



## Financial Reform: Muni Bonds and the LCR

This *In Focus* reviews legislative proposals to require regulators to allow large banks to use municipal (muni) bonds to meet the requirements of the Liquidity Coverage Ratio (LCR). Municipal bonds are debt securities issued by state and local governments or public entities to finance government spending and public activities. Certain bank regulators do not allow them to be used to meet the LCR, which may act as a disincentive for large banks to hold them compared to eligible assets. Whether municipal bonds are liquid enough to qualify under the LCR is a contentious issue, with possible implications for financial stability and the ability of states and localities to raise funds.

### Liquidity Coverage Ratio

Because of “liquidity mismatch” (e.g., banks fund long-term, illiquid loans with deposits that can be withdrawn on demand), banks are inherently prone to liquidity crises—a temporary loss of access to funding can cause an otherwise healthy bank to fail. In response to acute liquidity shortages and asset “fire sales” during the 2007-2009 financial crisis, the banking regulators—the Federal Reserve (Fed), Office of the Comptroller of the Currency (OCC), and Federal Deposit Insurance Corporation (FDIC)—issued a final rule in 2014 implementing the LCR. The LCR is part of bank liquidity standards required for large banks by Basel III (internationally negotiated bank regulatory standards) and the Dodd-Frank Act (P.L. 111-203). The LCR aims to reduce the liquidity mismatch by requiring banks to hold more liquid assets.

The LCR applies to two sets of banks. A more stringent version applies to the largest, internationally active banks—those with at least \$250 billion in assets and \$10 billion in on-balance-sheet foreign exposure. A less stringent version applies to depositories with \$50 billion to \$250 billion in assets, except for those with significant insurance or commercial operations. As of 2017, over 30 institutions must comply with the LCR. At this time, the rule does not apply to credit unions, community banks, foreign banks operating in the United States, or nonbank financial firms.

The LCR requires banks to hold enough “high-quality liquid assets” (HQLA) to be able to meet possible net cash outflows over 30 days in a hypothetical market stress scenario in which creditors are withdrawing substantial amounts of funds. An asset can qualify as a HQLA if it is (1) less risky, (2) has a high likelihood of remaining liquid during a crisis, (3) is actively traded in secondary markets, (4) is not subject to excessive price volatility, (5) can be easily valued, and (6) is accepted by the Fed as collateral for loans. The assets that regulators have approved as HQLA include bank reserves, U.S. Treasury securities, certain securities issued by foreign governments and companies, securities issued by U.S. government-sponsored

enterprises (GSEs), certain investment-grade corporate debt securities, and equities in the Russell 1000 Index.

Different types of assets are relatively more or less liquid. In the LCR, assets eligible as HQLA are assigned to one of three categories (Levels 1, 2A, and 2B). Assets assigned to the most liquid category (Level 1) receive more credit toward meeting the requirements, and assets in the least liquid category (Level 2B) receive less credit (see **Table 1**). For example, 50% of the value of a Level 2B asset counts toward the HQLA, and Level 2B assets can make up 15% of total HQLA, at most.

**Table 1. HQLA Requirements**

Asset Level	% of Asset Value Counting Toward HQLA	Max % of Total HQLA
Level 1	100%	100%
Level 2A	85%	n/a
Level 2B	50%	15%
Level 2A+2B	n/a	40%

**Source:** CRS based on Liquidity Coverage Ratio rule.

**Municipal Bonds in the LCR.** The Fed currently allows the depository institutions and holding companies it regulates to count a limited amount of municipal securities as Level 2B assets. The FDIC and OCC do not allow the depositories they regulate to count municipal securities as HQLAs. As a result, many banks subject to the LCR must comply with the Fed’s version of the LCR at the holding company level and the OCC/FDIC’s version of the rule at the depository subsidiary level.

In the 2014 final joint rule, municipal bonds did not qualify as HQLA to meet the LCR. However, a subsequent 2016 final rule issued only by the Fed changed its treatment of municipal securities. According to the Fed,

The final rule allows investment-grade, U.S. general obligation state and municipal securities to be counted as HQLA up to certain levels if they meet the same liquidity criteria that currently apply to corporate debt securities. The limits on the amount of a state’s or municipality’s securities that could qualify are based on the liquidity characteristics of the securities.

In the Fed’s rule, the amount of municipal debt eligible to be included as HQLA is subject to various limitations, including an overall cap of 5% of a bank’s total HQLA. The Fed requires banks to demonstrate that a security has “a proven record as a reliable source of liquidity in repurchase

or sales markets during a period of significant stress” in order for it to qualify as HQLA.

## Legislative Proposals

H.R. 1624, as passed by the House on a voice vote on October 3, 2017, would require any municipal bond “that is both liquid and readily marketable and investment grade” to be treated as no lower than a Level 2B HQLA for purposes of complying with the LCR.

Section 403 of S. 2155, which was reported by the Senate Banking, Housing, and Urban Affairs Committee on December 18, 2017, would require any municipal bond “that is both liquid and readily marketable and investment grade” to be treated as a Level 2B HQLA for purposes of complying with the LCR.

Both bills would effectively require the OCC and FDIC to bring the status of municipal bonds under the LCR in line with the Fed’s current treatment. Under S. 2155, municipal bonds could be treated only as Level 2B assets, whereas H.R. 1624 leaves open the possibility of regulators choosing to give them a more favorable status (as they could currently choose to do).

## Analysis

Some Members of Congress supporting this legislation have voiced concern about the LCR’s impact on the ability of states and local governments to borrow money. The legislation could also have an effect on bank profitability and riskiness. Because large banks’ holdings of municipal bonds are limited and the Fed already treats them as Level 2B HQLA, the effect of the proposal on both is likely to be limited.

**Municipal Finance.** To the extent that the LCR reduces the demand for banks to hold municipal securities, it would be expected to increase the borrowing costs of states and municipalities. The impact of the LCR on the municipal bond market is limited by the fact that relatively few banks are subject to the LCR. In addition, even banks subject to the LCR are still allowed to hold municipal bonds, as long as they have a stable funding source to back their holdings.

Some data indicate that the LCR may not have had a substantive impact on municipal finance. As shown in **Table 2**, banks subject to the LCR reported \$187 billion of municipal bond holdings in the third quarter of 2017, compared with total outstanding municipal debt of \$3.8 trillion. (The subset of these banks that must meet the stricter version of the LCR holds \$162 billion.) Further, the value of these holdings has grown by 30% since the LCR was implemented for banks that reported holdings in 2013.

In its final rule, the Fed did not provide an estimate of how many municipal bonds would qualify as HQLA. According to an estimate of the proposed rule by the Securities Industry and Financial Markets Association,

By one calculation, only \$186 billion of the nearly \$3.7 trillion of outstanding bonds would be eligible to be included as HQLA.... we do not believe that

excluding 95 percent of the market strikes the right balance.

Thus, proponents of the legislation argue that the Fed’s rule has not significantly mitigated the perceived impact of the LCR on municipal financing. However, under the legislation, the bank regulators would still be responsible for determining which bonds qualify, under the same criteria currently used by the Fed. Therefore, the number of municipal bonds eligible to be HQLA would increase (from zero) for OCC- and FDIC-regulated institutions, but would not necessarily change for Fed-regulated institutions.

**Table 2. Municipal Holdings at BHCs Subject to LCR**

Currently	2017 Q3	% Increase Since 2013:Q4 (pre-LCR)
BHCs over \$50B	\$187 billion	30%
BHCs facing stricter LCR	\$162 billion	25%

**Source:** CRS calculation using Federal Reserve Y9-C data.

**Notes:** Reported fair value of securities issued by states and political subdivisions in the United States. The percentage increase from 2013 is only for banks that reported data in 2013. Eight BHCs subject to the LCR did not report data in 2013.

**Bank Liquidity.** The LCR is meant to ensure that banks have ample assets that can be easily liquidated in a stress scenario. Some argue that municipal bonds should qualify as HQLA because most pose little default risk, but this confuses default risk, which is addressed by bank capital requirements, with liquidity risk, which is addressed by the LCR. A municipal bond may pose little default risk, but nevertheless be illiquid (i.e., hard to sell quickly).

Proponents of including municipal debt as HQLA claim that some municipal securities are more liquid than some assets that currently qualify as HQLA, such as corporate debt. However, for purposes of the LCR, frequent trading may not be the only relevant characteristic of HQLA. For example, regulators argue that one reason why municipal bonds should not qualify as HQLA is because banks cannot easily use them as collateral to access liquidity from repo (repurchase agreement) markets.

Some municipal securities are liquid in the sense that they are frequently traded, whereas others are not. According to data from the Municipal Securities Rulemaking Board, the 50 most actively traded municipal bond CUSIP (Committee on Uniform Securities Identification Procedures) numbers traded at least 1,972 times per year each, but even some of the largest value CUSIPs traded less than 100 times each in 2016.

## CRS Resources

CRS In Focus IF10208, *The Liquidity Coverage Ratio and the Net Stable Funding Ratio*, by Marc Labonte.

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