

# **Bond Case Briefs**

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## **US Muni Treasurers Warn LCR Could Crimp Spending.**

Municipal bonds are not highly liquid. To some, that's stating the obvious, but if US regulators write it into their version of Basel III's liquidity coverage ratio, state and city treasurers say their financing costs will rise.

It may seem unlikely, but if the residents of Cary in North Carolina notice public verges becoming unkempt, or pilots using Boston's Logan International Airport start seeing potholes, there could be a single cause – a rule drawn up in Switzerland and implemented by the US Federal Reserve Board.

This rule is the liquidity coverage ratio (LCR). If last October's Fed draft version is introduced unchanged, bonds issued by US states, cities and towns will not count towards the new liquidity buffers that banks are required to hold. This will reduce the value of the bonds and demand for them will drop, the argument goes. With banks currently holding around 10% of the stock of municipal debt, issuers fear they will have no choice but to pay higher coupons.

"As a muni issuer, we are concerned that if our bonds are not included it will reduce the market for them, increasing the interest we will have to pay, and increasing costs to our citizens and rate payers," says Town of Cary's finance director, Karen Mills. "We have service levels in Cary, such as how often we should sweep the streets or mow the medians, and it is a balancing act. If we have higher interest rates then we can't spend as much on other things."

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The LCR is supposed to ensure banks can survive a short-term liquidity squeeze. It forces institutions to hold enough high-quality liquid assets (HQLA) to cover their liabilities over a 30-day period of stress. For an individual bank, the ratio is calculated as its total HQLA divided by the estimated net cash outflows – based on the run-off rates set by regulators. The Fed has proposed banks will need to have an LCR of 80% by the start of 2015, rising by an additional 10% each year until the minimum becomes 100% in 2017.

HQLAs are split into three categories, as in the international version of the LCR, finalised by the Basel Committee on Banking Supervision in January 2013 (Risk February 2013). Level 1 assets, such as US Treasury debt and other government agency debt that is unconditionally guaranteed by the US government, can be held without limit and not receive a haircut. Level 2a assets, including debt issued by Fannie Mae and Freddie Mac, receive a 15% haircut. Level 2b assets, which include investment-grade corporate bonds and stocks in the S&P 500 index, get a 50% haircut (Risk July 2011). Taken together, Level 2 assets can be no more than 40% of the buffer, with 2b assets alone capped at 15% of the total.

"The proposed rule likely would not permit covered bonds and securities issued by public sector entities, such as a state, local authority or other government subdivision below the level of a sovereign (including US states and municipalities), to qualify as HQLA at this time," the rules say. The Fed argues municipal bonds are not "liquid and readily marketable", citing low daily trading

volumes as one justification.

Critics would like to see more of the Fed's reasoning. "There was not much in the proposed rule that justified throwing out municipal bonds from the definition of HQLA. There were maybe two sentences and we were hoping they would show more careful consideration," says Susan Collet, vice-president of government relations at Bond Dealers of America, a trade association representing bond brokers.

So, what was the Fed looking for? In short, assets that can be liquidated quickly in large volumes with little impact on prices. The rules say HQLAs must have a high potential to generate liquidity through sale or secured borrowing in a stressed environment. They also "exhibit low risk and limited price volatility, are traded in high-volume, deep markets with transparent pricing, and are eligible to be pledged at a central bank", according to the draft US rules. Defenders of municipal bonds argue the market satisfies much of this. On one point there is no debate: research by Citi points out that all US municipal bonds are accepted as collateral by the Fed at a 2-5% haircut, depending on maturity - the same applies to US agency securities. By comparison, the Fed accepts US AAA corporate bonds at a 3-6% haircut and all other investment-grade corporate bonds at 5-8%.

The other points are debatable. On the subject of price volatility, Citi's research claims that in 2008/2009, only Freddie Mac mortgage loans were subject to less depreciation - about 0.4% - over a 30-day period than AA-rated municipal obligations. This is because the sector, by and large, has robust ratings, its supporters say.

"Our rating has been pretty steady. We had one blip during 9/11, but other than that it has been AA-credit quality, even through the crisis," says John Prankevicius, chief financial officer at the Massachusetts Port Authority (Massport).

For the sector as a whole, research from Moody's Investors Service shows the average rating for investment-grade munis between 1970 and 2012 was AA3. The average rating for investment-grade corporates was roughly Baa1. Municipalities that commented on the proposed LCR tended to be highly rated (see box, Corporates fear jump in commercial paper costs).

"The history of default is so vastly less than on the corporate side," says George Friedlander, a municipal bond strategist at Citi and author of the bank's recent research on this issue. "During a financial crisis credit spreads widen out. Sectors with a history of default widen out more. That is a measure of liquidity - it is what spreads try to reflect. On that basis, the fact so many muni credits are vastly higher in average rating and lower in average default experience makes a case for them to be included as a stronger sector."

The two other main HQLA criteria are trading volume and depth of market. "As a purchaser, we manage a \$400 million portfolio, and we try to purchase other North Carolina municipal bonds and have a hard time finding them," says Town of Cary's Mills.

This might suggest the secondary market for municipal bonds is illiquid, trading infrequently, and the head of one small private investment firm, says that was certainly the case following the collapse of Lehman Brothers in 2008, when investors had to sell at a discount to exit their positions.

But according to data from the Securities Industry and Financial Markets Association (Sifma), which is quoted in numerous municipalities' comment letters to the Fed, 0.27% of the municipal market's outstanding par value is turned over every day on average, which is the same as federal agency debt and higher than the 0.19% seen for corporate bonds.

"I think there are US credits in the muni market that are high quality and have high liquidity, and have as much liquidity as some of the other assets the Federal Reserve says it would be acceptable to be holding," says Richard Ellis, state treasurer for Utah and chairman of the National Association of State Treasurers.

The argument matters because banks are becoming increasingly important as investors. As of September 2013, they held \$413 billion of municipal securities and loans, according to the Fed's flow of funds report - a year-on-year increase of 15.7% and a jump of more than 60% since the end of 2010. In total, roughly 11% of the market is held by banks.

"We have a lot of bonds outstanding, so a lot of folks have them, from big banks to regional players. All we are saying is if we're not included as HQLAs, then possibly - we don't know for sure - they could choose different assets to our bonds," says a debt manager at another small municipality in North Carolina.

Some banks are already threatening to pull back, say state treasurers. Utah's Ellis says he has spoken to financial advisers at Salt Lake City-headquartered Zions Bank who raised the possibility that the institution may have to cut its holdings. According to the bank's most recent annual filing, it holds \$558 million in held-to-maturity municipal securities with a further \$66 million in the available-for-sale category. "Zions has a lot of local debt, with much of it coming from small issuers - some with only a hundred thousand dollars outstanding - and now the bank is asking, 'What do we do? We have to unload these.' These are issuers without good market access, so their borrowing costs would be significantly higher," says Ellis. "Until now, the bank has bought some of these less-liquid bonds into its portfolio because they are assets it is happy to hold and it is supporting the local economy. Now there's a disincentive for the bank to do that."

One of those financial advisers is Jon Bronson, managing director at Zions Bank Public Finance, who confirms that if municipal bonds are not HQLAs then the bank will have less reason to hold them. This could affect other local investors, he adds. Bronson helps the bank to sell municipal bonds into the portfolios of several local community banks and sits on the board of one. "Every bank's response will be different," he says. "I'm on the board of a bank that buys munis in the secondary market and knowing the Basel III rules are coming - and those assets are currently not deemed HQLA - that little bank's appetite for munis will probably change."

There are other impacts too. Municipal debt can no longer be used to offset the potential cash outflows from municipal deposits, and Town of Cary's Mills says North Carolina-headquartered BB&T declined to bid when the town was renewing a certificate of deposit.

One capital markets vice-president at a large regional bank confirms the new rules are having an impact: "On the periphery, yes, it certainly could have an impact. As far as our firm's outlook goes, they have asked us to step back."

State treasurers and municipal issuers worry where this will end up - if banks pull back, the market for municipal debt will shrink, increasing their financing costs. "If interest rates are higher, we will have less capital to maintain assets," says Massport's Pranckevicius

Massport maintains runways, terminals, parking garages, hangars, piers and cranes, he adds, and those facilities employ more than 20,000 people.

"We create jobs through our capital programme. With higher interest rates, our costs would be higher, resulting in less dollars around to do the work that needs to get done on our capital assets. It becomes a spiral. You don't repair assets because costs have increased, so your assets deteriorate. If

you could put money to work, and people to work, it would create jobs, and that has a spillover effect into the construction industry. That's our concern," he says

Some are less sympathetic, saying municipal issuers are confused about what the LCR is supposed to do. One regulatory specialist at a North American bank points to the default of Detroit last year, and other municipalities shortly before. The municipal market has also been historically reliant on monoline insurance to guarantee its bonds – an issue at the centre of a court battle involving Detroit's outstanding swaps contracts – suggesting investors are not assured of their credit on its own terms (Risk September 2013).

"The LCR is not about yield or community reinvestment, or getting money to worthy borrowers. It is supposed to be about keeping cash in reserve, or other marketable securities that are high quality and liquid," he says.

Treasurers reject any comparison to Detroit. "We have a triple-A bond rating from all agencies. To compare us to Detroit is a non-comparison," says the second North Carolina municipality's debt manager. In addition, those hoping to change the existing definition are not expecting the blanket inclusion of municipal debt as a Level 1 asset, says Citi's Friedlander: "The proportion of muni assets that are below-investment grade is very small but no-one is asking that they are included."

While the fight goes on, municipalities say they are not reflecting the rule's potential impact in their funding forecasts. Instead, they are hoping amendments will make it into the final version of the LCR, which is expected within weeks.

"These bonds need to be included at Level 2a. Level 2b is already overcrowded with other assets and the restrictions are too tight. But there is a reasonable chance of getting that outcome," says Friedlander. "The case for this is excellent. I am encouraged because it is so strong."

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