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Fed Is Expected to Shift on Muni Bonds.

WASHINGTON—In a change of heart, the Federal Reserve will allow big U.S. banks to use some municipal bonds to meet new rules aimed at ensuring they have enough cash during a financial-market meltdown, according to people familiar with the matter.

The Fed and two other bank regulators had excluded debt issued by cities and states when approving liquidity rules in September, part of their post-2008 efforts to fortify banks against market turmoil.

But the Fed's decision is only a partial victory for the banks, state officials and lawmakers who had pushed for the change. The other two regulators, the Office of the Comptroller of the Currency and the Federal Deposit Insurance Corp., currently don't plan to follow the Fed, people with knowledge of those agencies said.

At issue is the treatment of municipal debt under the new liquidity requirements, which call for large banks to hold enough "high-quality liquid assets" to fund their operations for 30 days. The Fed plans to issue a proposal to let some municipal bonds qualify as safe assets.

OCC officials have indicated they aren't convinced municipal bonds can be traded easily enough to be included in the rule. The FDIC's position is unclear, but its portion of the rule affects only a few banks.

The change being crafted by the Fed has been sought by big banks such as Citigroup Inc. and Wells Fargo & Co., as well as state and local officials and top lawmakers in Congress including Sen. Charles Schumer (D., N.Y.). They warned that excluding all municipal-debt securities from the liquidity rules could eventually prompt banks to retreat from the $3.7 trillion market and force governments to scale back spending on roads, schools and other infrastructure projects financed with the bonds.

Those arguments largely fell on deaf ears at the OCC, where officials are privately dismissive of including the bonds in the rule, according to people familiar with the conversations. Representatives for the OCC and the FDIC declined to comment.

FDIC Chairman Martin Gruenberg at a September Senate hearing expressed some openness to considering including certain munis "based on supporting research or thoughts from the Fed," he told Mr. Schumer.

Michael Decker, a managing director at the Securities Industry and Financial Markets Association, a Wall Street trade group, said it welcomes any action to recognize "the inherent liquidity of municipal securities as bank investments."

Spokesman for Citigroup and Wells Fargo declined to comment.

Fed officials have long expressed more willingness to consider adding munis to the new rules. Fed governor Daniel Tarullo, at the same September Senate hearing, said he expected the central bank to reconsider the issue in response to evidence that some state and local debt is frequently traded and may be “comparable to that of the very liquid corporate bonds” that qualify as high-quality liquid assets.

The plan under discussion falls short of including all investment-grade municipal bonds, for which states and banks had pushed. The exact criteria for which kinds of municipal bonds would count under the rule hasn’t been set. A key focus of the criteria will be the ability of a bank to sell the bonds in a fairly short time frame, according to one of the people.

In addition, the bonds are expected to be treated on par with investment-grade corporate debt, meaning banks would only be able to count 50% of their face value when counting them as part of their funding buffers. Municipal officials and banks had pushed for an 85% credit.

The market for municipal debt is vast, with roughly 60,000 borrowers and 1.2 million individual bonds. Only a relatively small number of the bonds—from large states and cities such as California and New York—are frequently traded, according to industry experts. That is partly because the features of the market, including the tax-exempt status of most securities, encourage most investors to hold their bonds until maturity.

Banks underwrite bonds on behalf of states and localities, and also buy the securities as investments and to sell to their clients. They play an increasingly important role in the market, with banks having nearly doubled their ownership of municipal securities over the past decade, to more than 12% of the total amount outstanding, according to Fed data.

The full impact of just the Fed making such a change is unclear. The Fed’s version of the liquidity rule applies to bank holding companies with $250 billion or more in assets. A less-severe version of the requirements applies to bank-holding companies with between $50 billion and $250 billion in assets. For instance, those holding companies need only a 21-day funding buffer. But for some of the largest banks, like Citigroup and Wells Fargo, their national bank units are subject to the OCC’s rule, which would still exclude munis.

Smaller banks in the $50 billion to $250 billion asset range would be in the clear under the Fed’s contemplated change, however, because only the Fed’s rule applies to them.

To date, banks have by and large continued to hold lots of municipal bonds despite their exclusion from the rule, in part because they are seen as less risky than corporate debt and are priced competitively to other types of debt, according to officials at two large banks. If interest rates rise this year, they expect banks to begin to pare their holdings.

Some lawmakers aren’t waiting for the regulators to act. Rep. Luke Messer (R., Indiana) is preparing to introduce legislation as early as next week requiring regulators to alter the rule to include municipal bonds.

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