# LCR, HQLA And Munis

lending deposits business customers

**Summary:** Community banks should be among the beneficiaries of a rule change impacting how the biggest banks calculate their adherence to Liquidity Coverage Ratios, We give you an update.

Merrill research finds people are so stressed out about managing their money that they would be willing to do the following, if it meant they never had to manage their personal finances again: give up all social media platforms forever (41%), cut out carbs, sugar and/or alcohol (37%), lose access to their smartphone for a month (35%), or move back in with their parents (25%). Wow, some of those are drastic.

This got us wondering what community banks might give up to ensure they never again had to worry about liquidity. Speaking of liquidity, community banks should be among the beneficiaries of a rule change impacting how the biggest banks calculate their adherence to Liquidity Coverage Ratios (LCR). The LCR rule generally applies to banks with assets of $250B or more, but its impact can be seen throughout the industry and at much smaller sized institutions too.

Recall that the LCR was designed by regulators (following lessons learned from the credit crisis of 2008) to ensure the largest banks hold a sufficient reserve of high-quality liquid assets (HQLA) to allow them to survive a period of significant liquidity stress lasting 30 calendar days. That window is believed to be the minimum period necessary for corrective action to be taken by the bank's management or by regulators.

Now, after lengthy deliberation over a number of years, regulators have issued a final rule that amends the LCR rules to treat certain municipal obligations as HQLA. The final rule added a definition 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 by adding municipal obligations that, as of the LCR calculation date, are both liquid and readily-marketable and investment grade to the list of assets that are eligible for treatment as liquid assets.

This means the largest banks can now count (and therefore buy and hold) as liquid, readily marketable and investment grade municipal obligations in their HQLA. This should decrease yields on those instruments and increase prices, as large banks adjust to the new rules and perhaps reduce lower yielding options such as cash and Treasuries.

Even better, since the largest banks now have another option for their HQLA, they won't need to hold deposit rates at higher rates, just to support this calculation anymore.

If municipal bond prices rise due to this change, community banks could also be impacted as the equation for current holdings and attractiveness of future holdings is impacted.

Despite these changes, investing in local government financing is often viewed as evidence of a bank's commitment to its community, so that will continue. Clearly, there is much to consider when reviewing your municipal holdings and deposit pricing, as this change works through the system.

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