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Volcker Rule Shows Its Wide Reach.

Banks Scramble to Reshuffle Their Portfolios

The effects of the week-old Volcker rule are being felt thousands of miles from Wall Street as small and midsize banks begin to sell debt. Other institutions are looking for new ways to finance muni bonds.

Financial institutions and investors are scrambling to line up a new way to finance municipal-bond investments, with the week-old rule set to curtail banks' dealings in so-called tender-option bonds—a $75 billion niche of the market for debt issued by cities, states and local governments.

Meanwhile, more than a dozen small and midsize banks likely will need to sell collateralized debt obligations under a Volcker rule provision limiting certain risky bank investments, according to analysts. Zions Bancorp of Salt Lake City said Monday it would have to sell some CDOs, and that it would take a $387 million charge to write down the value of the securities.

Zions' move shows that five years after the financial crisis, some banks continue to hold significant chunks of risky, hard-to-value assets on their books, fueling uncertainty among investors about their true financial health.

The developments are the latest fallout from the formal adoption last week of the Volcker rule limiting risk-taking by federally insured depository institutions.

The rule, part of the 2010 Dodd-Frank financial regulatory overhaul, will force giant banks to rethink virtually every aspect of their trading activities. Many banks already have sold, wound down or spun off restricted activities such as proprietary-trading desks that make wagers with the bank's own money.

But the rule also is forcing changes at institutions thousands of miles from Wall Street, validating fears that unintended consequences from the rule could harm the financial industry and the U.S. economy.

"Regulators have been as methodical as they can be," said Clifford Rossi, a finance professor at the University of Maryland's business school. "But it's a daunting task for regulators to think through every aspect to make sure there isn't some hidden risk that they hadn't thought of."

In a tender-option bond transaction, banks, hedge funds and others use short-term borrowings to fund the purchase of long-term muni bonds. The hope is that they will profit from the difference in the interest they pay lenders—often money-market funds—and what they earn on the muni bonds.

The market is a fraction of the $3.7 trillion municipal-debt universe, but the debt has been popular with large investment firms such as OppenheimerFunds, Nuveen Asset Management and Eaton Vance, which often used the debt in leveraged strategies that aim to boost returns using borrowed money.

The Volcker rule, adopted in response to the 2008 financial crisis, will end large banks' participation in tender-option bonds as they are currently structured, which likely will reduce trading and curb the issuance of new bonds, said critics. Existing deals may have to be unwound.

Banks will be working "feverishly" to come up with other options for financing municipal bonds, said Margaret Sheehan, a partner at law firm Ashurst LLC who argued for an exemption on behalf of banks including J.P. Morgan Chase & Co., Wells Fargo & Co. and Deutsche Bank AG.

The Securities Industry and Financial Markets Association is forming a working group to find another way for its members to use leverage to invest in municipal debt, said David Cohen, managing director and associate general counsel at Sifma.

The trade group had said in its comment letter to regulators in February 2012 that "a disruption of tender option bonds will disrupt the municipal market."

Tax-exempt money-market funds have been the main buyers of floating-rate debt issued under tender-option bond programs, comprising 20% or more of some funds' assets. Assets in these types of money-market funds have shrunk to $257.4 billion from a peak of $483.8 billion, said Peter Crane, president of Crane Data LLC. The pool of investments that money market-mutual funds are able to buy has been shrinking, he said.

Banks and their attorneys are poring over the 953-page Volcker rule, which limits bank investments in CDOs backed by trust-preferred securities, or Trups.

Many small institutions issued the securities before the financial crisis through CDOs, which pooled the securities with those issued by other banks. The banks that acquired them saw them as a good investment partly because of steady interest payments they stood to receive.

Zions' projected write-down means that it is currently valuing at least some of its CDOs above fair value, reflecting the price at which it could sell them in the market. The write-down stems in part from a change in the bank's accounting treatment for the investments.

"This is not something that we had anticipated, nor do we think we reasonably could have anticipated based on what was in the proposed rule," Zions Chief Financial Officer Doyle Arnold said on a conference call with investors Monday.

Most other banks probably won't have to take significant write-downs, banking analysts said, in part because unlike Zions they don't have CDOs they were intending to hold until they matured. The Volcker Rule's requirement to sell those CDOs forced Zions to reclassify them, in a way that required the bank to re-value them and record part of its write-down.

Kevin Petrasic, a partner with the law firm Paul Hastings LLP who is advising banks on the Volcker rule, said the challenge for banks will be avoiding a "shotgun divestiture" of assets.

"What institutions will be doing is trying to figure out optimal timing," he said.