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New Bank Rule Would be Costly for Cities, States.

A new financial regulation meant to ensure that banks are able weather a panic would have an unpleasant side effect — making it more expensive for cities and states to fund projects.

The liquidity coverage rule, finalized by bank regulators in early September, would require banks to hold enough safe, liquid assets, such as Treasury bonds, that would be sellable even in a crisis to fund their operations for at least 30 days. Part of the 2010 Dodd-Frank financial reform law, the regulation is meant to prevent a repeat of 2008, when investment bank Lehman Brothers found itself unable to meet its creditors' demands and failed.

But by excluding municipal bonds from the definition of assets considered safe and making them less attractive to banks, some lawmakers and financial industry leaders say, the federal government may have unnecessarily raised the cost of doing business for cities and states, which rely heavily on issuing bonds for projects such as highways and schools.

"If there's less demand for bonds, obviously you end up paying higher interest rates," said Richard Ellis, state treasurer for Utah and president of the National Association of State Treasurers. "I don't know if you can quantify the impact" of the rule, Ellis said, "but it will mean less projects to fund."

Local governments and industry groups had been vocal about the potential harm that the rule would do while it was being considered by officials at the Federal Reserve, the Office of the Comptroller of the Currency and the Federal Deposit Insurance Corporation. They noted that some municipal bonds were at least as liquid as the corporate bonds included in the proposed rule.

When the agencies finalized the rule, Fed Governor Daniel Tarullo acknowledged those concerns and said that the Fed staff would look into amending the rule to include municipal bonds as high-quality liquid assets. It's not clear when a fix would be proposed, although implementation of the rules begins in January for the biggest banks and will be completed by 2017.

Treasurers have at least one powerful advocate pushing for the change — New York's Chuck Schumer, a member of the Senate Banking Committee and the No. 3 Democrat in the Senate.

After confronting Tarullo over the treatment of municipal bonds in a September congressional hearing, Schumer wrote a letter to the regulators saying "it is hard to understand how all three federal regulators finalized … with such glaring inconsistencies. … The broad exclusion of all municipal bonds from counting as [high-quality liquid assets] under the current rule makes no sense on the merits and could have disastrous side effects, so I hope the regulators will heed our call and reconsider it quickly."

Regulators likely will revisit the topic and categorize some segment of the roughly $3.6 trillion municipal bond market as liquid, speculated Michael Decker, co-head of municipal securities at the Securities Industry and Financial Markets Association. "We're convinced that there would be a negative effect" on state finances if the rule is kept as is, Decker added.

Some analysts believe that the regulators got it right — that municipal securities are not as liquid as high-quality corporate bonds or Treasury securities, and that leaving them out of the liquid assets category will not harm small governments' finances.

In a note written in response to the final rule, Wells Fargo's Brian Jacobsen wrote that the impact of the rule on the municipal bond market would be "negligible" and that "banks have already prepared for these regulatory changes, so a lot of the market adjustment has probably already taken place."

Others, however, warn that the rule could cause trouble over time.

"Even though in the near term the impact would be masked … when it could manifest itself is when you have a considerable downturn and municipals will continue to sell off for a considerable period because some of the liquidity providers — the big banks – may not be as quick to pick up munis as other assets that would help their liquidity ratios," said John Dillon, managing director at Morgan Stanley Wealth Management.

Dillon said that, while most municipal bonds are held by individual investors interested in their tax-exempt interest payments and are not liquid, there are enough widely traded municipal bonds to be included in the rule.

Leaving them out, he said, would ultimately hurt taxpayers. "Higher borrowing costs in munis, for whatever reasons, would just mean mom and pop — the residents of every state — paying more for their borrowing," Dillon said. "It really does have a trickle-down effect."

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