

**Meeting Between Staff of the Federal Reserve Board, the Office of the Comptroller of the
Currency (OCC), the Federal Deposit Insurance Corporation (FDIC),
and the Office of the Governor of the State of New York
October 9, 2014**

Participants: David Emmel, Dafina Stewart, Jahad Atieh, Adam Trost (Federal Reserve Board)

Patrick Tierney, Kerri Corn, James Weinberger, David Stankiewicz, Tiffany Eng
(OCC)

Kyle Hadley, Eric Schatten, Suzanne Dawley (FDIC)

Paul Williams (Dormitory Authority State of New York), Portia Lee (Dormitory
Authority State of New York), Charles Small (Office of Governor Cuomo)

Summary: Staff of the Federal Reserve Board, the OCC, and the FDIC met with Charles Small and other representatives of the office of the Governor of the State of New York and a representative of the Dormitory Authority of the State of New York (“DASNY”) to discuss the Liquidity Coverage Ratio rule, which implements the Basel III liquidity standards in the United States, and its treatment of securities issued by states and municipalities. This meeting was a follow-up to a meeting held on September 16, 2014. The attached document was discussed.

Attachment

High Quality Liquid Assets – Municipal Bond Followup

Proposal

We would propose that investment grade municipal bonds be added as Level 2A assets under LCR and HQLA. Further, investment grade municipal bonds could be limited to no greater than 25% of the HQLA assets without further qualification. This would permit banks to source bonds based on individualized assessments and strategies. Under this approach, if an institution needed to liquidate assets to meet cash outflows, fully 75% of the other HQLA assets could be marketed through direct sales or repurchase agreements, and the municipal market would further diversify risk to the system in an orderly liquidation of the municipal securities. The higher average credit quality of municipals and lower incidence of default in numerous studies further supports the inclusion of municipal bonds as Level 2A securities for purposes of HQLA. This has already been recognized at the Federal Reserve Bank since the haircut applied to municipals is the same as that for US Agencies and GSE securities, and lower than corporate bonds.

Overall Secondary Market Trading

The municipal market is characterized by substantial secondary market activity to provide a market-based liquidity to market participants. On average over the last five years, the daily average of secondary market activity involved approximately 41,000 trades. Market liquidity is further demonstrated by the number of unique securities that are traded daily as shown in Table 1. In 2013, the average daily trading in municipal bonds was approximately \$12.4 billion, compared to \$22.6 billion for corporate bonds. As a percentage of bonds outstanding in each market, daily trading amounted to .33% for municipals and .25% for corporates. This represents substantial market-based liquidity for municipal bonds and notes.

<u>Year</u>	<u>Par (\$millions)</u>	<u>Number of Trades</u>	<u>Number of Unique Securities</u>
2009	15,045	41,110	13,902
2010	14,880	41,656	15,053
2011	13,039	41,257	15,217
2012	12,801	38,544	14,314
2013	12,380	42,188	15,501

Source: 2013 Fact Book, Municipal Securities Rulemaking Board

In addition, there is trading activity that exists for all sizes of bond amounts. A characteristic of the municipal market is that large bond trades are frequently broken into smaller pieces so that they can be resold to households. This is the reason that approximately 44% of all municipal bonds are owned by households or surrogates for individuals such as trust accounts and mutual funds. When interest rates rise, retail buys. As a result of this underlying demand, fixed rate municipal bonds did not wind up in dealer hands during the credit crisis in 2008-09. Accordingly, the structure of the municipal market seems to reduce systemic risk to financial institutions in times of fiscal crisis when the value of corporate bonds and equities may fluctuate dramatically. The inclusion of municipal bonds among HQLAs would enhance the resiliency of a bank's pool of HQLAs and reduce the risk of illiquidity in times of market distress.

Trading Activity by Type of Security/Tenor

All types of municipal securities trade daily, much of which are bonds, notes, commercial paper, and bonds with longer maturities but with an optional put feature to enhance liquidity for the 2a-7 market (money market fund eligible). The secondary market trading for 2011 to 2013 for bonds/notes with different maturities is shown in Table 2.

Table 2
Security Type and Average Daily Trade Size*
(\$ millions)

	<u>2011</u>	<u>2012</u>	<u>2013</u>
Commercial Paper	\$ 909	\$ 808	\$ 641
Variable Rate (mostly Daily/Weekly)	5,045	4,745	4,296
Short Term Notes (<1yr)	87	82	72
Longer Notes	328	327	314
Bonds	6,527	6,761	7,012

Source: 2013 Fact Book, Municipal Securities Rulemaking Board
** May not foot because zero coupon bonds are not included in this analysis.*

For purposes of an expedited conversion to cash through the market, almost half of the daily trading is in securities that have shorter maturities, so the price volatility is substantially reduced. As has been argued by many municipal market participants, municipal bonds held their value as an asset class during the credit crisis in ways similar to US Treasuries. They demonstrated that the price stability of municipals, even at different ratings, was better than that of corporate bonds, as is the credit and default history of municipals. The Chief Investment Officer at AIG, faced with liquidating their very large portfolio of municipal securities at the height of the credit crisis in Q4 2008 and Q1 2009 found that high quality municipals were readily marketable liquid assets in contrast with other fixed income securities, with the exception of US Treasuries. This experience is evidence of the very desirable result that the HQLA rule is attempting to impose.

Trading Activity by Credit Type

The municipal bond market is broken down into General Obligation Bonds of states (some of which have larger economies than other sovereign countries which receive Level 1 HQLA treatment) and their cities, towns, and villages. A substantial portion of the municipal market consists of Revenue Bonds, much of which is for issuers with monopoly control over their service area or which are backed by pools of taxes and fees. Other Revenue Bonds are for institutions that contain business risk, such as universities and hospitals. However, these are generally well structured and are important to the communities or regions in which they provide services. A segment of the municipal market is also double barreled, in which the security has a revenue stream as well as a pledge of the host municipality to support the debt if necessary. The trading by credit type for 2011 to 2013 is seen in Table 3.

Table 3
Average Daily Secondary Market Trading by Credit-Type*
(\$ Millions)

	<u>2011</u>	<u>2012</u>	<u>2013</u>
General Obligation	\$2,794	\$2,903	\$2,978
Revenue	8,460	8,384	8,501
Double Barreled	292	274	241

Source: 2013 Fact Book, Municipal Securities Rulemaking Board
**May not add because certain CP and bond issues could not be categorized based on available data.*

As can be seen in Table 3, Revenue Bonds trade in three times the average daily volume of General Obligation Bonds. The amount of daily trading for both the Revenue Bonds and the General Obligation Bonds is also very steady.

Collateral

Certain of the larger banks accept municipal bonds as collateral for repurchase agreements with broker-dealers. In addition, they have established Tender Option Bond programs for their institutional customers as well as for their own book. The TOB programs are another approach used in the municipal market to provide liquidity and operate similarly to a repurchase agreement in the corporate sector.