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Invested in America

November 17, 2016

The Honorable Janet Yellen, Chair
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551

Re: Impact on Municipal Securities from Basel Committee on Banking Supervision's Fundamental Review of the Trading Book

The Municipal Securities Division of the Securities Industry and Financial Markets Association[1] ("SIFMA") appreciates the opportunity to share our views on the potential effects on the municipal securities market of the final rule on Minimum Capital Requirements for Market Risk published by the Basel Committee on Banking Supervision (the "Committee"), also known as Fundamental Review of the Trading Book ("FRTB"), and our suggestions for certain clarifications and changes[2].

Overview

SIFMA appreciates the work that has gone into the Committee's review of trading book capital requirements to promote consistent implementation of the standards across different jurisdictions in coordination with the Federal Reserve Board (the "Board"). While the effect of FRTB on certain trading securities is fairly muted, SIFMA is very concerned about the potential effects of significantly higher capital requirements on the municipal market and the potential material harm to liquidity. Past Basel capital regimes have long recognized the lower historical market risk and default probability of municipal securities in rulemaking, and FRTB as drafted would reverse this treatment and potentially penalize trading in municipal securities relative to other asset classes.

As the Board evaluates its process for U.S. implementation of FRTB, SIFMA urges that the Board adopt the needed flexibility under the international market capital rules to implement rules for U.S. municipal

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[1] SIFMA is the voice of the U.S. securities industry. We represent the broker-dealers, banks and asset managers whose nearly 1 million employees provide access to the capital markets, raising over $2.5 trillion for businesses and municipalities in the U.S., serving clients with over $20 trillion in assets and managing more than $67 trillion in assets for individual and institutional clients including mutual funds and retirement plans. 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.

[2] Basel Committee on Banking Supervision – Minimum capital requirements for market risk http://www.bis.org/bcbs/publ/d352.pdf

securities that make sense for the U.S. market. As currently proposed, FRTB would increase the amount of capital required to trade municipal securities by 3-6 times current levels or greater. The Internal Model Approach ("IMA"), which may or may not offer marginally better capital treatment, would be difficult for many dealers to implement, especially smaller firms. The higher costs of holding trading inventory would have a chilling effect on all dealers' ability to trade bonds and would materially erode liquidity in the market.

Sensitivity Based Approach ("SBA")

Many dealers will need to capitalize municipal security trading using SBA, either because they cannot justify the added administrative cost of implementing IMA or if some IMA requirements, such as the back-testing requirement, themselves prove too difficult to implement. Implementations of all three standardized capital components require important modification to remain broadly consistent with past capital regimes and to reflect the unique nature of U.S. tax-exempt instruments.

- General Interest Rate Risk ("GIRR") - As conveyed in the Committee's FRTB document, dealers would need to capitalize their long-dated net general interest rate delta at 106 basis points ("bps") times the dollar value of a 1 basis point change in interest rates ("bpv" or "dv01"). Most dealers making markets in municipal securities would consider themselves delta hedged with minimal exposure to general changes in interest rates. However, final implementation for tax-exempt municipal bonds should reflect that the sensitivity of municipal bonds to changes in rates is a fraction of taxable bonds, such as U.S. Treasury securities. Because of this dynamic, a common hedging strategy is to hedge long positions in tax-exempt municipal securities by shorting treasuries or paying fixed on an interest rate swap at a dv01 ratio of 40-60%. The resulting difference in dv01 between the bond and the hedge should not be treated as GIRR. The rule should explicitly allow for tax exempt securities to adjust for tax effects on the rate's sensitivities.

- Credit Spread Risk ("CSR") – As written, dealers would need to capitalize their credit spread risk at 100 bps (for investment grade municipal securities) or 400 bps (for sub-investment grade municipal securities) times the dollar value of 1 bp change in credit spreads ("CS01"). The grid for CSR capital appears to be calibrated to the way corporate bonds and other international markets behave. When applied to municipal bonds, there is a significant and disproportional increase in capitalization, particularly for higher rated municipal bonds. Credit spreads for AAA and AA-category municipal bonds have historically had very low volatility, and capitalizing a 100 bps change in credit spreads is overly punitive. The U.S. tax code also prevents dealers from selling short on tax-exempt bonds, creating a "long-only" market which is very different than the corporate market. All Public Sector Entities (PSEs) should be treated as government entities, including private activity bonds, and should be capitalized at 50 bps for investment grade and 300 bps for sub-investment grade.

- Default Risk Capital ("DRC") – As written, dealers would need to capitalize their jump to default risk at a certain risk weight by rating categories, which applies to all credit categories. The required risk weights of 0.50% to 6.00% for investment grade securities are well in excess of historical default probability of 0.03% to 0.42% for municipal securities[3]. While it appears that the single default probability table is calibrated to corporate bonds, under current capital rules sovereigns and PSEs have their own calibration. Using risk weights based on corporate default rates would imply that default risk weightings would be 750 times too large for general obligation municipal bonds and 37.5 times too large for revenue bonds.[4] Final implementation should allow for lower risk weights for municipal securities, given the very low historical probability of default.

The following table summarizes the net impact of FRTB on standardized capital for municipal bonds. SBA capitalization would be 7-8 times higher than current market capital rules for high grade bonds[5]. This incredible increase in capital will increase dealer costs and create harmful effects on liquidity and ultimately harm municipal entities through higher borrowing costs. Even under SIFMA's proposed changes and clarifications to SBA, capital would still materially increase for trading municipal securities.

Basel FRTB Capital for SBA ($ in MM) – Assumes $100MM bond with 70k BPV and CS01

Rating	BPV	CS01	DRC	Total SBA Capital	B2.5 Standardized[4]	Multiple vs B2.5 (x)
AAA	3.7	7.0	0.4	**11.1**	1.6	6.9
AA	3.7	7.0	1.5	**12.2**	1.6	7.6
A	3.7	7.0	2.3	**13.0**	1.6	8.1
BBB	3.7	7.0	4.5	**15.2**	1.6	9.5
BB / NR	3.7	28.0	11.3	**43.0**	1.6	26.9
CCC	3.7	28.0	37.5	**69.2**	1.6	43.3

Final implementation of FRTB for municipal securities must incorporate these necessary improvements, including changes to the GIRR implementation, and 50% reduction in CSR and DRC. With these changes, the required capital for municipal securities would still be 2-20 times the current standardized capital requirement, as shown in the following table[5]. Even when taking into account existing VBM and SVBM capital, the SIFMA proposal would still be a material increase in required capital, but will have a less draconian impact on trading in the municipal market.

[3] J.P. Morgan US Fixed Income Weekly, April 1, 2016, "Fundamental Review of Trading Book regulations could significantly increase the cost of capital for State and local governments."

[4] Bank of America Merrill Lynch, Municipals Weekly, August 19, 2016

[5] Excludes required VBM and SVBM capitalization under current market capital rules. Inclusion of this existing capital requirement is difficult because it is uniquely implemented at each firm inclusive of risk correlations within that firm. Inclusive of VBM and SVBM, capital would increase by 3-6 times or greater, depending on specific assumptions.

Proposed FRTB Capital for SBA ($ in MM) – Assumes $100MM bond with 70k BPV and CS01

Rating	BPV	CS01	DRC	Total SBM Capital	B2.5 Standardized	Multiple vs B2.5 (x)
AAA	nil	3.5	0.2	**3.7**	1.6	2.3
AA	nil	3.5	0.8	**4.3**	1.6	2.7
A	nil	3.5	1.1	**4.6**	1.6	2.9
BBB	nil	3.5	2.3	**5.8**	1.6	3.6
BB / NR	nil	14.0	5.6	**19.6**	1.6	12.3
CCC	nil	14.0	18.8	**32.8**	1.6	20.5

Internal Model Approach ("IMA")

Dealers would need to individually evaluate if they will incur the complexity and cost of approving and implementing IMA for municipal securities. While not unique to municipals, the data and back-testing requirements may prove challenging for municipal dealers, particularly smaller firms. A lack of data for historical individual securities can lead to significant additional capitalization of Non-Modelable Risk Factors ("NMRF").

The capitalization for Expected Shortfall is broadly consistent with the existing VAR methodology. However, final implementation of the Liquidity Horizon for municipal securities should reflect the treatment given to sovereigns. Municipal credit risk should be designated as 20-day horizon for investment grade and 40-day horizon for sub-investment grade, and should not be subject to treatment as corporate bonds with 40-day and 60-day liquidity horizons, respectively.

Capitalization of default risk under IMA can be very path dependent at the 99.9th percentile. While historical municipal default rates are quite low, a floor probability of 0.3%, and the difficulty correlating such a low default history, create the potential for penalizing high notional exposures with low default risk. This dynamic could limit the appetite for dealers to bid on large competitive new issuances for single borrowers.

Conclusion

The Board needs the flexibility to implement US market capital rules that take account of the unique nature of the U.S. municipal bond market and its importance in supporting and financing national infrastructure. An increase in capital costs on the order of magnitude being considered would greatly affect the ability of dealers to provide liquidity to the market, ultimately leading to increased liquidity

risk for investors and increased borrowing costs for state and local governments. Thank you for your attention to this matter. Please contact us if you have any questions.

Sincerely,

Michael Decker
Managing Director

cc: Norah M. Barger, Senior Adviser, Division of Banking Supervision and Regulation