



January 31, 2014

Legislative and Regulatory Activities Division
Office of the Comptroller of the Currency
400 7th St., SW
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Washington, DC 20219

Mr. Robert deV. Fierson, Secretary
Board of Governors of the Federal Reserve System
29th St. and Constitution Ave., NW
Washington, DC 20551

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

Docket ID OCC-2013-0016

Submitted through the Federal eRulemaking Portal

Introduction.

The Securities Industry and Financial Markets Association ("SIFMA")¹ is pleased to offer comments on the rulemaking jointly proposed by the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, and the Federal Deposit Insurance Corporation (the "Agencies") on "Liquidity Coverage Ratio: Liquidity Risk Measurement, Standards, and Monitoring" (the "Proposed Rule" or the "Proposal") (RIN: 1557-AD74). This comment letter is offered by SIFMA's Municipal Securities Division and focuses on issues raised by the Proposal related to municipal securities, municipal securities financing and state and local government finance. SIFMA is participating

¹ 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.

with other organizations in a separate industry-wide comment letter that will cover broader issues raised by the Proposal.

SIFMA's Municipal Securities Division is comprised of approximately 60 broker-dealers and banks active in the municipal securities market, including firms of all sizes, some of whom would be directly affected by the Proposed Rule and others to whom the rule would not apply directly but who would be affected by the Proposal's impact on the broader market. We are focused not only on the implications for our member firms but also on the potential effects of the Proposal on the ability of state and local governments to access the capital markets as efficiently as possible in order to finance important investment in public infrastructure.

The municipal securities market is a vital component of the nation's capital markets. With nearly \$3.7 trillion of securities and loans outstanding,² the municipal securities market provides financing for a large portion of the country's capital investment in schools, roads and highways, public power systems, water and sewer facilities, bridges and tunnels, public transit, airports, hospitals, colleges and universities and other public infrastructure. One of the oldest sectors of the capital markets, the municipal market provides a means for states and localities of all sizes to obtain the financing needed to achieve public policy goals.

Our comments on the Proposed Rule focus on three areas: the exclusion of municipal securities from the definition of High-Quality Liquid Assets ("HQLA"), outflow rate assumptions applied to bank liquidity facilities extended to certain special purpose entities (municipal Tender Option Bond financing vehicles), and the outflow rate assumptions assigned to public sector entity deposits that are collateralized with municipal bonds.

Municipal Securities as High Quality Liquid Assets.

The Proposed Rule would define HQLA and specify several proposed categories of financial assets that would be treated as HQLAs in computing a bank's LCR. Level 1 liquid assets would be defined largely as sovereign securities, including U.S. government and U.S. government-guaranteed securities, or zero-percent risk-weighted securities "issued by, or unconditionally guaranteed as to the timely payment of principal and interest 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" with certain characteristics. Level 2A liquid assets are proposed to include certain securities issued by U.S. government-sponsored enterprises and certain other sovereign entity and multilateral development bank securities. Level 2B liquid assets would include investment-grade corporate debt securities with certain characteristics, equity securities included in the Standard & Poors 500 Index, and other equities included in certain non-U.S. equity indexes with specified characteristics.

² Board of Governors of the Federal Reserve System, *Flow of Funds, Balance Sheets, and Integrated Macroeconomic Accounts*, Third Quarter 2013, Table L.211, page 98.

The preamble to the Proposed Rule states that U.S. municipal securities—debt securities issued by state or local governments, agencies and authorities—would not be treated as HQLAs because “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.” In response to Question 12 posed in the request for comments on the Proposed Rule, SIFMA believes it would be appropriate to include municipal securities that are investment-grade by virtue of their underlying credit quality as Level 2A liquid assets. The preamble of the Proposed Rule states “Assets that would qualify as HQLA should be easily and immediately convertible into cash with little or no loss of value during a period of liquidity stress.” Municipal securities generally have all the characteristics the Proposed Rule specifies for HQLAs and by some measures may be safer and more liquid than securities specified as HQLAs in the Proposal.

Trading volume: The preamble to the Proposed Rule states HQLA assets “tend to have active outright sale or repurchase markets at all times with significant diversity in market participants as well as high volume.” While it is true that not all municipal securities trade every day, which is also the case for investment-grade corporate and government-sponsored enterprise (“GSE”) debt securities, the municipal market is nonetheless liquid in that it is always possible to obtain executable price quotes from dealers for transactions of virtually any size. One factor that contributes to municipal market liquidity is that bonds with similar characteristics—maturity, coupon, credit quality, state of issuer, etc.—tend to trade similarly. This makes it possible for investors and dealers in general to gauge the market for bonds they own or want to buy or sell based on trades in similar securities and for dealers serving as liquidity providers to determine comparable market price levels.

In 2012 daily trading volume in the U.S. municipal market averaged \$11.3 billion.³ Average daily trading volume for corporate bonds was \$22.6 billion.⁴ However, on the basis of average daily trading volume in relation to total volume outstanding, in 2012 0.31 percent of total outstanding municipal securities traded each day versus 0.25 percent of outstanding corporate bonds.⁵ The higher turnover rate for municipal securities indicates a degree of liquidity that is at least comparable to investment-grade corporate securities, which are treated as HQLA under the Proposed Rule.

It is important to also note that because of the maturity structures of many municipal bond issues—municipal securities tend to be issued with serial maturities, or a series of sequentially maturing bonds that provides issuers with level debt service and emulates an amortizing loan—there tend to be many

³ SIFMA, “US Municipal Trading,”

<https://www.sifma.org/uploadedFiles/Research/Statistics/StatisticsFiles/Municipal-US-Municipal-Trading-SIFMA.xls?n=21349>.

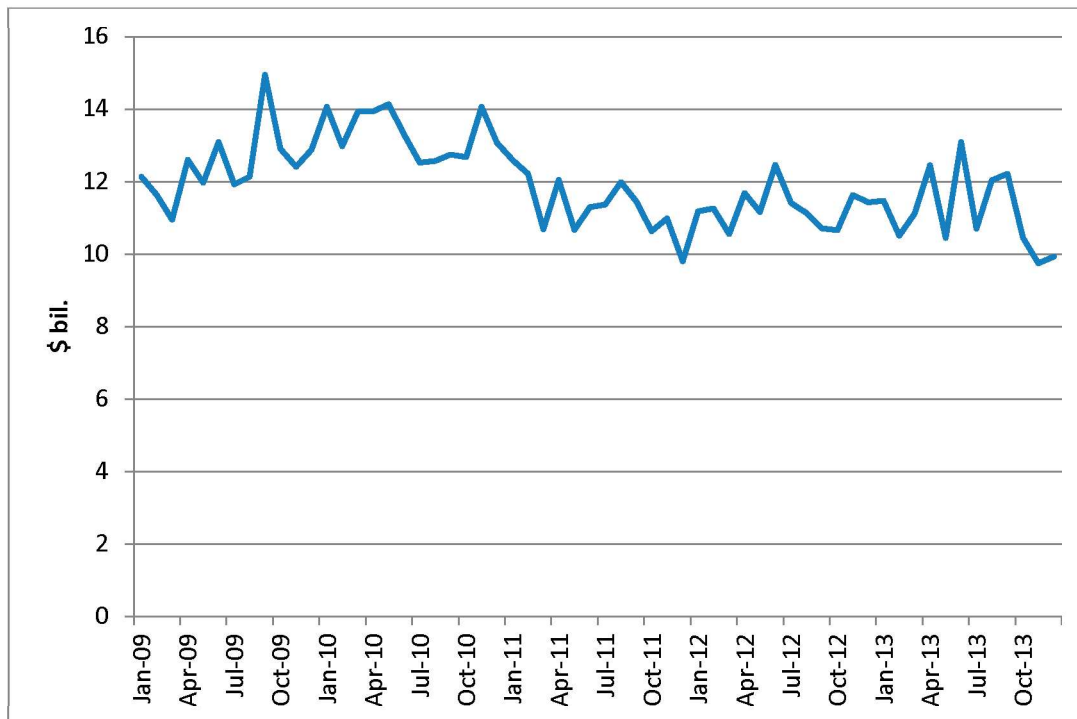
⁴ SIFMA, “U.S. Corporate Bond Trading Volume,”

<https://www.sifma.org/uploadedFiles/Research/Statistics/StatisticsFiles/Corporate-US-Corporate-Trading-Volume-SIFMA.xls?n=76698>.

⁵ Based on a SIFMA estimate of \$9.10 trillion of corporate bonds outstanding on December 31, 2012 from data on “Nonfinancial corporate business” and “Financial sectors” including sub-investment grade; see Board of Governors of the Federal Reserve System, Table L.212, page 99.

relatively smaller individual maturities of bonds than in other sectors of the debt markets. Large municipal bond issuers can have many hundreds of bond maturities outstanding, each with its own CUSIP number. A single bond issuance can have as many as 40 individual CUSIPs whereas a typical corporate bond issue has only one or several. Therefore, while individual maturities may seem to exhibit lower trading volumes, liquidity is better evaluated based on the ability to trade the bonds of an issuer more generally and not on the trading volume of the specific maturity or CUSIP.

Finally, trading volume in the municipal market, while subject to some seasonality and variation based on issuance activity and other factors, remains fairly constant within a range. The chart below shows average daily municipal market trading volume by month during the period from 2009 through 2013.⁶



Price stability: The preamble to the Proposed Rule states “assets that are appropriate for consideration as HQLA generally tend to have prices that do not incur sharp price declines.” Municipal securities are as price-stable as or are more price-stable than other securities which would be treated as HQLA under the Proposed Rule.

An analysis conducted by Citigroup Global Markets Inc. (“Citi”) in connection with its comments on the Proposed Rule examined the five worst month-over-month declines in average prices since 1925 for five asset categories, including AA-rated municipal general obligation bonds, A-rated municipal revenue

⁶ SIFMA, “US Municipal Trading,”

<http://www.sifma.org/uploadedFiles/Research/Statistics/StatisticsFiles/Municipal-US-Municipal-Trading-SIFMA.xls?n=79062>. From Municipal Securities Rulemaking Board data.

bonds, long-term U.S. Treasury securities, AAA-rated corporate bonds, and BBB-rated corporate bonds.⁷ The worst month-over-month price decline on AA-rated municipal general obligation bonds since 1925 was better than the worst month-over-month price depreciation realized on any of the other asset categories. The worst month-over-month price performance for A-rated municipal revenue bonds was better than the price depreciation of both long-term U.S. Treasury securities and BBB-rated corporate bonds. Considering relative price stability as indicative of liquidity, investment grade municipal bonds are as liquid as other asset classes that are proposed to be eligible for HQLA classification

Diverse group of market participants: The preamble of the Proposed Rule states, in regard to characteristics of HQLA, “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.” The U.S. Municipal market exhibits extraordinary diversity in terms of both investors and dealers. This diversity contributes to the market’s liquidity, particularly during times of market stress.

The table below provides holdings of municipal securities by category of investor as of September 30, 2013.⁸

Investor category	Amount (\$ bil.)
Households and nonprofit organizations	\$1,640
Mutual funds	621
U.S.-chartered depository institutions	404
Property-casualty insurance companies	332
Money market mutual funds	305
Life insurance companies	133
Closed-end funds	86
Rest of the world	63
Nonfinancial corporate business	29
Security brokers and dealers	18
Government-sponsored enterprises and Sallie Mae	14
State and local governments, excluding employee retirement funds	12
Exchange-traded funds	12
Nonfinancial noncorporate business	6
Credit unions excluding Corporate Credit Unions	5
Banks in U.S.-affiliated areas	3
State and local government employee retirement funds	3

⁷ Letter from Howard Marsh, Citigroup Global Markets Inc., to the Department of the Treasury, the Board of Governors of the Federal Reserve, and the Office of the Comptroller of the Currency, December 27, 2013, page 4.

⁸ Board of Governors of the Federal Reserve, Table L.211, page 97.

The investor base includes a healthy mix of retail and institutional investors. Among retail investors—indicated by “Households” in the table above—some securities are held directly by individual investors and some are held through “separately managed accounts,” or professional investment managers who buy and sell securities in institutional-size blocks for the benefit of retail investor clients. Thus the Household sector is itself a diverse population of thousands of individual investors. The significant retail participation in the market was an important factor in maintaining market liquidity during the financial crisis. Their participation helped to keep bond yields lower than they might otherwise have been.

With regard to sellside diversity, the Securities Exchange Act of 1934 requires all brokers, dealers and municipal securities dealers who transact trades in municipal securities to register with the Municipal Securities Rulemaking Board (“MSRB”), the self-regulatory organization for the municipal securities industry and market. As of January 23, 2014, 1,661 firms were registered with the MSRB.⁹ These registrants range from the largest full-service, multi-national banks and securities firms to small banks and brokers specializing in niche areas of the market. Registrants are based in every state except Alaska, including the District of Columbia and Puerto Rico.

Ability to value securities: The preamble to the Proposed Rule states “assets that can serve as HQLA tend to be easily and readily valued.” A number of tools and practices have evolved over the history of the municipal market that allows dealers and investors to value securities easily.

The municipal market exhibits solid price transparency and has since the current transparency initiative was implemented in January 2005. The MSRB maintains a system for the real-time collection and dissemination of all secondary market transactions in municipal securities. MSRB Rule G-14 requires brokers, dealers and municipal securities dealers to report “information about each purchase and sale transaction effected in municipal securities to the Real-time Transaction Reporting System.” Dealers are required to report within 15 minutes of the time of trade, among other data items, the CUSIP number, price, yield, par amount and whether the trade was a customer buy, customer sell or interdealer.¹⁰ The MSRB immediately disseminates trade data through its Electronic Municipal Market Access (“EMMA”) Web platform (<http://emma.msrb.org>) and as a direct feed to data subscribers. The EMMA platform allows all market participants to view a real-time “ticker” of municipal market transactions as well as search and view the database of trades by a long list of parameters. In addition, the EMMA platform provides access to issuer disclosure documents and other information useful in monitoring market activity.

The real-time price transparency of the municipal market provides a means for market participants to value securities even if they did not trade on a particular day. Dealers and investors can examine the prices of bonds with similar characteristics to gauge the value of a particular bond. Also, the market uses widely accepted pricing tools such as the MMD Scale published by Thomson Reuters to benchmark

⁹ Municipal Securities Rulemaking Board, “MSRB Registrants,” www.msrb.org/msrb1/pqweb/registrants.asp.

¹⁰ Municipal Securities Rulemaking Board, “MSRB Real-Time Transaction Reporting System Manual,” Version 3.1, April 2013, page 23.

transaction prices. The MMD Scale is a twice-daily offer-side indicative yield curve reflecting the institutional market for AAA-rated state general obligation bonds. Other pricing benchmarks such as Municipal Market Advisors Median Par AAA General Obligation and 5% AAA General Obligation curves, the Bloomberg BVAL Benchmark Municipal Curve as well as indexes published by Barclay's, *The Bond Buyer*, Standard & Poor's and others are also used. In addition, securities valuation services such as Interactive Data Corporation and others use pricing matrixes generated from trade data to estimate the values of individual bonds or portfolios.

The scope of individual maturities in the municipal market is not a hindrance to the ability to price securities or to liquidity in general. Many municipal borrowers issue bonds in serial maturities, and each maturity is treated as a distinct bond. A single bond issue can therefore be comprised of dozens of individual bonds. In pricing and trading, however, bonds of the same issuer tend to price and trade similarly, so the scope of individual maturities does not hamper market liquidity.

Central bank eligibility: The preamble of the Proposed Rule states "Assets that a covered company can pledge at a central bank as collateral for intraday liquidity needs and overnight liquidity facilities in a jurisdiction and in a currency where the bank has access to the central bank generally tend to be liquid and, as such, are appropriate for consideration as HQLA." Federal Reserve Banks accept municipal bonds to secure discount window advances, and municipal bonds may be used at Federal Reserve Banks to offset risk associated with extensions of daylight credit or master account activity.¹¹ The Federal Reserve System does not place any rating restrictions on municipals eligible to be pledged as collateral.

With regard to margin, Federal Reserve Banks generally provide favorable haircuts (i.e., high advance rates) for municipal bonds pledged as collateral for discount window advances or daylight credit. U.S. municipal securities with durations of up to five years are accepted at 98 percent of market value or internal fair market value estimate; bonds with durations up to ten years are accepted at 96 percent; and bonds with durations greater than 10 years are accepted at 95 percent. These are the same margin levels that are applied to AAA-rated, dollar-denominated foreign sovereign and supranational debt securities, which would be treated as Level 1 liquid assets under the Proposed Rule, and U.S. GSE securities which would be treated as Level 2A liquid assets.¹²

Risk profile: The preamble of the Proposed Rule states "Assets that are appropriate for consideration as HQLA tend to be lower risk. There are various forms of risk that can be associated with an asset, including liquidity risk, market risk, credit risk, inflation risk, foreign exchange risk, and the risk of subordination in a bankruptcy or insolvency."

Regarding liquidity risk, municipal securities generally do not experience any greater loss of liquidity during times of market stress, and arguably suffer less loss of liquidity relative to other asset classes which would be treated as HQLA under the Proposed Rule. One contributing factor is the diversity of the

¹¹ Federal Reserve System, "Federal Reserve Collateral Guidelines," January 2, 2013, page 3.

¹² Federal Reserve System, "Federal Reserve Discount Window & Payment System Risk Collateral Margins Table 1," Effective Date: October 19, 2009 (updated January 23, 2014), www.frbdiscountwindow.org/discountmargins.xls.

investor base for municipal securities, particularly the heavy participation by retail investors. During the fall 2008 financial crisis, when some groups of institutional investors were deleveraging, retail investors moved heavily into the municipal market, providing additional liquidity. Also, during periods of market stress, certain categories of assets proposed to be treated as HQLA, such as investment grade corporate bonds and equities in the S&P 500 Index, tend to be highly correlated. Pricing for both high-grade corporate debt and equities reflect financial fundamentals of the same issuers. Municipals, as a distinct asset class, are not as highly correlated to corporate debt and equities. Also, banks are and have been underexposed to municipal securities relative to other asset classes. As of September 2013, municipals comprised just 4.2 percent of all credit market instruments held by U.S.-chartered depository institutions.¹³ Thus, banks do not own enough municipal securities to pose any systemic risk.

Regarding credit risk, the U.S. municipal market is the safest sector of the U.S. capital markets after U.S. Treasury and other government-guaranteed securities based on default experience. The cumulative ten-year default rate for AAA-rated municipal securities is 0 percent, compared to 0.5 percent for AAA-rated corporate bonds. For BBB-rated municipal securities, the 10-year default rate is 0.3 percent compared to 4.74 percent for BBB-rated corporate bonds.¹⁴ Moreover, defaults that do occur tend to be concentrated among non-investment grade and non-rated bonds; defaults are rare among investment-grade municipal bonds.

In the years since the financial crisis, the municipal market has adapted to evaluating and pricing credits without the widespread use of bond insurance as a credit enhancement. Before the financial crisis, bond insurance provided by highly rated monoline insurance companies was a prevalent form of credit enhancement for municipal bond issuers. During the period between 2004 and 2007, 52 percent of new, long-term municipal bond issuance was covered by bond insurance. After the deterioration of many monoline insurance companies, which was triggered by their mortgage-related exposure, however, bond insurance became much less prevalent in the municipal market; during the period 2011-2013 only four percent of long-term issuance was insured.¹⁵ The movement away from the widespread use of bond insurance has strengthened the market from a credit perspective in that investors are now able to diversify among broad and heterogeneous underlying credits rather than relying on the credit quality of a handful of insurance companies.

Municipal credits performed well during the recent economic downturn following the financial crisis. According to Moody's, "more than 80 percent of roughly 7,240 general obligation (GO) and related ratings were unchanged through the downturn. By contrast, the average corporate rating declined to Ba2 in 2013 from Ba1 in 2009, showing the local government sector's relative resilience compared with

¹³ Board of Governors of the Federal Reserve, Table L.110, page 76.

¹⁴ BNY Mellon Wealth Management, "Muni Bond Defaults, Bankruptcies and Bondholder Protections," August 2013, page 1. From Moody's data.

¹⁵ *The Bond Buyer*, "A Decade of Municipal Bond Finance," www.bondbuyer.com/marketstatistics/decade_1/?data-type=monthly#dataTable.

corporate credits.”¹⁶ In addition, Moody’s points out that the average credit rating for investment grade municipal securities during the period 1970-2012 was Aa3, while the average rating for investment grade corporate bonds was Baa1.¹⁷ Prices of weaker credits tend to be more volatile during stressed market conditions.

Also, despite the disparate treatment for revenue and general obligation bonds for bank capital purposes—under the final Basel III bank capital rule, municipal general obligations bonds are in the 20-percent risk weighting category and revenue bonds are in the 50-percent category—the credit performance of general obligation bonds and revenue bonds of similar credit quality is indistinguishable. The more relevant credit-based distinction for municipal securities should be based on credit quality, distinguished by investment grade versus non-investment grade, rather than general obligation versus revenue.

Past performance in the municipal debt market supports an investment grade/non-investment grade bifurcation. As work by the staff of the Federal Reserve Bank of New York shows, defaults on municipal securities that generally do not meet the definition of “investment grade” under Code of Federal Regulations Title 12 part 1 are far more frequent than on municipal securities that generally do meet the definition (which implies that most defaults are on non-investment grade debt or non-rated debt).¹⁸ To illustrate, from 1970 through 2011, the cumulative 41-year total percentage of defaulting municipal securities which would have been very likely to meet the investment grade definition was less than 0.25 percent.

Market pricing for municipal securities also supports an investment grade/non-investment grade division rather than a general obligation/revenue division. For instance, the market does not generally 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. Similar examples abound.

Regarding the risk of subordination in bankruptcy or insolvency, municipal securities are somewhat unique among various asset classes. First, states generally are treated as sovereigns and are not eligible for bankruptcy under the U.S. bankruptcy code or under the Constitution.¹⁹ Second, while a municipality, or a “political subdivision or public agency or instrumentality of a State,” can enter bankruptcy under Chapter 9 of the U.S. bankruptcy code (11 U.S.C. § 109), there are significant differences between how bankruptcy applies to municipalities and how it applies to commercial entities.

¹⁶ Moody’s Investors Service, “US Local Government Ratings Mostly Held Steady Through the Downturn,” December 11, 2013.

¹⁷ Moody’s Investors Service, “US Municipal Bond Defaults and Recoveries, 1970-2012,” May 7, 2013.

¹⁸ Jason Appleson, Eric Parsons, and Andrew Haughwout, “The Untold Story of Municipal Bond Defaults,” Liberty Street Economics, August 2012. While the default statistics provided in this piece are misleading, the work clearly supports the perspective that investment grade municipals experience a very low default rate.

¹⁹ Jennifer Burnett, “3 Questions on State Bankruptcy,” Council of State Government E-Newsletter, www.csg.org/pubs/capitolideas/enews/issue65_3.aspx.

For example, a municipality cannot be forced into bankruptcy by a creditor. In addition, a municipality must be authorized by State law to enter bankruptcy, and many states have no provision whatsoever or impose significant hurdles to the use of the bankruptcy code by municipalities. Also, municipalities can use bankruptcy only for reorganization, not liquidation.²⁰

Regarding subordination, the standing of bondholders in a bankruptcy or insolvency is explicitly stated in bond indentures and is generally legally enforceable. Special revenue bonds generally provide investors with protections in case an affiliated government enters bankruptcy, since under Section 922(d) of the bankruptcy code special revenue bonds are generally exempt from the automatic stay that applies in a Chapter 9 bankruptcy.

Finally, we note that the Proposed Rule's treatment of municipal securities under the HQLA regime is inconsistent with the treatment recommended by the Basel Committee on Banking Supervision ("Basel Committee") and would likely result in an approach to the LCR that differs significantly from other Basel Committee jurisdictions. The Basel Committee generally recommends Level 2A liquid asset treatment for "marketable securities representing claims on or guaranteed by sovereigns, central banks, PSEs or multilateral development banks" meeting certain conditions.²¹ Public sector entities ("PSEs") are generally defined as governmental entities other than a central government and encompass U.S. state and local governments. Notably, the Basel Committee recommends Level 2A treatment for all PSE debt that meets the specified criteria, but only for corporate debt rated AA- or better.

Outflow assumptions for bank liquidity facilities.

The preamble to the Proposed Rule states "The agencies are proposing a 100 percent outflow rate for a covered company's liquidity facilities with special purpose entities (SPEs), given SPEs' sensitivity to emergency cash and backstop needs in a short-term stress environment, such as those experienced with SPEs during the recent financial crisis." While we are not commenting on the treatment of liquidity commitments extended to SPEs generally in this letter, we do believe that a 100-percent outflow rate is too high for liquidity commitments extended to a limited category of SPEs, namely, Tender Option Bond ("TOB") financing vehicles. Based on the nature of TOBs and on the market's historic experience with the vehicle, a maximum 30-percent outflow rate for commitments extended to these SPEs would be more appropriate, although even that rate reflects a much higher outflow rate than bank TOB liquidity providers experienced during the height of the financial crisis.

TOBs are a form of secured funding economically similar to repurchase agreements ("repo"). Banks, dealers and investors employ TOB financing for municipal securities because it is more efficient from a tax perspective to do so; due to restrictions imposed by the Internal Revenue Code, using repurchase agreements to finance bonds bearing tax-exempt interest is not efficient. Thus, TOB financing vehicles

²⁰ United States Courts, "Bankruptcy Basics: Municipal Bankruptcy," www.uscourts.gov/FederalCourts/Bankruptcy/BankruptcyBasics/Chapter9.aspx.

²¹ Basel Committee on Banking Supervision, "Basel III: The Liquidity Coverage Ratio and Liquidity Risk Monitoring Tools," January 2013, page 13.

are the principal means for investors to fund municipal assets. By enhancing demand for municipal securities, TOBs contribute to the liquidity of the municipal market and, in doing so, help to keep state and local government financing costs low.

From the perspective of the investors who purchase TOB floating rate certificates, TOBs are similar to variable rate demand obligations ("VRDOs"). VRDOs are variable rate securities issued directly by state and local governments which are also supported by a remarketing process and a bank liquidity facility. Both TOBs and VRDOs are purchased primarily by money market mutual funds, which generally do not distinguish between the two products in terms of risk. In fact, TOBs offer an additional source of liquidity—liquidation of underlying assets—that does not exist with VRDOs. However, because the bank liquidity facility extended on a VRDO is provided directly to a municipal issuer rather than to an SPE, under the Proposed Rule VRDO liquidity facilities would be subject to a 30-percent outflow assumption while liquidity facilities supporting TOB financing vehicles would be subject to a 100-percent assumption.

While various firms' TOB programs differ on some details, the basic structure is the same. Investors in TOBs—equivalent to lenders in a repurchase agreement transaction—are able to liquidate their holdings periodically. This liquidity is ultimately supported by a bank letter of credit or other standby facility, but the bank facility is only a "last resort" source of liquidity. The first source of liquidity to TOB investors is a periodic remarketing process. If that process fails, most TOB vehicles would be liquidated and the proceeds generated from the sale of the underlying bonds would be used to provide liquidity to the investors in the TOB financing in a manner similar to the liquidation of collateral to provide liquidity to repo lenders. In some TOB programs, liquidation of underlying bonds is contractually mandated before a backup bank facility can be drawn upon. Moreover, many TOB programs are significantly over-collateralized, so liquidation of underlying bonds would cover TOB investors' liquidity demands even when bond prices are falling. Backup bank liquidity facilities are usually the last means of providing liquidity.

During the 2008 financial crisis, most bank-provided liquidity facilities supporting TOBs were not drawn on at all. TOB sponsors were generally able to provide liquidity to investors through the remarketing process or by liquidating underlying bonds. With respect to the instances in which backup facilities for TOBs were drawn upon, we are not aware of any program for which the draw rates approached even 30 percent of the committed facilities amount, much less 100 percent. Based on this experience, a 100-percent outflow assumption for bank liquidity commitments extended to TOB financing vehicles is not appropriate. We therefore urge the Agencies to apply a maximum 30-percent outflow rate to liquidity commitments extended to TOB financing vehicles, consistent with the outflow rates assigned to liquidity commitments extended directly to municipal issuers' VRDOs.

Outflow assumptions for collateralized deposits.

State and local governments that maintain deposits at financial institutions generally require, pursuant to state law, that banks pledge collateral against such deposit balances that exceed deposit insurance limits. While the list of eligible collateral varies from state to state, municipal securities are generally

included. Collateralized deposits are treated as secured funding transactions under the Proposed Rule, and outflow assumptions for secured funding transactions would be based on the HQLA status of the collateral pledged. Because under the Proposed Rule municipal securities would not be treated as HQLA, public sector entity deposits collateralized with municipal securities would be subject to a 100-percent outflow assumption. This is not the appropriate treatment for collateralized state and local deposits for several reasons.

First, as already argued, it is appropriate to afford municipal securities treatment as Level 2A liquid assets under the LCR rule. If municipal securities are treated as Level 2A liquid assets, the outflow assumption for deposits secured by municipal securities would be 15 percent, not 100 percent.

Second, a 100-percent outflow assumption is not consistent with banks' experience with state and local collateralized deposits during the financial crisis. During the crisis, state and local governments with deposits secured by municipal securities did not withdraw funds on a net basis due to concern over the quality of the collateral underlying their deposits, a sensible reaction considering that it is often the case that the collateral backing a government's deposits are that government's own bonds. The table below provides preferred, or collateralized, state and local deposits for the period 2007-2012 and demonstrates that state and local preferred deposits grew each year during the period.²²

Date	\$ bil.
December 31, 2007	267
December 31, 2008	272
December 31, 2009	274
December 31, 2010	293
December 31, 2011	296
December 31, 2012	313

Third, a 100-percent outflow assumption is inconsistent with the Basel Committee's recommendation for treatment of deposits secured by municipal securities. The Basel Committee recommends a 15-percent outflow assumption for deposits secured by Level 2A liquid assets and a 25-percent assumption for "secured funding transactions with domestic sovereign, PSEs or multilateral development banks that are not backed by Level 1 or 2A assets."²³

Finally, the maximum outflow assumption for unsecured deposits under the Proposed Rule would be only 40 percent under the Proposed Rule. It is not plausible that a state or local government would be less likely to withdraw unsecured deposits during a period of financial stress than deposits secured by municipal securities. For these reasons, we urge the agencies to establish a maximum outflow rate

²² Federal Financial Institutions Examination Council, Bulk Data Downloads—Call Reports, <https://cdr.ffiec.gov/public/PWS/DownloadBulkData.aspx>.

²³ Basel Committee on Banking Supervision, page 28.

assumption of 25 percent for deposits secured by municipal securities, consistent with the recommendation of the Basel Committee.

Summary.

Municipal securities are a liquid, safe, actively traded asset class with a diverse base of market participants on both the buy and sell sides. Municipal securities are accepted by Federal Reserve Banks as funding collateral. They maintained their liquidity and strong credit performance during the financial crisis. Municipal securities thus meet each of the Agencies' own criteria established in the Proposed Rule for HQLA eligibility. We believe, therefore, that it is appropriate for the Agencies to include investment grade municipal securities among Level 2A liquid assets.

In addition, the Proposed Rule's outflow rate assumptions for both liquidity facilities extended to TOB financing vehicles and for collateralized deposits secured by municipal securities far exceed the banks' experience with those two products during the crisis. We therefore recommend that the Agencies adopt a 30-percent maximum outflow rate assumption for liquidity facilities extended to TOB financing vehicles and a 25-percent maximum outflow rate assumption for deposits collateralized by municipal securities.

We appreciate the opportunity to comment on the Proposed Rule. Please contact us if you have any questions.

Sincerely,

A handwritten signature in black ink, appearing to read "M. Decker", written in a cursive style.

Michael Decker
Managing Director