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Bank Buying Spree Undiminished by Liquidity Rules: Muni Credit.

Banks added to a record bet on the $3.7 trillion municipal market last quarter as an unprecedented rally overshadowed regulations that will remove an incentive for the companies to own the securities.

U.S. lenders boosted holdings of state and city debt by $4.7 billion from March through June to $430 billion, the most since Federal Reserve data begin in 1945. The purchases extended a more than four-year spree that swelled banks' ownership by $206 billion, exceeding all other types of investors, according to Fed data released yesterday.

The institutions' appetite helped propel the local-debt market to eight straight months of gains to start the year, the first time that has happened in Bank of America Merrill Lynch data going back to 1989. The banks are buying even as a pending rule change will exclude local debt from the easy-t--sell assets banks can hold to weather a credit crisis. Their demand is helping munis outpace corporate bonds and Treasuries.

"Munis are attractive," said Vikram Rai, a Citigroup Inc. municipal analyst in New York. "There's a global scarcity of high-quality, liquid assets."

Keeping Company

Banks aren't the only buyers this year. Individuals, who own at least 40 percent of the market as of June, have added $8.3 billion to muni mutual funds in 2014, Lipper US Fund Flows data show. Meanwhile, issuance is about 13 percent below last year's pace as the lingering strains of the recession that ended in 2009 leave officials wary of taking on new projects, data compiled by Bloomberg show.

Munis have earned about 8 percent this year, on pace for the biggest annual gain since 2011, according to Bank of America indexes. That compares with returns of 3 percent for Treasuries and 5.5 for corporate debt.

The rally has pushed muni borrowing costs toward generational lows. Benchmark 10-year munis yield about 2.28 percent. For buyers in the top federal income bracket, that's equivalent to a taxable rate of 3.8 percent. In comparison, similar-maturity Treasuries yield about 2.6 percent.

"Munis have been outperforming other asset classes," said Robert Donahue, a managing director at Concord, Massachusetts-based research firm Municipal Market Advisors. "Banks have really been buying for the yield."

Expanded Role

Since the credit crisis, banks have expanded their role in the municipal market as demand for other types of loans dimmed while the economy recovered.

They increased munis holdings every quarter since late 2009, even as the broader market began to shrink in 2011, Fed data show. By the end of June, they held 12 percent of the market, twice their share at the end of 2009.

State and local officials, including California Treasurer Bill Lockyer, have expressed concern that the new regulations will drive banks away from the market.

The rules, first released in 2013, were approved by the Fed and other regulators this month. While banks won't be able to use munis to satisfy the liquidity requirement, the Fed said it may tweak the rules to allow the most easily traded munis to be included.

Assets Aplenty

Most banks have enough assets on hand so that they don't need to use munis to meet the standards, which take effect starting in January, said Bank of America muni analyst Philip Fischer. The rules may cause banks to sell munis during times of financial stress, he said.

"We don't expect that to be a near-term effect, but it introduces one more risk to the market," said Fischer, who's based in New York.

Banks buy munis primarily for investment reasons, procuring money at short-term rates and plowing it into higher-yielding, long-term bonds, he said.

Munis maturing in 25 or more years are the biggest draw, said Citigroup's Rai.

As the market has rallied this year, long-dated securities have fared the best. Bonds maturing in more than 22 years have returned about 12 percent, according to Barclays Plc data. That compares with the 6.7 percent return on 10-year debt.

"We expect these buying patterns to continue," he said. "It's been a strong source of support."

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