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Chapman Client Alert

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Federal Banking Regulators Issue Interim Final Rule on Treatment of Certain Municipal Obligations as HQLA

On August 22, 2018, the three federal banking agencies issued an interim final rule implementing the May 2018 banking law's requirement that investment grade, liquid and readily marketable municipal obligations be treated as Level 2B "high quality liquid assets" (HQLA) under the liquidity coverage ratio (LCR) rule.[1] The interim final rule mirrors the wording of the recent banking law[2] by not imposing on municipal obligations any of the other requirements that apply to all other forms of Level 2B assets.

The 2018 banking law required the banking agencies to treat such municipal obligations as Level 2B HQLA within 90 days of the law's effective date on May 24, 2018. The agencies met that requirement by issuing the final interim rule on August 22, although technically the interim final rule only became effective on August 31, 2018, when it was published in the Federal Register.[3]

When the agencies issued the final LCR rule in 2014, they declined to treat any municipal obligation as HQLA even if the obligation met the liquidity and other requirements applicable to corporate securities and other Level 2B HQLA. In 2016 the Federal Reserve alone revised its LCR rule to permit a limited amount of municipal general obligations to be included in Level 2B HQLA if those obligations met all the requirements applicable to other Level 2B HQLA. The new rule will permit all forms of municipal obligations to qualify as Level 2B HQLA, with no special limitation, so long as they meet the investment grade and liquid and readily marketable requirements.

What Is a Municipal Obligation That Can Qualify as Level 2B HQLA under the New Rule?

The interim final rule adopts the exact language of the new banking law in defining a municipal obligation as an obligation of:

(1) A state or any political subdivision thereof; or (2) any agency or instrumentality of a state or any political subdivision thereof.

This definition covers both general obligations and revenue obligations. It also covers special authorities without general taxing authority and any other state or local agency or instrumentality that issues an obligation. Thus, the new rule should permit any municipal obligation to qualify as Level 2B HQLA so long as it meets the investment grade and liquid and readily marketable requirements.

The LCR rule's Section 3 definitions will retain the definition "public sector entity" as "a state, local authority, or other governmental subdivision below the U.S. sovereign entity level." The new definition of a municipal obligation, drawn directly from the text of the new banking law, does not seem to differ in any meaningful way from this existing public sector entity definition, which will continue to be used in the LCR for describing a "collateralized deposit" and for determining the maturity of certain obligations.[4] The agencies, however, did solicit comments regarding whether the term "political subdivision" or any other feature of a municipal obligation required clarification. Any such clarification could confirm that the public sector entity definition is equivalent to any issuer of a municipal obligation under the LCR rule.

What Does Investment Grade Mean for Level 2B HQLA?

As with all post-Dodd-Frank banking rules, a bank investing in, or otherwise owed, a municipal obligation must determine whether the obligation is investment grade without regard to any rating from a rating agency. The definition, found in 12 CFR 1.2(d), is:

Investment grade means the issuer of a security has an adequate capacity to meet financial commitments under the security for the projected life of the asset or exposure. An issuer has an adequate capacity to meet financial commitments if the risk of default by the obligor is low and the full and timely repayment of principal and interest is expected.

What Is a "Liquid and Readily Marketable" Municipal Obligation?

The LCR rule defines this requirement:

Liquid and readily-marketable means, with respect to a security, that the security is traded in an active secondary market with:

(1) more than two committed market makers;

(2) a large number of non-market maker participants on both the buying and selling sides of transactions;

(3) timely and observable market prices; and

(4) a high trading volume.

Banks currently apply these standards to all other Level 2 assets (*i.e.*, both Level 2A assets, such as GSE securities, and Level 2B assets, such as corporate securities). This definition will apply to determine the Level 2B eligibility of any form of municipal obligation (whether or not commonly understood as a security).

Why Won't Municipal Obligations Need to Satisfy All the Requirements Generally Applicable to Level 2B Assets?

Because the federal banking agencies interpreted the new law as requiring them to treat any investment grade, liquid and readily marketable municipal obligation as Level 2B HQLA, the agencies apparently agreed that the new law did not permit any other restrictions, including the additional restrictions generally applicable to Level 2B assets. The most important of those restrictions is the requirement that Level 2B assets be obligations issued or guaranteed by "by an entity whose obligations have a proven record as a reliable source of liquidity in repurchase or sales markets during stressed market conditions."[5] Additionally, these other Level 2B assets can not be the obligation of a "financial sector entity" or one of its consolidated subsidiaries.

Neither this historic price stability criterion nor the requirement that Level 2B assets not be the obligation of a financial sector entity or one of its consolidated subsidiaries will apply to the eligibility of a municipal obligation as Level 2B HQLA.[6]

To the extent the special Level 2B HQLA requirements for municipal obligations are not as restrictive as the LCR standards issued by the Basel Committee on Banking Supervision (BCBS), the BCBS periodic reviews of compliance with its standards may note that the US is not in full compliance with this standard.[7]

This is not unusual. Even today under the "standardized approach" for risk-based capital there is a special 50% risk weighting for "statutory multifamily mortgages," which was mandated by 1991 legislation as the Basel I risk based capital rules first became fully effective.[8] BCBS standards have no treaty or other legal effect in the US. The three federal banking agencies were all created by US law and can be directed through new laws to impose rules or regulations that differ from BCBS or other international standards.

The agencies were so precise in following the Congressional directive in the new banking law that they amended the OCC and FDIC definitions of "liquid and readily-marketable" to refer to the Federal Reserve definition even though the OCC and FDIC definitions were identical, because the new banking law referred to the Federal Reserve definition.

When Does the New Rule Become Effective?

Immediately. Technically, the rule became effective when it was published in the Federal Register on August 31, but already in July the federal banking regulators explained any bank could report as Level 2B HQLA any "municipal obligations that it believes meet the statutory criteria for inclusion in HQLA."[9] Thus, even before the new interim rule became effective any bank could report as Level 2B HQLA any municipal obligation covered by the new rule.

What Does It Mean That the New Rule Is an "Interim Final Rule"?

As noted above, the new banking law required the banking agencies to treat qualifying municipal obligations as Level 2B HQLA within 90 days of the law's May 24 effective date. To meet that deadline, the agencies issued the new rule without first issuing a proposal for comment. The interim final rule is effective immediately, but the agencies request comments so

that they can consider revising the rule. The strict requirements of the new banking law, however, mandate that the new rule will apply in all important respects. Any change to the rule would be minor, such as a potential clarification of the meaning of "political subdivision" mentioned above.

For More Information

If you would like further information concerning the matters discussed in this article, please contact the Chapman attorney with whom you regularly work.

1 "Agencies issue interim final rule regarding the treatment of certain municipal securities as high-quality liquid assets," August 22, 2018 press release https://www.federalreserve.gov/newsevents/pressreleases/bcreg20180822a.htm. The 2018 banking law also requires the agencies to amend the definition of HQLA in any other rule or regulation that uses the HQLA definition or its equivalent. Because other rules, such as the proposed net stable funding ratio rule, incorporate the LCR rule's definition of HQLA, the agencies presumably believe their amendments to the LCR rule itself are sufficient to satisfy the Congressional directive.

2 The new banking law is Public Law 115-174, the Economic Growth, Regulatory Relief, and Consumer Protection Act (EGRRPCPA), which became law on May 24, 2018. As a recent Wall Street Journal article explained, neither the formal name nor the cumbersome acronym for the new law has been popular. The law is more commonly referred to by its Senate bill number S. 2155. "Can you say EGRRCPA? Tongue-Twister Banking Law Confuses Washington," *The Wall Street Journal* (September 1, 2018) https://www.wsj.com/articles/can-you-say-egrrcpa-tongue-twister-banking-law-confuses-washington-1535814000

3 83 *Federal Register* 44451 (August 31, 2018) https://www.gpo.gov/fdsys/pkg/FR-2018-08-31/pdf/2018-18610.pdf

4 Section 3 of the LCR rule defines a public sector entity. Section 31(a) of the LCR rule exempts obligations owed to public sector entities from the rule that the maturity of a bank obligation equals the earliest date to which the bank could accelerate that maturity. Similarly, the LCR rule permits certain "collateralized deposits" to qualify as "operational deposits."

5 This quality must be "demonstrated" by:

(A) the market price of the security or equivalent securities of the issuer declining by no more than 10 percent during a 30 calendar-day period of significant stress, or

(B) the market haircut demanded by counterparties to secured lending and secured funding transactions that are collateralized by the security or equivalent securities of the issuer increasing by no more than 10 percentage points during a 30 calendar-day period of significant stress.

6 The Preamble to the 2014 release of the final LCR rule suggested market stress pricing history could be indicative of the "liquidity" and "market based characteristics" of Level 2 assets, but the final rule imposed the market stress pricing history as a separate requirement, not part of the definition of liquid and readily marketable obligations. See page 61452 of 79 *Federal Register* 61440 (October 10, 2014) https://www.gpo.gov/fdsys/pkg/FR-2014-10-10/pdf/2014-22520.pdf. The requirements of that definition, not the separate stress period historic pricing test, will determine a municipal obligations eligibility as Level 2B HQLA.

7 The BCBS conducts such reviews through its Regulatory Consistency Assessment Programme. The most recent report assessing US compliance with the BCBS LCR was issued in July 2017 https://www.bis.org/bcbs/publ/d409.pdf

8 Section 32(i) of the risk-based capital rules. The definition of statutory multifamily mortgages refers to Section 618(b)(1) of the Resolution Trust Corporation Refinancing, Restructuring, and Improvement Act of 1991.

9 "Interagency statement regarding the impact of the Economic Growth, Regulatory Relief, and Consumer Protection Act (EGRRCPA)," July 6, 2018, pages 3-4 https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20180706a1.pdf

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