Bond Case Briefs

Municipal Finance Law Since 1971

Counting Munis as Liquid Even If Markets Are Dry.

Municipal bonds historically have been an investment that lets you sleep easy. Their low-risk reputation has been tested in the last decade by some high-profile bankruptcies, with Puerto Rico and Detroit's being the most prominent. But in recent years, big banks have been scooping up more state and local debt than ever before. Now Congress is pushing to make the sector more even attractive to banks. The magic charm would be qualifying certain municipal bonds as High-Quality Liquid Assets, or HQLA. The question is whether that label might get slapped on bonds that are certainly high quality, but may not be really, truly liquid.

1. What's so desirable about being HQLA?

In the aftermath of the 2008 financial crisis, regulators wanted to make sure that banks didn't run out of money in the next credit crunch. They began requiring them to calculate what's called a liquidity coverage ratio (LCR) to test whether they hold enough cash and easy-to-sell assets to weather a short-term liquidity shock, when borrowing might be hard and buyers might disappear for less-than-sterling assets. The most valuable assets in this calculation are ones that can be sold quickly and without discount — High-Quality Liquid Assets.

2. What is Congress trying to do?

Regulators currently have left municipals out in the cold as far as HQLA is concerned, worried that too many municipal securities would be hard to sell in a hurry. Now, the House and Senate are moving to allow banks to treat certain municipal bonds as High-Quality Liquid Assets when calculating their liquidity ratio. The House Financial Services Committee unanimously approved a bill that would treat qualifying municipal bonds as high-quality liquid assets. The original form of the bill labeled them Level 2A assets in the existing regulatory framework, though an amendment changed that to 2B. The Senate has its own version of the bill which has secured largely bipartisan support, though it's at a standstill right now as their legislative calendar is inundated with other priorities, such as tax reform.

3. What's the difference between Level 2A and Level 2B?

Assets designated as Level 2B are treated more conservatively than those labeled Level 2A as they are considered to be more of a credit risk, and therefore less high quality, and not as liquid. In calculating their liquidity ratio, banks are required to impose a larger haircut, or discount, and 2B assets can only constitute 15 percent of total HQLA holdings. The haircut level for Level 2B assets ranges from 25 to 50 percent; no specific haircut percent has been proposed for municipal bonds so far.

4. Will Congress end up passing this?

Most likely, yes — even if not this year, with Congress "up to its eyeballs" in other business, says Philip Fischer, who heads up municipal research for Bank of America Merrill Lynch. After all, you'll be hard-pressed to find a legislator that doesn't want to make municipal debt, a key financing tool used in their own jurisdictions, more attractive. It'll get states and counties better rates and may marginally increase demand in the short-term.

5. Are banking regulators on board?

They've been divided on the HQLA question since 2016, when the Federal Reserve said it would allow HQLA treatment of state and municipal bonds that "meet the same liquidity criteria that currently apply to corporate debt securities." The other two major financial regulating agencies, the Federal Deposit Insurance Corporation and the Office of the Comptroller of the Currency, haven't taken that step. The disagreement among agencies leaves banks in an awkward position, Fischer said. Neither the OCC or the FDIC have issued a statement in support of or against this latest bill.

6. Are munis really high-quality liquid assets?

That depends on whom you ask. The vast majority of municipals are certainly high quality, given the taxing power of the government agencies that issue them, but it's also an extremely fragmented market that negatively affects just how liquid each issue may be at any given moment. They lack a dedicated exchange, so pricing can be disjointed, says Jeffrey Lipton, head of municipal research at Oppenheimer & Co. These peculiarities will require regulators to look beyond a rating to assess the trade volume and outstanding float of each specific bond before granting it HQLA status, he said. While this all will make the narrative more complicated, it shouldn't disqualify the sector from the race.

7. Why does this matter?

If municipal bonds gain regulatory par with certain corporate debt issues, they figure to become an even more popular part of a bank's portfolio. As of March 31, U.S. banks held a record $554 billion, or about 14.5 percent, of all outstanding municipal debt. Thanks goes in large part to President Barack Obama for this boom in bank municipal holdings. He signed a stimulus package in 2009 that gave banks enhanced tax incentives to purchase municipals. Granting certain municipals HQLA status now will likely see banks demand for municipals increase further. This would spark higher prices (and lower yields) for state and local debt. For President Donald Trump, a stronger market for municipal bonds might mean a better chance for his plan for $1 trillion in proposed infrastructure spending to come to fruition.

Bloomberg Markets

By Kristy Westgard

August 21, 2017, 2:00 AM PDT