

House Committee Advances Bill To Amend Treatment of Municipal Bonds under Liquidity Rules

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On Tuesday the House Committee on Financial Services passed along to the whole House a bill that would require the federal banking agencies to amend their liquidity rules (including the LCR Rule) to treat all “municipal obligations” (as defined in the bill) as level 2B high quality liquid assets (HQLAs), provided that they are (a) “liquid and readily marketable” (as currently defined in the LCR Rule) and (b) “investment grade” (as defined in the OCC’s Investment Securities Rule). The bill (H.R. 1624) was first introduced by Rep. Luke Messer in March and was reported out of the committee this week in substantially the same form as it was introduced.

The LCR Rule was amended in 2016 to permit banking organizations to recognize certain municipal bonds as level 2B HQLAs, provided certain criteria are met. The bill would require the federal banking agencies to implement two additional changes that would further liberalize the recognition of municipal bonds as HQLAs. Although the bill focuses on the LCR Rule, it would also require the federal banking agencies to make conforming changes to any other regulations that incorporate the defined term HQLA. If effected, this change could affect, for example, certain requirements related to resolution planning as well as aspects of the proposed NSFR rule.

First, the bill would require the agencies to expand the scope of municipal bonds that are eligible (provided other conditions are met) for HQLA treatment. Under the existing LCR Rule, only general obligation municipal bonds are eligible to be recognized as level 2B HQLAs, provided certain other criteria are met. Under H.R. 1624, both general obligation bonds and revenue bonds would be eligible to be recognized as level 2B HQLAs, provided the other criteria are met. A revenue bond is a type of municipal bond, distinct from general obligation bonds, that is supported by (and is generally used to finance) a specific public works project, such as a toll bridge, school system project or public infrastructure facility. Unlike general obligation bonds, revenue bonds are backed by the revenues of a particular project and not by the full faith and credit of the issuing municipality.

Specifically, the bill would require the agencies to define a municipal obligation as any “obligation of a State or any political subdivision thereof, or any agency or instrumentality of a State or any political subdivision thereof.” Under the LCR Rule, this definition would supersede the existing defined term “general obligation,” which is currently defined as “a bond or similar obligation that is backed by the full faith and credit of a public sector entity,” where a public sector entity means “a state, local authority, or other governmental subdivision below the U.S. sovereign entity level.” This change would permit revenue bonds to be recognized as level 2B HQLAs for the first time.

Second, the bill would further liberalize recognition of municipal bonds as HQLAs by eliminating two of the additional criteria currently required under the LCR Rule. Under the existing LCR Rule, in order to recognize a general obligation bond as a level 2B HQLA, the following four criteria must be met with respect to the bond:

1. It must be “liquid and readily marketable;”
2. It must be “investment grade” (as defined in the OCC’s Investment Securities Rule);
3. It must be “issued or guaranteed by a public sector entity whose obligations have a proven record as a reliable source of liquidity in repurchase or sales markets during stressed market conditions” (as demonstrated by certain quantitative indicia); and
4. It must not be “an obligation of a financial sector entity [nor of a consolidated subsidiary of a financial sector entity], except that a security will not be disqualified as a level 2B liquid asset solely because it is guaranteed by [such an

entity] if the security would, if not guaranteed, meet the criteria [in (2) and (3) above]”. See 12 C.F.R. 249.20(c)(2).

Under H.R. 1624, criteria (3) and (4) would be eliminated, leaving only criteria (1) and (2). The effects of this change would be two-fold. First, investment grade status alone would be sufficient to prove that a municipal obligor is of sufficiently high quality to meet the “quality” prong of HQLA status. No longer would banking organizations have to go through the extra steps of demonstrating both the historical and market evidence supporting the quality of the issuer. Second, this change would permit the recognition as HQLAs of bonds that achieve investment-grade status only with the help of a third-party financial guarantor (i.e., through bond insurance).

H.R. 1264 represents a continuation of Congressional efforts to push the federal banking agencies to relax their liquidity criteria for municipal bonds. By extending eligibility to revenue obligations without the need for a municipality to have a proven track record of liquidity under stressed conditions, this bill could, if enacted, materially expand the range of municipal bonds that can be included in HQLAs. As level 2B HQLAs and public sector entity securities, however, these bonds would still be subject to:

- a 50% haircut on their fair value;
- an overall cap on level 2B HQLAs of 15% of total HQLAs; and
- an overall cap on public sector entity securities recognizable as HQLAs of 5% of total HQLAs.

If you have any questions regarding the matters covered in this publication, please reach out to any of the lawyers listed below or your usual Davis Polk contact.

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