

April 23, 2019

**TO:** The Board of Directors

**FROM:** Doreen R. Eberley  
Director, Division of Risk Management Supervision

**SUBJECT:** *Final rule.* Liquidity Coverage Ratio Rule: Treatment of Certain Municipal Obligations as High-Quality Liquid Assets

**Summary:** The FDIC, the Board of Governors of the Federal Reserve System (FRB), and the Office of the Comptroller of the Currency (OCC) (collectively, the agencies) are jointly adopting as a final rule, without change, the interim final rule published in the *Federal Register* on August 31, 2018. The interim final rule amended the agencies' liquidity coverage ratio rule (LCR rule) to treat liquid and readily-marketable, investment-grade municipal obligations as high-quality liquid assets (HQLA) pursuant to the Economic Growth, Regulatory Relief, and Consumer Protection Act (EGRRCPA). Section 403 of the EGRRCPA (section 403) amended section 18 of the Federal Deposit Insurance Act and required the agencies, for purposes of their LCR rule and any other regulation that incorporates a definition of the term "high-quality liquid asset" or another substantially similar term, to treat a municipal obligation as HQLA that is a level 2B liquid asset if that obligation is, as of the calculation date, (A) "liquid and readily-marketable" and (B) "investment grade".

**Recommendation:** FDIC staff recommends that the Board adopt and issue the attached final rule and authorize its publication in the *Federal Register* with an effective date 30 days from such publication.

Concur:

Nicholas Podsiady  
General Counsel

## Background

The liquidity coverage ratio (LCR) rule<sup>1</sup> established a standardized quantitative liquidity requirement that is designed to promote the short-term resilience of the liquidity risk profile of large and internationally active banking organizations,<sup>2</sup> thereby improving the U.S. banking sector’s ability to absorb shocks arising from financial and economic stress and to further improve the measurement and management of liquidity risk.<sup>3</sup> Banking organizations subject to the LCR rule (covered companies) generally must maintain an amount of HQLA<sup>4</sup> equal to or greater than their projected total net cash outflows over a prospective 30 calendar-day period.

The EGRRCPA was enacted on May 24, 2018.<sup>5</sup> Section 403 amended section 18 of the Federal Deposit Insurance Act<sup>6</sup> and requires the agencies, for purposes of the LCR rule and any other regulation that incorporates a definition of the term “high-quality liquid asset” or another substantially similar term, to treat a municipal obligation as HQLA that is a level 2B liquid asset if that obligation is, as of the calculation date, (A) liquid and readily-marketable and (B)

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<sup>1</sup> 79 Fed. Reg. 61440 (Oct. 10, 2014), codified at 12 CFR part 50 (OCC), 12 CFR part 249 (FRB), and 12 CFR part 329 (FDIC).

<sup>2</sup> The LCR rule generally applies to a bank holding company, savings and loan holding company, or depository institution if (1) it has total consolidated assets equal to \$250 billion or more; (2) it has total consolidated on-balance sheet foreign exposure equal to \$10 billion or more; or (3) it is a depository institution with total consolidated assets equal to \$10 billion or more and is a consolidated subsidiary of a firm that is subject to the LCR rule (covered companies). Recent proposals from the agencies would, if adopted, revise the framework for determining the applicability of the standardized liquidity requirements, including the LCR rule, for U.S. banking organizations. *See* Proposed Changes to Applicability Thresholds for Regulatory Capital and Liquidity Requirements, 83 FR 66024 (Dec. 21, 2018) and Proposed Changes to Applicability Thresholds for Regulatory Capital Requirements for Certain U.S. Subsidiaries of Foreign Banking Organizations and Application of Liquidity Requirements to Foreign Banking Organizations, certain U.S. depository institution holding companies, and certain depository institution subsidiaries, [INSERT FR CITE WHEN AVAILABLE].

<sup>3</sup> 79 FR 61440 (Aug. 31, 2018).

<sup>4</sup> The LCR rule defines three categories of HQLA—level 1, level 2A, and level 2B liquid assets—and sets forth qualifying criteria for treatment of an asset as HQLA and compositional limitations for an asset’s inclusion in the HQLA amount. *See* 12 CFR 329.20-.22.

<sup>5</sup> Pub. L. 115-174, 132 Stat. 1296 (2018).

<sup>6</sup> 12 U.S.C. 1828(aa).

investment grade.<sup>7</sup> Section 403 also defines the terms “investment grade,”<sup>8</sup> “liquid and readily marketable,”<sup>9</sup> and “municipal obligation.”

### Interim final rule

On August 31, 2018, the agencies published an interim final rule amending the agencies’ LCR rule to implement section 403 and soliciting public comment.<sup>10</sup> The interim final rule added a definition to the agencies’ rule for the term “municipal obligations,” which, consistent with the EGRRCPA, means an obligation of (1) a state or any political subdivision thereof or (2) any agency or instrumentality of a state or any political subdivision thereof. In addition, the interim final rule amended the HQLA criteria with respect to level 2B liquid assets by adding municipal obligations that, as of the LCR calculation date, are both (A) liquid and readily-marketable and (B) investment grade (under 12 CFR part 1) to the list of assets that are eligible for treatment as level 2B liquid assets. Consistent with section 403, the interim final rule also

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<sup>7</sup> In 2016, the FRB adopted a final rule amending its LCR rule to include certain U.S. municipal securities as HQLA that are level 2B liquid assets, subject to certain limitations (2016 Amendments). 81 Fed. Reg. 21223 (Apr. 11, 2016), codified at 12 CFR part 249 (FRB). The 2016 Amendments permitted U.S. municipal securities to qualify as level 2B liquid assets if they were: (1) general obligation securities of public sector entities (that is, a state, local authority, or other governmental subdivision below the U.S. sovereign entity level); (2) investment grade under 12 CFR part 1 as of the calculation date; (3) issued or guaranteed by a public sector entity whose obligations have a proven record as a reliable source of liquidity in repurchase or sales markets during stressed market conditions; and (4) not an obligation of a financial sector entity or a financial sector entity’s consolidated subsidiary (unless only guaranteed by a financial sector entity or its consolidated subsidiary and otherwise eligible). The 2016 Amendments limited the inclusion of general obligation securities in the HQLA amount to 5 percent of the covered company’s total HQLA amount. The 2016 Amendments also limited the inclusion of general obligation securities of any single public sector entity to two times the average daily trading volume during the previous four quarters of all general obligation securities issued by that public sector entity.

<sup>8</sup> Section 403 specifically incorporates the OCC’s definition of “investment grade” under 12 CFR 1.2, which provides that “investment grade means the issuer of a security has an adequate capacity to meet financial commitments under the security for the projected life of the asset or exposure. An issuer has an adequate capacity to meet financial commitments if the risk of default by the obligor is low and the full and timely repayment of principal and interest is expected.”

<sup>9</sup> Section 403 specifically incorporates the FRB’s definition of liquid and readily marketable under 12 CFR 249.3, which states “Liquid and readily-marketable means, with respect to a security, that the security is traded in an active secondary market with: (1) More than two committed market makers; (2) A large number of non-market maker participants on both the buying and selling sides of transactions; (3) Timely and observable market prices; and (4) A high trading volume.”

<sup>10</sup> 83 FR 44451 (Aug. 31, 2018).

amended the definition of “liquid and readily-marketable” in the FDIC’s and OCC’s rules so that the term has the same meaning given to it under section 249.3 of the FRB’s LCR rule. The interim final rule also rescinded the FRB’s 2016 Amendments so that municipal obligations under the FRB’s rule are treated consistently with section 403.

### Comments from the Public

The agencies received nine comment letters addressing the interim final rule, including letters from trade associations, private sector enterprises, and one individual. Commenters generally expressed support for the inclusion of certain municipal obligations as HQLA and the agencies’ implementation of section 403 through the interim final rule. Many commenters asserted that municipal obligations were a suitable asset class for HQLA eligibility, with qualities consistent with other level 2B liquid assets, and that the interim final rule effectively satisfied the underlying intent of section 403. Some commenters suggested additional changes to the LCR rule for the agencies’ consideration, including changes that were not addressed or affected by section 403. The interim final rule was issued to implement section 403, and broader revisions to the LCR rule fall outside the scope of the changes that the agencies sought comment on in the interim final rule. Therefore, the agencies are not adopting these broader proposed changes in this final rule.

### Final Rule

The final rule adopts the interim final rule as final without change. The interim final rule’s changes to the LCR rule provided covered companies greater flexibility in meeting the LCR rule’s minimum requirements by expanding the types of assets that are eligible as HQLA.<sup>11</sup>

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<sup>11</sup> For FDIC- and OCC-regulated institutions, the interim final rule’s changes marked the first time that such institutions could treat any municipal obligations as HQLA. For FRB-regulated institutions, those changes broadened the types of municipal obligations that could be included as HQLA. In particular, because the FRB

The interim final rule did not otherwise affect which assets can be included as HQLA under the LCR rule.

Effective Date

The final rule will be effective 30 days from publication in the *Federal Register* pursuant to the Administrative Procedure Act.<sup>12</sup> The interim final rule will remain in effect until the final rule becomes effective.

Conclusion

FDIC staff recommends that the Board adopt the attached final rule and authorize its publication in the *Federal Register*, with an effective date 30 days from such publication.

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rescinded the 2016 Amendments as part of the interim final rule, municipal obligations were no longer required to be general obligation securities, and, as a result, many issuances of revenue bonds could qualify as municipal obligations.

<sup>12</sup> 5 U.S.C. 553.