Bond Case Briefs

Municipal Finance Law Since 1971

WSJ: Regulators to Complete Bank 'Liquidity' Rules.

WASHINGTON—States and localities could be on the losing end of new bank rules aimed at ensuring large financial firms have enough cash to operate during a crisis.

U.S. regulators are expected to finalize safeguards next month that large banks hold enough safe assets—such as cash or those easily convertible to cash—to fund their operations for 30 days if other sources of funding aren't available.

But the regulations are not expected to consider bonds issued by states and localities as "high quality liquid assets"–meaning such securities wouldn't qualify for use under the new funding requirements, according to people familiar with the matter. States and localities warn that could cause banks to retreat from the $3.7 trillion municipal bond market.

"The conclusion reached by the regulators is astounding in our view," said Tom Dresslar, a spokesman for Bill Lockyer, treasurer of California, one of the largest issuers in the municipal-bond market. "It makes no sense and it's against the public-policy interests of the U.S., not to mention the states and local governments."

The rules, which are under consideration by the Federal Reserve, Federal Deposit Insurance Corp. and Office of the Comptroller of the Currency, are intended to prevent a repeat of the 2008 financial crisis when financial markets froze due to a lack of liquidity. Regulators want banks to have enough ready cash on hand so they can finance themselves if markets freeze as they did in the last meltdown. Among those assets that will qualify under the rule as "liquid" are Treasurys and highly-rated debt issued by some foreign governments.

Large states, big banks and some lawmakers have mobilized to beat the back rule, which they warn will raise borrowing costs to finance roads, schools and bridges if banks retreat from the market. That effort has fallen on deaf ears, with regulators doubtful banks would abandon the municipal bond market because banks purchase municipal bonds to earn money—rather than to meet financing requirements—so their behavior is unlikely to change because of the new safeguards, according to a person familiar with the matter.

"There's a lot of angst over it, but we don't think it's going to have a real impact" on the market, the person said.

Banks have ratcheted up their purchases of municipal securities in recent years and currently hold about 11% of all outstanding bonds, up from about 7% in 2004, according to the Fed. Yet regulators estimate only about half of those holdings are at large banks that will be affected by the rules. In their October proposal, the Fed, OCC and FDIC said they didn't include municipal bonds because "these assets are not liquid and readily marketable in the U.S." The regulators added that securities sold by "public sector entities generally have low average daily trading volumes."

State and local officials insist that is not true and say municipal bonds meet every criterion the agencies established to define "high quality liquid assets," such as relative price stability during crises and lower risk of default than other securities. While individual municipal securities are often thinly traded, state and local officials who borrow money in the market say that is because most investors hold their securities until maturity and not because the market is illiquid.

Ben Watkins, the head of bond finance in Florida, said the proposed rules would drive up borrowing costs and crimp the amount of infrastructure projects states and localities can finance.

“We’re higher rated than the federal government and we’re certainly better managed financially,” said Mr. Watkins, noting Standard & Poor’s Ratings Services rates the Sunshine State triple-A but has downgraded the U.S. to AA+.

Robert Donahue, a managing director at Municipal Market Advisors, said the decision to exclude state and local securities is “counterintuitive” because the debt has low default rates and under the 2010 Dodd-Frank financial law, banks have to conduct additional research to ensure they only own high-quality municipal bonds.

“If this creates a drag on bank buying of munis, that would be an unfortunate consequence of this ill-advised exemption,” he said.

By ANDREW ACKERMAN
Aug. 22, 2014 1:58 p.m. ET