NAST, NASACT Make 11th Hour Appeal on Munis to Regulators.

WASHINGTON — State treasurers and financial officers are urging federal banking regulators to identify quantitative liquidity standards or characteristics that would allow at least some municipal securities to qualify as high-quality liquid assets in a rule to be released on Wednesday.

"It is unreasonable to treat an entire asset class of securities in the same way, as securities of different issuers will have different characteristics," the National Association of State Treasurers and the National Association of State Auditors, Comptrollers, and Treasurers warned the Treasury, Federal Reserve Board, and Federal Deposit Insurance Corporation said in an Aug. 29 letter. "A more reasonable approach would be for the rule to identify quantitative liquidity standards or characteristics that should be met in order for that particular security to be defined as an HQLA."

Excluding munis from the definition of HQLA will increase borrowing costs for state and local governments, reduce liquidity for and increase volatility of the muni market, and put muni issuers at a disadvantage to foreign governments in accessing the U.S. capital markets, the two groups warned the regulators.

The liquidity coverage ratio [LCR] rule that is due out 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.

But press reports stating the rule will not classify most or any munis as HQLA have caused issuers, rating agencies and dealers alike to raise concerns like those NAST and NASACT wrote about in their letter last week.

The two groups argued that muni bonds are low-risk, high-volume securities with transparent pricing and that they are readily marketable. Because of this, they argued, there is no reason to adopt a rule that will adversely impact the market.

Fed chair Janet Yellen told a Senate panel in July that munis did not approve to be liquid enough to qualify as HQLA.

But the groups told banking regulators: "We believe the proposed LCR rule will (1) increase borrowing costs for municipal issuers; (2) reduce market liquidity and increase volatility; and (3) disadvantage U.S. municipalities relative to foreign governments in accessing the U.S. capital markets, which NAST believes is not only unjustifiable but against the broader policy interests of the United States."

Dealer groups and lawmakers have also weighed in on the need to allow muni bonds to be HQLA. Citigroup Inc. managing director and senior municipal strategist George Friedlander predicted that bank appetite for bonds would shrink if munis are not HQLA under the rule. Banks have been major drivers of the market, and their holdings of munis have grown sharply since 2009.

More important, if munis are excluded as HQLA, then during periods of liquidity stress, if a bank's liquidity coverage ratio is constrained, it would not be able to provide any support or any marginal demand to the municipal securities market., thereby inducing additional market stress, Citi said in a research paper released last week.

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