Bond Case Briefs

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Fed Rule May Curb Bank Buying After Holdings Double: Bloomberg Muni Credit.

U.S. banks poured more than $200 billion into state and local-government debt since the onset of the financial crisis six years ago, boosting their share of the $3.7 trillion market to a two-decade high.

Now, if federal regulators have their way, California Treasurer Bill Lockyer says banks next year will have more incentive to buy debt sold by Saudi Arabia or Botswana than U.S. municipalities. The result, he says: higher costs for taxpayers.

California, Georgia and New York City are among issuers pressing regulators, including the Federal Reserve, to ease a rule that may curb buying by banks. The regulation, intended to guarantee that banks have enough easy-to-sell assets during a cash crunch, wouldn't let them use munis to satisfy the requirements, giving the companies less reason to hold the debt.

"Anything that reduces demand for our bonds could have a negative impact," said Diana Pope, who oversees debt sales for the Georgia State Financing and Investment Commission in Atlanta. "Banks are a big part of our market and anything that limits what they can invest in affects us."

Banks propped up demand last year as Detroit's record bankruptcy filing and bets that interest rates were set to rise led investors to pull money from local-debt mutual funds. Munis logged their biggest annual loss since 2008, pushing benchmark 10-year yields to a two-year high of 3.15 percent in September. The yield was 2.67 percent yesterday.

Growing Share

In the first nine months of 2013, banks added $41 billion of munis, Fed data show. That left them with $404 billion as of Sept. 30, or about 11 percent of the market. It was their biggest share since 1990 and double their holdings at the end of 2007, when they accounted for about 6 percent of the total.

"The bank bid has played a very important role in the market's performance since the credit crisis," said Matt Posner, an analyst who tracks regulatory issues for research firm Municipal Market Advisors, based in Concord, Massachusetts. "If this rule is put in place, many of these banks would have to curb their purchases."

The proposed rules are pending before the Federal Reserve Board, the Office of the Comptroller of the Currency, and the Federal Deposit Insurance Corp. They are part of the broader overhaul of securities oversight ushered in by the 2010 Dodd-Frank law, intended to prevent a repeat of the credit crunch.

Changes Possible

The regulators are reviewing public comments on the proposal, which may result in changes.

Greg Hernandez, an FDIC spokesman; and Eric Kollig, a spokesman for the Fed, declined to comment. Bill Grassano, a spokesman at the OCC, said the agency “doesn’t comment on proposed rules, but keep in mind that we do consider all comments.”

Separate regulations released last year, aimed at curbing banks’ speculative bets, will also bar investments known as Tender Option Bond programs, which use borrowed money to buy debt and have spurred demand for munis. Banks have been trying to figure out how to overhaul such funds to keep them operating.

The reserve rules have yet to be decided on and would be phased in starting on Jan. 1. They mandate how much the largest banks must hold in what regulators view as high-quality, liquid assets during times of financial stress.

Not Munis

Such assets would include Treasuries, bonds of foreign governments and other securities, including some stocks and corporate bonds. Municipal obligations wouldn’t count because regulators said they didn’t consider them easy enough to sell.

That exclusion may cause banks to reduce munis in favor of securities that meet the requirements, Fitch Ratings said on Jan. 30. The New York-based company said banks that operate as dealers, the market’s middlemen, may hesitate to commit money to trading of local debt, potentially making it harder for investors to transact in the securities.

In a Dec. 27 letter to regulators, Citigroup Inc.’s Howard Marsh, head of munis for the New York-based bank, said the rule would result in unnecessary “and in many instances unbearable” increases in financing costs for public works.

Danielle Romero-Apsilos, a bank spokeswoman, declined to comment.

Upheaval Potential

Kenneth Naehu, who oversees bonds for Banyan Tree Asset Management in Los Angeles, said the rule hasn’t gotten enough attention from investors.

“This is a real thing that I don’t think the market understands yet,” he said. “There is a potential for serious upheaval.”

Michael Decker, who lobbies on municipal bond issues for the Securities Industry & Financial Markets Association, a Wall Street trade group, echoed the concern.

“I don’t think there would be an instantaneous sell-off,” he said. “But I think it would be a discouragement, and over time you’d see banks play a less significant role in the market.”

In letters to regulators, state and local officials urged reconsideration of the muni exclusion.

New York City Comptroller Scott Stringer argued in a letter that the market is broad enough to meet regulators’ requirements, and that muni prices fell less than top-rated corporate debt during the credit crisis.

Banks bought $145 million of an $896 million New York bond sale completed last month, Stringer said.

Lockyer, whose state is the largest issuer of munis, also wrote to regulators last month asking for the proposed regulation to be amended. In an interview yesterday, he said the rules may raise risk at banks.

"The rule would provide greater incentives for U.S. financial institutions to do business with foreign governments than with more creditworthy U.S. municipal issuers," he said in his letter. Keeping it "would increase borrowing costs for municipal issuers" and heighten volatility in the market for their debt.

By William Selway Feb 12, 2014 5:00 PM PT

To contact the reporter on this story: William Selway in Washington at wselway@bloomberg.net

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