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Groups Urge Bank Regulators To Make Munis High Quality Liquidity Assets.

WASHINGTON — The Public Finance Network, elected public officials and dealer groups are urging bank regulators to categorize municipal securities as high quality liquid assets in a proposed rule, warning the failure to do so would significantly harm the municipal market and state and local governments.

The rule, as currently proposed, "will have significantly negative effects on the municipal securities market and communities across the country," warned the Public Finance Network, which consists of 17 muni market groups.

"Failing to qualify municipal bonds as HQLA would significantly reduce the appeal of municipal securities for banks to underwrite these securities and investors to purchase them, resulting in increased borrowing costs for state and local governments and [public sector entities] to finance desperately needed infrastructure projects," said a letter sent by the groups, which include the National Association of State Treasurers and National League of Cities.

The groups' concerns stem from a rule that the Federal Reserve System's Board of Governors, the Federal Deposit Insurance Corp. and the Office of the Comptroller of the Currency proposed in October to strengthen the liquidity positions of large financial institutions so they can better withstand periods of economic and financial stress.

The proposed rule would require large banks to maintain a minimum liquidity coverage ratio, defined as the ratio of HQLA to total net cash outflows. Assets would qualify as HQLA if they could be easily and immediately convertible to cash with little or no loss of value during a period of liquidity stress.

The regulators proposed three classes of HQLA: Level 1, which would include sovereign securities, including U.S. government securities and U.S. government-guaranteed securities; Level 2A, securities issued by U.S. government-sponsored enterprises and certain other sovereign entities; and Level 2B, investment-grade corporate debt with certain characteristics and equities in the Standard & Poors 500 Index.

The regulators said they did not include munis in any of these categories because they "these assets are not liquid and readily-marketable in U.S and thus do not exhibit liquidity characteristics necessary to be included in HQLA under this proposed rule."

But the groups strenuously disagreed. Michael Decker, managing director and co-head of munis at the Securities Industry and Financial Markets Association, urged the banking regulators to include investment-grade munis as Level 2A liquid assets. "While it is true that not all municipal securities trade every day, which is also the case for investment-grade corporate and … GSE debt securities, the municipal market is nonetheless liquid in that it is always possible to obtain executable price quotes from dealers for any transactions of virtually any size," he said in a letter to the regulators.

In 2012 daily trading volume in the U.S. muni market averaged $11.3 billion, compared to $22.6 billion for corporate bonds. However, on the basis of average daily trading volume in relation to total volume outstanding, 0.31% of total outstanding munis traded each day versus 0.25% of outstanding corporate bonds, Decker said. Trading volume in the muni market tends to remain fairly constant within a range, while subject to some seasonality and variation based on issuance activity and other factors, he added.

Bond Dealers of America chief executive officer Michael Nicholas said, "We disagree that municipal bonds are not readily marketable in U.S. markets."

"Municipal securities are known as the second safest available investment, aside from U.S. Treasuries, with state and local governments having nearly a zero default rate, and meeting the agencies' qualifications for limited price volatility, high trading volumes and deep and stable funding markets," the network said. The proposed rule "favors foreign debt securities over U.S. state and local debt securities, and in doing so threatens to increase costs for national infrastructure development, three-quarters of which is financed through tax-exempt bonds," it said.

New York City Comptroller Scott Stringer warned, "The proposed rule will likely result in decreased bank appetite for investment grade municipal securities" and hurt the city because large banks are significant purchasers of its debt. In a $896 million bond sale completed last month, bank purchases totaled $145 million or 16.2% of its fixed-rate offering, Stringer said.

"Banks have also made direct purchases and/or provided necessary liquidity support for the city's variable rate demand bonds, providing lower-cost funding to make our capital program more affordable," he added.

Connecticut Treasurer Denise Nappier said the proposed rule would "make the holdings of municipal debt by large banks less attractive and have a negative impact on the demand for municipal bonds."

"The availability of bank credit and bank direct purchase alternatives for state and local governments will likely decrease and grow more costly," she added.

John Pranckevicious, chief financial officer of The Massachusetts Port Authority, also called for munis to be treated as Level 2A HQLA, saying this would be necessary to "avoid any unintended and unnecessary increases in the cost of improving municipal infrastructure and engaging in new public works projects, which are vital not only to the authority and the New England region, but to the health of the U.S. air transport system."

SIFMA's Decker also said it makes no sense to assume that, in a financial crisis, such as the one in 2008, there would be 100% outflows for liquidity facilities extended to tender option bond financing and deposits collateralized by munis. Experience shows they should instead be 30% and 25%, respectively he said.

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FEB 3, 2014 5:07pm ET