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Municipal Market Participants Shocked By New LCR Definitions.

This article will focus on their perceptive views on the implications of the new NPR issued by the Fed regarding the Liquidity Cover Ratio for banks for municipal bonds in this paper: http://www.nabl.org/uploads/cms/documents/2012_10_25_Citigroup_Tax_Reform.pdf

Municipal market participants are aghast that the Fed's definition of 'High Quality Liquid Assets' – eligible assets that would determine a bank's ability to withstand a stress event – does not include even the highest quality municipal bonds. The Fed has probably heaped insult on injury by including, on the other hand, investment-grade corporate bonds and S&P 500 equity in HQLA.

Municipal bonds effectively get a 100% haircut

Citi analysts correctly call it 'draconian' that Munis are completely excluded from HQLA, pointing out that this is at odds with the Basel Committee Banking Supervision Guidance.

In fact, according to prior indications, municipals would have found a place in HQLA under Level 2A, but the Fed has apparently dispensed with this on the grounds of poor liquidity:

"…the agencies believe that, at this time, these assets are not liquid and readily-marketable in U.S. markets and thus do not exhibit the liquidity characteristics necessary to be included in HQLA under this proposed rule. For example, securities issued by public sector entities generally have low average daily trading volumes."

Since the average large bank would hold significant amounts of municipals, the authors point out that for the purpose of computing HQLA, these holdings are effectively being subjected to a 100% haircut.

This is patently unfair, given that in a stress event, good quality municipals would be more liquid than a medium, or lower-rated corporate bond.

Profound implications

The Fed's action has grave implications for the municipal bonds market.

This will severely cramp the ability of banks to invest in Munis.

As a result, market values and liquidity in the Muni bond market would deteriorate.

The larger banks would cease to function as liquidity makers in Munis. (The authors point out that banks absorbed much of the Muni paper that was offloaded by retail investors over the last 2.5 years).

State and local issuers will be hamstrung in their efforts to raise low-cost funding for their projects.

However, the new LCR is still in a comment period for some time, and therefore these are only proposals as of yet. Obviously, banks and muni issuers would have to bring these concerns before the regulators.

by Saul Griffith