

Bond Case Briefs

Municipal Finance Law Since 1971

Fed Rule Treating More Munis as HQLA Seen As Too Restrictive.

WASHINGTON - The Federal Reserve on Friday released final rule changes to treat more municipal securities as high-quality liquid assets under liquidity requirements for large financial institutions, but critics complain they do not go far enough and could hurt the muni market.

The rule changes will take effect on July 1, 2016, but other banking regulators still exclude munis as HQLA.

“Unfortunately, [the rule changes] will continue to discourage investment in our local communities. And, it will do little, if anything, to help cash-strapped school districts and municipalities finance critical infrastructure projects,” said Rep. Luke Messer, R-Ind., sponsor of a bill approved by the House in November that would go further than the Fed.

The final rule changes are slightly more lenient than those proposed last May after municipal market participants protested the liquidity rules adopted by the Fed, Office of the Comptroller of the Currency, and the Federal Deposit Insurance Corp. in September 2014 that excluded munis as HQLA because of concerns they were not liquid or readily marketable and could not be converted to cash during periods of financial stress.

The final rule changes treat as level 2B liquid assets municipal general obligation bonds that are backed by the full faith and credit of a U.S. state or municipality, are investment grade, and have been issued by an entity whose obligations have a proven track record as a reliable source of liquidity during periods of significant stress.

Munis would still have to meet the liquid and readily marketable standard outlined in the rule to be considered level 2B assets. There are three classifications of liquidity in the rule, level 1, level 2A and level 2B. Level 2B, which includes some corporate debt, is the lowest liquidity classification in the rule. Only 40% of an institution’s aggregate HQLA can be made up of level 2A and 2B assets, with only 15% of the total HQLA coming from level 2B assets.

One big change from the Fed’s first proposed changes is that the final rule allows insured munis to qualify as level 2B securities if the underlying security would otherwise qualify as HQLA without the insurance.

Another change is that the final rule eliminates the proposed requirement that institutions have no more than 25% of munis with the same CUSIP number.

However, the Fed still maintains a 5% limit on the amount of munis that a regulated institution can include as HQLA but does not limit the number of munis an institution could hold other than for complying with the Fed’s liquidity rule.

The final rule does not include revenue bonds as HQLA, but the Fed said it will continue to monitor the liquidity characteristics of revenue bonds and consider whether to include them as HQLA in the

future.

Dustin McDonald, director of the federal liaison center for the Government Finance Officers Association, said GFOA applauds the Fed's effort to include munis but believes the regulator ignored the group's broad input on the liquidity benefits munis could provide.

"The amendment does not sufficiently correct the 2014 rule and GFOA and our state and local government association partners will continue efforts to secure enactment of legislation to truly address the short-sightedness of the rule," McDonald said.

He was referring to Messer's bill, which would treat munis that are investment grade and readily marketable as Level 2A assets — the same level as some sovereign debt and government-sponsored debt of Fannie Mae and Freddie Mac. Munis could also account for up to 40% of a bank's HQLA under the bill.

Rep. Carolyn Maloney, a Democrat from New York who co-sponsored Messer's bill, said, "The OCC should follow the Fed's lead and offer similar relief in order to protect the municipal bond market, and cities and states across the country."

Sen. Mike Rounds, R-S.D., who has been mentioned as a candidate to offer an HQLA bill in the Senate, said the Fed proposal "is a step in the right direction" but that he plans to keep working in the Senate to give fair treatment to munis.

Dealer groups, like the lawmakers, welcomed the Fed's efforts, but criticized the limited nature of the changes.

John Vahey, director of federal policy at Bond Dealers of America, said it is "unfortunate that the Fed has chosen to continue to restrict and limit the use of general obligation bonds and completely exclude high-quality revenue bonds from the banking liquidity rule."

Michael Decker, managing director and co-head of the Securities Industry and Financial Markets Association municipal securities group, said the eventual effect of the rule will be to reduce demand for munis and potentially create higher borrowing costs for state and local governments.

Mike Stanton, head of strategy and communications at Build America Mutual, said BAM appreciates the Fed's willingness to make insured munis eligible for treatment as Level 2B liquid assets provided they meet the board's other criteria.

The Fed's liquidity rule applies to institutions that have at least \$250 billion in total consolidated assets or at least \$10 billion in on-balance sheet foreign exposure.

It also applies to state member banks that have at least \$10 billion in total consolidated assets and are consolidated subsidiaries of covered bank holding companies as well as nonbank financial companies that the Fed has supervisor over as designated by the Financial Stability Oversight Council.

Bank holding companies and certain savings and loan holding companies with at least \$50 billion in total consolidated assets who don't meet any other thresholds are also covered under the rule.

The Bond Buyer

By Jack Casey

April 1, 2016

Copyright © 2026 Bond Case Briefs | bondcasebriefs.com