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Relaxed Bank Rules Could Lift Municipal Bond Securities, ETFs.

The Federal Reserve may soon allow U.S. banks to hold municipal bonds to meet liquidity rules, opening up more demand for municipal securities and potentially lifting munis-related exchange traded funds.

After the fall off in March, munis have remained relatively flat for the year. Year-to-date, the iShares National AMT-Free Muni Bond ETF (NYSEArca: MUB) gained 0.6%, SPDR Nuveen Barclays Municipal Bond ETF (NYSEArca: TFI) increased 0.6% and Market Vectors Intermediate Municipal Index ETF (NYSEArca: ITM) rose 1.0%.

However, the municipal bond market could experience greater activity ahead if the Fed amends the liquidity rules for U.S. banks. According to people familiar with the matter, U.S. banks may soon be able to utilize municipal bonds as part of "high quality liquid assets" to fund operations for 30 days, the Wall Street Journal reports.

Previously, the Fed and two other bank regulators excluded city and state debt from the liquidity rules in September. While the Fed is cogitating on relaxing the rules, the Office of the Comptroller of the Currency officials argue that munis are not traded easily enough to be included in the rule.

Consequently, the Fed may push for changes, but the OCC could stand pat. The Fed's version of the liquidity rule would then apply to bank holding companies with $250 billion or more in assets, along with a less-severe version for bank-holding companies with between $50 billion and $250 billion in assets. However, the OCC has jurisdiction over some of the largest banks and would likely continue to exclude munis.

Back in September, Fed governor Daniel Tarullo said he expects the central bank to change its stance on munis inclusion as evidence that some state and local debt is frequently traded may be "comparable to that of the very liquid corporate bonds" that qualify under the high-quality liquid assets rule.

Big banks, such as Citigroup (NYSE: C) and Wells Fargo (NYSE: WFC), along with state and local officials and top Congressmen, have been pushing for the changes. Proponents contend that excluding all muni-debt securities from the liquidity rules could push banks to shun the $3.7 trillion market and force local governments to cut back on projects and spending.

According to the Fed, banks now account for 12% of the total outstanding municipal debt market. Banks have held on to munis because the asset class is seen as less risky than corporate debt and competitively priced relative to other bonds.

ETF Trends

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