



July 24, 2015

Mr. Robert de V. Frierson, Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue NW
Washington, DC 20551

Re: Treatment of U.S. Municipal Securities as High-Quality Liquid Assets
(Docket No. R-1514)

Dear Mr. Frierson:

Build America Mutual Assurance Company (BAM) welcomes the opportunity to comment in support of the Board of Governors' initiative to amend its liquidity coverage ratio (LCR) requirement to include certain U.S. municipal securities as high-quality liquid assets (HQLA), and to offer feedback on some elements of the Board's proposed rule that would implement this change. Municipal securities' high-quality risk profile is demonstrated by their exceptionally low default rates and rates of loss given default (which surpass the performance of other securities classified as Level 2A HQLA). In addition, as the Board observed in the text of its proposed rule, many U.S. municipal securities exhibit liquidity characteristics consistent with – or superior to – securities in other asset classes that the Board has already approved for inclusion as HQLA. Including municipal securities as HQLA would diversify the portfolio of securities that regulated financial institutions can use to satisfy their LCR requirement, which serves the Board's policy goal of "improving the banking sector's ability to absorb shocks arising during periods of significant stress."

The proposed rule would be strengthened if changed to allow regulated financial institutions to include municipal securities that meet the Board's liquidity and credit standards as Level 2A HQLA, with their treatment at least in line with that of sovereign debt. Moody's Investors Service has reported that the 10-year default rate on investment-

grade municipal securities is just 0.08%, far below the 2.087% rate observed among investment-grade sovereign debt.¹

The remainder of this letter focuses on the Board's specific invitation to offer comments on Section II.A.4 of the proposed rule, which would exclude securities that are "guaranteed by a financial sector entity" from inclusion as HQLA, regardless of their other risk and liquidity characteristics. That restriction would undermine the Board's other goals for this proposed rule without improving the risk or liquidity characteristics of the securities that do qualify as HQLA. In the final rule, we recommend that Section II.A.4 should be modified to state that U.S. regulated financial guarantors who only insure U.S. municipal bonds are not considered financial institutions whose guaranty disqualifies a municipal security from inclusion as HQLA.² This revision is warranted and in the public interest for several reasons:

Bond insurers that guarantee only municipal bonds have a risk profile that is distinct from that of the Board-regulated institutions subject to the LCR, and thus do not contribute to "wrong-way risk."

The proposed rule states that the Board is concerned that the risk profile of guarantees provided by financial sector entities would exhibit strong correlation with the risks of Board-regulated institutions during a period of market stress. This concern is reasonable, based on the observed risk characteristics of bond insurers during the 2007-08 timeframe, when many financial guarantors had insured securities like CDOs that paralleled the risks contained in the regulated institutions' loan portfolios, and led to guarantor ratings downgrades during the liquidity stress period.

However, it is important to recognize that the financial guaranty industry has responded with new corporate structures and business models that focus solely on municipal bonds, and thus have a risk profile that parallels that of the municipal market generally, rather than that of the regulated institutions. In fact, recent academic research suggests that the risk from municipal securities in the insurers' portfolios has historically been less than that in the municipal market more generally, and concludes that "[the guarantors'] pure security selection with respect to municipal issues appears to have

¹ "Sovereign Default and Recovery Rates, 1983-2013," Moody's Investors Service, April 11, 2014, p. 15; and "U.S. Municipal Bond Defaults and Recoveries, 1970-2013," Moody's Investors Service May, 7, 2014, p. 22

² Bond insurers who meet this definition include National Public Finance Guarantee and Municipal Assurance Corp., in addition to Build America Mutual.

been positive” and that “controlling for the underlying issuer credit quality at the time that bonds have been issued, the subsequent changes in issuer credit quality have been better for insured bonds than for bonds that were not insured.”³

In addition to the insurers’ strong track record of credit selection, insured municipal bonds are further strengthened by an industry structure that favors stability. Bond insurance generally guarantees timely payment of interest and principal when due, reducing the risk of a liquidity event driven by a default. BAM’s own underwriting guidelines take the principle a step further by prohibiting guarantees of variable-rate securities that are subject to acceleration. We also limit our exposure to single risks to 20% of BAM’s hard capital, so that a single, idiosyncratic risk cannot threaten the company’s overall financial stability.

Investors consider both the underlying credit quality of the borrower and the security added by the guarantor when valuing insured bonds. As a result, insured bonds that meet the Board’s other qualifications for HQLA status are unlikely to experience market value volatility that exceeds that of uninsured bonds.

As demonstrated in the Appendix to this letter, which contains the results of an extensive comparison of insured and uninsured trading values in the municipal bond market, investors today consider both the underlying credit quality of the security as well as the strength of the insurer’s guaranty when valuing their securities. As a result, the insurance does not interfere with the Board’s requirement that securities included as HQLA be “appropriately valued” for purposes of the LCR.

Together with the earlier risk discussion, this market-value experience is why the comparison between Section II.A.4 and the Board’s limits on the inclusion of financial institutions’ corporate debt securities or common equity shares is not relevant. Those corporate obligations’ risk profile is directly comparable to that of the regulated financial institutions. Municipal securities insured by muni-only guarantors, by contrast, exhibit a risk and volatility profile that is driven by:

- A) their own underlying credit quality and liquidity characteristics (which are, in turn, regulated by other provisions of the proposed rule), and

³ “Skin in the Game: The performance of insured and uninsured municipal debt,” D. Bergstresser, R. Cohen, S. Shenai, pp. 2-3

B) the “overlaid” credit-quality and liquidity characteristics of the guarantor, which reflect the overall pool of guaranteed bonds – but not those of other financial-sector entities.

As written, the rule would discourage prudent risk and liquidity management behavior by regulated financial institutions.

Municipal bond insurance is frequently utilized by financial sector entities, including those regulated by the Board, for multiple purposes, including:

- **Enhanced Transparency:** Recognizing that improving access to financial information about municipal securities issuers by providing it in an accessible, standardized format can make the market more efficient, Build America Mutual has invested significant resources to improve the transparency of its insured securities’ credit information. BAM publishes “Obligor Disclosure Briefs” for every transaction it insures, and updates these summaries annually. ODBs have been important in helping regulated banking institutions meet the requirement under the Dodd-Frank Law that they not rely solely on rating agencies for the credit assessments of the securities they hold. Excluding insured securities from the definition of HQLA will make it harder and more expensive for these institutions to monitor their holdings’ underlying credit quality.
- **Enhanced Liquidity:** Secondary-market bond insurance is frequently employed by regulated financial institutions to improve the price and ratings stability of securities they already hold – and which, in most cases, remain within the parameters that would qualify for HQLA status. Excluding insured bonds from LCR calculations would discourage this risk-limiting behavior and increase the volatility of regulated financial institutions’ LCR assets overall.

In conclusion, municipal securities that meet the board’s standards for credit quality, liquidity, and volatility – including those guaranteed by a bond insurer that only insures municipal bonds – should be admitted as HQLA because their inclusion in regulated institutions’ LCR calculations will advance the Board’s goals for improving the security and stability of the U.S. financial system.

It is important to also note that municipal securities' inclusion as HQLA will separately promote the efficient operation of a deep municipal securities market, which advances a broader public-policy goal of delivering affordable capital to public-sector infrastructure projects that are crucial to the nation's continued economic prosperity. According to U.S. Commerce Department construction spending data, states and local governments are responsible for more than 90% of the public construction spending in the nation, with the vast majority of that funding raised through the sale of municipal securities.⁴ As the first mutual insurer of municipal bonds, BAM was founded to lower infrastructure costs for issuers by providing investors, including regulated financial institutions, with a guaranty that provides enhanced liquidity and high-quality, durable ratings. That structure can also support the Board's goals for this proposed regulation.

We appreciate your consideration of the requested changes to section II.A.4. If we can provide any further information, please do not hesitate to contact us.

Sincerely,

A handwritten signature in black ink, appearing to read 'Seán W. McCarthy', with a stylized flourish at the end.

Seán W. McCarthy,
Chief Executive Officer, Build America Mutual Assurance Co.

⁴ "Value of Construction Put in Place, May 2015," U.S. Census Bureau, <https://www.census.gov/construction/c30/c30index.html>

APPENDIX – INSURED BOND VALUATION AND VOLATILITY

Build America Mutual monitors the secondary-market trading value of its insured bonds on an ongoing basis, primarily focusing on the spread between BAM-insured bonds, uninsured bonds from the same issuer and with the same structure, and a market benchmark. Analyzing this database provides insight into the volatility of municipal securities and market participants' current valuation practices, and allows us to draw two important conclusions that we believe the Board will find valuable in its review of the proposed rule:

Investors consider both the underlying credit quality of the borrower and the security added by the guarantor when valuing insured bonds.

This can be observed by comparing CUSIPs that are identical in all ways except for the presence of BAM insurance added in a secondary-market trade. On average, the BAM-insured bonds traded with a yield between 25 and 30 basis points below the comparable uninsured CUSIP. However, the yields on individual bonds varied more widely, because they incorporated investor assessments of underlying credit quality. A table with examples of BAM's most recent trading analysis is attached.

Municipal securities' volatility is low, even in a period of stress, and insured municipal securities demonstrate even lower volatility.

On March 9, 2015, Moody's Investors Service downgraded the bond rating of the Chicago Board of Education two notches to Baa3, initiating a period of increased volatility in the market value of the bonds of the Chicago Board of Education. We reviewed trading in comparable insured and uninsured CUSIPs for the Chicago Board of Education between March 1, 2015 and June 30, 2015 and found the following:

- The uninsured bonds (CUSIP: 167505QJ8; 5% coupon due in 2042) remained liquid despite the downgrade, with trading on 81 of the 85 trading days between March 1 and June 30.
- The maximum price loss for the uninsured CUSIP in any 30-day period during the second quarter was 12.1%, well below the Board's proposed 20% limit.

- Comparable insured bonds (BAM CUSIP: 167505QJ8 and AGM CUSIP: 167505PM2) also displayed strong liquidity, with at least one of the CUSIPs trading on 82 of the 85 trading days between March 1 and June 30.
- The maximum price loss for the insured CUSIPs in any 30-day period was 8.9%.

Secondary Market Trades Illustrate Market Valuation Dynamics

Tax-Exempt Examples

CUSIP	Description	Tax Status	Coupon	Maturity	Underlying Rating (M/S/F)	Insurer	Date of First BAM Wrap	Start of Trade Date Range	Last Trade on CUSIP	Weighted Avg Price	Weighted Avg YTW	Weighted Avg YTW Spread to MMD	Par Volume Traded	Number of Trades	BAM YTW Spread to MMD Benefit
537445QH4	AR Little Rock Sewer	FED & ST TAX-EXEMPT	3.50%	10/1/37	Aa3/NR/NR		3/2/15	2/13/15	7/13/15	\$96.773	3.714	89.0	\$118,795,000	975	-20.5
537445QJ0	AR Little Rock Sewer	FED & ST TAX-EXEMPT	3.50%	10/1/37	Aa3/NR/NR	BAM	3/2/15	2/13/15	7/13/15	\$97.875	3.638	68.5	\$6,945,000	119	
592250AK0	IL Met Pier	FED TAX-EXEMPT/ST TAXABLE	4.25%	6/15/42	NR/AAA/AA-		6/25/14	6/11/14	7/10/15	\$101.710	3.963	105.0	\$102,600,000	1198	-26.5
592250BF0	IL Met Pier	FED TAX-EXEMPT/ST TAXABLE	4.25%	6/15/42	NR/AAA/AA-	BAM	6/25/14	6/11/14	3/27/15	\$103.282	3.745	78.6	\$2,170,000	8	
800766JZ1	IL Springfield SD No. 186	FED BQ/ST TAXABLE	2.50%	2/1/18	A2/NR/NR		1/6/14	12/19/13	3/6/15	\$102.481	1.789	90.6	\$7,805,000	30	-35.6
800766KK2	IL Springfield SD No. 186	FED BQ/ST TAXABLE	2.50%	2/1/18	A2/NR/NR	BAM	1/6/14	12/19/13	5/12/15	\$103.921	1.428	55.0	\$5,990,000	50	
352802GG1	KS Franklin County No. 290	FED & ST TAX-EXEMPT	5.00%	9/1/28	A1/NR/A+		5/14/15	4/30/15	5/14/15	\$114.338	3.336	71.6	\$4,520,000	6	-26.1
352802GV8	KS Franklin County No. 290	FED & ST TAX-EXEMPT	5.00%	9/1/28	A1/NR/A+	BAM	5/14/15	4/30/15	5/27/15	\$116.570	3.100	45.5	\$1,000,000	4	
826775FJ2	MO Sikeston Electric	FED & ST TAX-EXEMPT	5.00%	6/1/20	NR/NR/BBB+		1/13/15	12/29/14	1/16/15	\$114.388	2.148	98.5	\$7,525,000	3	-37.2
826775FP8	MO Sikeston Electric	FED & ST TAX-EXEMPT	5.00%	6/1/20	NR/NR/BBB+	BAM	1/13/15	12/29/14	6/5/15	\$116.425	1.757	61.3	\$14,380,000	132	
975705AS3	NC Winston-Salem State Univ.	FED & ST TAX-EXEMPT	4.25%	6/1/32	NR/BBB/NR		7/22/14	7/8/14	6/12/15	\$99.307	4.291	136.4	\$22,120,000	121	-34.7
975705AT1	NC Winston-Salem State Univ.	FED & ST TAX-EXEMPT	4.25%	6/1/32	NR/BBB/NR	BAM	7/22/14	7/8/14	4/17/15	\$103.624	3.801	101.7	\$6,790,000	59	
59259YWF2	NY MTA	FED & ST TAX-EXEMPT	4.00%	11/15/34	A1/AA-/A		1/25/13	1/10/13	7/13/15	\$99.378	4.011	92.7	\$83,445,000	670	-29.1
59259YYR4	NY MTA	FED & ST TAX-EXEMPT	4.00%	11/15/34	A1/AA-/A	BAM	1/25/13	1/10/13	6/19/15	\$103.721	3.505	63.6	\$4,865,000	62	
63165TJB2	NY Nassau County	FED & ST TAX-EXEMPT	4.00%	4/1/33	A2/A+/A		9/10/13	8/26/13	6/11/15	\$88.590	4.911	93.1	\$42,380,000	143	-31.3
63165TKK0	NY Nassau County	FED & ST TAX-EXEMPT	4.00%	4/1/33	A2/A+/A	BAM	9/10/13	8/26/13	7/13/15	\$99.278	3.868	61.9	\$95,935,000	655	
709224ER6	PA Penn Turnpike Comm	FED & ST TAX-EXEMPT	5.25%	12/1/44	A3/A-/A-		10/20/14	10/3/14	7/10/15	\$113.373	3.640	76.4	\$311,945,000	324	-23.3
709224EU9	PA Penn Turnpike Comm	FED & ST TAX-EXEMPT	5.25%	12/1/44	A3/A-/A-	BAM	10/20/14	10/3/14	7/10/15	\$114.446	3.504	53.1	\$17,390,000	90	
915200TA7	VT University of Vermont	FED & ST TAX-EXEMPT	5.13%	10/1/39	Aa3/A+/NR		3/6/15	2/20/15	7/10/15	\$113.571	1.944	-85.7	\$28,165,000	130	-21.4
915200UV9	VT University of Vermont	FED & ST TAX-EXEMPT	5.13%	10/1/39	Aa3/A+/NR	BAM	3/6/15	2/20/15	7/7/15	\$112.440	2.099	-107.1	\$9,965,000	50	

Secondary Market Trades Illustrate Market Valuation Dynamics

Taxable Examples

CUSIP	Description	Tax Status	Coupon	Maturity	Underlying Rating (M/S/F)	Insurer	Date of First BAM Wrap	Start of Trade Date Range	Last Trade on CUSIP	Weighted Avg Price	Weighted Avg YTW	Par Volume Traded	Number of Trades	BAM YTW Spread to MMD Benefit
358240FC8	CA City of Fresno Water	FED TAXABLE/ST TAX-EXEMPT	6.75%	6/1/2040	NR/A/A+		6/5/15	5/21/15	7/13/15	\$110.259	5.956	\$13,320,000	108	-36.1
358240GG8	CA City of Fresno Water	FED TAXABLE/ST TAX-EXEMPT	6.75%	6/1/2040	NR/A/A+	BAM	6/5/15	5/21/15	7/10/15	\$115.438	5.594	\$9,180,000	53	
139369AA0	FL City of Cape Coral Gas Tax	FED TAXABLE	7.15%	10/1/2030	A2/NR/A-		6/5/15	5/21/15	6/25/15	\$116.377	3.709	\$11,490,000	28	-46.0
139369AS1	FL City of Cape Coral Gas Tax	FED TAXABLE	7.15%	10/1/2030	A2/NR/A-	BAM	6/5/15	5/21/15	6/9/15	\$118.840	3.249	\$3,000,000	1	
34281PLE1	FL FGUA (Pasco Utility)	FED TAXABLE	6.55%	10/1/40	A2/NR/NR		5/22/15	5/8/15	7/13/15	\$112.906	3.852	\$9,800,000	54	-44.8
34281PRS4	FL FGUA (Pasco Utility)	FED TAXABLE	6.55%	10/1/40	A2/NR/NR	BAM	5/22/15	5/8/15	6/24/15	\$115.230	3.404	\$3,135,000	2	
90341UBZ4	FL USF Financing Corp	FED TAXABLE	8.55%	7/1/2040	A1/A+/NR		6/8/15	5/22/15	7/13/15	\$120.864	3.950	\$2,390,000	16	-64.7
90341UDT6	FL USF Financing Corp	FED TAXABLE	8.55%	7/1/2040	A1/A+/NR	BAM	6/8/15	5/22/15	6/11/15	\$124.209	3.303	\$2,000,000	4	
276509CR5	IL Eastern Illinois University	FED TAXABLE/ST TAXABLE	6.20%	4/1/2029	Baa1/NR/NR		6/4/15	5/20/15	7/13/15	\$94.333	6.842	\$31,635,000	883	-203.9
276509DU7	IL Eastern Illinois University	FED TAXABLE/ST TAXABLE	6.20%	4/1/2029	Baa1/NR/NR	BAM	6/4/15	5/20/15	7/13/15	\$104.579	4.803	\$13,010,000	96	
276509DN3	IL Eastern Illinois University	FED TAXABLE/ST TAXABLE	6.35%	4/1/2036	Baa1/NR/NR		6/4/15	5/20/15	7/13/15	\$92.124	7.089	\$47,555,000	1173	-194.3
276509DV5	IL Eastern Illinois University	FED TAXABLE/ST TAXABLE	6.35%	4/1/2036	Baa1/NR/NR	BAM	6/4/15	5/20/15	7/8/15	\$104.091	5.145	\$27,700,000	121	
788244EE7	IL St Clair County	FED TAXABLE/ST TAXABLE	6.00%	10/1/2044	Aa2/AA/NR		6/9/15	5/26/15	7/13/15	\$98.720	6.088	\$77,485,000	311	-48.5
788244FK2	IL St Clair County	FED TAXABLE/ST TAXABLE	6.00%	10/1/2044	Aa2/AA/NR	BAM	6/9/15	5/26/15	7/7/15	\$103.067	5.603	\$9,960,000	185	