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U.S. Treasury Will Monitor Bank Liquidity Rule's Impact on Munis- Official.

(Reuters) - The U.S. Treasury will monitor the impact of a recent bank liquidity rule on the cost of new municipal debt issuance, a federal official said on Wednesday.

Kent Hiteshew, director of the Treasury's newly-formed Office of State and Local Finance, told a meeting of bond attorneys that he was aware of concerns that the elimination of municipal bonds from the definition of banks' high-quality liquid assets could potentially limit bank demand for the debt, pumping up costs of new bond issuance.

Earlier this month, the U.S. Federal Reserve, the Federal Deposit Insurance Corporation, and Office of the Comptroller of the Currency tightened rules on which assets banks can sell in the event of a credit crunch.

The rule did not count municipal bonds as "liquid assets," raising an outcry from states, cities, schools and other issuers of the debt.

Issuers say the rule will drive down banks' demand for their bonds, forcing them to offer higher interest rates on their debt in order to attract buyers. That, in turn, will make borrowing more expensive and curb their ability to embark on capital improvement projects.

Hiteshew noted that banks own just 12 percent of the \$3.7 trillion market, although they have doubled their aggregate exposure to municipal debt since 2008.

He also told the National Association of Bond Lawyers' workshop that the Obama Administration continues its legislative push for America Fast Forward Bonds as an alternative to tax-exempt issuance. The proposed bond program would follow the short-lived, but popular Build America Bond program that was part of the economic stimulus act.

"Overall, rather than a threat to tax-exempt financing, we think a permanent direct-pay taxable program, like America Fast Forward Bonds, would make the tax-exempt market more efficient and actually bolster support for tax-exempt bonds among federal policy makers," Hiteshaw said in prepared remarks.

Another speaker, Kevin Guerrero, senior counsel in the U.S. Securities and Exchange Commission's enforcement division, said the regulator continues to crack down on deficient disclosures by borrowers, noting settlements with high-profile issuers New Jersey, Illinois and Kansas involving their unfunded pension liabilities.

"Municipal disclosure has been and will continue to be an ongoing focus for us," Guerrero said, adding that the SEC's new initiative that encourages issuers and underwriters to self-report potential disclosure problems is just one aspect of that focus.

He also said the first phase of the initiative, which began in March, ended earlier this month for

underwriters to report potential disclosure problems and that the SEC was pleased with the response. Issuers have a reporting deadline of Dec. 1.

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(Reporting By Karen Pierog, additional reporting by Lisa Lambert in Detroit; Editing by Diane Craft)

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