NORTH CAROLINA

OFFICE OF THE TREASURER

JANET COWELL, TREASURER

January 27, 2014

Department of the Treasury
Office of the Comptroller of the Currency
Docket ID OCC-2013-0016
VIA ELECTRONIC MAIL: regs.comments@occ.treas.gov

Board of Governors of the Federal Reserve System
Attn: Robert deV. Frierson, Secretary
Docket No. R-1466
VIA ELECTRONIC MAIL: regs.comments@federalreserve.gov

FDIC
Robert E. Feldman, Executive Secretary
Attn: Comments / Legal ESS
RIN No. 3064-AE04
VIA ELECTRONIC MAIL: comments@FDIC.gov

RE: Federal Proposal for Bank Liquidity Coverage Rules; Unintended Negative Consequences to Municipal Bond Market

Ladies and Gentlemen:

The North Carolina Department of State Treasurer is following with interest the work of the Basel Committee on Banking Supervision ("BCBS"), particularly efforts aimed at ensuring that financial institutions have the necessary means to withstand short-term liquidity disruptions. We received notice of your proposed rule implementing the Basel III Liquidity Coverage Ratio for most large United States banks, and write to comment on it.

We are concerned that the proposed definition of High Quality Liquid Assets ("HQLA") excludes bonds of state and local governments (commonly referred to as "municipal bonds") although the BCBS proposal includes them in its definition of HQLA. We are dismayed that you do not recognize the liquid nature of municipal bonds. Further, we fear that your omission will have the unintended consequence of reducing the marketability of municipal bonds by discouraging banks from purchasing them. Financial institutions are a significant investor in the municipal bond market, so the impact of this omission will be great.

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I. Municipal Bonds are Safe Liquid Assets

We agree that HQLA should include assets that are low risk and have limited price volatility, are traded in high volume and may be pledged at the central bank. Any assumption that municipal bonds are not liquid and do not meet this criteria is unfounded. In support of the argument for their inclusion, consider the following:

A. Municipal bonds continue to carry high ratings. The average investment grade municipal bond carries an Aa2 rating while the average corporate rating is Baa for bonds rated by Moody's Investor Services.

B. The default rate for municipal bonds remains low in comparison to corporate bonds.

C. Price volatility in the municipal market during periods of stress has historically been lower than corporate bonds. This fact was evident during the 2008 financial crisis (the very crisis that led to the implementation of Basel III), when municipal bonds held their value better than corporate bonds in spite of the collapse of both the bond insurance industry and the auction rate security market, and the severe curtailing of the variable rate bond market.

D. A large and well-established market exists for municipal debt. As a percentage of outstanding bonds, municipal bonds trade at a greater rate than corporate bonds, and only slightly behind United States agency securities (excluding GNMAs). The Municipal Securities Rulemaking Board regulates approximately 1,600 registered broker-dealers for municipal securities. The investor base for municipal bonds is large and is comprised of households, mutual funds, United States depository institutions and insurance companies. More than forty percent (40%) of outstanding municipal bonds are held in retail or separately managed portfolio accounts. Additionally, there are billions of dollars of outstanding municipal bonds that have been advance-refunded with the expectation that United States Treasuries will be the source of future principal and interest payments.

E. Municipal bonds may be pledged at a central bank. In fact, the Federal Reserve accepts United States municipal bonds at a two to five percent (2 - 5%) haircut, comparable to the haircut applied to United States agency securities. Corporate bonds rated AAA receive a haircut of three to six percent (3 - 6%) while other investment grade corporate bonds receive a five to eight percent (5 - 8%) haircut. The Federal Reserve realizes the high credit quality and liquidity of municipal securities. We encourage you to do the

same and apply a consistent treatment of municipal securities to the determination on HQLA.

II. The Omission will Harm the Bond Market and the Nation as a Whole

We fear that the omission of municipal bonds from the definition of HQLA will do great harm to the nation as a whole as well as to its state and local governments for the following reasons:

A. The omission will have the unintended consequence of reducing the marketability of bonds by discouraging banks from purchasing them. Since 2010, financial institutions have increasingly invested in the municipal bond market to the benefit of both the market and state and local governments. Excluding municipal securities from classification as HQLA will rob financial institutions of a very safe source of liquidity and prevent institutions from using municipal bonds to diversify their portfolios. This will result in higher borrowing costs and lower interest rates on deposits for municipal borrowers. Moreover, we expect it to disproportionately affect small issuers who do not ordinarily attract bond fund and other non-bank purchasers. This will increase borrowing costs, leading to increased taxes and rates for citizens and delayed or forgone capital projects

B. The infrastructure needs of the nation are tremendous and state and local governments take the lead in fulfilling a large percentage of those needs. Any action that increases the borrowing costs for state and local governments will add to the nation's unfulfilled infrastructure needs and hinder these governments' ability to protect the health, safety and welfare of our citizens.

C. Lower demand for municipal debt by financial institutions will mean fewer bonds are available to collateralize state and local government deposits. More than $7 billion in deposits by the State of North Carolina and its local governments are collateralized by bonds held in escrow accounts. Decreased availability of bonds for collateralization will result in lower earnings rates for municipal deposits.

D. Excluding municipal securities from the HQLA classification will lessen the ability of financial institutions to provide liquidity support to state and local governments that have variable rate demand bonds outstanding. This will decrease the supply and increase the costs of liquidity agreements resulting in higher taxes and rates, or potentially preventing much-needed projects from being undertaken.

Clearly, municipal securities meet the criteria for inclusion in HQLA. Municipal bonds represent a secure investment by United States financial institutions and are more qualified to be classified as HQLA than most corporate bonds and the debt of other sovereign states. The State of North Carolina and its local governments have more than $34 billion in bonds outstanding. That debt is a very safe and liquid investment vehicle. Leaving this debt out of HQLA will have a negative impact on the bond market, the nation's infrastructure and the debt management of state and local governments. Accordingly, we ask that you include municipal bonds in the definition of HQLA. At a minimum, the definition should include investment grade municipal securities which can be accomplished by classifying municipal bonds as level 2A HQLA.

I appreciate the opportunity to respond. Please contact my office if you would like to discuss my response or this matter further.

Sincerely,

Janet Cowell