FinReg
Davis Polk Insights on Financial Regulation

Federal Banking Agencies Relax LCR Treatment of Municipal Bonds in Line with EGRRCPA

By Luigi L. De Ghenghi & Andrew Rohrkemper on August 23, 2018

POSTED IN LCR, LEGISLATION, LIQUIDITY REQUIREMENTS, U.S. CONGRESS

The three Federal banking agencies jointly released an interim final rule on August 22, 2018 that amends the agencies' respective liquidity coverage ratio (LCR) rules to treat as level 2B high-quality liquid assets (HQLAs) any municipal obligation that is both (1) "liquid and readily marketable" and (2) "investment grade." The amendment implements Section 403 of the Economic Growth, Regulatory Relief and Consumer Protection Act of 2018 (the EGRRCPA). Our visual memorandum on the EGRRCPA is available **here**. Because the amendment implements regulatory changes mandated by a statute, the agencies have determined that a notice of proposed rulemaking procedure is unnecessary. The interim final rule will become effective immediately upon publication to the Federal Register, which is expected in the coming days or weeks, although the agencies still request comment on any aspect of the rule.

Prior to the interim final rule, the Federal Reserve's LCR rule permitted only a subset of municipal obligations—those meeting the definition of "general obligation" municipal securities and meeting certain heightened criteria—to be recognized as HQLAs, pursuant to a 2016 amendment to the Federal Reserve's LCR rule. Even these eligible municipal obligations were subject to additional quantitative limitations, including an aggregate limit on the amount of eligible municipal obligations recognizable in a banking organization's total HQLA amount. The OCC's and FDIC's LCR rules did not permit *any* municipal obligations to be recognized as HQLAs.

The interim final rule aligns the three agencies' rules to a common standard that both expands the eligibility criteria and removes the municipal obligation-specific quantitative limitations under the existing Federal Reserve rule, as follows:

- ***Expanded Eligibility Criteria – General Obligations vs. Revenue Bonds:*** The interim final rule defines a municipal obligation as an obligation of a state or any political subdivision thereof or of any agency or instrumentality of a state or any political subdivision thereof. This definition is broader than the existing Federal Reserve criterion that restricts HQLA treatment to "general obligations," which are defined as bonds or similar obligations that are backed by the full faith and credit of a state, local authority or other governmental subdivision below the U.S. sovereign entity level (each a type of "public-sector entity"). The interim final rule effectively permits so-called "revenue bonds"—i.e., obligations of an agency or instrumentality of a state or municipality that are typically supported by revenues from a particular public-works project, such as a toll road—to be recognized as HQLAs for the first time.
- ***Expanded Eligibility Criteria – Liquidity Criterion and Financial Sector Entity Exclusion:*** The interim final rule eliminates two additional eligibility criteria for municipal obligations that were present in the Federal Reserve's LCR rule, and replaces them with the more straightforward criteria that the eligible municipal obligations be both "liquid and readily marketable" and "investment grade."
  - First, the interim final rule eliminates the Federal Reserve requirement that eligible municipal obligations must be issued or guaranteed by public-sector entity "whose obligations have a proven record as a reliable source of liquidity in repurchase or sales markets during stress conditions."
  - Second, the interim final rule also eliminates the Federal Reserve requirement that eligible municipal obligations must not be an obligation of a "financial sector entity" (or a consolidated subsidiary thereof), a broad term that includes pension funds, investment companies, non-regulated funds, and investment advisors.

  In lieu of these criteria, the interim final rule requires only that the municipal obligations be (1) "liquid and readily-marketable" (a criterion for recognizing virtually *any* asset as an HQLA, other than certain categories of assets that are presumptively liquid, such as Treasury securities) and (2) "investment grade." Consistent with the EGRRCPA, the investment grade criterion for municipal obligations incorporates by reference the definition of "investment grade" used in the OCC's investment securities regulations and elsewhere, meaning that the issuer has "an adequate capacity to meet financial commitments under the security for the projected life of the asset or exposure,"

which is met if "the risk of default by the obligor is low and the full and timely repayment of principal and interest is expected." *See* 12 C.F.R. § 1.2.

- ***Termination of Quantitative Limits:*** The interim final rule eliminates two additional quantitative limits imposed by the Federal Reserve's LCR rule on the recognition of eligible municipal obligations as level 2B HQLAs.
  - First, the aggregate amount of eligible municipal obligations recognizable in a banking organization's level 2B HQLA amount will no longer be limited to 5 percent of the banking organization's total HQLA amount.
  - Second, the interim final rule also eliminates the concentration-based limitation, which caps the amount of securities issued by a single public sector entity that a firm may recognize in HQLAs.

  Eligible municipal obligations are still subject to the limits, restrictions and other criteria generally applicable to level 2B HQLAs, including the 50 percent haircut applied to their fair value and the aggregate level 2B HQLA limit of 15 percent of a banking organization's total HQLA amount.

The interim final rule is applicable to all banking organizations subject to the LCR rule, including those subject to the less stringent "modified LCR" requirement under the Federal Reserve's LCR rule.