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SIFMA Suggests HQLA Change.

WASHINGTON - The investment grade bonds of issuers and obligors with at least \$100 million of marketable securities outstanding should qualify as high-quality liquid assets under federal banking rules, the Securities Industry and Financial Markets Association told regulators in a just-released letter.

SIFMA managing director and co-head of municipal securities Michael Decker made the case in a letter sent Tuesday to banking regulators responsible for a recently-adopted banking rule that requires the largest banks to hold a certain amount of high-quality, easily-marketable securities that could be converted to cash in a fiscal crisis. The liquidity coverage ratio rule, adopted last month and effective Jan. 1, was a joint effort by the Federal Reserve Board of Governors, the Federal Deposit Insurance Corporation, and the Comptroller of the Currency.

The liquidity rule principally applies to U.S. banking companies with at least \$250 billion in total assets or consolidated on-balance sheet foreign exposures of at least \$10 billion. Corporate bonds, U.S. Treasuries, and foreign sovereign debt are included in the rule's HQLA list, which is categorized on the basis of risk and liquidity. Level 1 assets are viewed as the most liquid and least risky, and Level 2a and 2b considered less liquid but still readily marketable.

Muni market participants are concerned that the decision not to classify any municipal bonds as HQLA will cause banks to reduce their muni holdings, thereby increasing borrowing costs for issuers while adding to volatility in the muni market. Many market commentators have said it is unreasonable to classify corporate bonds as HQLA, if munis are not because corporates have higher default rates.

Moody's Investors Service said the muni omission could hurt some credit ratings. And Sen. Chuck Schumer, D-N.Y., has pressed the regulators to move quickly with ongoing staff work to classify some of the most liquid munis as HQLA.

The LCR rule utilizes a four-part test to qualify securities as HQLA. The securities must have more than two committed market makers, a large number of non-market maker participants on both the buying and selling sides of transactions, timely and observable market prices and a high trading volume. Decker wrote that while SIFMA believes that test is appropriate for munis, additional criteria could be useful.

"Examining municipal market liquidity as measured by trading volume against issuer debt outstanding, there is no clear inflection point below which trading volume drops significantly," Decker wrote. "Nevertheless, bonds of issuers and obligors with at least \$100 million of marketable debt securities outstanding tend to demonstrate the highest degree of market liquidity."

SIFMA also suggested that the LCR rule impose a composition cap on munis, limiting them to 10% of an institution's total HQLA holdings.

"We believe amending the LCR Rule to provide for Level 2A liquid asset treatment for the

appropriate segment of the municipal securities market would be consistent with ensuring that banks subject to the rule hold a sufficient level of liquid assets and would contribute to safety and soundness by providing a means for banks to diversify liquid assets into a distinct asset class,” Decker wrote.

The regulators have all signaled that they are open to amending the rule, but have expressed doubt about how liquid munis really are and have argued that banks don’t hold munis for liquidity purposes. Market experts have said the current rule should be regarded as final until an amendment is adopted.

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