THE STATE of ALASKA
GOVERNOR SEAN PARNELL

Department of Revenue

COMMISSIONER'S OFFICE
Angela M. Rodell, Commissioner

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Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue NW
Washington, DC 20551
Attn: Robert deV. Frierson, Secretary
Docket No. R-1466

Dear Mr. Frierson:

As the Commissioner of Revenue for the State of Alaska, I am trustee to more than $53 billion in a sovereign wealth fund (Alaska Permanent Fund Corporation), trustee to more than $22 billion of pension assets and the sole fiduciary to more than $21 billion of state financial assets. I am also a board member to a number of debt issuers including the Alaska State Bond Committee, Alaska Housing Finance Corporation, Alaska Industrial and Export Development Authority, the Alaska Energy Authority and the Alaska Municipal Bond Bank Authority. On September 3, 2014, the Board of Governors of the Federal Reserve System (Board) and the Federal Deposit Insurance Corporation (FDIC) are scheduled to vote on the liquidity coverage ratio (LCR) final rule. I am very concerned and dismayed about news reports suggesting that the final rule by the Board, FDIC, and Office of the Comptroller of the Currency (OCC) (collectively, "the Agencies") may exclude municipal securities from the definition of "High Quality Liquid Assets" (HQLAs). The proposed rule does not include a robust analysis of characteristics of municipal securities, so while you have received submitted comments and data demonstrating why municipal securities meet the criteria for inclusion as HQLAs, I hope the news reports of the final rule are not accurate.

It is unreasonable to treat an entire asset class of securities in the same way, as securities of different issuers will have different characteristics. A more reasonable approach would be for the rule to identify quantitative liquidity standards or characteristics that should be met in order for that particular security to be defined as an HQLA.

I firmly believe that excluding municipal securities from HQLAs is not warranted given their liquidity and market-based characteristics. Additionally, the exclusion of municipal securities from HQLAs would increase borrowing costs for municipal issuers, reduce liquidity and increase volatility of municipal securities, and disadvantage U.S. municipal debt relative to foreign sovereign government debt.

**Municipal Securities Meet Criteria for Inclusion as HQLAs**

Based on my experience in the municipal market and a review of statistical information regarding the characteristics of the municipal market, I believe municipal securities meet all of the HQLA criteria as outlined in the proposed rule.

The proposed rule explains that assets classified as HQLAs "exhibit low risk and limited price volatility, are traded in high-volume, deep markets with transparent pricing, and are eligible to be pledged at a central bank." In addition, the proposed rule requires that certain categories of HQLA, including Level 2A HQLAs, be "liquid and readily-marketable", which means they are 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.

Each of the relevant criteria is addressed below:

**Low Risk and Limited Price Volatility** – Municipal securities are among the lowest risk securities across all markets, with the one-year default rate at only 0.012% from 1970 – 2012. (*Source: Moody's Investors Service, "US Municipal Bond Defaults and Recoveries, 1970 – 2012, published May 7, 2013*). Certainly, during the credit crisis and its aftermath, U.S. municipal securities have demonstrated dramatically greater credit stability than numerous European sovereign credits whose government securities may be treated as HQLAs under the proposed LCR rule. The low risk characteristics of municipal securities have already been recognized by the Agencies, leading to a 20% risk weighting under the Agencies' own regulatory capital rules.

Consistent with their extremely low credit risk, municipal securities have also demonstrated price stability similar to longer-term U.S. Treasury securities and investment grade corporate bonds that are proposed to be classified as HQLAs. For example, since 1925, the five worst month-over-month price movements for long-term AA municipal general obligation bonds and Single-A municipal revenue obligations range between -7.3% and -10.3%, comparable to the ranges for longer-term U.S. Treasury securities (-6.2% to -11.8%) and AAA and BBB corporate bonds (-6.2% to -9.7%). (*Source: Citigroup Global Markets Inc., December 27, 2013*)

**High Volume, Deep Markets with Transparent Pricing** – Trading volumes in municipal securities are comparable to trading volumes in corporate and GSE bonds that are treated as HQLAs under the proposed LCR rule. Analysis prepared by Citigroup Global Markets Inc. indicate the municipal market trades 0.31% of its total outstanding par every day, comparable to the markets for corporate bonds (0.20%) and GSE debt (0.33%). If non-investment grade and financial debt and certain other securities that are not expected to meet the HQLA criteria are excluded from the trading volumes, the municipal market's relative liquidity is even stronger. Thus, it is clear that the municipal securities market is a "high volume" market as required for HQLA status.

The municipal securities market is also deep and diverse, both in terms of market makers and non-market making participants. The Municipal Securities Rulemaking Board regulates over

1,600 registered broker-dealers who serve as market makers for municipal securities. Hundreds of thousands of individual retail investors hold about 44% of outstanding municipal bonds. Mutual funds (28%), banks (12%) and property and casualty insurance and life insurance companies (13%) are other large categories of municipal investors. (*Source: Securities Industry and Financial Markets Association*). Further, municipal securities comprise less than 4% of bank portfolios (*Source, Citigroup Global Markets Inc. December 23, 2013*), providing significant diversification benefits and reducing overall liquidity risk for Covered Financial Institutions if treated as HQLAs.

Municipal bond pricing is highly transparent, with all trades required to be electronically posted with 15 minutes of execution (Municipal Securities Rulemaking Board, Rule G-14). Market participants can easily access all relevant trading information through a variety of broadly available electronic data dissemination platforms, including the Municipal Securities Rulemaking Board EMMA on-line platform and private services.

**Eligible to Be Pledged at Central Banks** – The proposed LCR rule requires that HQLAs be eligible to be pledged at a central bank. The U.S. Federal Reserve Bank accepts all U.S. municipal bonds at a 2% to 5% haircut, the same haircut as U.S. Agency and GSE debt, and a lower haircut than U.S. investment grade corporate bonds.

**Liquid and Readily Marketable** – As explained in the preceding paragraphs, municipal securities meet the Agencies' definition of "liquid and readily marketable." They are traded in an active secondary market with: (1) about 1,600 municipal market makers nationwide; (2) a large number of non-market making participants on both the buy and the sell side; (3) timely and observable market prices (all trades reported and available to all market participants electronically within 15 minutes of trade execution); and (4) high trading volume (relative trading volumes similar to those for corporate bonds and GSEs).

In addition, the municipal bond performance during the 2008-2009 financial crisis demonstrated the depth and liquidity of such securities, supporting our view that municipal securities should be designated as HQLAs. In the six months from September 2008 when Lehman Brothers failed, through February 2009 when the stock market bottomed out, the primary issuance markets functioned extremely well, with municipal issuers raising over $135 billion of capital, in almost equal amounts each month. (*Source: The Bond Buyer*). The secondary municipal market also demonstrated strength and depth throughout this period.

**<u>Adverse Impact of Proposed LCR Rule on the Municipal Market</u>**

Many of the largest and most important participants in the municipal market will be Covered Financial Institutions under the proposed LCR rule. We believe the proposed LCR rule will (1) increase borrowing costs for municipal issuers; (2) reduce market liquidity and increase volatility; and (3) disadvantage U.S. municipalities relative to foreign governments in accessing the U.S. capital markets, which NAST believes is not only unjustifiable but against the broader policy interests of the United States.

**Impact to Collateralization of Public Funds**

In most states, banks must pledge collateral against any public deposits they hold. Municipal securities may be used as pledged collateral. Under the proposed LCR Rule, financial institutions will need to replace pledged municipal securities with other securities increasing the cost of collateral to the bank. Accounts of municipal entities are usually not highly profitable for financial institutions. Disallowing municipal securities, as a pledged security will reduce profit margins even more, thus incentivizing banks to not hold public depository accounts. State and local governments need access to the cash management and treasury tools offered by Covered Financial Institutions. These services are either not available, or limited in scope from community banks who are not subject to the LCR Rule. The result is more costly banking services, lower yields, or lack of needed cash management products to operate and efficient treasury system.

**Conclusion**

In conclusion excluding municipal securities from HQLAs is not warranted given their liquidity and market-based characteristics. Additionally, the exclusion of municipal securities from HQLAs would adversely impact issuers of municipal securities. I believe a more reasonable approach would be for the rule to identify quantitative liquidity standards or characteristics that should be met in order for a particular security to be defined as an HQLA.

Thank you for considering my comments.

Sincerely,

Angela M. Rodell
Commissioner

Cc: Senator Lisa Murkowski
Senator Mark Begich
Congressman Don Young
Janet Yellen, Chair
Stanley Fischer, Vice Chairman
Daniel Tarullo, Member
Jerome Powell, Member
Lael Brainard, Member