Financial Services Management

U.S. Regulatory Relief – Prudential Requirements

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Impact Assessment

- Muni bonds now count for limited LCR purposes but are unlikely to become major large-bank holdings nor will this change make a material difference in the muni-bond market.
- Banks using reciprocal-deposit networks have greater protection from sudden limits on these liabilities.
- Limited Volcker Rule relief provided to larger banking organizations somewhat liberalizes affiliated-fund cross-marketing.
- Community banks not allowed to use the new 10% LR will have reduced risk-based capital requirements for certain CRE exposures.

Overview

In this report, we continue our assessment of the 2018 financial-reform law, turning from the overall regional-BHC framework[1] and new leverage-capital regulation[2] to additional sections in the legislation that affect prudential standards governing insured depositories and their holding companies. The most important of these for larger companies change one aspect of the U.S. rules setting the liquidity coverage ratio (LCR)[3] and overturn some pending changes to commercial real estate

[1] See **SIFI27**, *Financial Services Management*, June 4, 2018.

[2] See **LEVERAGE14**, *Financial Services Management*, June 5, 2018.

[3] See **LIQUIDITY17**, *Financial Services Management*, October 1, 2014.

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risk weightings.[4] Large institutions also gain some relief selecting names for sponsored hedge or private-equity funds, but broader Volcker Rule changes await final action on a pending inter-agency proposal[5] and any subsequent initiatives.

Impact

Reflecting the legislation's broad focus on rolling back rules that banks find burdensome, the law requires the federal banking agencies to include certain municipal securities as high-quality liquid assets (HQLAs) for purposes of the LCR. The FRB in 2016 did so,[6] but the OCC and FDIC did not follow suit due to fears that – even with the limitations in the FRB's rule – municipal obligations could well be illiquid under stress and thus would undermine the HQLA construct.

The law forces these agencies' hands, but does not override limitations in the FRB standards. Because these regulations limit Level 2B assets and impose a hair-cut on them, resulting risks are likely to be small if the OCC and FDIC follow suit.

Advocates for this provision argued that the ability of larger banks and BHCs to hold municipal obligations as HQLA increases demand and thus reduces state and local debt-issuance costs. Efforts by the Congressional Research Service and others to evaluate this claim were unsuccessful due to the relatively small size of current bank holdings in the large municipal-bond market. Given that these obligations generally pay higher returns than other HQLAs, including them in required assets may lead banks to hold more bonds than they now do and earn a somewhat better return on at least a portion of costly HQLA holdings. However, statutory requirements that banks calculate the status of eligible municipal obligations each time HQLAs are tabulated add cost that may offset a good deal of these earnings advantages for banks that do not have other municipal-obligation holdings that warrant comparable monitoring.

Changes to the reciprocal-deposit rules do not affect the cost of FDIC premiums associated with these funds.[7] They will, however, protect reciprocal-network insured depositories from the potentially abrupt limitations on continued funding applicable to brokered deposits when a bank's condition weakens. Limits in the law reduce the extent to which these protections apply and thus the risk this is likely to pose to the Deposit Insurance Fund.

Finally, the law takes the unusual step of expressly overturning a detailed requirement in current risk-based capital rules along with a pending regulation related to commercial real estate (CRE) obligations. It does so because these are a particularly important asset class for smaller banks, making the current capital framework particularly costly. Some of these costs will now be removed when the

[4] See **CAPITAL219**, *Financial Services Management*, October 3, 2017.

[5] See *Client Report* **PROPTRADE25**, May 30, 2018.

[6] See **LIQUIDITY25**, *Financial Services Management*, April 6, 2016.

[7] See **DEPOSITINSURANCE103**, *Financial Services Management*, December 2, 2014.

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agencies implement the revised approach, but this is likely only if the FRB does so also for parent holding companies even though this is not clearly required by the new law. Provisions in it imposing a very favorable leverage ratio for banks and BHCs with assets under $10 billion[8] moot the need for preferable risk weightings unless the banking agencies deny eligibility and keep the companies with significant CRE exposures under the risk-based rules. None of this affects larger BHCs subject to the advanced approach,[9] which is generally more punitive than the standardized approach for this asset class.

What's Next

President Trump signed S. 2155[10] into law on May 24. The agencies are to issue rules revising the LCR in final form within ninety days of enactment. None of the other provisions discussed here has a deadline.

The final law falls considerably short of the sweeping relief originally contemplated in House-passed legislation.[11] As noted in a recent report,[12] Congress is unlikely to enact any of these additional provisions or those subsequently passed by the House to revise other aspects of the post-crisis regulatory framework.

Analysis

A. Liquidity Regulation

Under the law, eligible municipal obligations – i.e., investment-grade, liquid, and "readily-marketable" ones – may be included as Level 2B high-quality liquid assets. These criteria would have to be assessed each time that the HQLA a bank holds are calculated – i.e., at least once a quarter. As a result, banks and BHCs that want to hold municipal obligations as HQLAs will need to judge credit and liquidity risk on a schedule that may be considerably more frequent and demanding than that used for municipal obligations held for investment purposes.

As noted, current FRB rules are narrower than the broad scope included in the law, which does not appear to give the FRB or the other agencies authority to deviate from the broad authority provided for municipal obligations in Level 2B. Nothing in the law goes on to alter the underlying Level 2B restrictions. These impose a fifty percent haircut and fifteen percent limit on municipal bonds in Level 2B and an overall forty percent limit on Level 2 HQLA.

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[8] See **LEVERAGE14**, *Financial Services Management*, June 5, 2018.

[9] See **CAPITAL201**, *Financial Services Management*, July 19, 2013.

[10] See **SIFI24**, *Financial Services Management*, November 21, 2017.

[11] See **CAPITAL215**, *Financial Services Management*, June 16, 2017.

[12] See *Client Report* **REFORM147**, May 23, 2018.

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The law is explicitly limited to the LCR. As a result, it does not bind the agencies when they determine eligible HQLAs for purposes of the net stable funding ratio.[13]

B. Reciprocal Deposits

Reciprocal deposits placed by two banks with each other in equal amounts are now exempted from limitations on brokered-deposit acceptance by insured depositories that fall short of being well-capitalized. Brokered deposits have been clearly shown to increase the cost of FDIC receiverships because third-party deposit placements are usually below the insurance ceiling and depositories are chosen by the rate paid, not risk of potential FDIC intervention. Reciprocal deposits are generally also placed to arbitrage deposit-insurance protection, with banks swapping funds to keep the depositor's total deposit below $250,000 (i.e., half of a $500,000 deposit at one bank is swapped with a $250,000 deposit at another bank from another customer so the first bank's depositor has two deposits below the FDIC threshold and the customer at the second bank likely receives the same advantage). If a reciprocal deposit is withdrawn, the bank receives its own funding back and thus maintains contact with its customer even though the customer never knew that part of his or her funds had been used in a reciprocal transaction.

The exemption for reciprocal deposits is provided only if they do not exceed the lesser of $5 billion or twenty percent of the total liabilities of the agent institution (i.e., an insured depository placing reciprocal deposits through a network). The agent institution must also have a CAMELS rating of 1 or 2 and be well-capitalized. Waivers are to be obtained to hold reciprocal deposits above prior amounts if the bank's CAMELS rating slips. Interest-rate limits designed to ensure that reciprocal deposits at weaker banks are not "bid up" also apply under certain circumstances.

The CBO estimates that this provision will cost $25 million over ten years due to a very small increase in taxpayer costs associated with bank failure.

C. Volcker Rule

Institutions and their affiliates with less than $10 billion in assets and total trading assets and liabilities of less than five percent of total assets are exempted from the Volcker Rule. However, institutions controlled by others that exceed these limits are not exempted.

The Rule is also revised to permit sponsored funds to share the name or variations on a name with that of a bank acting as their investment adviser if:

- the investment adviser is not an insured depository and does not share the same name as an insured depository, a company that controls an insured depository, or a company treated as a BHC (i.e., certain foreign banks); and
- the name does not include the word "bank."

[13] See **LIQUIDITY26**, *Financial Services Management*, May 5, 2016.

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D. Commercial Real Estate

As noted, the law bars the federal banking agencies from finalizing a pending rulemaking setting risk weightings for certain commercial real estate obligations. The standardized approach[14] now requires that "high-volatility" (HVCRE) exposures receive a 150 percent risk weight instead of the usual 100 percent one. Now, the regulators may only impose the 150 percent HVCRE risk weighting on specified, higher-risk CRE positions. Loans made prior to January 1, 2015 are excluded.

The law does not expressly apply to BHCs, meaning that the FRB could keep its rules as is even though the OCC and FDIC will need to change their approach.

[14] See **CAPITAL200**, *Financial Services Management*, July 15, 2013.

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