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Chapman Client Alert

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The Federal Reserve Issues Final Rule Including Certain Municipal Obligations as HQLA

Fooling aside, April 1st brought news that the Board of Governors of the Federal Reserve (the *"Board"*) adopted a final rule to include certain U.S. municipal securities as high-quality liquid assets (*"HQLA"*) for purposes of the liquidity coverage ratio rule (the *"LCR rule"*) to which large banks are subject. The new rule is a small victory for the limited number of banks that are both subject to the LCR rule and regulated by the Fed, and some municipal issuers. Significant limitations on the inclusion of those assets remain, however, and there is no sign that the OCC and FDIC will follow suit. Absent an easing of the limitations on inclusion of those assets, and the adoption of similar rules by the other bank regulators, it is unlikely that the Fed's final rule will have an impact on LCR rule compliance for most banks. Although legislative efforts to include additional municipal securities as HQLA continue, the probability of legislative action is uncertain.

What is the final rule?

The final rule allows banks that are both subject to the LCR rule and regulated by the Fed to include securities backed by the full faith and credit of a U.S. state or municipality as HQLA, subject to several limitations. There are different categories of HQLA, and the municipal assets that are included under the final rule are treated as level 2B liquid assets, which are considered the least liquid and least desirable by a bank from a HQLA standpoint. The level 2B characterization is noteworthy because municipal securities advocates allege that designation at that level will depress demand for those assets.

To qualify as HQLA under the final rule, municipal securities must (i) be general obligations (i.e., backed by the full faith and credit) of a public sector entity, (ii) be investment grade, as determined on the calculation date, (iii) 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, and (iv) generally not be an obligation of a financial sector entity. Criteria (ii), (iii) and (iv) above are generally consistent with other level 2B liquid assets.

There are two other important limitations in the final rule: (i) the aggregate amount of municipal securities that may be included may not exceed 5% of HQLA, and (ii) municipal securities of a single issuer included as HQLA may not exceed two times the average daily trading volume for that security or equivalent securities of the issuer, as measured over the previous four fiscal quarters.

The trading volume limitation was criticized in the public comments to the proposed rule because many buyers of municipal obligations intend to hold them to maturity, which may distort the perceived liquidity of those assets during normal market conditions. The Board was not persuaded by that rationale, and believes that it controlled for such a possibility in an empirical study of historical trading volume that led it to conclude that this limitation is appropriate.

Public commentators also opposed the 5% limitation, but the Board was similarly unmoved by their response, and, in a perhaps telling passage in the release, wrote that the 5% limitation would help address "the overall liquidity risk presented by the structure of the U.S. municipal securities market."

Other preexisting limitations (from the LCR rule released jointly by all three regulators) include (i) the aggregate amount of level 2A and level 2B liquid assets is limited to 40% of HQLA, (ii) level 2B liquid assets may not exceed 15% of HQLA, and (iii) level 2B liquid assets are subject to a 50% haircut.

The final rule takes effect July 1, 2016.

What are the key differences between the proposed rule and the final rule?

The Fed relaxed two limitations that were included in the proposed rule: first, insured securities that would have been categorically excluded under the proposed rule may now be included if the unenhanced municipal security would

otherwise be eligible for inclusion as HQLA; and second, the final rule eliminated the 25% limit on the total amount of municipal securities with the same CUSIP number that could be included as HQLA. In each case it seems that the Board was persuaded that those limitations did not meaningfully enhance the liquidity of the municipal securities that are otherwise eligible for inclusion as HQLA.

What else should we know?

First, the Board devoted a healthy amount of ink to explaining its decision to limit eligible municipal assets to general (full faith and credit) obligations, and therefore quite visibly excluding revenue backed obligations. Painting with a broad brush, the release said that "[d]uring a period of significant stress the credit quality of revenue bonds tends to deteriorate more significantly than general obligation bonds," making their liquidity relatively less reliable. The Board, however, also seemed to recognize the inherent limitation of generalization: the release went on to say that the Board will continue to consider whether certain revenue bonds should be included as HQLA.

Second, the release modestly noted that "[m]any commentators also expressed a desire for the OCC and the FDIC to issue rules similar to the Board's proposed rule," but that, of course, the final rule only applies to entities regulated by the Board. In other words, because many of the large banks that are subject to the LCR rule are regulated by the OCC, the final rule will have limited application. Unless the other bank regulators adopt a similar rule the Board's action will not impact most of the large banks that hold a significant amount of municipal securities. And even if they do it's not clear whether the Board's final rule, given the limitations described above, would provide a significant additional source of HQLA to banks subject to the LCR rule.

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