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Bill Introduced to Require Bank Regulators to Treat Munis as HQLA.

WASHINGTON — A bipartisan coalition of House members has introduced legislation that would require federal banking regulators to treat certain municipal securities held by large banks and other financial institutions as high-quality liquid assets.

The bill, H.R. 2209, is sponsored by Rep. Luke Messer, R-Ind., with at least nine other co-sponsors, including several who have been prominent on muni issues such as: Rep. Steve Stivers, R-Ohio; Rep. Randy Hultgren, R- Ill.; Rep. Gwen Moore, D-Wisc.; and Rep. Michael Capuano, D-Mass. All 10 sponsors are members of the House Financial Services Committee, including high-ranking members Rep. Peter King, R-N.Y. and Rep. Carolyn Maloney, D-N.Y.

The bill is a response to a rule jointly adopted by the Federal Reserve, Comptroller of the Currency, and Federal Deposit Insurance Corporation late last year that requires the country's largest banks and other financial institutions to maintain a certain liquidity coverage ratio, or LCR, to ensure they can better deal with periods of financial stress. An LCR is defined as the ratio of HQLA to total net cash outflows. Assets would qualify as HQLA if they could be easily and quickly convertible to cash with or no loss of value during a period of liquidity stress.

Bank regulators failed to include munis as HQLA in the rules, contending are not liquid or easily marketable. They also said banks don't hold munis for liquidity.

The rule, which banks have to comply with by Jan. 1 2017, is designed to protect the U.S. financial system during times of stress by ensuring that banks with at least $250 billion of total assets or consolidated on-balance sheet foreign exposures of at least $10 billion have the flexibility to weather the storm.

Market groups and lawmakers have warned that the exclusion of munis will raise borrowing costs for issuers, as well as decrease liquidity and increase volatility in the muni market.

The Fed has seemed receptive to amending the rule to include at least some investment grade munis as HQLA, and Fed chair Janet Yellen told the Financial Services committee earlier this year that Fed staff were working "very expeditiously" to identify the munis that could qualify. But the OCC and the FDIC have been reluctant to make the change, though they have not ruled it out.

The Messer bill would require that the LCR rule treat munis that are investment grade and actively traded in the secondary market as "2A" liquid assets, the same tier as some sovereign debt and claims on U.S. government entities like Fannie Mae and Freddie Mac. Securities and bonds in the 2A category can account for up to 40% of a bank's HQLA under the rule. It is the second highest level of HQLA, below federal government securities and the strongest foreign debt.

Market groups are welcoming the bill.

"Bond Dealers of America supports efforts by legislators and regulators to accurately define municipal bonds as high-quality liquid assets," said BDA chief executive officer Mike Nicholas. "In times of extreme market stress, as in 2008 and 2009, highly-rated municipal bonds were a solid store of value, and to exclude municipal bonds from the liquidity coverage ratio would negatively impact demand and raise the cost of infrastructure and other job-producing municipal projects for issuers."

Dustin McDonald, director of the Government Finance Officers Association's federal liaison center, said his group's members support the Messer bill.

"The GFOA applauds the introduction of this important legislation and appreciates Congressman Messer's leadership on this issue," McDonald said. "GFOA and a number of our association partners have presented a very strong case to regulators about the need to admit muni securities as HQLA, and the liquidity of munis. There is no reason why investment grade munis should not be classified as HQLA."

Michael Decker, managing director and co-head of municipals at the Securities Industry and Financial Markets Association, also applauded the bill.

"We are encouraged that Congress is focused on the issue of bank investment in the municipal market," Decker said. "Banks provide a key source of demand for municipal securities, and the liquidity coverage ratio rule as finalized last fall will over time discourage bank investment in the market, to the detriment of state and local governments."

Sources said that a unilateral move by the Fed to amend the rule to include munis as HQLA, without the OCC or the FDIC, would probably not do much to resolve the HQLA problem because most of the banks big enough to impact liquidity are nationally-chartered institutions primarily regulated by the OCC.

According to Fed data, all but two of the nine institutions with more than $250 billion in holdings at the end of 2014 were banks primarily regulated by the OCC, and sources said such institutions would probably not feel free to count munis as HQLA just because the Fed alone amended the rule.

"It doesn't solve for what the market needs," said one bank analyst who asked not to be identified. The banks that would get some flexibility from a unilateral Fed change are those that control "a much smaller portion of the liquidity," then the OCC-regulated institutions, the analyst said.

Messer's bill is awaiting action before the Financial Services Committee, and could have a bright outlook there due to the support of the high-ranking Republicans as well as Democrats who co-sponsor it.

THE BOND BUYER

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MAY 4, 2015 1:38pm ET