# Bond Case Briefs

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## What the Volcker Rule Means for the Municipal Market.

One provision of the finalized Volcker Rule could cause headaches for states and localities that issue bonds.

The municipal market received a vote of confidence with the newly finalized Volcker Rule but one provision that eliminates a common bank investment tool could cause some headaches for states and localities that issue bonds.

U.S regulators finalized the rule, part of the Dodd–Frank Wall Street Reform and Consumer Protection Act, last week. The new reform restricts certain risky investments (like hedge funds) by banks. The first draft of the rule in 2011 included most types of municipal securities in such trading prohibitions. The final draft last week left them out, a move that “signals a recognition of their importance to public infrastructure creation and economic growth,” said analyst Matt Fabian of Municipal Market Advisers. (Three-quarters of the nation’s public infrastructure funding each year comes from municipal bonds.) This could actually help demand in the municipal market, he added.

But one aspect of the rule could put a damper on investmetn in municipal bonds. In limiting banks’ investments in hedge funds and other high risk vehicles, regulators also included what’s called Tender Option Bonds, or TOBs. These bonds represent a small fraction of the municipal market (about $75 billion of the $3.7 trillion market), and are short term bonds issued to hedge funds and banks to cover long-term investments. Short term borrowing has typically yielded very low interest rates while rates on longer-term bonds has been higher. So, banks hope to pocket the difference between the two rates as profit.

Regulators acknowledge that by limiting this investment option in the market, they are potentially burdening municipal bond issuers. There “may be an increase in financing costs to municipalities as a result of a decrease in demand for the types of municipal securities” typically financed with TOBs, the rule says. Without this financing mechanism, some municipalities may have to offer higher interest rates in order to sell their bonds.

But there is hope, said Thomas Jacobs, an analyst at Moody’s Investor Service. Although some banks will look to unwind these types of investments between now and the July 2015 implementation date for the rule, others will likely be looking for a way to work around the rule. Jacobs views the TOBs as an untended consequence of the Volcker Rule.

“I think someone didn’t want to start providing a lot of exemptions to [the rule] so they’re essentially telling people, ‘You have to find another way to do it,’” Jacobs said. “Once someone finds a way, I can’t think of a reason for a regulator to say, ‘That offends me.’ That violates the spirit of what they’re trying to do.”

BY LIZ FARMER | DECEMBER 18, 2013