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Federated
WORLD-CLASS INVESTMENT MANAGER®

January 29, 2014

Office of the Comptroller of the Currency
Legislative and Regulatory Activities Division
400 7th Street SW, Suite 3E-218
Mail Stop 9W-11
Washington, D.C. 20219

Mr. Robert deV. Fierson, Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue NW
Washington, D.C. 20551

Mr. Robert E. Feldman, Executive Secretary
Federal Deposit Insurance Corporation
Attention: Comments/Legal ESS
550 17th Street NW
Washington, D.C. 20429

Re: Liquidity Coverage Ratio: Liquidity Risk Management, Standards, and Monitoring
OCC Docket ID OCC-2013-0016, Docket No. R-1466 and FDIC RIN 3064-AE04

Ladies and Gentlemen:

This letter is in reference to the *Liquidity Coverage Ratio: Liquidity Risk Management, Standards, and Monitoring* proposed in RINs 1557 AD 74 (OCC), 7100 AE-03 (Federal Reserve) and 3065-AE04 (FDIC), 78 Fed. Reg. 71818 (Nov. 29, 2013) (the "Release"). Our comments solely relate to the treatment of municipal obligations and investment companies as high-quality liquid assets ("HQLAs") under the proposed liquidity coverage ratio ("LCR"). We object to the categorical exclusion of (1) state and local government obligations and (2) shares of registered investment companies from HQLAs proposed in the Release.

Federated Investors, Inc. ("Federated") is one of the leading investment management firms in the United States. As of December 31, 2013, Federated's total managed assets were $376.1 billion, including $27.2 billion in obligations of state and local governments and their agencies ("municipal securities"). Federated has managed municipal securities since 1976, and thus has a long-term perspective on the market for these securities.

The LCR proposal is complicated, but essentially would require all internationally active banking organizations and covered nonbank companies to maintain, on a consolidated basis, HQLAs equal to or greater than their total net cash outflows over a prospective 30 calendar-day period ("total net cash outflows"). In other words, a banking organization's LCR would equal the ratio of its consolidated HQLAs to its consolidated total net cash outflows, and the organization would have to maintain an LCR of 100% or greater by 2017.

HQLAs would be divided into three proposed levels. Level 1 HQLAs would include:

- Reserve Bank balances;

- Foreign withdrawable reserves;

- A security issued by, or unconditionally guaranteed by, the U.S. Department of the Treasury or a U.S. government agency the obligations of which are guaranteed by the full faith and credit of the United States government, provided (in the case of an agency) that the security is liquid and readily-marketable;

- A security issued by, or unconditionally guaranteed by, a sovereign entity, the Bank for International Settlements, the International Monetary Fund, the European Central Bank and European Community, or a multilateral development bank, that is: (i) assigned a 0% risk weight;[1] (ii) liquid and readily-marketable; (iii) issued by an entity whose obligations have a proven record as a reliable source of liquidity in repurchase or sales markets during stressed market conditions; and (iv) not an obligation of a regulated financial company, investment company, non-regulated fund, pension fund, investment adviser, or identified company, and not an obligation of a consolidated subsidiary of any of the foregoing (collectively, "financial sector entities"); and

- A security issued by, or unconditionally guaranteed by, a sovereign entity that is not assigned a 0% risk weight, where (i) the sovereign entity issues the security in its own currency, (ii) the security is liquid and readily-marketable, and (iii) the organization holds the security in order to meet its net cash outflows in the jurisdiction of the sovereign entity.

To qualify as "liquid and readily-marketable," a security must be "traded in an active secondary market with: (1) more than two committed market makers; (2) a large number of non-market maker participants on both the buying and selling sides of transactions; (3) timely and observable market prices; and (4) a high trading volume." One hundred percent of the current market value of Level 1 HQLAs would be included in calculating an organization's LCR.

Level 2A HQLAs would include:

- A security issued by, or guaranteed by, a U.S. government-sponsored enterprise, that is investment grade and senior to preferred stock;

- A security that is issued by, or guaranteed by, a sovereign entity or multilateral development bank that is: (i) not included in Level 1 HQLAs; (ii) assigned no higher than a 20% risk weight;[2] (iii) issued by an entity whose obligations have a

[1] Only sovereign entities with an OECD country risk classification of 0 or 1 qualify for a 0% risk weight. *See*, 12 C.F.R. § 3.32(a)(2) (2013).

[2] Only sovereign entities with an OECD country risk classification of 2 qualify for a 20% risk weight. *Id.*

proven record as a reliable source of liquidity in repurchase or sales markets during stressed market, and (iv) not an obligation of a financial sector entity.

All Level 2A HQLAs must qualify as liquid and readily-marketable. Eighty-five percent of the current market value of Level 2A HQLAs would be included in calculating an organization's LCR.

Finally, Level 2B HQLAs would include:

- A corporate debt security that is: (i) investment grade; (ii) issued by an entity whose obligations have a proven record as a reliable source of liquidity in repurchase or sales markets during stressed market conditions; and (iii) not an obligation of a financial sector entity; and

- A common equity share that: (i) is included in the Standard & Poor's 500 Index or a comparable index of liquid equity securities; (ii) if the share is issued in a currency other than U.S. dollars, the organization must hold the share in order to cover its net cash outflows in that currency's jurisdiction; (iii) is issued by an entity whose publicly traded common equity shares have a proven record as a reliable source of liquidity in repurchase or sales markets during stressed market conditions; (iv) is not issued by a financial sector entity; (v) if held by a depository institution, is not acquired in satisfaction of a debt previously contracted; and (vi) if held by a consolidated subsidiary of a depository institution, the depository institution can include the publicly traded common equity share only if the share is held to cover net cash outflows of the consolidated subsidiary.

All Level 2B HQLAs must be "publicly traded" (i.e., listed on a national securities exchange registered with the Securities and Exchange Commission or a foreign securities exchange regulated by a national regulatory authority) as well as liquid and readily-marketable. Only 50% of the current market value of Level 2B HQLAs would be included in calculating an organization's LCR. Level 2B HQLAs could not represent more than 15% of the total HQLAs used to calculate an organization's LCR, and Level 2A and 2B HQLAs could not represent more than 40% of such HQLAs.[3]

1. MUNICIPAL SECURITIES SHOULD NOT BE CATEGORICALLY EXCLUDED FROM HIGH QUALITY LIQUID ASSETS

A "sovereign entity" would be defined as "a central government (including the U.S. government) or an agency, department, ministry, or central bank of a central government." This definition would preclude municipal securities from qualifying as Level 2A HQLAs, even if they meet all of the requirements for this level. Municipal securities could not even qualify as Level 2B HQLAs, which is limited to corporate securities.

[3] All HQLAs would also be subject to certain operation and general requirements that are not germane to Federated's comments.

The proposed exclusion of municipal securities from HQLAs was intentional. According to the Release:

> The proposed rule likely would not permit covered bonds and securities issued by public sector entities, such as a state, local authority, or other government subdivision below the level of a sovereign (including U.S. states and municipalities) to qualify as HQLA at this time. While these assets are assigned a 20 percent risk weight under the standardized approach for risk-weighted assets in the agencies' regulatory capital rules, the agencies believe that, at this time, these assets 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. For example, securities issued by public sector entities generally have low average daily trading volumes.[4]

The Release does not cite any data in support of this conclusion that *all* municipal securities are illiquid, which is contrary to Federated's experience. According to the Municipal Securities Rulemaking Board's 2012 Fact Book (the "MSRB Fact Book"),[5] from 2009 to 2012, the daily volume in municipal securities has averaged between 37,000 and 47,000 trades, for a par amount of between $12 and $15 billion. While many municipal securities are held to maturity, there is a substantial secondary market for municipal securities. Of the average $3.5 trillion of municipal securities traded per year during this period, approximately $1.7 trillion per year (48%) were secondary market trades.[6]

The Release indicates that, "[i]n identifying the types of assets that would qualify as HQLA, the agencies considered the following categories of liquidity characteristics …: (a) Risk profile; (b) market-based characteristics; and (c) central bank eligibility."[7] Many municipal securities share all of these characteristics.

1.1 Many Municipal Securities Have High-Quality, Low Risk Profiles

Many municipal issuers have very low risk profiles. For example, nine states currently have AAA/Aaa credit ratings from Standard & Poor's and Moody's Investors, which are higher than the current credit ratings of U.S. obligations. Another four states have the same credit ratings (AA+/Aaa) as the United States.

Notwithstanding some recent municipal bankruptcies, the default rates for municipal securities have been much lower than the default rates for the corporate obligations proposed to be included in Level 2B HQLAs. Recent Standard & Poor's studies provide the following comparison:

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[4] Release at 71827.

[5] Available at http://www.msrb.org/msrb1/pdfs/MSRB-FactBook-2012_WEB.pdf.

[6] *Id.* at 8. Secondary market transactions include both customer sold and inter-dealer trading.

[7] Release at 71823.

10-Year Cumulative Transition Rates to Default[8]		
Credit Rating	Municipal 1986 – 2012	Corporate 1981 – 2012
AAA	0.00%	0.88%
AA	0.02%	1.16%
A	0.08%	2.12%
BBB	0.30%	5.27%

States also compare favorably with many countries that would be included in Level 1 or 2A HQLAs. For example, three states (California, Texas and New York) had gross domestic products in excess of $1 trillion in 2012.[9] If these states were countries, California would have the ninth largest economy in the world (between Canada and Australia), Texas would have the eleventh largest economy (between Spain and Korea) and New York would have the twelfth largest economy (between Korea and The Netherlands).[10] The risk profiles of obligations issued by these states, particularly general obligations backed by the state's taxing authority, are lower than the risk profiles of many sovereign obligations that would qualify as HQLAs.

1.2 Many Municipal Securities Have the Market Characteristics of Liquid and Readily-Marketable Assets

The Release cites three market-based characteristics shared by HQLAs:

- they have active markets at all times with significant diversity in market participants as well as high volume;
- their prices do not incur sharp price declines, even during times of stress; and
- they are easily and readily valued.[11]

Many municipal securities share all three of these characteristics.

(a) <u>There Are Active Markets for the Obligations of Many State and Local Government Issuers</u>

The MSRB Fact Book table of the 50 most active securities in 2012[12] shows 23,733 trades in Illinois state obligations and 12,871 trades in California state obligations, in aggregate

[8] Standard &Poor's RatingsDirect® *2012 U.S. Public Finance Defaults And Rating Transition Data: Defaults Increase, But The Sector Remains Stable Overall* (Mar. 28, 2013) and *Default, Transition, and Recovery: 2012 Annual U.S. Corporate Default Study And Rating Transition* (Mar. 20, 2013).

[9] U.S. Bureau of Economic Analysis, *Widespread Economic Growth in 2012: Advance 2012 and Revised 2009–2011 GDP-by-State Statistics*, Table 1: Real GDP by State 2009-2012 (press release, June 6, 2013), http://bea.gov/newsreleases/regional/gdp_state/2013/pdf/gsp0613.pdf.

[10] Based on data from the International Monetary Fund, World Economic Outlook Database, Oct. 2013, http://www.imf.org/external/pubs/ft/weo/2013/02/weodata/index.aspx.

[11] Release at 71823-24.

[12] MSRB Fact Book at 23.

principal amounts of $4.7 billion and $16.7 billion, respectively. These are among the most conspicuous examples of regular and active trading in large issuers of municipal securities.

The Release also notes: "Diversity of market participants, on both the buy and sell sides, is particularly important because it tends to reduce market concentration and is a key indicator that a market will remain liquid."[13] The market for municipal securities is highly diversified. According to Federal Reserve data, at the close of 2012, households held 44.6% of the outstanding municipal securities and loans, investment companies held 28.6%, insurance companies held 12.4%, banks held 9.8% and governments, corporations, and dealers held the remaining 4.6%.[14] The Release further notes, "the presence of multiple committed market makers is another sign that a market is liquid." According to the MSRB Fact Book, six or more dealers covered over 56% of the securities traded in 2012 (by number of trades).[15]

(b) Historically, High-Quality and Widely-Held Municipal Securities Generally Have Not Incurred Sharp Price Declines During Periods of Financial Stress

The proposed requirements for a Level 2A HQLA would treat an issuer as "an entity whose obligations have a proven record as a reliable source of liquidity in repurchase[16] or sales markets during stressed market conditions" if "[t]he market price of the security or equivalent securities of the issuer declin[ed] by no more than 10 percent during a 30 calendar-day period of significant stress." During the recent financial crisis, the most significant one-month declines in the S&P Municipal Bond GO Index were 4.87% (in February 2008) and 4.56% (in September 2008). This demonstrates that most general obligation municipal securities experience price declines of less than half the percentage permitted for Level 2A HQLAs. In fact, 90% of the more than 12,500 municipal securities in the index in February 2008 experienced price declines of less than 10%, and over 93% of the more than 12,900 index securities experienced price declines of less than 10% during September 2008.

(c) Most Municipal Securities Can Be Readily Valued on a Daily Basis from a Number of Different Pricing Services

Although municipal securities are not traded on an exchange, this is also true of obligations issued by the U.S. Treasury, government agencies and sponsored enterprises, and other proposed Levels 1 and 2A HQLAs. Most issuers of municipal securities have simple capital structures and the terms of the securities are not complicated, which makes them easy to value. Federated normally does not have difficulty obtaining quotations from dealers for widely-held municipal securities that must be valued daily for our mutual funds and regularly for our separate

[13]Release at 71824.

[14]Federal Reserve Statistical Release Z.1, Financial Accounts of the United States, L.211 Municipal Securities and Loans (Dec. 9, 2013), http://www.federalreserve.gov/releases/z1/Current/accessible/l211.htm.

[15]MSRB Fact Book at 35.

[16]Municipal securities are not regularly used as collateral for repurchase agreements, so data on haircuts for these securities is not available.

accounts. As previously noted, investment companies hold over 28% of all municipal securities, which they must value on a daily basis.

1.3 Municipal Security May Be Used as Collateral at the Discount Window

The final market characteristic of HQLAs is central bank eligibility. Municipal securities are eligible collateral for loans at the Federal Reserve discount window.[17] Thus, many municipal securities share all of the characteristics of sovereign obligations that would be included in HQLAs. These characteristics would also allow these municipal securities to satisfy the "liquid and readily-marketable" requirement for Level 2A HQLAs.

1.4 It Would Be Inappropriate to Categorically Exclude Municipal Securities from HQLAs

Federated is concerned that the categorical exclusion of municipal securities from HQLAs will lead to a self-fulfilling prophecy regarding their liquidity. The proposed LCR will create an incentive for banking organizations to hold HQLAs. If municipal securities are excluded from HQLAs, this incentive could cause banking organizations to shift capital away from municipal securities, which would remove an important source of liquidity from the municipal market. Without this liquidity, municipal securities would become less readily marketable and borrowing costs for public sector entities would increase.

The exclusion of municipal securities from HQLAs would also be contrary to the policies of other Federal laws and regulations. For example, the so-called Volker Rule permits banking organizations to invest in municipal securities, on a proprietary basis as well as for purposes of market making. This reflects the importance of banks in financing municipal issuers and a policy of encouraging banks to participate in the market for municipal securities. The proposed LCR would create a disincentive for banks to hold municipal securities, thereby thwarting this policy and injuring the capital markets.

2. INVESTMENT COMPANIES SHOULD NOT BE CATEGORICALLY TREATED AS FINANCIAL SECTOR ENTITIES

The Release proposes to treat "investment companies" (defined as companies registered under the Investment Company Act of 1940 and foreign equivalents of such companies) as financial sector entities. This would prohibit a bank from treating shares of an investment company as HQLAs, even if Level 1 HQLAs comprise the investment company's entire portfolio. For example, a bank could not include in its LCR shares of an investment company that held only U.S. Treasury obligations.

Securities issued by financial sector entities would be excluded from HQLAs "since they would … be correlated with covered companies [banks and nonbank companies subject to the proposed LCR requirement] (or wrong-way risk assets)."[18] The Release does not provide any

[17] Federal Reserve Collateral Guidelines (Jan. 1, 2013).

[18] Release at 71824.

data supporting this assertion, which simply cannot be substantiated in the case of investment companies. Shares of an open-end investment company or exchange-traded fund are fully correlated to the market value of its portfolio, insofar as the investment company continuously offers to redeem its shares at the net asset value of its portfolio.[19] Shares of a closed-end fund may trade at a small discount or premium to their net asset value, but their value is still strongly correlated to the value of the underlying portfolio.

Thus, if an investment company does not invest in financial sector entities (or wrong-way risk assets), the value of its shares will not be correlated with covered companies. There is no reason to discourage a covered company from investing in HQLAs through an investment company rather than directly. Use of an investment company will decrease the assets' risk profile, insofar as investment companies provide their shareholders with professional management, including credit analysis and diversification, and related services, as well as the protections of the Investment Company Act. Closed-end and other exchange traded fund offer the same liquidity as the publicly traded equity securities included in Level 2B HQLAs. Open-end funds generally offer enhanced liquidity, settling trades on a next-day or, in the case of money market funds, same-day basis, rather than the standard trade date plus three or five days settlement available on exchanges or in the over-the-counter markets.[20]

Ideally, banks should "look through" an investment company to its underlying portfolio, and include a proportionate share of any HQLAs held by the investment company when calculating their LCRs. Federated realizes that this would be impractical, however, even if the investment company were to report its portfolio holdings on a daily basis. Federated therefore recommends determining an investment company's HQLAs status based on its investment policies. If, for example, the investment company has a policy of investing primarily in HQLAs, then its shares would be treated as HQLAs. The HQLA level of the shares would be based on the lowest level HQLAs permitted by the investment policy.

Rule 35d-1 under the Investment Company Act requires an investment company that refers to type of securities in its name to have a policy of investing at least 80% of its assets in such securities. For example, a fund must have an policy of investing at least 80% of its assets in U.S. Treasury obligations to call itself a "Treasury Fund." Federated proposes using the same standard for the purpose of calculating an LCR. Thus, shares of the Treasury Fund in the example would be treated as Level 1 HQLAs, while shares of a fund with a policy that permits investment in Level 2A government securities as well as Treasuries would be treated as Level 2A HQLAs. A bank could also treat as Level 2B HQLAs shares of an ETF that mirrors an index at least 80% of which is composed of Level 2B HQLAs.

[19] *See*, 15 U.S.C. §§ 80a-5(a)(1) (defining an "open-end" investment company), 80a-2(a)(32) (defining a "redeemable security") and 80a-2(a)(41) (defining "value").

[20] In the absence of an emergency, open-end investment companies must settle redemptions within seven days, which compares favorably to the settlement period for many HQLAs, such as federally guaranteed mortgage backed-securities. *See*, 15 U.S.C. § 80a–22(e).

3. CONCLUSION

Federated does not contend that all municipal securities or investment company shares should be included as HQLAs for purposes of calculating a banking organization's LCR. We simply contend that these securities should be included or excluded based on their individual characteristics, rather than categorically excluded. We propose treating municipal securities in the same manner as debt issued by other governments and government agencies and treating investment companies based on their investment policies. Banking regulations should not create incentives for U.S. banks to prefer obligations issued by the government of Chile over, for example, general obligations of the State of New York, or deter them from using investment companies to manage their HQLA holdings professionally and more effectively.

Federated believes that any categorical exclusion of municipal or investment company securities from HQLAs would be completely arbitrary. We therefore recommend that the LCR requirement be amended to permit municipal securities to qualify as Level 2A HQLAs[21] on the same basis as obligations issued by sovereign entities and government sponsored enterprises. We further recommend that an investment company with a policy of investing (under normal market conditions) 80% of its assets in HQLAs be treated as an HQLA of the same level as the lowest level HQLAs permitted under this investment policy, rather than being treated as a financial sector entity.

Please feel free to contact John McGonigle if you have any questions regarding these comments.

Very truly yours,

/s/ John W. McGonigle
Vice Chairman
Federated Investors, Inc.

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[21] As noted in the Release, general obligations of public-sector entities (PSEs) are assigned a risk-weight of 20%. E.g., 12 C.F.R. §3.32(e)(1). Revenue obligations of PSEs, which have a risk-weight of 50%, would not be included in Level 2A HQLAs. Given the 100% risk weight assigned to corporate obligations that would be included in Level 2B HQLAs, Federated also recommends that the agencies consider including PSE revenue obligations in Level 2B. As municipal securities are exempt from registration under federal securities laws, however, they would need to be excluded from the proposed "publicly traded" requirement of Level 2B HQLAs.