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BofA Sees Limited Harm To Munis From New Bank Liquidity Rule.

Bank of America Merrill Lynch today weighs in on the new federal regulations governing what liquid, easy-to-sell securities big banks need to hold in reserve, regulations that so far exclude municipal bonds from this category of high-quality liquid assets. BofA is among those who see limited harm to the muni markets, and it lists five specific reasons why:

[T]he immediate impact of the adopted rule is likely to be limited for several reasons. First, as Regulators point out, only roughly half of the $425 billion of municipal securities held by domestic banks are held by those large banks subject to the new requirements. Second, most banks subject to these regulations are already in compliance with, or have made significant strides toward compliance with, the regulations as currently drafted. Third, were municipal securities to be added to the definition of HQLA in accord with the international regulations under Basel, municipal securities would still be subject to a 15% haircut as a Level 2a asset type, and further limited by the requirement that Level 2a and 2b assets can make up no more than 40% of total HQLA. Fourth, some municipal securities may be allowed to be counted toward HQLA in the near future, though no proposal or criteria for inclusion have yet been released. And, lastly, the Regulators contend that banks likely purchase municipal securities for profit generation rather than as a means of meeting Regulator's capital and liquidity requirements.

Although regulators have said they're still reviewing whether munis should be treated as high-quality liquid assets, BofA says investors shouldn't assume they'll eventually be included in the category:

While political opposition to the exclusion of municipal securities in the definition of HQLA is likely to persist following the adoption of the rule, some municipal securities may get a reprieve if the Fed adopts a rule allowing those securities in the future. That said, the market should treat these rules as final until further notice. They serve to introduce a new long-term regulatory risk that should be priced. Over time, the muni market may be compelled to find a higher-priced source of liquidity if these rules become binding on banks.

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By Michael Aneiro