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[Fed's Final Treatment of Municipal Securities as High-Quality Liquid Assets Disappoints the Industry: Butler Snow]

Treatment of Municipal Securities in Fed's Final HQLA Rule Draws Unenthusiastic Industry Reactions

On April 1, 2016, the Federal Reserve Board released its final regulations[1] respecting treatment of municipal securities as high-quality liquid assets ("HQLA") for purposes of its liquidity coverage ratio rule for "covered companies" – the 11 most highly capitalized United States banks – after strenuous criticism from the municipal securities industry and a Congressional response that included a bill that has passed in the House of Representatives[2]. In the final rule, the Federal Reserve Board revised the original proposal by modestly expanding those municipal securities that would qualify for inclusion in a covered company's HQLA, but rejected most commenters' recommendations. The following discussion summarizes the original Fed proposal, the principal comments from affected trade groups, the final regulation, the Fed's rationale for its determinations and the pending legislation.

Financial Crisis and Bank Regulatory Response

In the aftermath of the financial crisis of 2008 and 2009, international banks sought to ensure sufficient liquidity for the largest banks by establishing a quantitative liquidity coverage ratio standard pursuant to the Basel III capital and liquidity reforms. United States bank regulators, including the Board of Governors of the Federal Reserve System (the "Fed"), the Office of the Comptroller of the Currency (the "OCC"), and the Federal Deposit Insurance Corporation (the "FDIC") published a joint Notice of Proposed Rulemaking (the "NPR"), adopted on September 3, 2014[3], that established a Liquidity Coverage Ratio ("LCR") to be maintained by larger banks and holding companies[4]. The LCR would require covered institutions, during periods of non-stress, to maintain an amount of high-quality liquid assets that is not less than 100% of its total net cash outflows over a prospective 30 calendar day period.

Significantly for municipal securities issuers and the municipal securities industry, securities issued by "public sector entities" (*i.e.*, state and local government issuers) were not included as HQLAs in the original NPR.

Objections to NPR and Subsequent Fed Proposal

After predictable objections from trade groups representing municipal issuers, banks and the municipal securities industry, based upon potential harm to municipal securities issuance from exclusion of municipal securities as eligible HQLAs under the NPR, on May 28, 2014, the Fed (but without participation by the OCC or the FDIC) issued a proposal (the "Fed Proposal") that would permit covered institutions to include certain U.S. municipal securities as HQLAs under strict criteria described below.

The Fed Proposal

The Fed Proposal limits eligibility of U.S. municipal securities to investment grade general obligations that are not insured. Revenue obligations, irrespective of credit standing, would not qualify as HQLAs[5]. Additionally, the Fed Proposal imposes significant concentration risk limitations on a covered institution's holdings of HQLA-eligible U.S. municipal securities:

- No more than 25% of an individual CUSIP may be included in a bank's stock of HQLA;
- No more of a single issuer's bonds than an amount equal to two times the average daily trading volume of that issuer's bonds over the previous four quarters may be included in a bank's stock of HQLA; and
- No more than 5% of a bank's total stock of HQLA may be comprised of municipal securities.

Issuer and Industry Comments

During the public comment period on the Fed Proposal, which ended July 24, 2014, the Fed received 13 comment letters from issuers and industry groups[6]. All commenters argued that the HQLA standards for municipal securities in the Fed Proposal were excessively limiting, with the exception of Better Markets, Inc., which argued that municipal securities should not be included in HQLAs at all because of the provision in the Fed Proposal that leaves the determination whether a security is "investment grade" to the covered institution itself.

A primary objection from all trade group commenters – including the Securities Industry Finance and Marketing Association ("SIFMA"), the Bond Dealers Association ("BDA") and a joint comment from 15 issuer groups that included the Government Finance Officers Association, the National Association of Counties, the National League of Cities and the U.S. Conference of Mayors – was the exclusion of investment grade revenue obligations from HQLA eligibility. Specifically, SIFMA noted that the credit quality of many revenue obligations is regarded by the market as preferable to general obligations, particularly in light of adverse treatment of general obligations in recent municipal bankruptcies such as Detroit's. Indeed, the PFM Group noted that the Fed Proposal "reduces the universe of outstanding eligible municipal securities by more than $2 trillion." Likewise, the Bond Dealers Association noted that the exclusion of revenue securities from HQLA effectively limits the municipal securities that would be eligible for inclusion as HQLA to less than 40% of securities issued in 2015.

Commenters, including municipal bond insurer Build America Mutual Assurance Company, also criticized the exclusion of insured general obligations from the HQLA eligibility, arguing that the Fed Proposal misconceived the role of bond insurance of otherwise investment grade obligations, which does not substitute for the underlying credit and actually adds liquidity to such securities.

Regarding the concentration risk limits in the Fed Proposal, commenters argued that they are based on misunderstandings of the municipal market. With regard to the limitation to 25% of a pertinent CUSIP (i.e., maturity), commenters argued that the rule would push banks to hold many smaller portions rather than large-block portions that are more liquid because of their appeal to institutional investors. SIFMA argued that the 25% limit is actually counterproductive to liquidity and that, alternatively, this rule should be dropped "in favor of reliance on the risk management systems banks already have in place."

Regarding the two-times average daily trading volume limitation, SIFMA noted that historic trading volume may not be the best indicator of liquidity in that many bonds are bought as buy-and-hold investments.

Regarding the limitation of U.S. municipal securities to not more than 5% of a bank's total HQLA, SIFMA noted that no other asset class eligible for inclusion in HQLA, including corporate securities, has an asset-specific limitation. Additionally, the LCR rule separately limits 40% of total HQLA for Levels 2A and 2B combined and has a 15% limit for Level 2B. Thus, SIFMA argued that the existing limitations are sufficient without the addition of the 5% limit.

Pending Legislation

In response to dissatisfaction with the Fed Proposal and the non-participation of the FDIC and OCC in establishing uniform HQLA standards, Representative Luke Messer (R-Ind.) and co-sponsor Representative Carolyn Maloney (D-NY) introduced legislation that would require the Fed Rule "to treat a municipal obligation that is both liquid and readily marketable (as defined in the Final Rule) and investment grade as of the calculation date as a high-quality liquid asset that is a level 2A liquid asset." The legislation would also require the FDIC and the OCC to conform their HQLA regulations to this statute. The proposed legislation passed the House of Representatives on February 1, 2016, as H.R. 2209 and has been referred to the Senate. As of this writing, there is no Senate sponsorship.

The Final Fed Rule and the Fed's Rationale; Industry Disappointment

The final Fed Rule makes two basic changes to the Fed Proposal: First, general obligation municipal securities insured by a bond insurer may count as Level 2B liquid assets as long as the underlying municipal security would otherwise qualify as HQLA without the insurance. Second, the final Fed Rule eliminates the 25% limitation on the total amount of outstanding securities with the same CUSIP number that could be included as Level 2B liquid assets. <u>Notably, the final Fed Rule continues to exclude revenue obligations from HQLA status.</u> A summary of the Federal Reserve Board's rationale for the final Fed Rule is set out in the following footnote[7] .

The final Fed Rule will take effect on July 1, 2016.

In interviews with The Bond Buyer[8], Congressional and trade group spokespersons expressed disappointment in the final Fed Rule. Representative Luke Messer said "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." John Vahey, Director of Federal Policy at Bond Dealers of America, observed that 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."

Potential Impact of the Final Fed Rule? Prospects for a Legislative Override?

What, then, will be the impact of the Fed Rule as adopted? On the one hand, indications are that the HQLA limitations will reduce demand for U.S. municipal securities for covered banks and thus result in increased interest rates for securities bought by covered banks. Also, the continuing absence of a joint regulation that includes the OCC and the FDIC could result in differential standards that could disrupt the market even further. However, since the Fed Rule, as finally adopted, will directly affect only a dozen or so of the largest U.S. banks, it is unknown whether the ultimate Fed HQLA standards will affect non-covered bank lenders and the bond market generally[9].

In light of the passage of House Resolution 2209, the matter is not fully resolved. Whether House Resolution 2209 gains a Senate sponsor and can pass during this election year (not to mention the possibility of a Presidential veto) is speculative, but the industry response to the Fed's action on HQLA may not be finished yet.

by E. Alston Ray and Caitlyn T. Smith

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Footnotes

[1] 81 Fed. Reg. 21223 (April 11, 2016).

[2] H.R. 2209, passed February 1, 2016.

[3] 79 Fed. Reg. 61439 (October 10, 2014).

[4] U.S. banks currently meeting the criteria for "covered companies" under the Basel III standards are as follows: J.P. Morgan Chase & Co., Bank of America, Citigroup, Wells Fargo & Co., Goldman Sachs Group, Morgan Stanley, U.S. Bancorp, Bank of New York Mellon, PNC Financial Services Group, Capital One, HSBC North America Holdings, State Street Corporation, and TD Bank U.S. Holdings.

[5] The LCR divides HQLA into three categories of assets: Level 1, Level 2A, and Level 2B liquid assets. Specifically, Level 1 liquid assets are limited to balances held at a Federal Reserve Bank and foreign central bank withdrawable reserves, all securities issued or unconditionally guaranteed as to timely payment of principal and interest by the U.S. government, and certain highly liquid, high credit quality sovereign, international organization and multilateral development bank debt securities. Level 1 liquid assets, which are the highest quality and most liquid assets, may be included in a covered company's HQLA amount without limit and without haircuts. Level 2A and 2B liquid assets have characteristics that are associated with being relatively stable and significant sources of liquidity, but not to the same degree as Level 1 liquid assets. Level 2 liquid assets include obligations issued or guaranteed by a U.S. government-sponsored enterprises (GSE) and certain obligations issued or guaranteed by a sovereign entity or a multilateral development bank that are not eligible to be treated as Level 1 liquid assets. The LCR subjects Level 2A liquid assets to a 15% haircut and limits the aggregate of Level 2A and Level 2B liquid assets to no more than 40% of the total HQLA amount. Level 2B liquid assets, which are liquid assets that generally exhibit more volatility than Level 2A liquid assets, are subject to a 50% haircut and may not exceed 15% of the total HQLA amount. Under the LCR, Level 2B liquid assets include certain corporate debt securities and certain common equity shares of publicly traded companies. Level 2 liquid assets, including all Level 2B liquid assets, must be liquid and readily marketable as defined in the LCR to be included in HQLA. Under the LCR final rule, U.S. municipal securities were not included in the definition of HQLA. However, under the final Fed Rule all U.S. municipal securities that qualify as HQLAs will constitute Level 2B liquid assets.

[6] All public comments to the Fed Proposal are available on the Fed website at http://www.federalreserve.gov/generalinfo/foia/ProposedRegs.cfm.

[7] In its summary of the final rule, the Federal Reserve Board offered the following rationale for its determinations (emphasis added):

a) Certain US municipal securities may be included as a **level 2B liquid asset** if they meet the liquid and readily marketable standard in the LCR rule

    i) These securities will not be included as a level 2A liquid asset

b) Revenue bonds **still are not** eligible for inclusion as a level 2B liquid asset:

    i) During periods of significant stress, the credit equality of revenue bonds tends to deteriorate more significantly than general obligation bonds.

    ii) During times of significant stress, probability of default is considered along with the magnitude of expected loss upon default. Without general taxing authority support, the market would likely be more concerned about the probability of default for a revenue bond as compared to a general obligation bond.

iii) Historically, there have been a significantly higher number of defaults on revenue bonds than general obligation bonds.

iv) Liquidity could disappear if the specified revenue source of a revenue bond were found to be insufficient to meet its obligation, regardless of the total amount of the revenue bond outstanding.

c) A Board-regulated covered company **may include** as a level 2B liquid asset a US general obligation municipal security that has a guarantee from a financial institution as long as the company demonstrates that the underlying US general obligation municipal security meets all of the other criteria to be included as level 2B liquid assets without taking into consideration the insurance.

d) The final rule **retains** the limitation on the inclusion of US general obligation municipal securities of a single issuer. A Board-regulated covered company that owns more than 2x the average daily trading volume of all US general obligation municipal securities issued by a public sector entity may include up to 2x the average daily trading volume of such securities as eligible HQLA:

i) The Board believed that this 2x average daily trading volume cap could likely be absorbed by the market within a 30 calendar-day period of significant stress without materially disrupting the functioning of the market.

ii) The Board believed that this requirement ensures that US general obligation securities included as eligible HQLA remain relatively liquid and have buyers and sellers during periods of significant stress.

e) The final rule **retains** the 5% limitation on the amount of US municipal securities that can be included in a Board-regulated covered company's HQLA amount:

i) The Board believed this limit will act as a backstop to address the overall liquidity risk presented by the municipal securities market, including the large diversity of issuers and sizes of issuances by ensuring covered companies' HQLA amounts are not overly concentrated in and reliant on US municipal securities.

f) The final rule **eliminates** the 25% limitation on the total amount of outstanding securities with the same CUSIP number that could be included as level 2B assets:

i) This limitation could have barred certain companies from including certain municipal securities, and particularly small issuances, in their HQLA amount.

[8] "Fed Rule Treating More Munis as HQLA Seen As Too Restrictive," *The Bond Buyer*, April 1, 2016.

[9] Many thanks to Belinda Hannah at First National Banker's Bank in Birmingham, Alabama, and Alan Ganucheau, Greg Brewer, Jason Thomas and Steve Cole at Hancock Bank, for taking the time to discuss the Fed Proposal and its potential impact on the municipal securities market. However, nothing in this post is attributable to them or their employers, and, of course, any errors in this post are my own.