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Citi Analysis Shows Bank Regulators That Most Munis Are Liquid.

WASHINGTON — Citi bankers are urging bank regulators to treat most municipal securities as high quality liquid assets in a banking rule proposed to ensure banks are equipped to handle severe financial and economic stress.

They made their plea in a three-page letter accompanied by 15 pages of analysis showing why most munis should be considered as eligible as HQLA. The letter, signed by Ward Marsh, Citi's managing director for municipal securities, was sent to bank regulators on Wednesday. It follows several other dozen letters sent state and local officials and firms that have all warned the failure to categorize most munis as HQLA will hurt the muni market and governments.

Alan Anders, the director for finance in New York City's Office of Management and Budget, warned the regulators in a recent letter that the proposed rule "is overly restrictive" and would cause banks to make fewer investments in munis, decreasing demand and liquidity for munis, while increasing borrowing costs.

It would also reduce the amount of bank capacity available to fund credit and liquidity support for muni variable-rate bond programs, Anders said.

Marsh echoed Anders' concerns in a brief interview and said also that categorizing munis as illiquid could actually cause them to be less liquid. But Citi's letter did not contain concerns and focused instead on why munis should be considered eligible as HQLA.

The controversy over the rulemaking comes at a time when banks have been playing a growing role in the municipal market. Banks held $416.4 billion of munis last year, almost double from 2009. Banks have been the marginal buyers of munis over the past year as tax-exempt mutual funds have had record outflows.

The rule, proposed by the Federal Reserve Board and other bank regulators in October, could be finalized as soon as early summer and would take effect in January. It would create a standardized minimum liquidity requirement for large and systemically important banks and other financial institutions. These institutions would be required to maintain a minimum liquidity coverage ratio, defined as the ratio of HQLA to total net cash outflows over a 30-day period of stress.

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 rule proposes 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 sovereign entities; and Level 2B, investment grade corporate debt with certain characteristics and equities in the Standard & Poor's 500 Index.

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

They did not give specific reasons for these views. Citi bankers met with officials at the Federal Reserve, the Office of the Comptroller of the Currency and the Federal Deposit Insurance Corp. in recent weeks so they could understand the basis of their concerns.

Citi's letter analysis addresses each concern and urges the regulators to treat investment-grade munis as eligible for Level 2A HQLA, on a par with GSE securities. Banks would have to take a 15% haircut, meaning they could only take 85% of their muni holdings into account in determining their liquidity coverage ratio. Industrial development bonds issued for nonprofit or other corporate obligors should be eligible for Level 2B HQLA, on a par with investment-grade corporates, which would have a 50% haircut.

To address concerns about concentration of assets, Citi recommended the rule limit to 25% the inclusion of eligible muni assets in a bank's total amount of HQLA.

Historically munis have been treated similarly to GSE securities in federal regulation and legislation, Citi said. Munis and GSE securities were given the same credit-risk weights under previous international Basel Accords on capital. They also have the same liquidity values at the Federal Reserve discount window.

From the standpoint of a liquidity coverage ratio, investment-grade munis would provide a greater diversification benefit than either GSE securities or nonfinancial corporate bonds, Citi said.

Munis, especially those that are investment-grade, generally have higher credit quality and lower historic default rates than corporate bonds, the bank said. "Despite the recent increase in media attention on U.S. public sector credit issues, cumulative realized credit losses on all municipal debt over the past 100 years has amounted to less than 1%," Citi told the regulators.

Citi also said muni defaults are less correlated with recessions than defaults of corporate bonds. In fact, the bank argued that when times get tough and munis become cheaper, the muni market becomes more liquid and deeper, with crossover buyers from the taxable market and more retail investors coming into the market.

To address concerns about the decline in muni trading during the financial crisis, Citi said it was auction rate securities and variable rate demand notes, neither of which is expected to be eligible as HQLA. The ARS market collapsed and there was, among other things, a lack of reasonably priced credit support for VRDNs.

"Rather than a precipitous drop-off in fixed-rate activity, we see that volumes have ebbed and flowed only marginally, with the highest trading volumes having occurred in 2008 and 2013," Citi said in its analysis.

The bank said there is a lot of price transparency in the muni market, particularly for investment-grade munis. The Municipal Securities Rulemaking Board's EMMA makes pricing and other trade data available for free on a near real-time basis. In addition, three major non-bank pricing services price munis for clients, the bank said.

To address concerns that the muni market did not have a large repo or repurchase agreement market, which most liquid markets have, Citi said investment-grade munis have "deep, diverse and stable secured funding availability away from the taxable repo market" and that it, alone, has roughly $8 billion of collateralized deposits from the public sector entities, almost 75% of which is secured with muni assets.

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