BILL LOCKYER
TREASURER
STATE OF CALIFORNIA

January 31, 2014

Office of the Comptroller of the Currency
400 7th Street, S.W., Suite 3E-218
Mail Stop 9W-11
Washington, D.C. 20219
Attention: Legislative and Regulatory Activities Division
Docket ID OCC-2013-0016
RIN 1557 AD 74

Board of Governors of the Federal Reserve System
20th Street & Constitution Avenue, N.W.
Washington, D.C. 20551
Attention: Robert de V. Frierson, Secretary
Docket No. R-1466
RIN 7100-AE03

Federal Deposit Insurance Corporation
550 17th Street, N.W.
Washington, D.C. 20429
Attention: Robert E. Feldman, Executive Secretary
RIN 3064-AE04

Re: Liquidity Coverage Ratio, Liquidity Risk Measurement, Standards, and Monitoring

Ladies and Gentlemen:

The rule proposed by your Agencies to implement for certain U.S. banks the liquidity coverage ratio (LCR) standard established in January 2013 by the Basel Committee on Banking Supervision (Basel Committee) would harm the State of California (State) and its taxpayers by increasing borrowing costs on municipal bonds and making it more expensive and riskier to manage the State's operational cash balances.

On behalf of the State, I respectfully request the proposed LCR rule be amended to eliminate these substantial, and unjustified, fiscal threats.

The State of California is one of the largest issuers of municipal bonds in the country, and the State Treasurer's Office manages the sale of those bonds. My office has two significant concerns about the proposed LCR rule.

First, the exclusion of municipal securities from the definition of High Quality Liquid Assets (HQLAs) would increase borrowing costs for the State of California – and other municipal

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issuers throughout the U.S. The exclusion is not warranted given the demonstrated depth, diversification and liquidity of the municipal market.

Further, the proposed LCR rule would unduly disadvantage U.S. municipal issuers – which provide essential services and infrastructure to U.S. citizens – relative to foreign countries such as Slovenia, Saudi Arabia, Botswana, France, Italy, Taiwan and the United Arab Emirates. Those nations' sovereign debt would qualify as HQLAs under the proposed LCR rule, while U.S. municipal bonds would not. As a result, the rule would provide greater incentives for U.S. financial institutions to do business with foreign governments than with more creditworthy U.S. municipal issuers. Such a result would be unjustifiable and clearly against the broader policy interests of the United States.

Second, the proposed LCR rule treats collateralized municipal deposits (CMDs) as "secured funding transactions" with no liquidity value to the banks and subjects CMDs to a 100 percent unwind requirement. Additionally, it adopts an assumed outflow rate of 100 percent for CMDs secured by non-HQLAs.

My office administers the State's Centralized Treasury System and its $58 billion Pooled Money Investment Account. We strongly believe the assumptions underlying these provisions are completely at odds with historical market experience and that the proposed rule would increase the costs and risks associated with managing the State's operational cash balances.

Concerns about the proposed LCR rule extend beyond municipal issuers to banks, rating agencies and other important market participants.

To address these concerns, I respectfully request your Agencies to amend the proposed LCR rule in two ways. First, designate all investment grade municipal securities as Level 2A HQLAs. Second, exclude CMDs from the secured funding unwind requirements of Section 21(f) of the rule and reduce the assumed outflow rate for non-HQLA-backed CMDs to 25 percent, which would be consistent with the Basel Committee's recommended maximum rate.

The first section of this letter explains in detail why my office believes investment grade municipal securities should be treated as Level 2A HQLAs and why failure to do so would increase borrowing costs for municipal issuers, heighten volatility in the municipal market and penalize U.S. municipal issuers relative to foreign governments. The second section discusses why CMDs should not be treated as "secured funding transactions," or be assigned a 100 percent outflow rate when backed by non-HQLAs, and why the proposed CMD provisions would increase costs and administrative burdens for municipal depositors.

TREATMENT OF MUNICIPAL SECURITIES UNDER PROPOSED LCR RULE

The proposed LCR rule states that assets classified as HQLAs "exhibit low risk and limited price volatility, are traded in high-volume, deep markets with transparent pricing, and...are eligible to be pledged at a central bank." In addition, the rule requires that certain categories of HQLA, including Level 2A HQLAs, be "liquid and readily-marketable." That means they are traded in an active secondary market which features: more than two committed market makers; a large number of non-market maker participants on both the buying and selling side of transactions; timely and observable market prices; and a high trading volume.

Based on my office's experience as one of the largest issuers of municipal bonds, and our review of a variety of statistical information regarding the municipal market, we believe investment grade municipal securities meet all these criteria. We disagree with the Agencies' conclusion that "[municipal securities] are not liquid and readily-marketable in U.S. markets and thus do not exhibit the liquidity characteristics necessary to be included in HQLA under this proposed rule." The paragraphs below discuss each of the relevant criteria.

Low Risk and Limited Price Volatility – Municipal securities are among the lowest-risk securities across all markets. This is in part demonstrated by extremely low historical default frequencies for rated municipal bonds. For example, the average one-year default rate was only 0.012 percent from 1970 through 2012. (*Source: Moody's Investors Service, "US Municipal Bond Defaults and Recoveries, 1970–2012, published May 7, 2013*). In addition, municipal securities do not pose foreign exchange risk to U.S. financial institutions and generally present significantly less bankruptcy risk than corporate debt. Under Chapter 9 of the U.S. Bankruptcy Code, a municipality cannot be forced into bankruptcy by a creditor and the standing of bondholders in bankruptcy is explicitly stated in bond indentures and is legally enforceable. In addition, states are not eligible to file bankruptcy.

Since the 2008-09 credit crisis and during the subsequent protracted recovery, U.S. municipal securities have demonstrated exceptional credit strength and stability. For example, according to Moody's Investors Service (Moody's), "more than 80% of roughly 7,420 general obligation and related ratings were unchanged through the downturn. By contrast, the average corporate rating declined to Ba2 in 2013 from Ba1 in 2009, showing the local government sector's relative resilience compared to corporate credits." Certainly, municipal credits have experienced greater credit stability than numerous European sovereign credits whose government securities would be treated as HQLAs under the proposed LCR rule. The Agencies already have recognized the low risk characteristics of municipal securities by assigning them a 20 percent risk weighting under the Agencies' own regulatory capital rules.

Consistent with their very low credit risk, municipal securities also have demonstrated less price volatility than other asset classes. For example, over the last 90 years, the largest monthly price declines for AA-rated municipal general obligation (GO) bonds (-9.2 percent) and A-rated municipal revenue bonds (-10.3 percent) was less than the maximum drop for U.S. Treasury prices (-11.8 percent) and BBB corporate bonds (-15.7 percent). (*Source: Wells Fargo Bank Comment Letter on Proposed LCR Rule*) In addition, the averages of the five worst monthly price declines of AA-rated municipal GO bonds (-8.48 percent) and A-rated municipal revenue bonds (-9.04 percent) were comparable to the average for U.S. Treasuries (-7.80 percent) and better than the average for BBB corporate bonds (-12.22 percent). (*Source: Wells Fargo*)

In short, municipal securities have demonstrated price stability similar or superior to U.S. Treasury securities and investment grade corporate bonds the proposed LCR rule classifies as HQLAs.

High Volume, Deep Markets with Transparent Pricing – In order to accurately assess trading volume in the municipal market, we believe it is most appropriate to look at aggregate trading volumes for an individual issuer or credit, rather than trading of individual CUSIPs. Due to the common use of serial maturity structures, a single issuer often will have hundreds or even thousands of individual CUSIPs outstanding. For example, the State currently has 1,500 CUSIPs outstanding for our GO bonds. While each individual CUSIP may not trade on a regular basis, a price for any of the CUSIPs can be readily and easily quoted by a dealer based on where other State GO bonds are trading. Thus, the best measure of liquidity is the volume of California GO bonds traded relative to the State's total outstanding GO debt. In 2013, 0.30 percent of all California GO bonds traded daily, a ratio that shows the market for the State's bonds is liquid and active.

Looking more broadly at the municipal market, daily municipal security trading volumes relative to aggregate outstanding municipal debt compare favorably to trading volumes for assets treated as HQLAs under the proposed LCR rule. According to data published by the Securities Industry and Financial Markets Association (SIFMA), the municipal market in 2013 traded 0.30 percent of its total outstanding principal every day, compared to 0.19 percent for corporate bonds and 0.32 percent for government-sponsored entities (GSE). Further, in 2013 the average daily trading volume in the municipal market was $11.2 billion, almost twice as much as the average daily trading volume in GSE debt of $6.5 billion.

These statistics make clear the municipal securities market is a "high volume" market as required for HQLA status.

The Municipal Securities Rulemaking Board (MSRB) regulates more than 1,600 registered broker-dealers who serve as market makers for municipal securities. Individual retail investors hold about 44 percent of outstanding municipal bonds. Mutual funds (17 percent), U.S. chartered depository institutions (11 percent), property and casualty insurance companies (9 percent), money market mutual funds (8 percent) and life insurance companies (4 percent) are other large holders of municipal securities. (*Source: Z.1 statistical release of the Financial Accounts of the U.S., Federal Reserve, December 9, 2013*). Further, municipal securities comprise less than 4 percent of bank portfolios (*Source, Citigroup Global Markets Inc. December 23, 2013*), and would provide diversification opportunities to banks if treated as HQLAs.

Clearly, the municipal securities market is deep and diverse.

In the municipal market, all trades are required to be electronically posted within 15 minutes of execution (MSRB, Rule G-14). Market participants easily can access relevant trading information through a variety of broadly available electronic data dissemination platforms, including Thomson-Reuters, the MSRB's EMMA online platform and Bloomberg Information Services. In other words, municipal bond pricing is fully transparent.

Eligible to Be Pledged at Central Banks – The proposed LCR rule requires that HQLAs be eligible to be pledged at a central bank. The U.S. Federal Reserve Bank accepts U.S. municipal bonds at a 2 percent to 5 percent haircut, the same as U.S. GSE debt, and lower than U.S. investment grade corporate bonds.

<u>Liquid and Readily Marketable</u> – For certain classes of HQLAs, including Level 2A assets, the Agencies have indicated the securities must be deemed "liquid and readily marketable." To meet this definition, the securities must trade in an active secondary market with more than two market makers. There are, in fact, about 1,600 municipal market makers nationwide. The secondary market also must have a large number of non-market making participants on both the buy and the sell side of transactions. Individuals, separately managed account managers, a wide variety of mutual funds, property and casualty insurance companies, life insurance companies, banks, closed-end funds and hedge funds all are active, long-term municipal market participants.

Your Agencies also have indicated the market for such securities should have timely and observable market prices. All municipal trades are reported and available to all market participants electronically within 15 minutes of trade execution. Finally, the proposed LCR rule says the secondary market for Level 2 assets and other HQLAs is characterized by high trading volume. The relative trading volumes in the municipal market are similar to those for corporate bonds and GSEs, with evidence of higher volumes during periods of stress.

<u>Clearly, by your Agencies' own standards, the secondary market for municipal securities is "liquid and readily marketable."</u>

<u>Municipal Market Performance During the Financial Crisis</u> – The performance of the municipal bond market during the 2008-09 financial crisis provides evidence of the depth and liquidity of the market and supports municipal securities' designation as Level 2A HQLAs. In the six months from September 2008, when Lehman Brothers failed, through February 2009, when the stock market bottomed out, the primary municipal issuance market functioned extremely well. Issuers raised more than $135 billion of capital, in almost equal amounts each month. (*Source: The Bond Buyer, A Decade of Municipal Bond Finance*). The secondary municipal market also demonstrated strength and depth throughout this period. For example, in 2008, daily trading volumes for municipal securities averaged 0.52 percent of principal outstanding, higher than the daily trading volumes for 2012 or 2013. During the fourth quarter of 2008, the daily trading volume for the State's GO bonds averaged 0.42 percent of principal outstanding, higher than in 2013 (0.30 percent).

<u>Thus, both broader market data and California-specific data demonstrate the municipal market performs well and maintains excellent liquidity during periods of severe financial stress.</u>

<u>Adverse Impact of Not Classifying Municipal Securities as HQLAs</u> – Many of the largest and most important participants in the municipal market are banks subject to the proposed LCR rule. Based on our extensive experience in the municipal market, my office believes the rule, as currently drafted, would increase borrowing costs for municipal issuers, reduce market liquidity, increase market volatility and unjustifiably disadvantage U.S. municipalities relative to foreign governments in accessing U.S. capital markets.

Banks will prefer to hold assets that qualify as HQLAs over assets that do not. Therefore, non-HQLA securities may be allocated balance sheet capacity by banks only if such securities generate higher returns than HQLAs. If municipal securities are not treated as HQLAs, the largest dealers in the municipal market likely would downsize their municipal bond inventories to reduce the amount of non-HQLA securities they hold and/or require higher revenues to sustain current levels of activity.

Therefore, issuers will face higher costs due to higher underwriting fees, reduced market liquidity and wider bid-asked spreads, as the major dealers and banks adjust their business practices in reaction to the proposed LCR rule.

If banks become less willing to hold an inventory of municipal bonds, which we believe is likely, the rule also would have the unintended consequence of increasing volatility in the municipal market. That, in turn would increase financial risk not only for issuers and professional investors, but also for retail investors who directly or indirectly hold municipal bonds.

Banks also provide direct lending to municipal issuers by privately purchasing municipal securities. If municipal securities are not deemed HQLAs, we believe banks will charge higher rates on these direct-lending products.

In addition, bank portfolios hold approximately 11 percent of all outstanding municipal securities, with a large portion of these holdings at banks covered by the proposed LCR rule. If municipal securities do not qualify as HQLAs, these banks will tend to divest themselves of existing holdings and only acquire new positions if bonds offer substantially higher yields than HQLAs with similar risk characteristics. Given that banks have been a significant buyer of the State's bonds over the years, this could increase our cost of capital.

Lastly, the proposed LCR rule would disadvantage U.S. municipal issuers providing essential services and infrastructure to U.S. citizens vis-à-vis foreign countries whose sovereign debt would qualify as HQLAs. Such countries include Slovenia, Saudi Arabia, Botswana, France, Italy, Taiwan and the United Arab Emirates. The taxpayers in California and across the country who would be harmed by the proposed rule no doubt would be surprised to learn a federal regulation favors foreign countries over their own states and local governments – for no legitimate reason.

By excluding municipal securities from the definition of HQLA, the proposed LCR would provide U.S. financial institutions greater incentives to do business with foreign governments than more creditworthy U.S. municipal issuers. That result is simply indefensible. It would clearly damage the country's broader policy interests. It should not be allowed to stand.

COLLATERALIZED MUNICIPAL DEPOSITS' TREATMENT UNDER PROPOSED LCR RULE

Municipal entities currently have more than $400 billion of CMDs with insured depository institutions. These deposits are a critical component of many municipal entities' cash management activities. In most cases, the deposits are required under state and local laws to be collateralized by the institution which holds them. In some cases, the deposits are collateralized by municipal bonds, which, under the proposed LCR rule are not designated as HQLAs.

Currently, municipal bonds comprise about 23 percent of the collateral provided by banks to the State for deposits. The deposits represent a stable source of funding for banks and are fundamentally different from the secured funding that banks use to finance securities inventory in the wholesale funding markets. The proposed LCR rule fails to recognize the fundamental differences and classifies CMDs as "secured funding transactions."

First, as my office understands it, the proposed treatment of CMDs as secured funding transactions would require banks to hold liquidity reserves (i.e. Level 1 Assets such as cash or U.S. Treasuries) equal to 100 percent of the amount of such deposits or cause a decline in their LCR.

Second, the proposed LCR rule effectively assumes 100 percent of CMDs would be withdrawn if a bank became financially distressed, with the associated collateral becoming unencumbered for purposes of the LCR calculation. When the deposits are withdrawn, if the newly unencumbered HQLAs released back to the banks cause total holdings of that particular type of HQLA to exceed a depository institution's HQLA limits for that type of security [e.g., GSE mortgage-backed securities (MBS)], going over the limit would adversely impact the institution's LCR. Given that a high percentage of CMD collateral is comprised of GSE MBS and municipal securities, treating CMDs in this manner could have an adverse impact on banks' LCR calculations.

Finally, the proposed LCR rule assumes 100 percent of CMDs backed by municipal securities (which are not deemed HQLAs under the proposed LCR rule) would be withdrawn over a 30-day period of financial stress. This outflow assumption is greater than the outflow assumption for unsecured_deposits from municipal entities, which is set at 25 percent to 40 percent for uninsured deposits.

<u>Assuming higher outflow rates for CMDs than for unsecured municipal deposits is illogical and would further discourage banks from accepting CMDs.</u>

The key assumption behind the proposed LCR rule's treatment of CMDs also appears to be completely at odds with historical market experience. For example, Wells Fargo Bank, the successor to Wachovia Bank, told my office Wachovia's CMDs declined by only 11 percent during the peak attrition month after the Lehman Brothers bankruptcy. Citigroup has stated it did not experience any material public-sector deposit outflows during the 2008-09 crisis. Statistics from the Federal Financial Institutions Examination Council show CMDs grew every year from 2007 through 2012.

My office's own direct experience is consistent with this history. During the financial crisis, we did not make any "risk-driven" withdrawals of CMDs.

<u>In short, CMDs are a stable source of depository funding for banks.</u>

The proposed LCR rule's treatment of CMDs would create a stronger incentive for banks to stop offering these products because of the decreased profitability resulting from the issues described above. If banks eliminate this product, the State and other municipal issuers could lose access to critical, cost-effective depository services that are required to efficiently manage our cash management and payment service needs.

Conclusion

An objective analysis of the municipal securities market clearly shows investment grade municipal securities "exhibit low risk and limited price volatility, are traded in high-volume, deep markets with transparent pricing, and...are eligible to be pledged at a central bank." By any reasonable standard, and as repeatedly demonstrated by historical performance, they are "liquid and readily-marketable."

Excluding investment grade municipal securities from the pool of HQLAs will increase the cost of capital for municipal issuers, heighten market volatility, reduce direct lending to municipal borrowers, and unfairly disadvantage U.S. municipal issuers relative to foreign governments in the competition for cost-effective capital.

The data and history also provide clear and convincing evidence that CMDs constitute a stable source of depository funding that should not be treated the same as secured financing transactions used by financial institutions to finance inventory in the wholesale funding markets. Doing so would be inconsistent with market experience and increase costs and risks associated with managing operational cash balances.

The proposed LCR rule should be amended to:

- CMDs from the unwind requirements of Section 21(f).
- Designate all investment grade municipal securities as Level 2A HQLA.
- Reduce the assumed outflow rates for CMDs secured by municipal securities to 25 percent.

The proposed LCR rule has a laudable goal – to strengthen banks' ability to withstand financial stress. That objective can be attained, however, without inflicting undue harm on governmental entities and the taxpayers they serve. As drafted, the LCR rule would inflict such harm. The amendments we seek would ensure it does not.

I appreciate your consideration of our comments and welcome any questions the Agencies may have for us.

Sincerely,

BILL LOCKYER
California State Treasurer