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Munis in Limbo Awaiting Clarity on Bank Liquidity Regulations.

Yesterday the Fed and other regulators announced a new rule detailing what easy-to-sell investments big banks need to hold in reserve in case of a crisis. When it came to deciding if municipal bonds should be eligible for this category of so-called high-quality liquid assets, regulators basically punted. Munis aren't eligible for now, but Fed Governor Daniel Tarullo went to the trouble of releasing a separate statement saying that while most muni bonds "are not sufficiently liquid to serve the purposes of HQLA in stressed periods," regulators are still "working on ideas" to figure out how some munis could eventually be considered for inclusion in the HQLA club.

The announcement didn't cause any real drop in muni-bond prices, but analysts say munis could suffer in the long run if they're not eventually granted HQLA membership.

"The potential impact of this decision is difficult to assess but none of it is good for the municipal bond market," writes J.R. Rieger, global head of fixed income at S&P Dow Jones Indices, today. "Discouraging banks from buying or holding municipal bonds most likely will have the consequence of reducing the liquidity of certain municipal bonds normally pursued by the banking community."

Chris Mauro, head of U.S. municipals strategy at RBC Capital markets, says most investment-grade munis, particularly those of regular muni-bond issuers, ought to qualify, and fears the issue will hang over the market for a while. From Mauro today:

[W]e believe that the blanket exclusion of munis from the definition of HQLAs would have negative long-term implications for the municipal market, potentially dampening demand and liquidity for the asset class. Additionally, it could have the effect of reducing the amount of bank liquidity available to fund credit and liquidity support for Variable Rate Demand Note (VRDNs) programs, bank direct purchase programs, and tender option bond programs…. [W]e fear that the proposed new rule will award the HQLA designation to only a narrow slice of the municipal market….

While we are encouraged by the regulators openness to discuss including municipals as an HQLA, we are worried that the final ruling may extend beyond the January 1, 2015 effective date of the LCR rule, thus introducing an added element of uncertainty to the municipal market.

September 4, 2014, 4:44 P.M. ET

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