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Fed: Some Munis May Become HQLA in Liquidity Rule.

WASHINGTON — Municipal securities will not qualify as high-quality liquid assets under a new federal liquidity coverage ratio rule slated to take effect on Jan. 1. Federal Reserve Board officials said they are working on a proposal to include some municipal bonds as HQLA at a later date, but municipal market participants were disappointed at the delay.

The rule unveiled and adopted unanimously by the Fed on Wednesday, would implement Basel III regulations. It would require large banks to maintain a certain ratio of HQLA to total net cash outflows. The idea is that the banks would then be able to easily and immediately convert those assets to cash during a period of liquidity stress.

Fed board member Daniel Tarullo said Wednesday that the Fed staff are at work on a proposal to allow some munis to qualify as HQLA, but that proposal is not ready and the agency wanted to finalize the rule now so that banks can begin to prepare to implement it.

A draft rule earlier this year alarmed the muni market, prompting groups to warn regulators that excluding munis from the definition of HQLA will increase borrowing costs for state and local governments, reduce liquidity and increase volatility in the muni market, and put muni issuers at a disadvantage to foreign governments in accessing the U.S. capital markets. Market advocates have argued doggedly that many munis can be sufficiently liquid to be included as HQLA.

“While it is true that most state and municipal bonds are not sufficiently liquid to serve the purposes of HQLA in stressed periods, public comments and staff analysis over the past several months suggest that the liquidity of some state and municipal bonds is comparable to that of the very liquid corporate bonds that can qualify as HQLA,” Tarullo said. “Staff has been working on ideas to develop some criteria for determining which such bonds fall into this category and thus might be considered for inclusion as HQLA. That work has not yet been completed, and it is important to get this final rule adopted now, so that the largest banks can begin to prepare for its implementation on Jan. 1. However, I anticipate that staff will be coming back to us with a report on efforts to develop a proposal along these lines.”

A staff presentation at the meeting said that a “limited number” of municipal securities exhibit liquidity characteristics comparable to the highly liquid corporate bonds that do satisfy the coverage ratio rule, and that the future proposal will include “the most liquid” munis.

Fed chair Janet Yellen said municipalities are fearful that their access to capital markets could be impacted by the failure to classify munis as HQLA, but Fed manager of credit, market, liquidity risk and policy David Emmel told her that staff believe the impact on local economies and bank behavior will be minimal.

Banks hold munis for reasons other than to have high-quality assets on hand, Emmel told Yellen, and staff expect banks to continue to hold munis.

“We don’t believe the impact will be significant,” Emmel said.

Market participants were disappointed with the outcome, especially after a full-scale campaign by dealers and issuers alike to pressure regulators into allowing at least some highly-rated munis to satisfy HQLA requirements under the rule. Thirty-one state treasurers signed onto an 11th-hour appeal sent to the board late last week. But the indication that some munis could be HQLA in the future did take some of the sting from the news.

"While it was disappointing to see munis not included in the final rule, it is encouraging to know that governors and Federal Reserve staff are committed to developing rule changes that will allow some muni securities to qualify as HQLA," said Dustin McDonald, director of the Federal Liaison Center at the Government Finance Officers Association. " GFOA will be reaching out to staff to discuss next steps."

Tom Dresslar, spokesman for California State Treasurer Bill Lockyer, expressed concern at continuing statements about how most munis are not sufficiently liquid and said the Fed should take care not to exclude too many munis when it proposes the revision later.

"The exclusion of municipal bonds is wholly unjustified, so the commitment to adopt a subsequent rule that brings at least some of them under the tent is welcome," Dresslar said. "But any future rule should not be stingy in welcoming munis. It should be generous. "

Bond Dealers of America senior counsel and senior vice president for federal regulatory policy Jessica Giroux said the group was disappointed, but wanted details on the muni proposal.

"We would be interested to find out more of the specifics behind this consideration since our position is that muni's generally should be included as HQLA," Giroux said.

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