Bond Case Briefs

Municipal Finance Law Since 1971

Banks to Revamp Leveraged Muni Funds After Volcker Curbs.

Wall Street banks are trying to prevent the Volcker Rule from forcing them to wind down funds that use borrowed money to bet on the $3.7 trillion municipal-bond market.

The rule, named for former Federal Reserve Chairman Paul Volcker and approved by regulators last week, limits banks' ability to run investments known as tender-option bond funds. The investments form a $70 billion segment of the local-debt market, according to the Securities Industry and Financial Markets Association. The funds issue short-term securities and use the proceeds to buy longer-maturity local-government obligations, profiting from the difference in interest rates.

The purchases help lift demand for tax-exempt debt by giving investors a way to make leveraged bets on munis. Banks are searching for ways to restructure the funds to keep them in compliance with the law, which goes into effect in 2015.

"This affects trading desks and investors alike and they are working to find a solution," said Vikram Rai, a municipal-bond analyst with Citigroup Inc. in New York. "There could be some restructuring that could happen so that business is continued as usual."

Banks create tender-option bond funds for institutional investors seeking higher returns from munis, which pay lower yields than other debt because their interest is exempt from federal income tax. The vehicles issue short-term debt to money-market funds and use the proceeds to buy securities. Some of the investment returns go toward repaying the short-term debt, with investors pocketing whatever is left over.

The debt is typically backed by banks, which agree to repurchase it, so it can be sold at low interest rates to money-market funds.

The new regulations don't take effect until mid-2015. Sifma, the New York-based trade group that represents banks and investors, is researching ways to allow the funds to keep operating once the new rules kick in.

"Sifma is in an exploratory phase now, working with sell-side and buy-side Sifma members to come up with a solution," David Cohen, managing director and associate general counsel at the group, said in an interview. "We expect to be able to do that."

Citigroup's Rai said he expects that such changes will be found, and he doesn't anticipate that funds will be required to unwind their investments.

"I don't think we'll see any forced selling," he said.

One potential option would be for banks to bring in a third party to take over the job of backstopping the short-term debt issued by the funds, J.R. McDermott, head of short-term and liquidity products at New York-based Morgan Stanley, said on a conference call yesterday.

Lawyers are also examining whether the funds are permissible under certain exemptions in securities laws, he said.

“A lot of this is really in discovery mode right now, there’s not a lot of solutions in the marketplace,” McDermott said. “Everybody is obviously treating this with the utmost of urgency.”

By William Selway and Brian Chappatta Dec 17, 2013

To contact the reporters on this story: William Selway in Washington at wselway@bloomberg.net; Brian Chappatta in New York at bchappatta1@bloomberg.net

To contact the editor responsible for this story: Stephen Merelman at smerelman@bloomberg.net