Bond Case Briefs

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Bloomberg: Banks Fret Over Fed's Planned Liquidity Requirement.

U.S. banks led by JPMorgan Chase (JPM:US) & Co. and Wells Fargo (WFC:US) & Co. have bought a record amount of municipal debt. That demand is now at risk under a Federal Reserve proposal that excludes local bonds from a list of easy-to-sell assets.

Banks added $63 billion of the securities in the year through June, more than any category of buyer, helping lower state and city borrowing costs as individuals yanked a record amount of cash from muni mutual funds, Fed data show. The companies hold about $390 billion of munis, the most since at least 1945 and about 10.5 percent of the market. Three years earlier, they owned about 6 percent.

JPMorgan, the biggest U.S. bank, more than doubled its holdings in that period, to $37 billion, outpacing seven other banks reviewed by Bloomberg. The industry's appetite may drop and yields climb if the Fed plan is implemented, according to analysts from JPMorgan, Morgan Stanley (MS:US) and Municipal Market Advisors. Some banks may have bought on the assumption the bonds would satisfy liquidity rules, Peter DeGroot, a strategist at JPMorgan in New York, said in an Oct. 25 report.

"If it causes them to change the way they are accounted for in the bank portfolios, that could be significant for the muni market because it's reducing the demand," said Daniel Solender, director of munis in Jersey City, New Jersey, for Lord Abbett & Co., which manages $16.5 billion of local debt.

Cash Destination

Banks have directed more cash to state and local debt as they have fewer opportunities to extend commercial and home loans after the financial crisis, said Marty Mosby, a bank analyst with Guggenheim Securities LLC in Hernando, Mississippi.

The Fed on Oct. 24 said some banks should be required to hold enough assets that are easy to sell during a 30-day credit crunch. While the central bank included Treasuries, certain sovereign debt and publicly traded investment-grade corporate securities among assets that would meet the proposed rule, it excluded state and local debt.

The requirements are intended to satisfy global rules making the financial system less vulnerable to periods of stress similar to the credit freeze after Lehman Brothers Holdings Inc.'s bankruptcy filing in 2008.

January Deadline

"This is going to increase the market's reliance on a rebound in mutual-fund buying," said Matt Fabian, a managing director at Concord, Massachusetts-based research firm Municipal Market Advisors.

Under the proposal, the rule would phase in starting in 2015, with full compliance in 2017, according to the Fed notice. The public comment period ends on Jan. 31.

Barbara Hagenbaugh, a Fed spokeswoman in Washington, referred to the central bank's notice on the proposal.

"The agencies believe that, at this time, these assets are not liquid and readily marketable," the notice says. "For example, securities issued by public-sector entities generally have low average daily trading volumes."

About $10.4 billion of munis traded daily on average last month, according to Municipal Securities Rulemaking Board data. That compares with about $19.5 billion of investment-grade and high-yield corporate debt, data from the Financial Industry Regulatory Authority show.

Loss Feeder

The $3.7 trillion municipal market has already lost 2.4 percent this year, the worst performance since 2008, Bank of America (BAC:US) Merrill Lynch data show. Local debt has suffered along with other fixed-income assets amid bets a growing economy will lead the Fed to curb its bond-buying program.

"The rule raises the yield at which this important group of counter-cyclical buyers would provide liquidity," DeGroot said in his report. "General-obligation bond spreads may experience some pressure over the near term as these assets may have been positioned with the assumption that they would be included" among eligible assets, he said.

The proposal would consider corporate bonds rated one level above junk as liquid assets while excluding state general-obligation debt, Chris Mauro, head of muni strategy at RBC Capital Markets in New York, said in an Oct. 30 report.

Moody's Investors Service's average general-obligation rating among states it grades is one step below the top, according to David Jacobson, a spokesman.

Disruption Denial

"It's just hard to believe there would be no market for triple-A state general obligations during a period of credit disruption," Mauro said in an interview.

The Fed's proposal also excludes letters of credit that banks extend to variable-rate munis for additional security, Mauro said. Such a move may push up costs for that financing method, he said.

Well-known entities such as states and large cities and issuers rated one or two levels below top-rated borrowers trade frequently, Solender said.

"The higher-grade parts of our market have a lot of liquidity," Solender said. "There's a lot of demand for them right now."

Top-rated munis have lost 1.2 percent this year, about half the decline of the average city and state bond this year, Bank of America data show.

Individual Reliance

Individuals hold about 70 percent of munis either directly or through mutual funds, and decreased bank demand would extend the market's reliance on those buyers, Michael Zezas, chief muni strategist at Morgan Stanley in New York, said in an Oct. 29 report.

JPMorgan boosted its holdings from $14.7 billion three years ago, based on its securities portfolio and trading account, according to quarterly filings. The 152 percent increase is the biggest among the eight banks reviewed. Justin Perras, a spokesman, declined to comment.

San Francisco-based Wells Fargo, the fourth-largest U.S. bank, increased state and local debt to $43 billion from $17.8 billion in the same period. Ancel Martinez, a company spokesman, declined to comment.

Pittsburgh-based PNC Financial Services Group (PNC:US) Inc., the second-biggest U.S. regional bank, had $2.2 billion of munis as of June 30, up from $1.3 billion three years earlier. Fred Solomon, a spokesman, declined to comment.

Trend Buster

Some banks are going against the trend. Bank of America's muni assets fell 30 percent to about $5 billion during the period, even though the Charlotte, North Carolina-based bank has added in each of the last three quarters. Jerry Dubrowski, a spokesman, declined to comment.

Citigroup (C:US) Inc. held $21.8 billion of munis, down almost 2 percent from June 2010. Scott Helfman, a spokesman for the New York-based bank, declined to comment.

In the municipal market this week, issuers are set to sell about $5 billion in long-term debt with benchmark yields at a four-month low, data compiled by Bloomberg show.

The interest rate on AAA 10-year munis is 2.64 percent, the lowest since June 21. That compares with 2.55 percent on similar-maturity Treasuries.

The ratio of the yields, a gauge of relative value, is about 104 percent, compared with an average of 94 percent since 2001. The higher the figure, the cheaper munis are compared with federal debt.

Following is a pending sale:

Massachusetts plans to sell about $288 million in highway grant-anticipation notes backed by federal aid next week, Bloomberg data show.

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