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[Fed Proposes Relaxing Rules Affecting Municipal Bonds.]

WASHINGTON—Large U.S. banks will be able use some municipal bonds to meet new postcrisis rules aimed at ensuring they have enough cash during a financial-market meltdown under relaxed rules proposed by the Federal Reserve.

The long-awaited move reflects a change of heart by the central bank, which had excluded debt sold by cities and states when approving new postcrisis rules last fall aimed at fortifying banks against market turmoil.

Big banks such as Citigroup Inc. and Wells Fargo & Co., which underwrite, buy and sell the bonds, had been pushing for the move because they want more flexibility in meeting the new rules related to the safety of their funding mix. The banks, along with state and local officials and top lawmakers such as Sen. Charles Schumer (D., N.Y.) warned that excluding all municipal bonds would make the bonds less attractive for banks to hold, potentially making it more expensive for municipalities to issue debt that finances roads, schools and other infrastructure projects.

The Fed's decision is only a partial victory for Wall Street since many banks may not benefit from the policy shift. Two other bank regulators, the Office of the Comptroller of the Currency and the Federal Deposit Insurance Corp., haven't committed to follow the Fed. As a result, it is unclear how many big banks, which typically have large subsidiaries regulated by the OCC or FDIC, would take advantage of the regulatory change.

"Most of the banks that have to deal with this are regulated by the OCC," making the Fed move "somewhat of a nonevent," said Tom Metzold, senior portfolio adviser at Boston-based Eaton Vance.

The Fed proposal relates to how municipal bonds are treated under new liquidity requirements that the banking agencies adopted last September. The rules call for large banks to hold enough "high-quality liquid assets" to fund their operations for 30 days. The Wall Street Journal reported in April that the Fed planned to reverse its prior stance and let some municipal bonds qualify as safe assets.

The Fed said its proposal "would maintain the strong liquidity standards" of its current rules, "while providing banks with the flexibility to hold a wider range of" high-quality assets that could be sold for cash in a crisis.

Thursday's proposal "is solely a Fed action," said a spokesman for the OCC, which regulates national banks. OCC officials don't believe municipal bonds can be traded easily enough to be included as assets that could be sold quickly in a pinch, people familiar with their thinking have said.

A spokeswoman for the FDIC, which plays a smaller role in regulating the institutions affected by the rule, said the agency "is closely monitoring the municipal securities markets to assess the impact of the liquidity coverage rule. The FDIC will consider adjustments to the rule, which was designed to strengthen the liquidity position of our largest financial institutions, if necessary."

In March, Comptroller Thomas Curry noted banks have increased their holdings of municipal securities since the liquidity rules were issued last fall, suggesting worries that the rules would drive banks from the markets are overblown. Michael Decker, co-head of municipal securities at the Securities Industry and Financial Markets Association, said that could change when interest rates rise and banks alter their investment strategies.

The Fed proposal would allow some banks and bank holding companies—but not their OCC-regulated national bank subsidiaries—to count some municipal bonds toward their required funding buffer under the new liquidity rules. The proposed rule wouldn't affect banks' ability to invest in municipal bonds. But it could make those investments more attractive by allowing the bonds to count toward meeting a bank's liquidity requirements.

The exact criteria for which kinds of municipal bonds would count toward a bank's funding requirement are likely to disappoint some proponents of the change. The proposal wouldn't count all investment-grade municipal bonds, only a subset of the bonds known as "general obligation" bonds. Insured debt wouldn't count. It also would treat the bonds on par with investment-grade corporate debt, meaning banks would be able to claim 50% of their face value when counting them as part of their funding buffers. Municipal officials and banks had pushed for a higher percentage. The proposal also says the municipal bonds, in total, could count as a maximum of 5% of a bank's total funding buffer.

"It's certainly welcome that the Fed has reopened this issue," said Mr. Decker of the securities industry group. "With that said, the proposal would impose pretty significant restrictions and limitations."

The Fed is soliciting public comment on the proposal and could make changes.

The market for municipal debt encompasses roughly 60,000 borrowers and 1.2 million individual bonds. A small slice of bonds from large states and cities are frequently traded, according to industry experts. That is because most investors hold the tax-exempt bonds until their maturity rather than selling them.

Over the past decade, banks have nearly doubled their ownership of municipal securities, to more than 12% of the total amount outstanding, according to Fed data.

— Aaron Kuriloff contributed to this article.

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THE WALL STREET JOURNAL

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Updated May 21, 2015