ASSET PRESERVATION ADVISORS

"2018 Legislation Reclassifies Municipals as High-Quality Liquid Assets" JUNE 2018

In Order To Move Forward, We Must Look Back

Twenty years ago, two firms announced a merger; a deal that would secure the new company's spot as the number one financial services organization in the world. The new conglomerate, Citigroup, combined banking, securities and insurance services under one roof through a $135 billion merger and combined firm assets of close to $700 billion.[1] The deal was newsworthy because of its size, but also because it violated two prominent banking regulations of the day: the Glass-Steagall Act (Glass-Steagall) and the Bank Holding Company Act of 1956. When asked about the violations, CEO of Citicorp, Sandy Weill retorted "we are hopeful that over time the legislation will change….we have had enough discussions to believe this will not be a problem." As predicted, one year later, the legislation changed.

Glass-Steagall was enacted following the Great Depression, restricting banks from merging with insurance underwriters. While not completely repealed in 1999, the Act was amended to allow bank holding companies to engage in previously forbidden commercial activities, such as insurance *and* investment banking. The change in legislation opened the flood gates for mergers and acquisitions that wouldn't have been possible prior to 1999 and was possibly the first step in a series of events that led to the 2008 financial crisis. As a result, the largest banks became even larger, consequently posing greater risk to the entire financial system.

Exhibit 1

A Legislative Timeline: Regulation of the Financial Industry

Competitive Equality Banking Act
1987

1999
Repeal of certain aspects of the Glass-Steagall Act
allowing bank holding companies to engage in previously forbidden commercial activities

The SEC loosened capital requirements for 5 Wall Street Banks,
opening the door for extreme leverage
2004

2005
Passage of the Bankruptcy Reform Act
Created a priority status for banks holding derivative contracts

The start of the Great Recession
2008

2010
Passage of the Dodd-Frank Wall Street Reform & Consumer Protection Act
A massive financial regulatory reform established in response to the 2008 financial crisis

The Economic Growth, Regulatory Relief and Consumer Protection Act
2018

Data Source: Federal Deposit Insurance Corporation (FDIC)

The Pendulum Swings Back

After the phrase "too big to fail" permeated the vernacular of both Wall Street and Main Street alike, the pendulum swung back in the direction of the Glass-Steagall Act with the 2010 passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank). Intended to decrease various risks in the U.S. financial system by increasing regulation in certain aspects of banking, Dodd-Frank effectively imposed a great burden to the U.S. banking system.

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The Volcker Rule (Section 619), a key component of Dodd-Frank, restricts bank investment, eliminating proprietary trading and attempting to limit speculative trading.[2] The Volcker Rule strongly curtails the ability of banks to employ risk-on trading techniques when simultaneously servicing clients as a depository. It also regulates financial firms' use of derivatives, in an effort to prevent "too big to fail" institutions from taking increased risks. Most notably, higher reserve requirements imposed by Dodd-Frank require banks to hold a larger percentage of their assets in cash, thereby assuring a lesser allocation to marketable securities, like bonds.

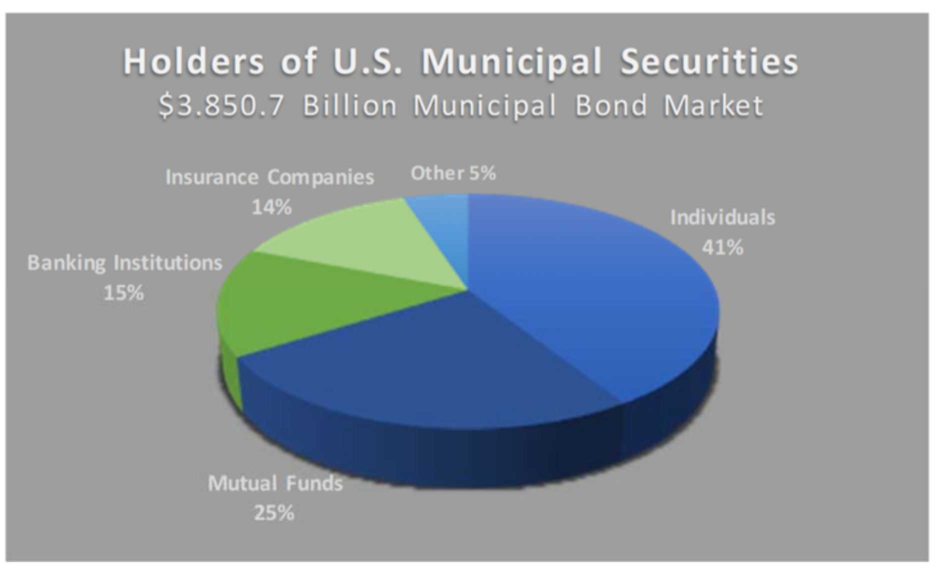
Critics of Dodd-Frank have pointed to its potential to restrict the ability of U.S. firms to compete with foreign competitors and to the regulations that appear to be intended mainly for larger institutions. Some claim that it has unjustly impaired smaller banks, leading to a further consolidation of the banking industry as many regional banks merged, closed their doors, and new bank charters became almost non-existent. One of its most prominent critics, President Donald Trump, determinedly advocated the potential benefit of a rollback of Dodd-Frank regulations. The President said, in January of 2018, that he wants to give banks the freedom to loan to customers deemed too risky under Dodd-Frank; people that he believes would use the funds to start new businesses, adding to the economic growth of the country. Proponents supporting the rollback, reason that it would provide much needed relief for community banks and credit unions.

Banks May Have Their Sights Set on Municipals

On Tuesday, May 23rd, the U.S. House of Representatives passed the most substantial banking bill since Dodd-Frank: legislation that would ease bank rules introduced in the wake of the 2008 financial crisis. The measure, titled The Economic Growth, Regulatory Relief, and Consumer Protection Act (S. 2155), was dubbed "the Crapo legislation" by the media after the bill's sponsor, Senator Mike Crapo (R-ID.)

Dodd-Frank defined "systemically important financial institutions" (SIFIs) as banks with greater than $50 billion in assets under management.[3] With the new legislation, the threshold for SIFIs will jump to $250 billion. Designed to help spur growth and economic development in cities served by community and regional banks, the legislation alleviates the constraints of strict regulation for those institutions that fall below the threshold. Dodd-Frank required banks to hold High-Quality Liquid Assets (HQLA) as well as meet a specific Liquidity Coverage Ratio (LCR). The ratio threshold was put into place so banks would maintain sufficient HQLA to meet their liquidity needs for a 30-day, significant stress scenario.

Exhibit 2



Source: SIFMA; 1Q 2018

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In an attempt to maintain a high-level of liquidity on banks balance sheets, HQLA can only include securities with a high potential to be easily converted into cash without taking a significant loss. Aimed at rolling back many aspects of the Volcker Rule provisions, the Crapo legislation eases some of the capital requirements and leverage ratios for large custodial banks, eases regulation for small and regional banks and exempts small lenders, with assets less than $10 billion from requirements of the Volcker Rule.

Most notable for municipal bond market participants is the legislations' reclassification of investment-grade municipal bonds as high-quality liquid assets (HQLA).

Since the financial crisis of 2008, banks have become a more traditional buyer of municipal bonds. Historically, banks and property and casualty insurance companies have been important players in the municipal market, owning an estimated 20%-30% of outstanding municipal debt, combined.[4] APA believes this measure will provide banks an incentive to increase their municipal holdings by allowing banks to hold high-quality municipals as part of their liquidity requirement.

In our opinion, including municipals as HQLA will not only help banks but help the municipalities who depend on traditional buyers to help fund vital projects and the vast infrastructure needs of this country.

There are three categories of HQLA with decreasing levels of quality: level 1, level 2A, and level 2B. Level 1 assets, such as U.S. Treasuries or Federal Reserve Balances, have no haircut while level 2A and 2B have a 15% and 50% haircut, respectively. Level 2A assets include higher-risk securities guaranteed by a sovereign entity or a security issued by a government sponsored enterprise, such as Fannie Mae. While municipal bonds were historically not included as level 2B assets, despite their extremely low default rate, high-quality municipal bonds, investment-grade corporates, and liquid and readily marketable publicly-traded common stocks are all considered level 2B capital.[5] With the inclusion of municipals, APA expects banks will once again be encouraged to increase their holdings of municipal bonds, giving municipalities expanded access to capital.

For more information about Asset Preservation Advisors customized portfolio management, please contact: ContactUs@AssetPreservationAdvisors.com, (404) 261-1333

[1] The New York Times; Citicorp and Travelers Plan to Merge in Record $70 Billion Deal; A New No. 1: Financial Giants Unite; The New York Times archive, April 7, 1998, https://www.nytimes.com/1998/04/07/news/citicorp-and-travelers-plan-to-merge-in-record-70-billion-deal-a-new-no.html (accessed 6/17/2018)

[2] The Federal Reserve; Volcker Rule; Section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act; https://www.federalreserve.gov/supervisionreg/volcker-rule.html (accessed 6/17/18)

[3] The Federal Reserve; Regulating Systemically Important Financial Firms; Governor Daniel K. Tarullo, June 3, 2011, https://www.federalreserve.gov/newsevents/speech/tarullo20110603a.htm (accessed 6/15/18)

[4] SIFMA; US Municipal Securities Holders, Q1 2018, https://www.sifma.org/resources/research/us-municipal-securities-holders/ (accessed 6/18/18)

[5] Basel Committee on Banking Supervision; Basel III: The Liquidity Coverage Ratio and liquidity risk monitoring tools, January 2013, https://www.bis.org/publ/bcbs238.pdf (accessed 6/18/18)

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