

Chapman Client Alert

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Current Issues Relevant to Our Clients

Treasury Report Recommends Certain Municipal Obligations as HQLA

On June 12, 2017, the Department of Treasury issued the first report in a series regarding regulation of the financial system in a manner consistent with Core Principles set forth in Executive Order 13772 signed by President Trump on February 3, 2017. A copy of the report can be [found here](#). The report addresses the regulation of the depository system, covering banks, savings associations and credit unions. The report recommends that high-grade municipal bonds be categorized as Level 2B liquid assets instead of generally being excluded as HQLA currently.

Findings and Recommendations

One of the Core Principles is to make regulation efficient, effective and appropriately tailored. In response, the findings and recommendations of the report list six areas in which Treasury believes the government could improve the efficiency of bank regulation. Regulation of capital and liquidity is the first and most robust area of those recommendations, and it includes a recommendation to expand the list of assets qualifying as high quality liquid assets (HQLA) for purposes of calculating the Liquidity Coverage Ratio (LCR). In specific, the report states that high grade municipal bonds should be treated as Level 2B liquid assets, rather than being excluded from HQLA as they generally are today.

Although the Federal Reserve issued a final rule including certain municipal obligations as Level 2B liquid assets in the spring of last year, that rule limited the kinds of municipal obligations that could be included, and the other prudential regulators have not followed suit, meaning that, for most practical purposes, municipal obligations are not HQLA. More on the Fed's Rule can be [found here](#).

Considerations

The report offers few specifics relating to including high grade municipal obligations as HQLA. One obvious question is how Treasury (or its designees) would define high-grade. Despite requests by certain commentators to its proposed rule, the Fed declined to make any revenue-backed obligations eligible as Level 2B assets in its final rule, which is a significant limitation. It remains to be seen whether Treasury's view of high grade municipal obligations may include revenue backed obligations.

The Fed rule also capped the aggregate amount of municipal securities that may be included as HQLA at 5%, so a similar cap may surface in any rulemaking resulting from Treasury's report.

While the Administration and the public contemplate the report, there could be congressional action of a similar nature. Members of both houses of Congress have made proposals to require regulators to treat certain municipal obligations as HQLA. Although the specifics of those proposals vary, they may be taken up by Congress while Treasury works to implement its recommendations.

With the Administration, the regulators and Congress engaged on this topic, the discussion may turn more on which municipal obligations should be considered HQLA and under what conditions, rather than the threshold question of whether certain municipal obligations should be included at all. Such a shift in conversation would be a welcome development for municipal advocates, who have been seeking HQLA treatment for certain municipal obligations at least since the final LCR rule was issued in 2014.

[For More Information](#)

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