

April 22, 2016

Mr. Antonio Weiss  
Counselor to the Secretary  
U.S. Department of the Treasury  
1500 Pennsylvania Avenue, NW  
Washington, DC 20220

Dear Mr. Weiss:

The American Bankers Association (ABA)<sup>1</sup> and ABA Securities Association<sup>2</sup> (ABASA) appreciate the opportunity to comment on the Department of the Treasury's Notice and Request for Information on the Evolution of the Treasury Market Structure (RFI). The RFI seeks insight into the structural changes in the U.S. Treasury market and their implications for market functioning. Additionally, the Department of the Treasury requests comment on the types of Treasury market data that should be made available to the official and private sectors.

We support the Department of the Treasury's comprehensive review of the structure and functioning of the U.S. Treasury market. Treasury securities serve a unique and vital purpose for the U.S. economy and global financial markets. In addition to funding the Federal Government, Treasury securities play a key role in the liquidity operations of commercial banks, establish a benchmark interest rate for other instruments, and are used as collateral in a wide variety of financial transactions. U.S. banking organizations have always performed an important part in government finance, at national, state, and local levels. Banks continue to participate and interact with the U.S. Treasury markets in important ways, making the integrity and efficient functioning of these markets a keystone to the health of the U.S. financial system.

Banking organizations interact with the Treasury market in a variety of ways. Changes in the Treasury markets will impact commercial banks and bank-affiliated broker-dealers asymmetrically. This letter highlights the importance of the U.S. Treasury markets specifically to U.S. commercial banks, which often participate as long-term investors. As highlighted in the Joint SIFMA-ABA comment letter, larger bank affiliated broker-dealers continually interact with

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<sup>1</sup> The American Bankers Association is the voice of the nation's \$16 trillion banking industry, which is composed of small, regional, and large banks that together employ more than 2 million people, safeguard \$12 trillion in deposits, and extend more than \$8 trillion in loans.

<sup>2</sup> The ABA Securities Association is a separately chartered affiliate of the American Bankers Association, representing those holding company members of the American Bankers Association that are actively engaged in capital markets, investment banking, swap dealer and broker-dealer activities.

the Treasury market in their roles as large scale market makers, providing liquidity<sup>3</sup> to the primary and secondary Treasury markets. Consistent with the recommendations found in the separate joint letter, ABA and ABASA support providing post-trade data to the official sector, but does not support public dissemination of price and trade data.

As discussed more fully below, the banking industry relies on the efficient functioning of U.S. Treasury markets. It is important, then, for Treasury to understand the drivers of change to the structure and function of the Treasury market – including an understanding of how the Basel III capital and liquidity requirements are impacting the U.S. Treasury and other fixed income markets. Historically, banking organizations have acted as market makers, providing essential liquidity to markets such as those for government and corporate debt. This liquidity provision has served an important role in the depth and functioning of financial markets. Banking organizations, however, have been driven by the new capital and liquidity regulatory requirements to shrink their balance sheets, change their funding mix, and exit low margin, capital intensive business lines. This restructuring of bank balance sheets and activities, by extension, is impacting both markets and bank customers.

Going forward, we encourage Treasury to (1) review the new banking regulatory framework to identify where rules overlap, work at cross purposes, or create harmful unintended consequences; (2) make findings from its research public in a manner that protects the proprietary information of firms while encouraging continued robust public discussion; and (3) continue to solicit industry's comments as Treasury moves forward with its review.

#### *U.S. Treasury Securities are a Key Component of Bank Liquidity<sup>4</sup>Risk Mitigation*

U.S. bank investment portfolios are comprised of several types of instruments reflecting investment authority granted by law, employment of different business strategies, and management of bank activities within appropriate risk tolerances. Over time, U.S. Treasury securities have become an important source of contingent funding. Historically, banks held U.S. Treasury securities as safe, liquid instruments that could be used to meet obligations in case of an unexpected liquidity need. In fact, under recent regulatory regimes, such as the Liquidity Coverage Ratio (LCR), banks are now required to hold a stock of cash and/or U.S. Treasuries against expected stressed outflows as predicted by regulatory models.<sup>5</sup> Banks outside the scope of the LCR are also strongly encouraged to hold liquid assets.<sup>6</sup> Currently the commercial banking system holds almost \$500 billion in U.S. Treasuries, a record amount that is up sharply since 2008 with the flight to safety and implementation of the LCR (See chart 1). Therefore, it is imperative to banking organizations that the U.S. Treasury markets remain operationally sound so that that banks can efficiently monetize their stores of sovereign instruments if needed.

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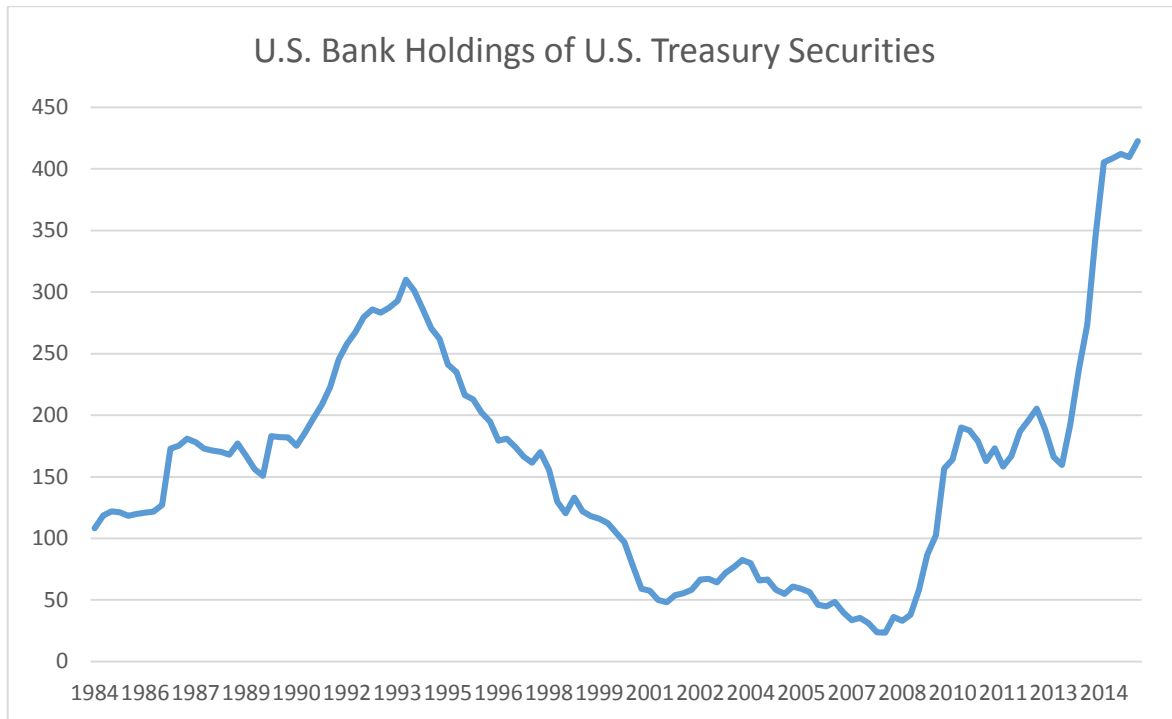
<sup>3</sup> Market liquidity in this context largely refers to an investor's ability to buy/sell assets, readily, and at a predictable price, in a desired size without materially moving the market.

<sup>4</sup> Liquidity in this context comprehends a financial institution's ability to fund assets and meet financial obligations.

<sup>5</sup> 61440 Federal Register Vol. 79, No. 197 / Friday, October 10, 2014

<sup>6</sup> 13656 Federal Register Vol. 75, No. 54 Monday, March 22,

Chart 1.



Source: FDIC Call Reports

### *U.S. Treasury Securities are an Important Benchmark*

The efficient functioning of U.S. Treasury markets is also important to banks for pricing loans. U.S. Treasury securities are seen as a proxy for a risk-free interest rate (*i.e.*, the rate considered to be free of default and marketability risk), and therefore serve as benchmarks for pricing loan instruments.

Thirty-year fixed-rate residential mortgages are most commonly priced off of the 10-year U.S. Treasury note.<sup>7</sup> Similarly, commercial real estate (CRE) capitalization rates (cap rate) and the 10-year Treasury rate have demonstrated strong correlation. The 10-year U.S. Treasury rate and cap rate spread have been used to determine market risk premia for investments in CRE.<sup>8</sup> Further, while a significant amount of CRE debt was historically priced off of the bank's prime rate, more recently, loan pricing has been tied to medium-to-long-dated Treasuries.<sup>9</sup> Some Federal student loan debt is also benchmarked annually against yields on 10-year U.S. Treasury notes, and thus banks offering private student loans may similarly price relative to U.S. Treasury notes.<sup>10</sup>

<sup>7</sup> [http://www.nytimes.com/2008/11/16/realestate/16mort.html?\\_r=0](http://www.nytimes.com/2008/11/16/realestate/16mort.html?_r=0)

<sup>8</sup> A narrower spread may demonstrate greater investor appetite for CRE yields, and, therefore, a higher risk tolerance. See, [http://www.ey.com/Publication/vwLUAssets/EY-commercial-property-outlook-in-a-rising-rate-environment/\\$FILE/Commercial%20property%20outlook%20in%20a%20rising%20rate%20environment.pdf](http://www.ey.com/Publication/vwLUAssets/EY-commercial-property-outlook-in-a-rising-rate-environment/$FILE/Commercial%20property%20outlook%20in%20a%20rising%20rate%20environment.pdf).

<sup>9</sup> Ibid.

<sup>10</sup> <http://www.forbes.com/sites/stephendash/2015/09/02/the-impact-of-financial-market-volatility-on-student-loans/#12c611322c31>.

To the extent that the spread over the index does not compensate for periods of greater or lesser volatility, volatility in Treasury security values can lead to inconsistencies in pricing over time. This matters, for example, in that periods of artificially depressed Treasury yields (*e.g.*, during periods of flight to safety) relative to interest rates more closely related to actual risk may cause banks to underprice their loans. When such periods persist, as has been the situation during the prolonged period Federal Reserve suppression of interest rates, risks will accumulate in the economy and the financial system.

#### *U.S. Treasury Securities Are Used as Collateral Across the Financial System*

U.S. Treasury securities are used as collateral in a wide variety of financial transactions. In fact, several regulations show preference for the use of U.S. Treasuries to satisfy collateral requirements (*e.g.*, uncleared swaps margin rules require have lower haircuts for short-dated Treasuries as compared to other forms of eligible non-cash margin collateral). This preference reflects the current minimal risk of default and high liquidity of these instruments. If the underlying assumptions about the Treasury market prove to be incorrect, a firm's collateral management practices may prove to be inadequate, particularly in times of stress.

We are also concerned that the accumulation of new regulations encouraging holding of Treasury instruments could create a shortage for collateral purposes in times of financial stress. The incentives for holding Treasuries to meet LCR requirements, for money market funds to qualify for stable net-asset-value treatment, for favorable risk-based capital treatment (including Basel III standards and the G-SIB surcharge), to satisfy resolution plan liquidity demands, and in various stress test scenarios, could leave insufficient amounts to meet collateral needs, in turn suppressing financial activities relying upon that collateral (*e.g.* for swaps transactions or for repurchase agreement markets).

#### **Conclusion**

U.S. Treasury securities are very important to banks of all sizes for the management of liquidity risk, loan pricing, and as collateral. ABA and ABASA applaud and support the Department of the Treasury's efforts to understand what is driving changes in the U.S. Treasury markets. We urge the Treasury to work closely with the banking industry on this review. If you have any questions about these comments, please contact the undersigned at (202) 663-5187 or email: [atouhey@aba.com](mailto:atouhey@aba.com).

Sincerely,



Senior Regulatory Advisor  
American Bankers Association



Executive Director and General Counsel  
American Bankers Association Securities Association

