Senate Passes Bill to Scale Back Banking Regulations, Expand High Quality Liquid Assets

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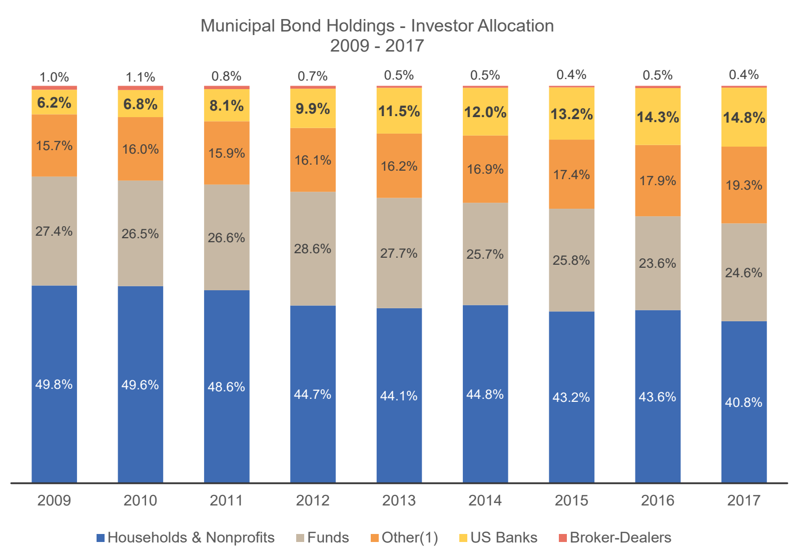
On March 14, 2018, the Senate passed bipartisan legislation aimed at loosening the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) regulations on banks and financial firms instituted in the aftermath of the financial crisis. Senate Bill 2155 (S.2155), known as the Economic Growth, Regulatory Relief, and Consumer Protection Act, would modify a central component of the Liquidity Coverage Ratio (LCR), which stipulates that large banks must maintain a minimum level of liquidity to help ensure access to sufficient cash during times of acute financial and economic stress. Banks are required to meet this standard through holdings of High Quality Liquid Assets (HQLAs), which include cash and other low-risk assets, but not municipal bonds. A key provision in S.2155 allows banks to include liquid, investment grade municipal bonds as HQLA holdings. This may create an additional incentive for banks to hold these securities, thereby increasing investors' interest in municipal debt, which could help to offset any negative impact on demand from the lower corporate tax rates introduced in recent tax reform legislation.



Source: Federal Reserve Board Financial Accounts of the United States. March 8, 2018. (1) Other includes insurance companies, non-financial companies, government-sponsored enterprises and other holders of municipal bonds.

Historically, commercial banks, along with insurance companies and individual households, have been major purchasers of municipal bonds. However, in the past two decades bank holdings of this asset class outpaced other investors. From 2000 to the fourth quarter of 2017, U.S. bank ownership of municipal securities has grown by 263%. This increase represents a long-standing trend, with banks adding to their municipal portfolios every year from 1996 to 2013.[1] As illustrated in the chart to the right, banks have experienced the greatest percentage and overall dollar increase of municipal bond holdings compared to other groups of investors, rising 8.6% and $343.7 billion, respectively. Additionally, their holdings have more than doubled since 2009 while other investors have seen modest increases, or decreases

1 Albano, Christine. (2013, October 21). Banks Accumulate Record Muni Holdings, as Growth Slows. The Bond Buyer. https://www.bondbuyer.com/news/banks-accumulate-record-muni-holdings-as-growth-slows

in their holdings.[2] However, in the aftermath of the recent tax reform legislation, the allocation of municipal securities in bank portfolios remains uncertain. With a drop in the corporate tax rate from 35% to 21%, the tax exemption offered by municipal bonds carries less value for corporate institutions, particularly U.S. banks. S.2155 may reverse some of the tax legislation's negative impact by allowing large banks to meet liquidity rules though the purchase of these tax-exempt bonds.

This is not the first time that the subject of municipal bonds' exclusion from the HQLA classification has been raised. In response to market participants' displeasure at the regulations initially issued, the Federal Reserve (Fed) adjusted the LCR rules to include general obligation municipal bonds issued by public sector entities, excluding revenue bonds, as HQLAs. While preferential to the total exclusion of municipal securities from HQLAs, this modification by the Fed was viewed as too narrow in scope to have any measurable impact on the municipal market. This was primarily due the limited universe of allowable municipal bonds, and because the adjustment only applied to banking institutions regulated by the Fed, rather than those subject to oversight from either the Office of the Comptroller of the Currency (OCC) or the Federal Deposit Insurance Corporation (FDIC). Alternatively, S.2155 seeks to broaden acceptable types of municipal bonds to include those that are investment grade, liquid and readily marketable, for all three of the U.S. bank regulators (the Fed, FDIC and OCC). The change to allowable HQLAs would categorize municipal bonds as level 2B assets, which are subject to a 50% "haircut" and cannot account for more than 15% of total HQLA holdings.

Categorization of HQLAs

Category	Assets
Level 1	• Unrestricted Federal Reserve balances • U.S. Treasuries • Securities issued by U.S. government agencies whose obligations are guaranteed by U.S. government • Low-risk securities issued or guaranteed by a sovereign foreign entity, the Bank for International Settlements, the International Monetary Fund, the European Central Bank, or European Community
Level 2A	• Securities issued by a U.S. government-sponsored enterprise, including Fannie Mae or Freddie Mac • Higher-risk securities guaranteed by a sovereign entity or multilateral development bank
Level 2B	• Investment-grade corporate securities • Liquid and readily marketable publicly-traded common stocks • *Municipal bonds (to be included via S.2155)*

Source: Bank for International Settlements, January 2013. Banking Committee on Banking Supervision. Basel III: The Liquidity Coverage Ratio and liquidity risk monitoring tools.

While many Democrats joined their Republican colleagues in supporting a roll back of certain Dodd-Frank provisions, some Democrats remained opposed to the bill. Of particular concern was the provision that would raise the threshold at which banks are considered systemically risky and subject to more stringent Fed rules from $50 billion to $250 billion, effectively reducing the list of banks held to stricter oversight measures. Other components of the legislation include curtailing the applicability of the Volcker Rule and other prohibitions related to speculative trading, reducing the capital requirements for custody banks, adjusting the rules and standards related to mortgage lending for housing market financial institutions, and providing additional protections for consumers related to credit reporting.

Notwithstanding these concerns, the bill easily passed the Senate with a 67-31 vote. Next, the bill will be

2 Federal Reserve Board. Financial Accounts of the United States. March 8, 2018.

taken up by the House, which has previously shown its willingness and desire to roll back post-financial crisis regulations. In June 2017, the House passed the Financial CHOICE Act, a bill that dramatically reduces many of the regulatory constructs of Dodd-Frank and strips the Consumer Financial Protection Bureau (CFPB) of almost all of its regulatory authority. The CHOICE Act is far broader than the Senate legislation, as co-sponsors of S.2155 were forced to take a more measured approach and maintain many of the CFPB provisions long championed by Democrats.

While House Republicans may push for an expanded version of the Senate bill, they may also adopt the more conservative legislation, concluding that some easing of regulations are better than none. With the entire House of Representatives up for election this term, it is unclear whether the House will take up S.2155 before the spring.

Conclusion

While it remains difficult to predict the long-term impact that S.2155 will have on the municipal bond market if it becomes law in its current form, it is clear that U.S. banks and municipal market participants interpret this legislation as a step in the right direction. Though municipal securities would be classified as level 2B assets, meaning that they are not considered as easily saleable as other HQLAs, they would nonetheless count toward large banks' liquidity requirements and potentially provide these banks with an additional reason to maintain their significant holdings of municipal bonds.