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Client Alert

May 29, 2015

LCR – The Fed Takes Tentative Step to Expand HQLAs

When the Office of the Comptroller of the Currency (the "OCC"), the Board of Governors of the Federal Reserve System (the "Board") and the Federal Deposit Insurance Corporation (the "FDIC") finalized the Liquidity Coverage Ratio (the "LCR") in September 2014, they excluded municipal securities from qualifying as high-quality liquid assets ("HQLAs") under the rule. However, the Board stated that it would continue to examine whether at least some U.S. municipal securities could be included as eligible HQLAs. On May 21, 2015, the Board invited public comment on a proposed rule that allows Board-supervised institutions that are subject to the LCR to count certain U.S. municipal securities as HQLAs, subject to limitations related to the amount outstanding of a particular issuance, the average daily trading volume of an issuer's municipal securities and a cap on the amount of municipal securities that can count as HQLAs.

Application

The proposed rule only applies to bank holding companies, certain savings and loan holding companies, state member banks and nonbank financial companies designated by the Financial Stability Oversight Council for Board supervision to which the Board has applied the LCR by rule or order. The proposed rule does not apply to OCC or FDIC regulated institutions, but as a practical matter, these institutions would benefit from the application of the proposed rule to their holding companies.

Inclusion of U.S. Municipal Securities as Eligible HQLAs

Criteria

The proposed rule allows certain U.S. general obligation municipal securities to count as level 2B HQLAs. The municipal securities must satisfy requirements similar to those that level 2B corporate debt securities must satisfy. They must be liquid and readily marketable, investment grade under 12 CFR part 1, issued by a public sector entity whose securities have a demonstrated record as a reliable source of liquidity in repurchase or sales markets during stressed market conditions, and they cannot be an obligation of a financial sector entity or its consolidated subsidiaries. Under the proposed rule, a security that is issued or guaranteed by a financial sector entity is considered to be an obligation of that entity. Therefore, if a general obligation municipal security is insured by a bond insurer, such a security cannot be included as an eligible HQLA. The liquidity of the securities must be demonstrated by a record of market prices declining and collateral haircuts increasing by no more than 20% during a 30-calendar-day period of significant stress.

Limitations

The proposed rule limits the amount of general obligation municipal securities that a covered institution can consider HQLAs in three ways. First, a covered institution can only count a particular municipal security holding as an eligible HQLA if it does not exceed, on a fair value basis, 25% of the total amount of outstanding securities with the same CUSIP number. This calculation should be made before the 50% haircut that is applicable to level 2B liquid assets. Second, the aggregate fair value of the municipal securities included as eligible HQLAs cannot exceed two times the average daily trading volume of all general obligation municipal securities issued by that issuer. Lastly, municipal securities cannot exceed 5% of an institution's total HQLAs. The 5% limit applies both on an unadjusted basis and after taking account of the unwind applicable to certain secured funding transactions, secured lending transactions, asset exchanges and collateralized derivatives transactions.

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