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Fed Proposes Limited Muni HQLA Rule.

WASHINGTON – The Board of Governors of the Federal Reserve System has proposed a rule that would amend the Fed's liquidity coverage ratio requirement (LCR) to include some uninsured investment-grade general obligation municipal securities as high-quality liquid assets (HQLA) — a move market participant have said matters little unless other regulators follow suit.

The Fed proposal would partially modify a rule jointly adopted by the Fed, the Comptroller of the Currency, and the Federal Deposit Insurance Corporation late last year that requires the country's largest banks and other financial institutions to maintain a certain 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.

The regulators failed to include munis as HQLA in the rules, contending that they 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 a financial storm. However, the Fed's proposal does not change the rules of the Comptroller (OCC) or the FDIC.

The Fed is proposing to treat munis as level 2B liquid assets under the LCR as long as they meet the same requirements as corporate bonds, being liquid and readily marketable. Level 2B assets cannot account for more than 15 percent of the total HQLA amount, but the Fed is also capping the muni amount at 5% of an institution's total HQLA holdings.

This would be less favorable treatment than proposed under legislation introduced by Rep. Luke Messer, R-Ind. earlier this month, which would treat certain munis as 2A assets, which could account for up to 40% of a bank's HQLA under the rule.

"Although the board has concluded that certain U.S. general obligation municipal securities are sufficiently liquid to be included as eligible HQLA, the board proposes to limit the aggregate amount of all U.S. general obligation municipal securities that may be included in the HQLA amount to ensure appropriate diversification of asset classes within a board-regulated institution's HQLA amount," the Fed said in its proposal.

The Fed also made clear that bonds guaranteed by insurers should not be able to qualify as HQLA.

"Under the proposed rule, U.S. general obligation municipal securities would qualify as HQLA only if they are not obligations of a financial sector entity and not obligations of a consolidated subsidiary of a financial sector entity," the Fed said. "Thus, if a bond insurer insures the general obligation municipal securities of a U.S. public sector entity, the securities would not be eligible for inclusion in HQLA."

The Fed reached that conclusion, the proposal explains, because such guarantees could be risky

during periods of financial stress and that stipulation is consistent with requirements imposed on corporate bonds and other 2B HQLA.

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

But sources told The Bond Buyer last month that a unilateral move by the Fed 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: Bank of New York Mellon/Bank of New York Mellon Corp. and State Street Bank & Trust Co/State Street Corp-.

Fed officials who hosted a conference call Thursday acknowledged that banks under OCC supervision would still not be free to hold munis as HQLA under this proposal, but said it remains unclear how that could impact the banks or the market. In a press release, the Fed touted the proposal as a way to “maintain the strong liquidity standards of the LCR while providing banks with the flexibility to hold a wider range of HQLA.”

The Fed is soliciting comments on the proposed rule until July 24.

THE BOND BUYER

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MAY 21, 2015 2:40pm ET

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