



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](http://www.sifma.org). This letter supplements other comments provided by SIFMA on this proposal.

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**Background:**

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<sup>1</sup> (“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.

**Discussion:**

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”).<sup>2</sup> 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<sup>3</sup>. 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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<sup>1</sup> Such borrowers typically include non-profit healthcare institutions, non-profit higher educational institutions and other similar non-profit organizations.

<sup>2</sup> See Section II.A.4 of the Advanced Approaches NPR.

<sup>3</sup> See 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.<sup>4</sup> 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<sup>5</sup> 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<sup>6</sup>. Any disparity between US and EU regulations on this point could put US Banks at a significant competitive disadvantage.

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<sup>4</sup> *Ibid.*

<sup>5</sup> 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).

<sup>6</sup> 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,

A handwritten signature in black ink, appearing to read "M. Decker". The signature is fluid and cursive, with a large initial "M" and a long, sweeping underline.

Michael Decker  
Managing Director and Co-Head of Municipal Securities



October 22, 2012

The Honorable Ben S. Bernanke, Chairman  
Board of Governors of the Federal Reserve System  
20<sup>th</sup> Street and Constitution Avenue, NW  
Washington, DC 20051  
**Docket No. R-1430 / RIN 7100-AD87**

The Honorable Martin J. Gruenberg, Acting Chairman  
Federal Deposit Insurance Corporation  
550 17<sup>th</sup> Street, NW  
Washington, DC 20429  
**RIN 3064-AD95; 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-2012-0008**

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: Treatment of Unrealized Gains and Losses on US Municipal Debt Securities

The Securities Industry and Financial Markets Association ("SIFMA") is pleased to comment on "Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Minimum Regulatory Capital Ratios, Capital Adequacy, Transition Provisions, and Prompt Corrective Action." 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](http://www.sifma.org). This letter supplements other comments provided by SIFMA on this proposal.

## I. Introduction

In June 2012, the Agencies issued the joint notice of proposed rulemaking (“NPR”) listed above, that would revise their risk-based and leverage capital requirements consistent with agreements reached by the Basel Committee on Banking Supervision (“BCBS”) in “Basel III: A Global Regulatory Framework for More Resilient Banks.” This letter will address the NPR in regard to U.S. municipal debt securities, described by the Agencies in the Standardized Approach proposed rule as either “General Obligations” or “Revenue Obligations” of Public Sector Entities (“PSE”), which the Agencies have defined to 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. In the NPR and the corresponding Proposed Rule (released on August 30, 2012), the Agencies discuss the “Treatment of Unrealized Gains and Losses of Certain Debt Securities in Common Equity Tier 1 Capital” and go on to mention U.S. municipal debt securities (“US PSE Debt”), stating:

*“The agencies also seek comment on whether unrealized gains and losses on general obligations issued by states or other political subdivisions of the United States should receive similar treatment, even though unrealized gains and losses on these obligations are more likely to result from changes in credit risk and not primarily from fluctuations in a benchmark interest rate.”*

We respectfully disagree with the Agencies that valuation changes in such securities are “more likely to result from changes in credit risk and not primarily from fluctuations in a benchmark interest rate.” To the contrary, one hundred years of data demonstrate that valuation changes in municipal debt securities are primarily driven by fluctuations in benchmark interest rates, and not changes in credit risk.

If the Agencies conclude that Accumulated Other Comprehensive Income (“AOCI”) associated with US Government Debt Obligations (i.e., U.S. Treasury Securities) should be excluded from Common Equity Tier 1 Capital (“CET1”), then both U.S. PSE General Obligation Debt and U.S. PSE Revenue Debt with certain credit characteristics should receive the same treatment. The Investment Grade definition, contained in Title 12 Code-of-Federal-Regulations<sup>1</sup> (“CFR”) Part 1, which were recently updated in order to meet the ratings removal requirements of Section 939A of the Dodd-Frank Act, and relied upon by the Agencies to bifurcate corporate exposures in the June 2012 joint final rule covering “Risk-Based Capital Guidelines: Market Risk”, should be used to define the US PSE Debt that should be eligible to have AOCI excluded from CET1. The Agencies could further narrow the universe of eligible US PSE Debt for this purpose (without regard to whether General Obligation or Revenue Obligation) by subdividing the revised Investment Grade definition, with the strongest credits being defined as Very High Quality (“VHQ”), and only allowing AOCI exclusion from CET1 for US PSE debt which met the VHQ designation (see Appendix A).

Symmetrical treatment for the exclusion of AOCI on CET1 for Government Obligations and VHQ Municipal Bonds is warranted in consideration of the following:

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<sup>1</sup> Department of Treasury, Office of the Comptroller of Currency Docket ID OCC–2012–0005. June 2012 Final Rule.

- A) Valuation changes on VHQ Municipal Bonds move in line with valuation changes on municipal bonds that have been legally defeased with US Government Obligations (Treasury Securities or SLGS<sup>2</sup>), which are referred to as PreRefunded (“PreRe”) Municipal Bonds. Both the market and the Code of Federal Regulations make clear that PreRe Municipal Bonds are treated as US Government risk and not the risk of the municipal issuer. Therefore, if no material spread basis exists between PreRe Municipal Bonds and other VHQ Municipal Bonds, one can infer that any basis that does arise between VHQ Municipal Bonds and on-the-run US Treasuries is not credit risk related.
- B) VHQ Municipal Revenue Obligation Bonds demonstrate no material price/valuation deviations from VHQ Municipal General Obligation Bonds. The Agencies should not make any distinction based on Revenue Obligation pledge vs. General Obligation pledge. The distinction should be based on credit quality, as it appears the Agencies intend to prevent credit driven valuation changes from being filtered from CET1. During the 2008 credit crisis, for example, VHQ Municipal Revenue Obligation Bonds displayed less spread variation to VHQ Municipal General Obligation Bonds than the spread variation observed between various off-the-run Treasury Notes and Treasury Bonds of similar maturity.
- C) Federal Reserve H.15 data shows that during financial stress of the 1930’s and 1970’s, valuation changes on VHQ Municipal Bonds were similar to that of US Government Debt Obligations.
- D) Despite attempts to sensationalize U.S. Public Sector credit issues in the popular media, over the past 100 years the realized credit losses on all municipal debt has been less than 1%. Given that there are over 78,000 unique US PSE entities, even if one US PSE filed bankruptcy every day for the next year; that would represent a 0.5% annual default rate. Although today’s credit evaluation methods cannot be applied to the past 100 years, if we use available NRSRO ratings, which was market practice from the 1920’s to 2010, there is no available evidence that a VHQ Municipal Bond ever defaulted.
- E) As recently noted<sup>3</sup> by staff of the Federal Reserve Bank of New York, defaults on US PSE debt that would meet the Type I and Investment Grade definition are extraordinarily rare. From 1970 through 2011, the 41-year cumulative total percentage of defaulting US PSE Obligor which would generally meet the Type I and Investment Grade definition was less than a quarter of one-percent.

Supporting evidence for the first four statements is contained in exhibits A, B, C, and D, respectively.

We support the desire to align CET1 with Tangible Common Equity (“TCE”); however, we do not believe this should be achieved by inhibiting municipal government access to bank financing relative to Federal

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<sup>2</sup> SLGs are State and Local Government Series (Federal Regulations (“CFR”) Title 31, Part 344). SLGs are non-marketable U.S. Government Obligations used primarily for creating escrows to legally defease the principal and interest of Municipal Bond Obligations.

<sup>3</sup> Jason Appleson, Eric Parsons, and Andrew Haughwout, “The Untold Story of Municipal Bond Defaults,” Federal Reserve Bank of New York, August 2012.

government access to bank financing, as both Federal and municipal entities govern and serve public taxpayers. Public policy and national interests, implemented at both the Federal and local level via debt financing, benefit the United States of America as a whole, and finance investment in such important areas as elementary schools, preference for home-ownership, military spending, bridges, water delivery systems, roads and subways, among others. Municipal Bonds issued to finance these national objectives should receive the same AOCI exclusion from CET1.

Individual State laws require that public sector deposit monies held at banks in excess of the FDIC insured amount be collateralized with either U.S. Municipal Securities or US Government Obligations. According to Federal Flow of Funds data, State & Local Governments had \$409bn of deposits on June 30, 2012. The ability of a bank to take and collateralize these public sector deposits will be damaged if AOCI associated with Municipal and Government Securities impacts CET1, as the additional regulatory capital required to support the Security position will likely make the business untenable from a regulatory capital perspective.

Even if the future is different from the past 100 years, and the default rate on PSE debt increases materially, PSE debt will not lead to widespread U.S. banking problems like the ones caused by bad real estate debt during the savings and loan<sup>4</sup> crisis or the broader financial crisis of 2008. Banks do not hold enough U.S. PSE debt, nor is there enough in existence, to lead to similar banking system losses. US deposit institutions currently hold \$4 trillion of non-GSE mortgages<sup>5</sup> vs. \$0.3 trillion of US PSE debt, and US tax law discourages banks from holding most state and local government debt. Since 1952 (earliest Fed data available), US Banks have held on average ten times the amount of non-GSE real estate backed mortgage debt than US PSE debt.

Additionally, consistency should be desired for the treatment of US PSE Debt within the US Agency Basel III Standard Approach NPR, the US Agency Basel III Advanced Approach NPR and the pending US Agency release on the Basel III Liquidity Coverage Ratio NPR. Ultimately, the US Agencies should harmonize the standard risk-weights, LCR eligibility and AOCI exclusion from CET1 for US Debt classes. For instance, all VHQ Municipal Bonds should be eligible for a 20% risk-weight under the standard approach, symmetrical AOCI treatment with US Government Obligations and eligible as liquid collateral for LCR purposes.

Depending on the views of other interested parties, such as foreign governments, state and local governments, and other industry groups, the Agencies should consider excluding AOCI from CET1 for all debt instruments which meet the Type I Security definition as contained in 12 CFR Part § 1.2. Delineating debt securities at the OCC definition of "Type I", for this purpose, would align with US Congressional preference demonstrated by public laws 73-66 and 106-102, which were implemented via 12 U.S.C. 24 (Seventh).

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<sup>4</sup> Former FDIC and RTC chairman William Seidman, "History of the 1980's. Lessons for the Future"

<sup>5</sup> Federal Reserve statistical release, Flow of Funds Accounts of the United States.



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,

A handwritten signature in black ink, appearing to read "M. Decker". The signature is fluid and cursive, with a large initial "M" and a long, sweeping underline.

Michael Decker  
Managing Director and Co-Head of Municipal Securities

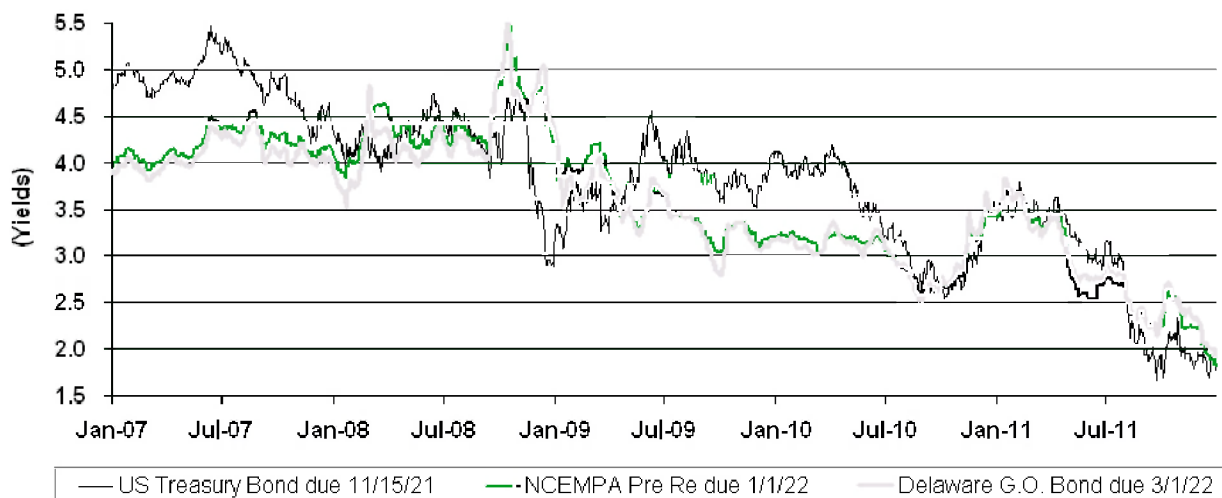
**EXHIBIT A****a. Valuation changes on VHQ Municipal Bonds are predominantly attributable to changes in benchmark interest rates and supply vs. demand factors, and not from changes in credit risk.**

*“The agencies seek comment on alternatives to the proposed treatment of unrealized gains and losses on AFS securities, including an approach where the unrealized gains and losses related to debt securities whose valuations primarily change as a result of fluctuations in a benchmark interest rate would be excluded from a banking organization’s regulatory capital”*

Valuation changes on VHQ Municipal Bonds generally follow the direction of Treasury Yields (presumed to be Benchmark Interest Rates), except during rapid de-levering periods, such as late 2008 and early 2009. However, these brief distensions are driven by liquidity contractions and not because of a perceived change in the Credit Risk of VHQ Municipal Bonds. This same phenomenon can be observed in the Treasury Market, where off-the-run treasuries widened to on-the-run treasuries and where less liquid US Government Guaranteed paper, such as Israel AID Bonds, widened even further.

VHQ Municipal Bonds do at times exhibit price and yield volatility versus the Treasury Yield Curve (assuming this is what the Agencies meant when describing “benchmark interest rates”); however, it is easily proven that this volatility does not come from credit risk, as the yields on PreRefunded (US Government Obligation risk and 0% risk weight) municipal bonds tracked yields on VHQ Municipal Bonds. Below is a comparison of three debt instruments:

- US Treasury Bond due 11/15/2021, CUSIP 912810EL8
- North Carolina Eastern Municipal Power Agency (“NCEMPA”) CUSIP 658196GA2, legally defeased with US Treasury Collateral in 2003 to a maturity date of January 1, 2022
- General Obligation Bond of the State of Delaware due 3/1/2022



The chart shows that the Delaware General Obligation Bond moves in line with the PreRe NCEMPA Bond. Over the five-year horizon shown above, the average yield on the Treasury Bond was 3.81%, the average yield on PreRe NCEMPA bond 3.59% and on the Delaware State General Obligation Bond 3.55%. During the 4Q of 2008 both the NCEMPA PreRe and the Delaware G.O. Bond lagged the rally in treasury rates, however the Delaware G.O. Bond did not materially deviate from the NCEMPA PreRe. The reason for the very brief distension between VHQ Municipal Bonds and US Government Bonds was not credit related; it was caused by the rapid reduction of financial leverage which existed globally during the month of December 2008.

Furthermore, this same phenomenon was observable in US Government Obligations (shown below), as 20-year old Treasury Bonds widened by 75bp versus just-off-the-run 10-year Treasury notes of the same maturity.

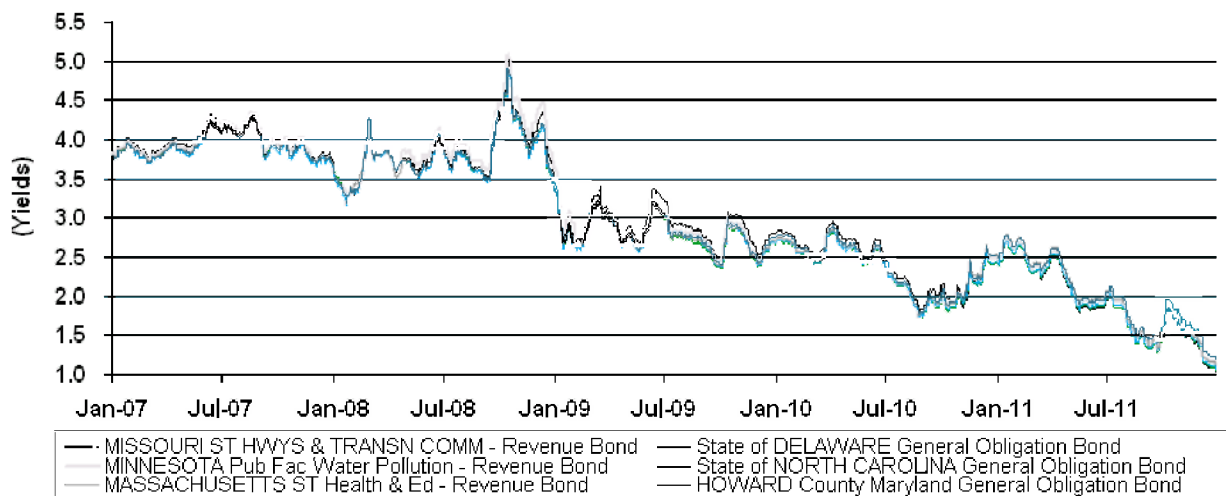


Under the present monetary arrangement (non convertible free floating currency), US Government obligations have no default risk (except for intentional repudiation or Congressional failure to raise the Debt Limit). Therefore, credit risk could not be the cause of an 80bps spread widening between US Government Obligations with the same final maturity, but differing dates of issue. The differential between like-maturity Government Obligations represents a liquidity preference, not a credit concern. The market has demonstrated this, as pre-2008 the spread was less than 10bps, and after going up to 80bps in 2008, has presently returned to 10bps. The same liquidity phenomenon explains the distension of both VHQ Municipal Bonds and pre-re municipal bonds versus on-the-run Treasuries during 2008. Neither very old Treasury Securities nor VHQ Municipal Bonds deviated from on-the-run treasuries because of “credit risk” – they both deviated because of acute liquidity contractions.

**EXHIBIT B****b. Valuation changes on VHQ Revenue Obligation Bonds are the same as valuation changes on VHQ General Obligation Bonds.**

VHQ Municipal Revenue Bonds demonstrate no material price/valuation deviations from VHQ Municipal General Obligation Bonds. For purposes of AOCI, the Agencies should not make their distinction based on Revenue Obligation Pledge vs. General Obligation Pledge. The distinction should be based on credit quality, as it appears to be the Agencies' intent to prevent valuation changes driven by credit risk changes from being filtered from CET1. During the 4Q of 2008, VHQ Municipal Revenue Bonds displayed less spread volatility compared to VHQ Municipal General Obligation Bonds (see chart below) than recently off-the-run Treasury Notes and 20-year old Treasury Bonds (see top chart on prior page).

The chart below shows the historic yield levels of three VHQ General Obligation Bonds and three VHQ Municipal Revenue Obligation Bonds:



We can observe that the market values of these bonds are materially similar, however the market is also conscious that they are not all backed by the same credit source. State of Delaware General Obligation bonds (AAA/Aaa) will be used as a benchmark for this discussion, since the prior section demonstrated that the market treats them as nearly identical to PreRe Municipal Bonds (US Government Obligation risk). Using daily prices, on December 17<sup>th</sup> 2008, the Minnesota Water Pollution Control Revenue Bonds reached a peak spread over the Delaware State General Obligations of 36 basis points, i.e., 0.36%. During the 3Q of 2008, the average spread between these two municipal credits was 15 basis points 0.15%. Subsequently, in early 2009, the spread between the two bonds narrowed back, and has been between one and ten basis points each trading day since. This shows us that the mild basis which exists between the VHQ General Obligation Bonds and VHQ Revenue Obligation Bonds is no greater than that which was observed between different US Government Obligations (on-the-run treasuries versus off-the-run treasuries, or active treasury strips versus Israel AID Bonds, for example).

Summary of Bonds shown in chart above, along with their peak widening to Delaware State GO Bonds:

<u>CUSIP</u>	<u>GO/Rev</u>	<u>Description</u>	<u>Maturity</u>	<u>Coupon</u>	<u>PeakSprd(bp)</u>
60636WJG1	Revenue Ob	Missouri State Highway & Transportation Comm	02/01/18	5.00%	22
246380B65	General Ob	Delaware State G.O.	03/01/18	5.00%	0
604114QQ4	Revenue Ob	Minnesota Pub Fac Water Pollution Control	03/01/18	5.00%	36
658256VG4	General Ob	North Carolina State G.O.	04/01/18	5.00%	4
57585K3E6	Revenue Ob	Massachusetts St Health & Education Auth	07/01/18	5.00%	12
442565QY6	General Ob	Howard County Maryland	08/15/18	5.00%	16

**EXHIBIT C**

c. **During severe systematic banking stress & economic stress, such as the 1930's & 1970's, valuation changes on VHQ Municipal Bonds were similar to Treasury Bonds.**

Two indices from the Federal Reserve's H.15 release allow us to look at historical financial stress periods:

- Composite Yields on US Treasury Bonds with Maturity over ten years
- Bond Buyer 11 General Obligation Bond Index based on 20-year Municipal Bonds

**Great Depression Period:** Looking at the 1930's, and assuming a bank acquired 20-year maturity Treasuries and 20-year maturity VHQ Municipal Bonds at the average available yields from January 1926 to December 1928, the table on the following page represents the annual valuation changes, based on annual yield averages.

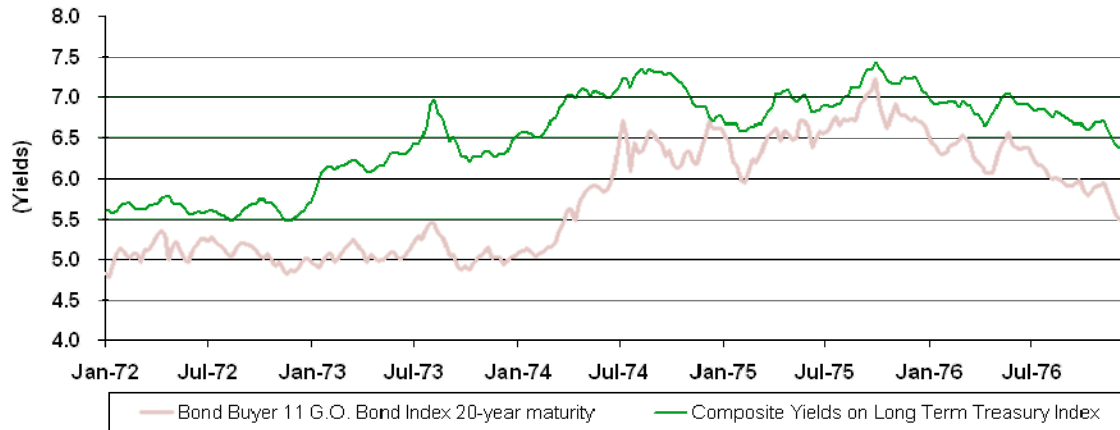
	<u>1926-'28</u>									
<u>Yields</u>	<u>Avg</u>	<u>1929</u>	<u>1930</u>	<u>1931</u>	<u>1932</u>	<u>1933</u>	<u>1934</u>	<u>1935</u>	<u>1936</u>	<u>1937</u>
Treasuries	3.45%	3.60%	3.29%	3.34%	3.68%	3.31%	3.12%	2.79%	2.69%	2.74%
Municipals	4.02%	4.28%	4.08%	3.87%	4.33%	4.29%	3.73%	3.00%	2.69%	2.67%

<u>Cumulative Price</u>										
<u>Change</u>		<u>1929</u>	<u>1930</u>	<u>1931</u>	<u>1932</u>	<u>1933</u>	<u>1934</u>	<u>1935</u>	<u>1936</u>	<u>1937</u>
Treasuries		-2.2%	2.4%	1.6%	-3.3%	2.0%	4.8%	10.1%	11.7%	10.8%
Municipals		-3.5%	-0.8%	2.0%	-4.1%	-3.6%	4.1%	15.3%	20.4%	20.8%

The price changes shown represent the cumulative AOCI impact of the portfolio that was acquired over the three years before 1929. Negative numbers represent OCI losses. Marking the portfolios versus monthly data produces peak losses of 11% for Municipals in May of 1933 and 11% for Treasuries in January of 1932, both of which materially reverted the subsequent month. No reasonable analysis of the yield data from the 1930's can demonstrate that Treasuries have materially less price risk than VHQ municipal bonds, or said in reverse, that VHQ Municipal Bonds created any more valuation risk for banks than Government Securities did during the 1930's.

**1970's Stagnation:** During 1973-1975, the United States incurred significant economic stress, as Oil prices more than doubled, equities were in a bear market, home prices fell and New York City ran into severe fiscal pressures (municipal issuer with the most outstanding debt at that time). During that period VHQ Municipal Bonds underperformed treasuries in 1974 & 1975, however viewed back from

1972, we see that VHQ Municipal Bonds materially outperformed Treasuries during 1973. VHQ Municipal Bonds were yielding 90% of Treasuries during 1972. When the economy started its downturn in 1973, VHQ Municipal Bonds outperformed treasuries, rallying to 81% of Treasury Yields. Subsequently, VHQ Municipal Bonds backed up to 85% of treasuries in 1974 and 95% of treasuries in 1975 before returning to 90% of treasuries during 1976. Cumulatively, during that period, VHQ Municipal Bonds exhibited no more valuation volatility than Government Obligations.



**EXHIBIT D**

- d. Realized Credit losses on all U.S. PSE Obligations since the founding of the Federal Reserve in December 1913 have been trivial. There is no evidence we are aware of that a VHQ U.S. PSE Debt Obligation has ever defaulted.**

**1929 to 1937 – Great Depression Period:** The National Bureau of Economic Research, General Series Number 94, titled “The Postwar Quality of State and Local Debt” by George Hempel, provides significant insight into the credit performance of U.S. PSE Debt Obligations during the Great Depression, and is the source for the content provided in this paragraph. This study shows that from 1929 to 1937, the total ultimate realized credit losses on U.S. PSE Obligations was \$100 million on outstanding debt of \$17.6 billion, or 0.6% (outstanding debt is taken from 1932). However securities cannot be valued on ultimate realized losses (as they won’t occur until the future), the market will value Securities based on fear of potential losses. On that metric, “Credit Risk” needs to reflect the potential universe of market perceived “Default” and the various iterations thereof. On the most expansive measure, the total associated or affiliated indebtedness of state and local units with recorded defaults from 1929-1937 was \$2.8bn, or 15% of average total PSE debt outstanding during that period. A second definition of “default” is the total amount of debt that had either delayed interest payments and/or delayed principal payments associated with it, which was \$1.35bn, or 7.3% of total outstanding debt. A third definition of “default” is the total dollar amount of the delayed or missed interest and principal payments which was \$0.32 billion, or 1.7% of total outstanding debt. The final metric, mentioned initially, was ultimate unrecovered principal and interest, which as \$100 million, or 0.6% of outstanding debt. Market psychology for securities valuation would gravitate to the 15% “potential fear” number, which proves that some Municipal Bonds are primarily credit risk driven, however more importantly, also proves that valuations on VHQ Municipal Bonds are not susceptible to being “credit-contaminated” by wide-spread “Default” fears. The historic yield data on VHQ Municipal Bonds from the Great Depression shows that these VHQ Bonds were not materially impacted by the potential for credit losses on other municipal securities. The market was able to discern and evaluate the differences between VHQ Municipal Bonds compared to the entire realm of all Municipal Bonds.

**1970 to 2011 – Post U.S. unilateral termination of Bretton Woods system:** Relying on municipal market professionals who have been in the business since 1970, along with studies from the NSRO’s, there is no known example of a VHQ Municipal Bond defaulting. According to Moody’s data, no Municipal Bond carrying ratings better than Aa3 defaulted within 3-years of carrying that rating or better, i.e., none of the 70 defaults on Moody’s rated municipal bonds during this period occurred on VHQ Municipal Bonds.

**Prominent Municipal “Defaults” over the past 40-years:** Below are four of the most notorious municipal credit stories since 1970. Importantly, none of the Bonds that were defaulted on, or close to being defaulted on, were VHQ Municipal Bonds as described in this paper. As reference, none of these PSE entities were rated “Aa3” or better by Moody’s at the time of the market became aware of the credit issues:



City of New York (1970's): New York City specific problem related to rolling short-term financing. No principal or interest was lost by public investors in New York City General Obligation Debt. Banks, the State of New York and eventually the Federal government all helped to resolve the issue.

Washington Public Power Supply Nuclear Projects 4 & 5 (1980s): Washington State Court invalidated contracts with local municipalities after the plants were never completed after initial build costs quadrupled and power prices declined. Bond holders recovered 40% of their principal exposure.

Orange County California: Losses on an investment portfolio triggered liquidity crises, causing the County to file for bankruptcy; however bondholders lost no principal or interest.

Jefferson County Alabama: County failed several times to bring sewer system up to EPA standards. Eventually, Federal Court mandated the County spend an ultimately unaffordable amount of money improving the sewer system. Recovery is still pending.

## **Appendix A – Defining “Very High Quality”**

The Agencies can use the existing definitions contained in *12 CFR Part § 1*, which was updated in June of 2012, to define the boundary of securities that are eligible to have their AOCI excluded from CET1. Per *12 CFR Part § 1*; Type I Securities eligible for purchase by national banks as Investment Securities include U.S. Government Obligations, GSE Obligations, Municipal General Obligations, and certain Municipal Revenue Obligations (along with other Obligations as prescribed by the OCC, such as Canadian Government Debt). The OCC, in order to meet the requirement by Congress for the removal of all NSRO ratings from regulations, recently changed the definition of “Investment-Grade” and “Investment Security” to the following:

### *12 CFR Part § 1.2 – Definitions*

*(d) Investment Grade means the issuer of a security has an adequate capacity to meet financial commitments under the security for the projected life of the asset or exposure. An issuer has an adequate capacity to meet financial commitments if the risk of default by the obligor is low and the full and timely repayment of principal and interest is expected.*

*(e) Investment Security means a marketable debt obligation that is Investment Grade and not predominately speculative in nature.*

The debt instruments grouped together in the Type I Security definition (versus type II to Type VI or non permissible activities) occurs because of direct Congressional and Presidential passage of The Banking Act of 1933 (Public Law 73-66, 48 stat. 162, enacted June 16, 1933), commonly referred to as Glass-Steagall. Even in the mindset of that environment, which was perhaps similar to the current environment, our predecessors understood monetary system realities along with national interests that necessitated entirely exempting certain classes of debt from new regulations (codified in 12 U.S.C. 24 (Seventh)). That preference for all (and only) Type I Securities, should be continued by excluding their AOCI from impacting CET1.

In order to address the Agencies over-riding preference to prevent valuation changes associated with credit perception from being filtered from CET1, the Agencies could specify that only VHQ Municipal Bonds obtained the symmetrical treatment to Government Obligations in regards to AOCI impact on CET1. Very High Quality can be defined in CFR as follows:

### *Suggested 12 CFR Part § 1.2 – Additional Definition*

*( ) Very High Quality means the issuer of a security has a **very** adequate capacity to meet financial commitments under the security for the projected life of the asset or exposure. An issuer has a **very** adequate capacity to meet financial commitments if the risk of default by the obligor is **very** low and the full and timely repayment of principal and interest is **highly** expected.*

The division point for VHQ would generally correspond to the credit quality groupings described by both the BCBS numerous times and the US Agencies in their NPR’s that were released prior to June of 2012 (and post the original ’88 Basel Accord). For example see Federal Register / Vol. 73, No. 146 / Tuesday,

July 29, 2008 / Proposed Rules, starting on page 43982, where in Table 3, the first two categories are grouped together.

It's important to note that neither "Investment Grade" nor the proposed "VHQ" definitions are purchase only requirements, but ongoing requirements, subject to review throughout the time the Investment Security is held by the National Bank, per general risk management practices along with OCC requirements (which were recently made more stringent via Final Guidance). In so far as the credit quality of the Municipal Bond declined, so that the bond no longer met the VHQ Municipal Bond definition, the Bond would become ineligible that quarter, and all AOCI associated with the Bond would immediately flow through to CET1. This would prevent Bonds whose valuation became primarily driven by credit from being filtered from CET1.



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](http://www.sifma.org). This letter supplements other comments provided by SIFMA on this proposal.

Washington | New York

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**Background:**

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.

**Improving Risk Sensitivity:**

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<sup>1</sup> (“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<sup>2</sup> 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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<sup>1</sup> Department of the Treasury, Office of the Comptroller of the Currency, Docket ID OCC-2012-0005, Final Rule.

<sup>2</sup> 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<sup>3</sup>, 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.

#### **Harmonizing Agency Rules:**

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%<sup>4</sup>) 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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<sup>3</sup> "The Untold Story of Municipal Bond Defaults" – Jason Appleson, Eric Parsons, and Andrew Haughwout, August 2012

<sup>4</sup> 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,

A handwritten signature in cursive script, appearing to read "M. Decker".

Michael Decker  
Managing Director and Co-Head of Municipal Securities