June 3, 2015

The Federal Reserve Proposes Including Certain Municipal Obligations as HQLA

To kick off the Memorial Day weekend the Federal Reserve Board announced a proposal to include certain state and municipal general obligation bonds in the calculation of High Quality Liquid Assets (HQLA), the numerator of the new Liquidity Coverage Ratio (LCR) requirement to which large banks are subject. Although the proposal is a step in the right direction for municipal issuers looking to sustain banks' appetite for their bonds, and would help banks comply with the LCR, the limitations contained in the proposal make it a far cry from the broad inclusion many issuers and banks have called for since the final LCR was adopted without allowing for any municipal bonds as HQLA. In addition, the OCC and FDIC have not followed the Fed and made similar proposals. Without a significant easing of the restrictions contained in the proposal AND support from both the OCC and FDIC, the Fed's expansion of HQLA to include certain municipal obligations is unlikely to have a meaningful impact on banks subject to the LCR.

Which Banks Are Affected by the Proposal?

Only banking organizations that are subject to the LCR and also primarily supervised by the Fed would benefit from the proposed rule. In general that means (i) bank holding companies and state member banks with $250B or more in assets or $10B or more in on-balance sheet foreign exposure, (ii) state member banks with $10B or more in assets that are subsidiaries of the entities described in clause (i), and (iii) bank holding companies with $50B or more in assets that are subject to a less stringent LCR. Fed data indicate that only two banks with over $250B in assets were not regulated by the OCC: Bank of New York and State Street. As a result, only two of the nine largest banks would benefit from the proposed rule change unless the OCC and FDIC follow suit.

Which Assets Are Allowed to be Included as HQLA under the Proposal?

An asset must meet four criteria to be HQLA under the proposed rule. First, it must be a general obligation of the issuing entity, backed by its full faith and credit. Second, it must have an investment grade rating as of the date of calculation of HQLA. Third, it must be issued by an entity whose obligations have a proven record as a reliable source of liquidity in repurchase or sales markets during a period of significant stress (as determined by an empirical formula). Fourth, it must not be an obligation that is issued or "guaranteed" by any financial sector entity or a consolidated subsidiary of any financial sector entity.

The proposal specifically excludes revenue obligations of a municipal issuer because, according to the Fed, during a period of significant stress revenue derived from a particular project may decline dramatically due to an overall contraction in spending, with a corresponding reduction in the price and liquidity of the securities secured by that revenue. Although the Fed's explanation for excluding revenue obligations is plausible in certain contexts (it cites a stadium project as an example), the rationale for it unfortunately fails to consider the many revenue-backed obligations of essential service systems (e.g., water/sewer, energy, transportation) the demand for and revenues of which should be inelastic during an economic downturn.

The fourth exclusion, requiring that the obligation may not be of a financial sector entity (which includes being guaranteed by a financial sector entity), is particularly relevant to banks because it would exclude insured bonds from HQLA. Although the instances are limited, banks occasionally purchase insured bonds, primarily when an issuer wants to preserve the ability to offer the insured bonds for public sale after the initial bank holding period. Excluding insured bonds that would otherwise constitute HQLA under the proposal is a curious result because the underlying obligation of the issuer would be an HQLA but for the insurance, which should enhance rather than impair the quality of the bonds.

What Are the Limitations on Inclusion of Municipal Securities as HQLA?

There are three limitations on a bank's ability to include otherwise eligible municipal obligations in its calculation of HQLA. First, a bank may include a municipal security as a HQLA only to the extent that the fair value of the bank's securities with the same CUSIP number do not exceed 25% of the total amount of outstanding securities with the same CUSIP number. The Fed is concerned that large holdings of a given issuance of bonds may be less liquid during times of financial stress than smaller holdings. Second, for each municipal issuer, a bank may only include the fair value of its securities in an amount up to two times the average daily trading volume of the issuer's general obligation securities, as measured over the previous four quarters. The Fed is concerned that if the trading of a given municipal issuer's obligations increases significantly during a period of stress, it will signal a decline in the value of the issuer's securities. Finally, eligible municipal obligations may only constitute 5% of a bank's total HQLA. Absent this limitation, qualifying municipal obligations would be treated equally with other level 2B liquid assets, which are allowed to constitute up to 15% of a bank's total HQLA amount. The Fed indicated that it was imposing the 5% limit on qualifying municipal obligations "to ensure appropriate diversification of asset class within a bank's HQLA." Interestingly, however, it did not impose a similar limit to any other category of assets within a single HQLA level. That approach may not be surprising since municipal obligations were completely excluded from HQLA as the LCR was initially adopted, but it is disappointing news to many issuers and banks.

What Happens Next?

Comments on the Fed's proposed rule are due July 24. We expect robust commentary from interested parties regarding the nature of the assets eligible for inclusion as HQLA (particularly relating to the exclusion of revenue obligations, which in some respects may be of higher quality than general obligations due to the favorable treatment of "special revenue" obligations in a Chapter 9 proceeding), and the limitations imposed on otherwise eligible assets. Additionally, the proposal is likely to draw commentary from a wide audience in the hope that it will ultimately influence the OCC and FDIC to propose similar changes. At the same time there is a bill circulating in the U.S. House of Representatives that would require all three regulators to count all actively traded investment grade municipal obligations as HQLA.

For More Information

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