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Final Rule Makes Munis High-Quality Liquid Assets.

Municipal bonds will soon qualify as high-quality liquid assets under Federal banking regulations, a designation market participants expect to provide banks a greater incentive hold their debt.

The Federal Reserve, the Office of the Comptroller of the Currency, and the Federal Deposit Insurance Corp. said Thursday they were adopting, without change, the August 2018 interim rule to allow investment-grade munis that are "liquid and readily marketable" to qualify as level 2B HQLA. The rule will take effect 30 days after publication in the Federal Register, which usually takes about three business days.

"The efforts of issuers over the past few years has helped establish what we all know to be true: municipal securities are both high quality and liquid assets," said Emily Brock, director of the Government Finance Officers Association?s federal liaison center. "We look forward to seeing the benefits of the final rulemaking for issuers and the market as a whole."

The rule change was required by the Economic Growth, Regulatory Relief, and Consumer Protection Act of 2018, which President Donald Trump signed into law in May 2018. The issue is important to the muni market because banks would have had less incentive to hold muni debt had it lacked the HQLA designation.

The rule change followed a struggle that began in 2014, when the regulators adopted Liquidity Coverage Ratio rules to 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.

All of the bank regulators initially excluded munis as HQLA in the LCR rules because they believed they were not liquid. Muni market groups protested.

The Fed later revised its rules, but its muni HQLA provisions were seen by many in the market as too restrictive. Specifically, they allowed only general obligation bonds to count as HQLA and limited the amount of securities issued by a single issuer that a bank could include as eligible HQLA to two times the average daily trading volume of that issuer. In addition, munis could comprise no more than 5% of a bank?s overall HQLA.

The final rule will now allow many revenue bonds, including private activity bonds in some cases, to qualify as Level 2B HQLA. That will put these munis on a par with mortgage-backed securities. Muni market groups have said they believe the long track record of munis as a stable investment warrants them being classified as level 2A assets, the same as foreign sovereign debt. The level matters because regulators apply a larger discount to level 2B assets when calculating rick-based capital than to level 2A assets: 25% instead of 15%.

"We look forward to assessing future opportunities that may afford further enhancements to the final rulemaking," said Brock.

Bank holdings of munis had grown steadily for years excepting a dip during the recession 10 years ago, but the federal tax law passed in 2017 slashing the corporate tax rate to 21% from 35% has made munis less appetizing for banks and their holdings have dropped.

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