Bond Case Briefs

Municipal Finance Law Since 1971

Fed Will Consider Adding Municipal Debt as Quality Asset.

WASHINGTON—States and localities that raise cash in the $3.7 trillion municipal bond market moved closer to winning a reprieve Wednesday after regulators agreed to consider allowing banks to use certain types of municipal debt to satisfy a new post-crisis financing rule.

Banking regulators on Wednesday finalized safeguards to require that banks hold enough liquid assets such as cash or Treasury notes to fund their operations for 30 days if other sources of funding aren't available. Under the final rules, municipal securities issued by states and localities won't count as "high-quality liquid assets," meaning such securities wouldn't qualify for use under the new funding requirements.

Still, the Federal Reserve, which helped craft the rules with two other agencies, opened the door to eventually including at least some municipal securities. Federal Reserve Gov. Daniel Tarullo said he expects the central bank to reconsider the issue in response to evidence that some state and local debt is frequently traded and may be "comparable to that of the very liquid corporate bonds" that qualify as high-quality liquid assets.

The market for municipal debt is vast, with roughly 60,000 borrowers and 1.2 million individual bonds. Only a relatively small number of the bonds—from large states and cities such as California and New York—see their securities frequently traded, according to industry experts. That is partly because the features of the market, including the tax-exempt status of most securities, encourage most investors to hold their bonds until maturity.

The Fed's decision to reconsider whether to fully exclude municipal securities was first reported last week by The Wall Street Journal.

States and localities have warned excluding their securities could cause banks to retreat from the municipal market in which they have increasingly become an important player, with four of the largest U.S. banks alone holding some $100 billion of such debt, according to consulting firm Municipal Market Advisors. State Treasurers and other officials say their costs to finance roads, schools and bridges could jump if banks retreat from the market—costs that will ultimately be borne by taxpayers.

"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," said Tom Dresslar, a spokesman for California Treasurer Bill Lockyer. "But any future rule should not be stingy in welcoming munis. It should be generous."

Mr. Dresslar added municipal bonds meet every criterion the agencies established to define high quality liquid assets. "Continued statements from staff and regulators that there's only a small slice of munis that might qualify as HQLA do not comport with the facts," he said.

The Fed stressed any change in treatment for municipal bonds would only apply to a limited number of the securities, given that few are frequently traded. While many securities issued by states and municipalities have low likelihoods of default, “the liquidity characteristics of these securities range significantly, with most securities issued by public sector entities exhibiting low average daily trading volumes and limited liquidity, particularly under stressed economic scenarios,” the Fed staff wrote in a memo released Wednesday.

THE WALL STREET JOURNAL
By ANDREW ACKERMAN