RBC Capital Markets®

January 31, 2014

By Electronic Mail

Office of the Comptroller of the Currency
Legislative and Regulatory Activities Division
400 7th Street SW
Suite 3E-218, Mail Stop 9A-11
Washington, DC 20219
(Docket Number OCC-2013-0016; RIN 1557 AD 74)

Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue NW
Washington, DC 20551
Attn.: Robert de V. Frierson
(Docket No. R-1466; RIN 7100-AE-03)

Federal Deposit Insurance Corporation
550 17th Street NW
Washington, DC 20429
Attn.: Comments, Robert E. Feldman, Executive Secretary
(RIN 3064-AE04)

Re: Comment on a Proposed Rule to Implement a Quantitative Liquidity Requirement

Ladies and Gentlemen:

Royal Bank of Canada Capital Markets, LLC ("RBCCM") appreciates the opportunity to share our views in response to the request for public comment issued by the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, and the Federal Deposit Insurance Corporation (collectively, "the Agencies") on a proposed rule ("the NPR" or "the proposal")[1] that would implement a quantitative liquidity requirement consistent with the liquidity coverage ratio ("LCR") standard established by the Basel Committee on Banking Supervision ("Basel" or "Basel Committee"). In this letter, RBCCM is providing comments specifically in relation to covered bonds and our view that they should qualify as High Quality Liquid Assets ("HQLA"). Our central arguments in support of this position are as follows:

[1] 78 Fed. Reg. 71818 (Nov. 29, 2013) [hereinafter NPR] *available at* http://www.gpo.gov/fdsys/pkg/FR-2013-11-29/pdf/2013-27082.pdf.

1. Treating covered bonds as HQLA is consistent with their treatment by other jurisdictions and with the Basel Committee's goal of harmonization;

2. Covered bonds are liquid assets;

3. Covered bonds are high-quality assets;

4. Treating covered bonds as HQLA will promote financial stability; and

5. Treating covered bonds as HQLA is important to housing finance reform in the U.S.

Each of these points is discussed in more detail below.

1. Treating covered bonds as HQLA is consistent with their treatment by other jurisdictions and with the Basel Committee's goal of harmonization.

The Basel Committee published international LCR standards in December 2010 and revised those standards in January 2013. As the Agencies have said, the purpose of the Basel LCR is to establish "an internationally harmonized quantitative liquidity standard that has the primary objective of promoting the short-term resilience of the liquidity risk profile of internationally active banking organizations".[2] RBCCM is supportive of the Basel Committee's efforts to strengthen liquidity within and across jurisdictions, and of the efforts by the Agencies to implement liquidity standards in the U.S. that are consistent with the Basel standards. However, we believe the exclusion of covered bonds from classification as HQLA is inconsistent with these dual objectives of strengthening resilience and promoting cross-border harmonization. Specifically, the December 2013 report of the European Banking Authority ("EBA") to the European Commission ("EC") on highly liquid assets recommends that covered bonds be classified as HQLA by the EC[3]. While there remains debate on the specific classification between Level 1 and Level 2A[4] it appears likely that they will, in fact, receive one of those

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[2] NPR at page 4.

[3] See EBA, *Report on Appropriate Uniform Definitions of Extremely HQLA and HQLA and on Operational Requirements for Liquid Assets* (December 2013) [hereinafter EBA Report], *available at* https://www.eba.europa.eu/documents/10180/16145/EBA+BS+2013+413+Report+on+definition+of+HQLA.pdf. The EBA report, covering the period of January 1, 2008 through June 30, 2012, distinguishes between "Extremely High Quality Liquid Assets" ("extremely HQLA") and HQLA. Within these distinctions, the report suggests on page 18 the following with respect to covered bonds, without specifically indicating which level should ultimately be assigned by the EC: "If it is shown that credit quality is a determinant of liquidity for individual assets, this would imply that the covered bond sample as a whole may be found to have better liquidity characteristics than corporate bonds and government bonds. . . . In reality, corporate bonds and covered bonds of the same credit quality might be equally liquid." It also noted on page 26 that, in reference to the ongoing debate regarding the ultimate classification of covered bonds and in recommendation of HQLA status, "The analysis shows that some covered bonds display an excellent liquidity based on the available data, which reflects the European covered bond market."

[4] See EBA Report at page 26. ("Nevertheless, two thirds of the observations come from markets that did not experience a real estate crisis. There are doubts as to whether the findings of the current analysis are sufficient to justify a deviation from the international standards and the inclusion of some covered bonds in the category of

HQLA classifications – rather than be excluded altogether as HQLA. This conclusion is supported, in part, by the study's analysis of the strength of the European covered bond market's performance during and after the financial crisis[5]. Moreover, the Office of the Superintendent of Financial Institutions ("OSFI") in Canada has currently slated covered bonds to be rated as Level 2A HQLA[6].

Given the Basel Committee's objective of harmonizing liquidity standards across jurisdictions, and given the statements from the EC and Canada in support of treating covered bonds as HQLA, it would be inconsistent with the goal of cross-border harmonization for the Agencies to exclude covered bonds from the HQLA pool.

2. Covered bonds are liquid assets.

In the NPR, the Agencies state firstly that covered bonds are not liquid enough for HQLA classification. In addressing this claim, it is important to highlight that the product has a long and established history in Europe, dating to the 18th century, and has demonstrated the potential to achieve a status within the U.S. financial system that is comparable to covered bonds' status in Europe and that is similar to the market for publicly traded corporate debt. Our examination of covered bond secondary market pricing and performance relative to publicly traded investment grade corporate bonds, which are defined in the proposal as level 2B liquid assets, demonstrates that covered bonds display liquidity characteristics comparable to publicly traded corporate debt. In particular, the data demonstrates stable and observable pricing, as well as adequate secondary market trading volume. This data runs counter to the Agencies' claim that "these assets are not liquid and readily marketable".[7]

In the graph below, we have plotted a 3-5 year composite U.S. Dollar denominated covered bond credit spread index versus the Bloomberg 1-5 year Corporate Index. As is apparent, the two data series are correlated, with the relationship growing stronger over time, arguably in concert with the increasing size of the domestic covered bond market. Along these lines, nearly 75% of all domestic covered bond issuance has occurred in the past three years with substantial additional issuance projected in the coming years.

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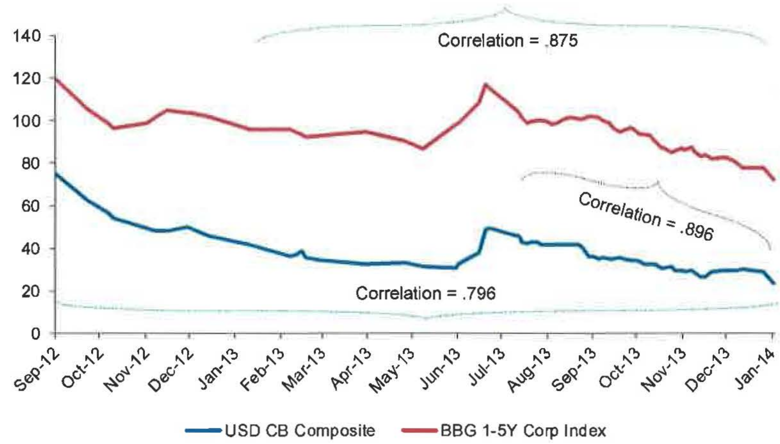
extremely high quality liquid assets the characteristic of which is to allow unlimited recourse to such instruments to cover for liquidity requirements.")

5 EBA Report at page 21.

6 See OSFI, *Liquidity Adequacy Requirements (LAR), Chapter 2 – Liquidity Coverage Ratio* (November 2013), *available at* http://www.osfi-bsif.gc.ca/Eng/fi-if/rg-ro/gdn-ort/gl-ld/Pages/LAR_chpt2.aspx. Paragraph 45 states that, "A 15% haircut is applied to the current market value of each level 2A asset held in the stock of HQLA. Level 2A assets are limited to the following: . . . .Corporate debt securities (including commercial paper) and covered bonds that satisfy [certain] conditions."

7 NPR at page 24.

RBCCM USD 3-5Y CB Composite vs. Bloomberg 1-5Y Corp Index[8]



The second component of "liquidity" that warrants highlighting is the volume of turnover in the secondary space. Looking across Trade Reporting and Compliance Engine ("TRACE") data for the 170 most actively traded triple-A corporate securities, 42 (i.e., 24.7%) are covered bonds. As the table below illustrates, of the top 15 most actively traded triple-A rated corporate securities, four (i.e., 26.7%) are covered bonds issued by the Royal Bank of Canada. This would support the assertion that covered bonds have adequate turnover in the secondary market and places them in very good stead with a number of "Blue Chip" securities that are currently classified as HQLAs.

Top 15 Active Triple-A Corporates[9]

Top 15 Most Actively Traded (by volume) AAA Corporates	
Security	Volume ($m)
MSFT 3 5/8 12/15/23	$373,821
MSFT 4 7/8 12/15/43	$222,696
RY 2 10/01/18	$201,392
MSFT 1 5/8 12/06/18	$185,931
RY 1 1/8 07/22/16	$160,688
JNJ 4 1/2 12/05/43	$137,426
MSFT 2 3/8 05/01/23	$122,900
RY 1.2 09/19/17	$122,144
HUGHES 3 1/2 09/01/23	$117,914
MSFT 2.95 06/01/14	$105,160
RY 0 5/8 12/04/15	$93,955
MSFT 1 5/8 09/25/15	$90,606
JNJ 1.2 05/15/14	$89,485
JNJ 3 3/8 12/05/23	$70,435
MSFT 3 1/2 11/15/42	$67,697

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[8] RBCCM analysis based on Bloomberg *US Corporate Bond 1 to 5 Year Index* and RBCCM data as of January 10, 2014.

[9] RBCCM analysis based on TRACE data for the total nominal USD volume of AAA Corporate bonds trading over the 50-day period ending January 10, 2014.

There is also evidence that covered bonds maintain their liquidity characteristics during periods of stress. The EBA's December 2013 report on HQLA highlights in significant detail the strength of the European covered bond market's performance during the timeframe of its study, which covers the period of January 1, 2008 through June 30, 2012. The report finds that, "At an aggregate level this analysis showed that sovereign bonds were the most liquid assets in the sample, followed closely by covered bonds and some other forms of public sector securities. Corporate bonds were shown to be moderately liquid, while ABS, gold and equity showed low levels of market liquidity on a number of important metrics."[10]

3. Covered bonds are high-quality assets.

The NPR also raises concerns about "risks [posed by covered bonds] regarding interconnectedness and wrong-way risk among companies in the financial sector."[11] Covered bonds are dual recourse instruments; their debt service is primarily the responsibility of the issuer, but they are also backed by a pool of non-securitized collateral. The collateral is most commonly a pool of residential mortgage loans, which are managed and held on-balance sheet in an amount at least equal to the amount of covered bonds outstanding for each bond issuance. As covered bonds are not securitizations, investor recourse in the event of a covered bond default is two-fold; to the issuer and, in the event of issuer insolvency, directly to the collateral pool, to which investors typically have first lien priority with respect to claims, ahead of unsecured creditors. Accordingly, the risk associated with covered bonds lies ultimately with the collateral and not solely with the issuing financial institution.

The high quality nature of the collateral associated with covered bonds, along with their high correlation to publicly traded corporate bond pricing and liquidity, suggests that covered bonds for these reasons alone warrant treatment as, at minimum, Level 2B liquid assets. Indeed, given the potential for further development of the U.S. covered bond market, the attendant evidence of further liquidity, and the aforementioned robust liquidity characteristics of covered bonds in Europe during and after the financial crisis, covered bonds might eventually warrant classification as level 2A liquid assets in parity with the Basel standard.

To further strengthen covered bonds' status as HQLA, we share the view described in the comment letter submitted by the Securities Industry and Financial Markets Association ("SIFMA") and the Structured Finance Industry Group ("SFIG") that a U.S. dollar denominated covered bond should only qualify as a Level 2B liquid asset if:

(1) It is a security registered for offer and sale under the Securities Act of 1933 ("Act") or, if exempt from such registration, is eligible for resale in reliance of Rule 144A of the Act;

(2) It is a senior debt security issued by a regulated unaffiliated financial institution located in an Organization for Economic Co-Operation and Development ("OECD") country;

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[10] EBA Report at page 21.

[11] NPR at page 24.

(3) It is investment grade under the OCC's investment regulation;

(4) The applicable transaction documents grant debtholders (or a trustee on their behalf) the right to sell the covered asset pool upon payment default and such sale could not be stayed or otherwise delayed due to the insolvency of the issuing entity under applicable law; and

(5) It is sponsored by an entity whose obligations have a proven track record as a reliable source of liquidity in repurchase or sales markets during stressed market conditions, demonstrated by (A) the market price of the covered bond or equivalent securities of the sponsor declining by no more than 20 percent during a 30 calendar-day period of significant stress, or (B) the market haircut demanded by counterparties to secured lending and secured funding transactions that are collateralized by the covered bond or equivalent securities of the sponsor declining no more than 20 percentage points during a 30 calendar-day period of significant stress.

4. Treating covered bonds as HQLA will promote financial stability.

Financial regulators and lawmakers in the U.S. have long-recognized that covered bonds can play a meaningful role in promoting financial stability for U.S. financial institutions and the U.S. financial system as a whole[12]. Notwithstanding its concerns about the accessibility of a covered bond asset pool in the event of a receivership or a conservatorship, the Federal Deposit Insurance Corporation ("FDIC") has, at least conceptually, endorsed covered bonds' positive impact on financial institutions and the financial system: "Based upon the information available to date, the FDIC agrees that covered bonds may be a useful liquidity tool for [insured depository institutions] as part of an overall prudent liquidity management framework and the parameters set forth in this policy statement."[13]

It follows that failing to assign at least level 2B liquid asset status to covered bonds could have unintended negative consequences on the stability of financial institutions in the U.S. and on the U.S. financial system as a whole. Financial stability is promoted not only by the quality of liquid assets but by the diversity of such assets. We believe regulatory policy should encourage firms to have as broad a mix of HQLA as possible and that, for the aforementioned reasons, covered bonds merit inclusion in that mix. Moreover, if this asset class cannot be counted as HQLA, then current and potential investors could be dissuaded from active participation in the U.S. covered bond market and market liquidity in general could be negatively affected.

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[12] *See* Department of the Treasury, *Best Practices for Residential Covered Bonds* (July 2008) [hereinafter Treasury Best Practices], *available at* http://www.treasury.gov/about/organizational-structure/offices/General-Counsel/Documents/USCoveredBondBestPractices.pdf; The United States Covered bond Act of 2011, H.R. 940, 112th Congress [hereinafter H.R. 940]; and The United States Covered Bond Act, S. 1835, 112th Congress [hereinafter S.1835].

[13] 73 Fed. Reg. 21949, (April 23, 2008), *available at* http://www.fdic.gov/regulations/laws/rules/5000-1550.html.

5. Treating covered bonds as HQLA is important to housing finance reform in the U.S.

As U.S. policymakers contemplate reforms to U.S. housing finance, many have called for legislative and other measures to support covered bonds as one financing option that is consistent with safe and sound banking practice[14]. However, excluding covered bonds from the pool of HQLA will discourage financial institutions from participating in the growing U.S. covered bond market and could further impede the return of private capital to the residential mortgage market. Instead, by designating covered bonds as HQLA, the Agencies will help ensure that these instruments can serve as a source of housing finance that serves policymakers' goals of enhancing the role of private capital in the mortgage marketplace and promoting stability within financial institutions and the financial system as a whole[15].

Conclusion.

In summary, we would reiterate that recognizing covered bonds as HQLA is consistent with their treatment by the Basel Committee, and by their expected designation as highly liquid assets by the EC and by OSFI. Inconsistency with the international community would create an unlevel playing field and diverges from the Basel Committee's goal of harmonization. The U.S. covered bond market demonstrates secondary market liquidity and trading volume characteristics that are comparable to highly rated publicly traded corporate debt, which has been accorded HQLA status in the proposal. Based on the characteristics of covered bonds – including their trading volume, stable pricing, and dual-recourse instrumentality – we believe that, subject to the criteria described herein, the asset class fully meets the NPR's description of a highly liquid asset. We further believe that treating covered bonds as HQLA will promote financial stability by allowing banks to hold as diverse a pool of liquid assets as possible and by promoting market liquidity in the United States. Finally, covered bonds can help private capital return to the residential mortgage market.

Again, we at RBCCM appreciate the opportunity to comment on the proposed rule. We would be pleased to answer any questions regarding the statements made in this letter.

Respectfully,

John Rhinelander
Global Head, Fixed Income Origination

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[14] *See* H.R. 940 and S. 1835.

[15] Treasury Best Practices at page 6.