



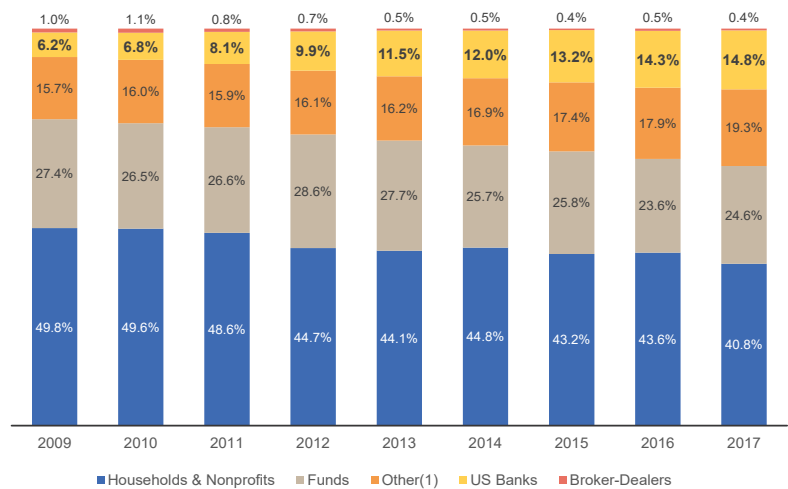
# President Trump Signs Bill to Scale Back Banking Regulations, Adds Municipal Bonds to High Quality Liquid Asset Designation

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On May 24, 2018, President Donald Trump signed 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. S.2155, known as the Economic Growth, Regulatory Relief, and Consumer Protection Act, was passed by the House of Representatives earlier this week after the Senate approved it in March. The newly-passed legislation alters bank liquidity rules by expanding the definition of High Quality Liquid Assets (HQLA) to include municipal bonds. This modifies 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 funds during times of acute financial and economic stress. Banks are required to meet this standard through holdings of HQLAs, which previously included cash and other low-risk assets, but not municipal bonds. S.2155 may help offset the potential negative impacts on demand for municipal securities arising from tax reform's reduction in corporate tax rates, and instead incentivize banks to maintain or increase their holdings.

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 2017, U.S. bank ownership of municipal securities grew by 263 percent.<sup>1</sup> This increase represents a long-standing trend, with banks adding to their municipal portfolios every year from 1996 to 2013.<sup>2</sup> 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 percent and \$343.7 billion, respectively.

Municipal Bond Holdings - Investor Allocation  
2009-2017



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.

<sup>1</sup> Federal Reserve Board. Financial Accounts of the United States. March 8, 2018.

<sup>2</sup> Christine Albano, Banks Accumulate Record Muni Holdings, as Growth Slows, The Bond Buyer, October 21, 2013, <https://www.bondbuyer.com/news/banks-accumulate-record-muni-holdings-as-growth-slows>.



Additionally, their holdings have more than doubled since 2009 while other investors have seen modest increases, or decreases in their holdings.<sup>3</sup> In the aftermath of recent tax reform legislation, however, the ongoing allocation of municipal securities in bank portfolios remains uncertain. With a drop in the corporate tax rate and the market expectation of rising interest rates, the tax exemption offered by municipal bonds carries less relative value for corporate institutions, including U.S. banks. The bank deregulation bill may offset some of tax reform's negative impact by allowing large banks to meet regulatory liquidity rules through the purchase and holding of these securities.

This is not the first time that the subject of municipal bonds' exclusion from the HQLA classification has been addressed. In response to market participants' displeasure at the regulations' omission of municipal debt securities, in 2016 the Federal Reserve (Fed) adjusted the LCR rules for banks under its oversight 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, the Fed's modification was viewed as too narrow in scope to have any measurable impact on the municipal market. This was primarily due to 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, as well as expand to all banks regulated by the three U.S. bank regulators (the Fed, OCC and FDIC). The change to allowable HQLAs would categorize municipal bonds as level 2B assets, which are subject to a 50 percent "haircut," or discount to market value, and cannot account for more than 15 percent of a single institution's total HQLA holdings.

Other components of the legislation include raising the asset threshold at which banks are subject to stricter oversight from \$50 billion to \$250 billion, 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. The measure easily cleared both the Senate and the House, with the president declaring his support by signing the bill into law.

### Categorization of HQLAs

| Category | Assets   |
|----------|--|
| Level 1  | <ul style="list-style-type: none"> <li>• Unrestricted Federal Reserve balances</li> <li>• U.S. Treasuries</li> <li>• Securities issued by U.S. government agencies whose obligations are guaranteed by U.S. government</li> <li>• 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</li> </ul> |
| Level 2A | <ul style="list-style-type: none"> <li>• Securities issued by a U.S. government-sponsored enterprise, including Fannie Mae or Freddie Mac</li> <li>• Higher-risk securities guaranteed by a sovereign entity or multilateral development bank</li> </ul>   |
| Level 2B | <ul style="list-style-type: none"> <li>• Investment-grade corporate securities</li> <li>• Liquid and readily marketable publicly-traded common stocks</li> <li>• Municipal bonds (included in S.2155)</li> </ul>   |

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

<sup>3</sup> Federal Reserve Board. Financial Accounts of the United States. March 8, 2018.



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## Conclusion

While it remains difficult to predict the long-term impact that S.2155 will have on the municipal bond market, it is clear that U.S. banks and municipal market participants interpret this legislation as a step in the right direction. Though municipal securities are classified as level 2B assets, meaning that they are not considered as easily saleable as other HQLAs, they nonetheless will count toward large banks' liquidity requirements and potentially provide these banks with an additional reason to maintain their significant holdings of municipal bonds. Please reach out to your advisor at PFM to discuss any concerns you may have or to better understand the potential impact on your financing plans.

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