
Treasury Recommends Treating High-Grade Munis as HQLA.

WASHINGTON – The Treasury Department is recommending that high-grade municipal securities be included as high quality liquid assets under federal banking rules, a stance that state and local groups as well as some legislators have taken since the rules were first passed.

The Treasury made its recommendation to include munis as Level 2B liquid assets, the lowest level categorization of high quality, in a report compiled in response to President Trump's Feb. 3 executive order on core principles for regulating the U.S. financial system. The order laid out seven "core principles" that the Trump administration would like the financial system to adhere to, such as making regulations as efficient as possible. It directed Treasury to compile a report on how the current rules and regulations governing the financial system are operating with respect to those principles.

Treasury compiled its report after meeting with numerous regulators, including the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corp., and the Federal Reserve Board.

Department officials also met with a range of stakeholders. The recent report on the depository system is one of four that Treasury plans to release to comply with Trump's order. The others will focus on capital markets, the asset management and insurance industries, and non-bank financial institutions.

Treasury does not specify what types of munis it believes should qualify as "high-grade," meaning it would likely be up to the regulators to determine which munis they consider to be worthy of a Level 2B classification. Federal banking rules say HQLA should, among other things, be easily and immediately convertible into cash with little or no expected loss of value during a period of liquidity stress. HQLA should also have lower risk, and demonstrate minimal volatility.

Emily Brock, director of the Government Financial Officers Association's federal liaison center, said the report's recommendation of classifying some munis as HQLA "shows the administration's commitment to what we know to be the case, that muni bonds are not only high quality but also a liquid investment."

"I think that is a great testament to the progress of [munis as] HQLA," she added.

The Fed, OCC, and FDIC adopted rules in 2014 that require banks with at least $250 billion of total assets or consolidated on-balance sheet foreign exposures of at least $10 billion to have a high enough liquidity coverage ratio – the amount of HQLA to total net cash outflows – to deal with periods of financial stress.

State and local groups as well as other municipal market participants were troubled after the regulators did not include munis as HQLA under the new rules because of concerns that they were not liquid enough. Dealers and issuers said the choice to exclude munis would increase borrowing costs for state and local governments and lead to higher volatility in the municipal market.

The concerns spurred the Fed to act in April 2016 by revising its rule to count munis as level 2B HQLA assets if they meet the same liquidity criteria that applies to corporate debt. Market participants said they were grateful for the recognition but were still concerned that the proposal was too restrictive because the amended rule said munis could only account for 5% of total HQLA. There was also concern that the rule would be too limited because the Fed lacks jurisdiction over many of the larger banks that invest in munis. The FDIC and OCC did not change their rules to be line with the Fed's.

Muni market concerns also led to proposed, bipartisan bills in both the House and Senate during the last legislative session. Neither bill became law during the session but both have been reintroduced this session and have received support from state and local groups.

Sens. Mike Rounds, R-S.D., and Mark Warner, D-Va., have sponsored a bill that would require bank regulators to treat munis that are investment grade, liquid, and readily marketable as Level 2B liquid assets. Level 2B also includes corporate debt and publicly traded common stock. Reps. Luke Messer, R-Ind., and Carolyn Maloney, D-N.Y., go even farther with their bill, which would treat munis that are investment grade, liquid, and readily marketable as Level 2A liquid assets. Level 2A also includes debt from U.S. government-sponsored enterprises like Fannie Mae and Freddie Mac as well as foreign sovereign debt. While Level 2B assets can only make up 15% of a bank's HQLA, Level 2A assets can make up 40% under the current banking rules.

Brock said that having a recognition of munis as HQLA from the administration as well as from Congress is "a huge step in the right direction." She said GFOA is pushing for a Level 2A classification and that designation as Level 2B "is pretty much as drastic a concession as we're willing to make."

GFOA, along with 14 other state and local groups, wrote a letter to the Senate Banking Committee and each member of the House in April urging the committee and members to support the currently pending legislation. Brock said the request has been well-received in the committee.

Adding the administration's push for including munis under the regulators' rules gives a second way, aside from Congress, of reaching the groups' goal if the OCC, FDIC, and Fed all follow the administration's recommendation. Brock said that GFOA is supportive of all the efforts to achieve the goal and is of the perspective that whatever way gets munis included fastest is worth pursuing.

The Bond Buyer

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