Bond Case Briefs

Municipal Finance Law Since 1971

Bank Liquidity Rules Seen Cooling Demand for Bonds: Muni Credit.

Regulatory changes aimed at heading off another financial crisis may curb purchases of municipal bonds by banks, potentially undermining demand from the biggest buyer in the $3.7 trillion market.

The Federal Reserve and the Federal Deposit Insurance Corp. will meet separately on Sept. 3 to consider measures laying out what easy-to-sell assets banks must keep on hand to weather a month-long credit squeeze. A draft of the rules excludes munis, according to a person familiar with the matter, which would give banks less incentive to own state and local debt.

The companies have added more than $200 billion to their muni holdings since the start of 2010, more than any other segment of investor, according to Fed data. The influx has buoyed prices at times when individuals were selling because of speculation that interest rates were set to rise or bets that issuers such as Puerto Rico would struggle to pay their bonds.

"Banks have been large purchasers of municipal bonds, and that's certainly been helpful in keeping rates low," said Ben Watkins, director of Florida's bond-finance division. "Removing banks as one of the demand components will exacerbate the impact in situations where munis have fallen out of favor."

Crisis Prevention

The new regulations are based on international standards developed by the Basel Committee on Banking Supervision. They're designed to prevent a repeat of the 2008 credit crisis by ensuring that banks can produce enough cash to operate during times of stress.

The initial proposal, released in 2013 and with a suggested phase-in beginning next year, would allow banks to use securities including Treasuries, foreign-government debt and corporate bonds to satisfy those requirements. The regulators said state and city obligations don't trade frequently enough to be included.

The FDIC, the Office of the Comptroller of the Currency and the Fed are formulating the rules. The Wall Street Journal reported yesterday that the Fed is considering allowing banks to use some munis toward the requirement, in response to criticism from lawmakers and state officials.

David Barr, an FDIC spokesman; Bryan Hubbard at the OCC; and Eric Kollig at the Fed all declined to comment.

Taxpayers' Lament

The proposed treatment has riled state and local officials, who say it will boost interest rates on debt sold for projects such as bridges, roads and schools. Officials from Chicago, Los Angeles, New York and Philadelphia were among those who pressed regulators to reconsider. California, the biggest issuer of munis, assailed the plan.

“If the regulators exclude municipal bonds, they will poke a stick in the eye of American taxpayers,” said Tom Dresslar, a spokesman for California Treasurer Bill Lockyer. “It will increase their borrowing costs because it will reduce demand for municipal bonds.”

Individual investors seeking munis’ tax-exemption still dominate local-government bonds. Households own about $1.6 trillion, or 44 percent, directly through brokerage accounts.

Yet since the 2008 credit crisis, banks have become a growing force as demand for other types of loans dimmed.

JPMorgan’s Holdings

The institutions have increased their holdings for 18 consecutive quarters since late 2009, even as the overall market shrank in 10 of those periods, Fed data show. As of March 31, banks held $425 billion, about 12 percent of the market, twice the share from four years earlier.

JPMorgan Chase & Co. and Wells Fargo & Co. own the most among the biggest U.S. banks, with $44 billion and $47 billion, respectively, at the end of June, according to regulatory filings. Jessica Francisco, a spokeswoman for JPMorgan in New York, declined to comment, as did Ancel Martinez, a spokesman for San Francisco-based Wells Fargo.

The change probably won’t influence JPMorgan’s muni holdings because the bank has already planned to exclude the securities from the assets it will use to satisfy the new rules, according to a person with knowledge of the matter who requested anonymity without authorization to speak publicly about the bank’s decisions.

Austerity Cushion

While Fitch Ratings has said that the new regulations could lead banks to reduce holdings, a slowdown in municipal issuance may mask the impact.

The market is on pace to shrink for a fourth straight year as local officials stung by the recession’s financial strains have been reluctant to take on new projects.

Munis have earned 8 percent this year through Aug. 27, beating corporate bonds and Treasuries, according to Bank of America Merrill Lynch indexes, Yields on benchmark 10-year munis fell to 2.17 yesterday, the lowest since May 2013.

“The supply-demand equation is so out of whack right now that at least in the short-run I don’t think it will have much effect,” said Justin Land, who helps oversee $3.5 billion of munis at Wasmer Schroeder & Co. in Naples, Florida.

“I don’t think banks will necessarily become sellers of muni debt, just because they have a lot of excess capital and are trying to build reserves,” he said. “They just may not be the aggressive buyers they’ve been over the past few years.”

The repercussions of the change will become most evident during times of market stress, when banks may be more prone to stay on the sidelines, Citigroup Inc. muni analysts Vikram Rai, Mikhail Foux and George Friedlander said in an Aug. 26 research note.

“We haven’t seen any definitive effect to date, but that doesn’t mean it won’t be felt,” said Watkins, the Florida official. “How that occurs and when that occurs is difficult to predict, but there definitely will be an impact.”

By William Selway

Aug 28, 2014 5:00 PM PT

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

To contact the editors responsible for this story: Alan Goldstein at agoldstein5@bloomberg.net Mark Tannenbaum, Mark Schoifet