

**American Public Gas Association  
American Public Power Association  
Council of Infrastructure Financing Authorities  
Education Finance Council  
Government Finance Officers Association  
International City/County Management Association  
International Municipal Lawyers Association  
Large Public Power Council  
National Association of Counties  
National Association of Health and Higher Education Facilities Authorities  
National Association of Local Housing Finance Agencies  
National Association of State Auditors, Comptrollers and Treasurers  
National Council of State Housing Agencies  
National League of Cities  
U.S. Conference of Mayors**

October 16, 2012

The Honorable Ben S. Bernanke, Chairman  
Board of Governors of the Federal Reserve System  
20th Street and Constitution Avenue, NW  
Washington, DC 20051

The Honorable Martin J. Gruenberg, Acting Chairman  
Federal Deposit Insurance Corporation  
550 17th Street, NW  
Washington, DC 20429

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

**Regulatory Capital Rules: Standardized Approach for Risk-weighted Assets; Market Discipline and Disclosure Requirements and Regulatory Capital, Implementation of Basel III, Minimum Regulatory Capital Ratios, Capital Adequacy, Transition Provisions, & Prompt Corrective Action**

**Federal Reserve System [Docket No. R-1442 / RIN 7100-AD87]  
Federal Deposit Insurance Corporation [RIN 3064-AD95 & RIN 3064-AD96]  
Office of the Comptroller of the Currency [Docket No. OCC-2012-0008 & OCC-2012-0009]**

Re: Question 4: The agencies request comment on the proposed treatment of exposures to PSEs;  
Definition of Capital A. Capital Components & Eligibility Criteria for Regulatory Capital Instruments

Dear Chairman Bernanke, Chairman Gruenberg, and Comptroller Curry:

We appreciate the opportunity to comment to the before mentioned agencies on the Joint Notice of Proposed Rulemaking (JNPR) released in June 2012 which incorporates certain international capital standards for banking institutions as proposed by the Basel Committee on Banking Supervision (BCBS). The organizations listed above represent state and local governments and authorities who issue municipal securities – defined in the proposed rulemaking as Public Sector Entities (“PSEs” or “Municipals Bonds”). As drafted, the proposal would have negative effects on the municipal market that will adversely impact communities across the country.

## **Set a Risk-Weight Category That Reflects the True Risk of Municipal Securities**

Under the JNPR, general obligation Municipal Bonds would be assigned to the 20% risk weight category, while revenue obligation Municipal Bonds would be assigned to the 50% risk weight category. The rationale given by the Agencies for this difference in the proposal is that *“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.”*

It is often cited, and factually correct, that general obligation Municipal Bonds have a lower default rate than revenue Municipal Bonds. However, Municipal Bonds of all types are significantly less risky than other investment vehicles<sup>1</sup>. As a result, the JNPR is inconsistent with publicly available research and does nothing to achieve the Agencies’ stated goals of increased risk-sensitivity. (As data from a report<sup>2</sup> from members of the Federal Reserve Bank shows, the 40-year total cumulative default rate on municipal bonds, both general obligation and revenue bonds, that generally met the Office of the Comptroller of the Currency’s Type I and Investment-Grade definitions has been extremely low. The data shows that the number of defaults on Investment-Grade rated Municipal Bonds was less than 0.25%. The data also shows the number of defaults per issuer on those bonds which would not meet that definition was substantially higher - over 4%.)

Additionally, the JNPR wrongly states that revenue obligations are dependent for repayment on revenue from specific projects. Actually, in most cases, these repayments are based on a specific tax or type of revenue (toll road revenues, revenues from utility customers in the case of water, electric, gas and other utilities), frequently with a promise by the borrower to charge whatever rates are necessary to pay for debt service and other costs.

To correctly reflect the systemic risk of Municipal Bonds to the U.S. and the international banking systems, we believe Investment-Grade Municipal Bonds, as defined by existing rules contained in the Code-of-Federal-Regulations<sup>3</sup> (“COFR”) Title 12 part 1, should be assigned to the 20% risk-weight category, whether they are general obligation or revenue bonds. Municipal Bonds which do not meet the Investment-Grade criteria should be assigned to the 50% risk-weight category. These changes would prevent the JNPR from unfairly harming state and local governments and authorities who may see debt issuance costs rise under the JNPR’s unsupported bias against Municipal Bonds. Such changes would also better align the JNPR with the objective of both the BCBS’s<sup>4</sup> and U.S. Agency’s goal to create “more risk-sensitive capital requirements” and a safe and sound financial system.

## **Impact of Valuation Changes on Regulatory Capital Should be the Same For Municipal Securities As They Are for U.S. Treasuries**

Banks own trillions of dollars of fixed rate debt instruments including \$306 billion of municipal bonds, and the proposed JNPR contemplate significant changes to the regulatory capital rules related to debt securities held by banks under the Available-for-Sale election. Specifically, the JNPR asks for comment on whether non credit related valuation changes associated with U.S. government debt obligations (Treasuries) and Municipal Bonds, owned by the banks, should impact regulatory capital. We believe that Municipal Bonds should receive the same treatment as U.S. governmental debt obligations for this regulatory purpose. Congress through its development of and revisions to federal banking laws, has demonstrated time after time over the last 80-years that Municipal Bonds should be grouped with U.S. Treasury Bonds for regulatory purposes.<sup>5</sup> Therefore, we strongly believe that

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<sup>1</sup> Moody’s Investor Service Special Comment, March 7, 2012: *U.S. Municipal Bond Defaults and Recoveries, 1970-2011*. Page 2

<sup>2</sup> “The Untold Story of Municipal Bond Defaults” – Jason Appleton, Eric Parsons, and Andrew Haughwout, August 2012

<sup>3</sup> Department of the Treasury, Office of the Comptroller of the Currency, Docket ID OCC-2012-0005, Final Rule

<sup>4</sup> Basel Committee on Banking Supervision, International Convergence of Capital Measurement and Standards, #128

<sup>5</sup> 12 USC Title 12 - Par. Seventh. Pub. L. 106-102 inserted at end “In addition to the provisions in this paragraph for dealing in, underwriting, or purchasing securities, the limitations and restrictions contained in this paragraph as to dealing in, underwriting, and purchasing investment securities for the national bank’s own account shall not apply to obligations (including limited obligation bonds, revenue bonds, and obligations that satisfy the requirements of section 142(b)(1) of title 26) issued by or on behalf of any State or political subdivision of a State, including any municipal corporate instrumentality of 1 or more States, or any public agency or authority of any State or political subdivision of a State, if the national bank is well capitalized (as defined in section 1831 of this title).” [http://uscode.house.gov/download/pls/Title\\_12.txt](http://uscode.house.gov/download/pls/Title_12.txt)

Municipal Bonds should be treated the same as U.S. Treasury Bonds, and both debt types of bonds should have their valuation changes exempt from regulatory capital rules.

### **Setting the Wrong Policy Precedent**

Lastly, use of the suggestions we have proposed will lay the correct groundwork for the remaining aspects of Basel III that the Agencies plan to implement these rules. Forthcoming Agency rules on liquidity and funding requirements (liability structure needed to support bank commitments to the U.S. Municipal Bonds), based on the current JNPR would harm the break-even lending rates that banks can offer to municipalities. Additionally, not only could these proposed rules have an immediate negative effect on the Municipal Bonds, it could lead to further erosion of bank's ability to support variable rate Municipal Bond issuance in the future.

### **Conclusion**

Municipal Bonds do not represent a systemic risk to the U.S. financial system. It is unfair to lump municipal bonds into the realm of other types of securities where banks have far more exposure, particularly where municipal bonds already meet an established criteria of Type I securities. For example, U.S. banks currently hold \$4 trillion of non-GSE mortgage debt while only \$300 billion of Municipal Bonds, demonstrating that even if municipals experienced loss rates similar to mortgages in 2008, the safety and soundness of the U.S. financial system would not be harmed in the same way. Furthermore, it would seem unusual that under the JNPR, first-lien residential mortgages could be in the 35% risk-weight category while, for instance, a Massachusetts Water Resources Authority bond, would be in the 50% risk-weight category. If the Agencies are going to exclude valuation changes on \$18 trillion dollars of U.S. Government and agency obligations from impacting regulatory capital, then we fail to see how including a portion of \$3 trillion of U.S. Municipal Bonds would materially alter systematic financial risk.

Thank you very much for the opportunity to comment on this important issue. Public policy and national interests implemented at the Federal, State, and local levels through debt financing benefit the country as a whole by ensuring our citizens have essential infrastructure to provide for education, roads, bridges, water delivery systems, transportation systems, public power, affordable housing and public safety.

Sincerely,

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