the remainder of the Fed's newly proposed rule.

<u>General Obligations and Revenue Obligations</u>

Under the Proposal, only general obligation ("GO") municipal securities are eligible to qualify as HQLA. While we recognize that the Fed's capital regime treats GO and revenue bonds differently—GO securities are in the 20-percent risk weighting category and revenue bonds are in the 50-percent category—this distinction is not supported by either the relative credit performance or price volatility of GO and revenue bonds.

Moreover, as we have discussed at length in previously-submitted comments to the Agencies,[3] there are several asset- and market-based security characteristics that should be considered when evaluating the liquidity of any given security, including credit quality, source of repayment, position size, CUSIP size, issuer size, etc. As discussed therein, we believe that issuer credit quality is positively correlated to liquidity. While there may also be perceived correlations between the source of repayment (general

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[1] See, for example, letter from Michael Decker, Managing Director, SIFMA to the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve and the Federal Deposit Insurance Corporation, Docket ID OCC-2013-0016, January 31, 2014 and SIFMA and The Clearinghouse, "Response to questions posed by the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation and the Board of Governors of the Federal Reserve (Docket ID OCC-2013-0016)," June 30, 2014.
[2] See, for example, letter from the Public Finance Network to the Comptroller of the Currency, the Federal Deposit Insurance Corporation and the Board of Governors of the Federal Reserve (Docket ID OCC-2013-0016), January 31, 2014.
[3] Letter from SIFMA and The Clearinghouse, "Response to questions posed by the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation and the Board of Governors of the Federal Reserve (Docket ID OCC-2013-0016)," June 30, 2014.

obligation versus revenue obligation) or the type of municipal debt (State versus local) and liquidity, it is actually the average credit quality of the issuers in each of these categories of debt that is primarily determinative of liquidity. Moreover, as also discussed therein, the most indicative liquidity characteristic is size. The size of the issuer's total debt outstanding, the size of the given CUSIP and the size of the position being traded are all indicative. In our experience, however, the issuer's total amount of debt outstanding is the most determinative among these for municipal securities.

Finally, the term "general obligation" is not universally defined, nor does it necessarily imply a greater level of security than the term "revenue obligation." Some GOs are backed by an unlimited tax pledge against debt service while some are backed by a tax pledge subject to a rate ceiling. Some unlimited tax pledges may be more enforceable than others. In short, a general obligation pledge can be a very secure form of financing, but it is not inherently or necessarily more secure than a revenue bond. Consider as an example the outcome of the bankruptcy of the City of Detroit. In the final bankruptcy settlement approved last year, holders of the City's unlimited tax GOs were paid off at 74 percent of face value. Holders of the city's limited tax GOs received 41 percent of their claim. Holders of the city's water and sewer special revenue bonds, backed by a dedicated pledge of revenue derived from water and sewer fees, were either fully reinstated or received full payment. This is because revenue bonds generally are secured by a pledge of "special revenues," as defined in the U.S. Bankruptcy Code, and, as a result, under Section 922(d) of the Bankruptcy Code, application of pledged revenues to pay revenue bonds is not stayed if the issuer commences a case under Chapter 9 of the Bankruptcy Code. Also, under Section 928 of the Bankruptcy Code, the pledge continues to be effective as to post-petition revenue. (These protections are not available to corporate bonds or to many GO municipal bonds.) Consequently, the revenues pledged to support debt service on municipal revenue bonds are generally outside the reach of competing creditors of a bankrupt municipality.

Insured and uninsured bonds

Under the Proposal, bonds that are insured by a bond insurer would not be treated as HQLA based on the notion that insured bonds are obligations of a financial sector entity or obligations of a consolidated subsidiary of a financial sector entity, which in general are excluded from HQLA eligibility under the Rule. Insured bonds, however, are not primarily obligations of financial sector entities; they are principally obligations of the bond issuer, who remains obligated for all debt service payments despite the insurance "wrap." In a transaction wrapped by bond insurance, the bond insurer becomes obligated to make debt service payments to investors only if the issuer fails to make a principal or interest payment. Thus, the bond insurance provides an additional layer of credit protection for investors.

The proposal would result in a perverse outcome: When there are two bond issues of the same issuer with the same credit backing that would otherwise satisfy the criteria for inclusion as HQLA, one uninsured and the other insured, the uninsured issue would be treated as HQLA while the insured issue would not, despite the fact that the only difference between the two is the incremental credit protection provided to the ineligible security.

Investors in insured bonds do not look primarily to the insurance wrap as the basis for repayment; they look to the ability of the issuer to meet its debt service obligations. In that respect, while insurance provides incremental value for the wrapped bonds, it is not the principal source of value. Insurance never makes bonds less liquid or weaker credits, but the Proposal seems to reflect that as true.

Thus, we urge the Fed to revise the Proposal in order not to exclude from eligibility insured municipal securities that otherwise (without regard to the insurance) satisfy the criteria for inclusion as HQLA.

Concentration risk provisions

The proposal also significantly limits the ability of banks that are subject to the LCR to include eligible municipal securities in their stock of HQLA:

- No more than 25 percent of an individual CUSIP may be included in a bank's stock of HQLA;
- No more of a single issuer's bonds than an amount equal to two times the average daily trading volume of that issuer's bonds over the previous four quarters may be included in a bank's stock of HQLA; and
- No more than five percent of a bank's total stock of HQLA may be comprised of municipal securities.

Limitation associated with 25 percent of a CUSIP

The most readily liquid trading segment of the municipal market is block-size ($5 million or greater) positions of investment-grade bonds of large issuers. However, the provisions designed to mitigate concentration risk would have the combined effect of pushing banks to hold many small positions rather than more liquid block-size positions. The limitation related to 25 percent of an individual CUSIP is perhaps the most onerous of these, particularly when combined with the limitation that only GO bonds would be eligible HQLA. In general in the municipal securities market, large, institutional-size blocks of bonds tend to be more liquid than smaller positions because block sizes appeal to large institutional investors and active traders. As already mentioned, limiting eligible HQLA to GO bonds only would limit the size of banks' positions in particular CUSIPs because GOs tend to be issued with serial maturities, and each CUSIP tends to be relatively smaller. Limiting bonds eligible as HQLA to 25 percent of each CUSIP would effectively further shrink the size of banks' positions and actually reduce, not enhance liquidity.

The most liquid position sizes in the municipal market are institutional block-size positions of $5 million or more. The Municipal Securities Rulemaking Board ("MSRB") commissioned a study of secondary market trading in municipal securities based on trades reported to the MSRB's Real-Time Trade Reporting System.[4] Among other issues, the study measured the "total customer-to-customer [price] differentials, calculated by subtracting the price at which the initial customer sold the municipal security

[4] Municipal Securities Rulemaking Board, *Report on Secondary Market Trading in the Municipal Securities Market*, July 2014.

in a [“dealer buys”] trade at the beginning of a customer-to-customer transaction chain from the price at which the final customer purchased the security in a [“dealer sells”] trade at the end of the chain.” This differential effectively reflects the bid-ask spread, a key measure of liquidity. The smallest customer-to-customer price differential—11 basis points for trades involving one dealer intermediary—was for trades over $5 million.[5] Moreover, trade sizes over $5 million also exhibited the lowest frequency of multiple dealer intermediaries; the average number of dealer intermediaries for same-size customer-to-customer trade chains over $5 million was only 1.10.

It is reasonable to assume that large LCR banks will continue to focus their investments in the most liquid segment of the market, block sizes of at least $5 million. By our rough calculation, the 25-percent limitation would effectively eliminate approximately 27 percent par amount of serial GO bonds as potential bank investments because the CUSIP size falls between $5 million and less than $20 million, meaning banks would have to take on positions below $5 million to be in compliance with the 25-percent limit.

Moreover, focusing on the portion of a CUSIP owned by banks is not an ideal means of addressing the issue of concentration risk. LCR banks already have sophisticated systems and procedures in place to manage credit exposure and concentration risk. The systems banks use focus on factors like issuer, maturity, credit quality, sector, state and other factors that have proven to be relevant to credit and liquidity risk management. Banks generally do not focus on the portion of a CUSIP they own because that factor is generally irrelevant to the risk exposure a particular position might represent. If the Fed is concerned about concentration and position limits, we urge that the CUSIP limitation in the proposal be dropped in favor of reliance on the risk management systems bank already have in place.

Finally, the credit support for municipal securities is virtually always identical among CUSIPs within the same issuance transaction. Holders of all CUSIPs have the same claim on revenue, and credit analysts, including credit rating agencies, treat all CUSIPs within an issue the same. Except that they serve to distinguish among maturities, CUSIPs simply are not a distinction that matters. We disagree that the 25-percent limitation is a useful indication of liquidity. If the 25-percent limit is retained, however, it should be applied to all outstanding obligations of the issuer payable from substantially the same source of funds (e.g., GOs or water system revenues), since the cost of credit surveillance would be spread among this entire group of obligations, so for liquidity purposes all obligations within the group should be fungible.

Lastly, a lack of clarity exists in the Proposal surrounding the circumstance where a bank owned more than 25 percent of a CUSIP. In this case, would an amount equal to 25 percent of the CUSIP be permitted as eligible HQLA or would the entire position become ineligible because it exceeded the 25-percent threshold? If the Fed maintains the 25-percent test in the final rule—which, for the reasons discussed above, we would strongly advise against—we seek clarification on this point.

[5] *Ibid*., page 35.

<u>Limitation related to two times average daily trading volume</u>

The restriction based on two times average daily volume, we believe, uses an inappropriate measure of liquidity to limit HQLA eligibility. Trading volume in some issues that would be highly sought after investments in a stressed market—large, highly-rated GO and revenue bonds of frequent, well-known issuers—may trade relatively infrequently because they held by institutional investors as buy-and-hold investments. Those same investors in a stressed market would gravitate to the same issues, enhancing their liquidity.

Fed Governor Lael Brainard recently recognized a trend that a larger portion of bonds is being bought and held by investors that hold positions to maturity and that do not trade as frequently as others. "The share of bonds owned by entities that tend to hold securities until maturity, such as mutual funds and insurance companies, has increased in recent years, which would lead turnover to decline even with no change in market liquidity," Governor Brainard said recently.[6] This is consistent with patterns in the municipal market, where key sources of institutional demand—mutual funds, property and casualty insurance companies, commercial banks—tend to hold positions for long periods, often to maturity, and not trade actively, suggesting that historic trading volume may not be the best indicator of liquidity. However, when block-sized positions do become available, these same investors are active buyers, serving as a source of liquidity.

Governor Brainard also recognized that the market sectors that are often thought of as most liquid—dominated by high-frequency trading, high trade volumes, automated trading, etc.—may be the most susceptible to liquidity swings in times of market stress. "This consideration would be most relevant in the markets that are amenable to high-frequency trading, and automated trading more generally, where assets are fairly standardized, such as equities and U.S. Treasury securities, and less relevant in markets where securities are more idiosyncratic, such as corporate bonds," he said.[7] The reference to "idiosyncratic" markets applies aptly to the U.S. municipal market.

One reason why trading volumes may appear low and may not be a good reflection of liquidity relates to the motivations of investors to sell their holdings. The interest on most municipal securities is exempt from federal and in many cases state income taxes. Investors tend to hold tax-exempt municipal securities in taxable accounts, and many of these investors are tax-sensitive. They may be unwilling to sell positions—even though there would likely be ready buyers—in order to avoid the recognition of gains or other taxable events. So in this respect reduced trading volume is more the result of owners' unwillingness to sell rather than a dearth of demand or liquidity.

Moreover, using average daily trading volume as a determinant of position size eligible to be included as HQLA raises operational concerns. LCR banks would need to build systems to analyze trading volume for

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[6] Lael Brainard, Remarks at "Policy Makers' Panel on Financial Intermediation: Complexities and Risks for 'The Future of Financial Intermediation: Banking, Securities Markets, or Something New?,'" Salzburg Global Forum on Finance in a Changing World, July 1, 2015, page 2.
[7] Ibid., page 4.

current and prospective positions to ensure that the positions identified for compliance with the LCR Rule did not exceed the two-times-average-daily-trading-volume threshold. These systems do not exist today, and would be expensive to create.

There is no indication that historic trading volume, even as recent as the preceding four quarters, is an indication of liquidity. We would urge the Fed to drop this provision in its entirety from the Proposal.

Limitation related to five percent of total HQLA

The Proposal would limit banks' holdings of municipal securities as eligible HQLA to no more than five percent of a bank's total HQLA. The Fed states that this provision is included in the Proposal "to ensure appropriate diversification of asset classes within a Board-regulated institution's HQLA amount." While we appreciate the need for diversification, we point out that no other specific asset included in Level 2A or Level 2B HQLA has an asset-specific limitation like the proposed five-percent test. Some of those assets are measurably less safe and less liquid than investment-grade municipal securities. We therefore question the need for a separate test for municipal securities.

Moreover, as the Proposal points out, there already exist in the LCR Rule limits of 40 percent of total HQLA for Levels 2A and 2B combined and a 15-percent limit for Level 2B. We therefore urge the Fed to drop the five-percent test. The existing limits on Level 2 assets are sufficient to limit and diversify banks' investments.

Cross border considerations

The rule would create a perverse international inconsistency that would disadvantage many U.S. State and local government issuers. Firms subject to multiple LCR reporting and compliance requirements will find the treatment of U.S. municipal securities is less cumbersome and treated at a higher HQLA level under non-U.S. LCR rules, which creates an awkward situation where U.S.-specific securities are treated worse domestically than internationally. For instance the European Commission's Delegated Regulation EU 2015/61, which promulgated specific LCR requirements as introduced by the European Parliament and the Council of the European Union, specifies that "Level 2A assets shall include…assets representing claims on or guaranteed by…a regional government, local authority or public sector entity in a [non-EU Member State] provided that they are assigned a 20% risk weight…" (Commission Delegated Regulation EU 2015/61 Article 11 Paragraph 1b). This simple example demonstrates not only that all general obligation "GO" municipal securities would be classified as Level 2A under European LCR rules (see General obligation and revenue bonds section above for risk weighting discussion), but also that these securities would not be subject to the other municipal security-specific concentration and other restrictions introduced in the Fed proposal as these other considerations are unique to the Fed proposal. As a result, SIFMA implores the Fed to reconsider its proposed rule in terms of the areas we have specified.

Conclusion

We applaud the Fed for taking the important step of proposing to amend the LCR Rule to include certain municipal securities as eligible HQLA. We believe investment-grade municipal securities meet the qualifications for HQLA, and we appreciate that the Fed's Proposal has reopened this discussion.

The restrictions and limitations the Fed has proposed on municipal securities that could be included as eligible HQLA—the prohibition on revenue bonds and insured bonds, the limitation of 25 percent of a CUSIP, the two-times-daily-trading-volume restriction and the five-percent restriction—would severely limit the universe of municipal securities that banks could include as eligible HQLA. By one calculation, only $186 billion of the nearly $3.7 trillion of outstanding bonds would be eligible to be included as HQLA. While we recognize that the Fed seeks to ensure that only the most secure and liquid segment of the market is eligible for banks' LCR compliance, we do not believe that excluding 95 percent of the market strikes the right balance.

We urge five key changes to the Fed's proposal:

- Include municipal revenue bonds as eligible HQLA. Investment-grade revenue bonds are as safe and liquid—in some cases more so—than GOs.
- Permit insured municipal securities as eligible HQLA. Insured bonds are not obligations of financial entities, and insurance makes bonds safer and more liquid, not less safe and less liquid.
- Eliminate the 25-percent-of-each-CUSIP restriction or, if not eliminated, apply it to all issuer obligations payable from substantially the same source of funds. LCR banks have sophisticated systems and procedures in place to effectively manage concentration risk.
- Eliminate the two-times-daily-trading-volume restriction. Trading volume by itself is not a good predictor of liquidity.
- Eliminate the five-percent-of-total-HQLA limit. The existing limits on Level 2 assets are sufficient to ensure diversification.

We again commend the Fed for proposing changes to the LCR Rule. With our suggestions, we believe the Rule could permit banks to include reasonable amounts and types of municipal securities as eligible HQLA. We would be happy to discuss these matters further.

Sincerely,

Michael Decker
Managing Director