THE BOND BUYER

Congress sends bill to make some munis HQLA to Trump

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WASHINGTON – President Trump is expected to sign a bill passed by Congress on Tuesday that will make tradable, investment-grade municipal securities high-quality liquid assets under bank liquidity rules.

The bill, which would roll back some provisions of the 2010 Dodd-Frank Act and ease the impact of the so-called Volcker Rule and protect Puerto Rico investors, was passed by the House on Tuesday by a vote of 258 to 159 after the Senate approved it in March by a vote of 67 to 31.

"Today, the House passed two critical pieces of bipartisan legislation that are soon to become law. We look forward to sending these bills to the president's desk," said House Speaker Paul Ryan, R-Wis. "This is a major step forward in freeing our economy from overregulation."

The Economic Growth, Regulatory Relief and Consumer Protection Act (S. 2155), sponsored by Senate Banking Committee chairman Mike Crapo, R-Iowa, hit a roadblock after the Senate approved it and Rep. House Financial Services Committee chairman Jeb Hensarling, R-Texas, insisted a slew of reform bills be added to it.

But Ryan promised Hensarling votes on those separate financial reform bills, paving the way for the full Senate to vote on the Crapo bill as approved by the Senate Banking Committee.

The HQLA provisions in the bill are in response to Liquidity Coverage Ratio rules adopted by the Federal Reserve Board, the Office of the Comptroller of the Currency, and the Federal Deposit Insurance Corp. in 2014.

These rules require banks with at least $250 billion of total assets or consolidated on-balance- sheet foreign exposures of at least $10 billion to have a high enough

liquidity coverage ratio – the amount of HQLA to total net cash outflows – to deal with periods of financial stress.

Bank regulators refused to include any munis as HQLA in the rules, believing they were not liquid. State and local groups complained the rules would discourage banks from investing in munis. Dealers joined issuers in warning the rules would increase borrowing costs for state and local governments and lead to higher volatility in the municipal market.

The concerns spurred the Fed to revise its LCR rules in April 2016 to count munis as level 2B HQLA assets if they meet the same liquidity criteria that applies to corporate debt.

Market participants said they were grateful for the action, but that the proposal was too restrictive because the amended rule said munis could only account for 5% of total HQLA. They also worried the changes wouldn't mean anything because the Fed lacks jurisdiction over many of the larger banks that invest in munis and the FDIC and OCC kept their original rules, which did not include any munis as HQLA.

Under the Crapo bill, banks would be able to treat some munis as level 2B HQLAs, the same level as for mortgage-backed securities. That's a level down from the 2A HQLA securities the market was hoping munis would be placed into, the same level for sovereign debt.

Muni groups applauded the vote.

"The National Association of State Treasurers commends Congress for taking a positive step toward supporting indispensable infrastructure projects across the nation," said Beth Pearce, NAST President and Vermont State Treasurer. "One of our top priorities as treasurers is to finance public infrastructure upgrades at the lowest possible cost to taxpayers. Lawmakers have taken concrete action to lower borrowing costs and better position states to invest in infrastructure projects at the state and local level."

Ten days ago when it appeared Congress was about to pass the Crapo bill muni market group officials were generally pleased.

"This is very exciting news for issuers of municipal bonds at a critical time in our market," said Emily Brock, director of the Government Finance Officers Association's federal liaison center.

Bond Dealers of America president Mike Nicholas applauded the forward movement on this issue but said his group will continue pushing for more favorable treatment of munis.

“With this vote, Congress will encourage infrastructure development nationwide and reduce borrowing costs for state and local governments,” Nicholas said. “While the BDA believes municipal bonds deserve the classification of level 2A liquid assets due to the long track record of safe investment, level 2B is a step in the right direction. BDA will continue to aggressively advocate on Capitol Hill for level 2A treatment for municipal bonds.”

Michael Decker, a managing director and co-head of municipal securities at the Securities Industry and Financial Markets Association, noted that the regulators will have work to do if and when the bill becomes law.

“We are pleased and encouraged that Congress appears poised to pass legislation requiring regulators to provide HQLA treatment for many investment-grade municipal securities,” said Decker. “When the legislation is enacted, the next step will be for regulators to amend their Liquidity Coverage Ratio rules to comport with the new law. We look forward to working with regulators on that initiative.”

Among the Dodd-Frank rollbacks, the Crapo measure would reduce the number of banks considered “systemically important” and “too big to fail” by bank regulations by raising the amount of assets to $250 billion from $50 billion.

The bill also would exempt from the Volcker Rule firms with less than $10 billion in assets and with total trading assets and liabilities not exceeding more than 5 percent of their total. The Volcker Rule would prohibit banks making certain kinds of speculative investments that could harm their customers.

The legislation would put an end a legal loophole that allowed broker-dealers to defraud Puerto Rico investors by underwriting the territories bonds and then repackaging those bonds into mutual funds whose shares they then sold exclusively to investors on the island. The bill would apply the Investment Company Act of 1940 to investment companies operating in Puerto Rico and other territories.

The House passed an identical bill (H.R. 1366) in early May of 2017. That bill was sponsored by Rep. Nydia Velázquez, D-N.Y.

The Crapo measure also requires the General Accountability Office to produce a report detailing the impact that Hurricane Maria has had on foreclosures, delinquencies, and homeownership in Puerto Rico. GAO would be required to provide policy recommendations to address adverse impacts.