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SIFMA Warns Fed Basel Capital Standards for Trading Would Hurt Munis.

WASHINGTON – The Securities Industry and Financial Markets Association wants bank regulators to avoid adopting harsh international capital standards for trading that could have a chilling effect on the municipal market and hurt liquidity.

The dealer group made a plea for more flexible standards in a letter it sent to the Federal Reserve Board about the final rule on Minimum Capital Requirements for Market Risk, also known as Fundamental Review of the Trading Book (FRTB), published in January by the Basel Committee on Banking Supervision.

The Fed and other bank regulators are charged with U.S. implementation of the international framework that the Basel Committee adopted, which among other things, is meant to ensure that banks have adequate capital relative to risks on their trading books. SIFMA plans to send similar letters to other bank regulators as well.

Michael Decker, managing director and co-head of munis at SIFMA who authored the letter, said that the FRTB would increase the amount of capital required to trade munis by three to six times the current levels. "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," Decker wrote in the letter. The decrease in liquidity would ultimately lead to increased borrowing costs for state and local governments, he added.

"SIFMA is very concerned about the potential effects of significantly higher capital requirements on the municipal market and the potential material harm to liquidity," he wrote. "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."

The goal of SIFMA's letter, Decker said, is to try to raise concerns with U.S. banking regulators before they get too far along in the process of drafting regulations.

Decker detailed the changes SIFMA would like to see in the two different approaches a bank could take under the framework, the sensitivity based approach (SBA) and the internal model approach (IMA), which allows banks to devise their own model subject to regulatory approval. He called the SBA "the default method for calculating capital charges for securities held by banks or bank-affiliated broker-dealers for trading" and wrote it will likely be what most dealers choose when working to comply.

"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," Decker wrote.

The part of the SBA that SIFMA believes would most affect munis is the approach's measurement of default risk. Decker said the approach assumes default risk rates of 0.5% to 6% for investment grade securities, which is more closely aligned with corporate securities and thus much higher than the 0.03% to 0.42% that municipal market participants experience.

“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,” Decker wrote. He added that the default rate risk, among other parts of the approach, “reflects a lack of attention or a lack of understanding on the part of the Basel committee of the way the municipal market behaves relative to other products.”

SIFMA would also like to see the SBA’s treatment of general interest rate risk (GIRR) altered. GIRR is designed to measure the interest rate risk associated with a bank’s trading portfolio and measures how much more or less volatile a particular security is in relation to general interest rates.

SIFMA is concerned that the currently proposed method of evaluating GIRR would overstate the interest rate risk associated with munis because it would not capture the reduction in risk that banks realize when they hedge their muni positions, such as by shorting treasuries.

Additionally, Decker said SIFMA believes the SBA’s approach to credit spread risk, a separate part of the SBA, also overstates the risk associated with a municipal product. Munis are “a very safe product” in “a very safe market” where there tends to be relatively little volatility associated with changes in credit risk, Decker wrote.

Without SIFMA’s changes, Decker said, banks would need to have roughly seven times more capital for triple A-rated bonds and nine-and-a-half times more capital for those that have a triple B-rating. Even with the changes though, required capital for munis would still be from two to 20 times the current standardized capital requirements, according to Decker. It would be 2.3 times higher for triple-A bonds and 3.6 times higher for those rated triple-B.

Decker also asked the Fed to change some guidelines for the IMA so that it would designate municipal credit risk as a 20-day horizon for investment grade and a 40-day horizon for sub-investment grade instead of the 40-day and 60-day horizons the guidelines currently have, respectively. The liquidity horizons refer to the time required to exit or hedge a risk position without materially affecting market prices in stressed market conditions.

He also raised concerns that the IMA guidelines have a floor default rate probability of 0.3% while many munis have default rates that are much lower than 0.3%.

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