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Striking a Balance on Muni Bonds.

A new federal rule opens the door to counting municipal bonds in bank assets.

Let's dispatch with the bad news first: The municipal bond market has taken yet another hit this month. A new federal rule excludes muni bonds from the liquid assets that banks must hold in case of an emergency. Issued by the U.S. Federal Reserve, the Office of the Comptroller of the Currency and the Federal Deposit Insurance Corporation, the rule exists to make sure banks have enough assets on hand that can quickly be converted to cash in the event of a financial crisis.

The good news is that public finance officials were prepared for the ruling. Ever since the draft rule was released a year ago, they've been slowly building a case to reverse it, arguing that municipal bonds should be designated high quality liquid assets (HQLA) alongside easily sellable assets like Treasuries or highly rated corporate bonds. While the Federal Reserve still issued the rule, it did recommend that some municipal bonds eventually be included as HQLAs.

Why is this inclusion important? A big reason is that the blanket exclusion of munis "would have negative long-term implications for the municipal market, potentially dampening demand and liquidity," according to RBC Capital Markets' Chris Mauro. An assessment by Fitch Ratings in January noted that if banks weren't allowed to count municipal bonds as liquid assets, it would be more expensive for banks to hold the bonds on their balance sheets and, as a result, could lead to banks reducing their muni bond portfolios.

Fortunately for cities, the new liquidity rule won't likely have an immediate impact. As long as overall interest rates remain low, muni bonds will be an attractive option for banks. Indeed, banks have been increasing their presence in the $3.69 trillion municipal market, holding $425.2 billion up from $221.9 billion in 2008. But, wrote Chicago's CFO Lois Scott in a letter to more than a dozen of her counterparts, "when economic conditions change, we will need and want America's big banks to stand by us."

Until then, observers will be watching to see which muni bonds will be exempted and counted as easily sellable liquid assets. Mauro finds the wording of the final rulemaking document troubling for its repeated assertion that "most" municipal bonds do not possess liquidity characteristics consistent with the objectives of the rule. Specifically, the final rulemaking notes that "many municipal securities are not liquid and readily-marketable."

"Accordingly," said Mauro, "we fear that the proposed new rule will award the HQLA designation to only a narrow slice of the municipal market. As we have previously articulated, we believe that most investment-grade municipals, particularly those of frequent issuers, should qualify as HQLAs." In fact, most municipal governments are investment grade, rated BBB- or higher.

In any case, transportation advocates worry that the cost of project financing will increase for governments whose bonds are excluded from this rule. "That could also adversely impact development of public-private partnerships for transportation projects," said Pete Ruane, president and CEO of the American Road & Transportation Builders Association.

The high-borrowing-cost argument is one that gets made a lot on Capitol Hill, most often as a reason not to start taxing investors’ interest earned on municipal bonds. In recent years, though, that same argument has gotten regulators to drop municipal bonds from being part of the Volcker Rule’s “risky investments” category (although it did place limits on banks’ use of tender-option bonds, which represent a small fraction of the municipal market).

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