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Fed Rule Would Let Banks Hold Some Munis as Crisis Buffer.

The Federal Reserve, in a split from other financial regulators, plans to let banks hold investment-grade municipal bonds to comply with a rule aimed at keeping lenders safer during a crisis.

The Fed's proposal released Thursday would ease the burden on bank-holding companies, which are required to hold enough assets that can be easily converted into cash during a financial meltdown. While two other U.S. bank supervisors didn't think municipal debt was easy enough to sell when they approved a liquidity rule last year, the Fed said it was willing to reconsider the bonds in a future action.

The proposed rule would allow investment-grade U.S. state and municipal bonds to be counted as high-quality liquid assets "if they meet the same liquidity criteria that currently apply to corporate debt securities," the Fed said in a statement. "The limits on the amount of a state or municipality's bonds that could qualify are based on the specific liquidity characteristics of the bonds."

The Fed's proposal makes strict demands on the investment-grade munis that can be held, insisting they not total more than 5 percent of a bank's liquidity buffer. The agency didn't elaborate on the scope of the muni market it thinks will fit the criteria, but the general-obligation munis must have a track record of stability when riding out previous crisis periods.

Qualifying Bonds

The proposal, open for public comment until July 24, could exclude a segment of the market because it disqualifies general obligations backed by bond insurers, which the Fed points out could have the same risks as banks during times of financial distress.

States and localities have issued about $1.1 trillion of general obligations, according to data compiled by Bloomberg. Of those bonds, about $226 billion are insured, the data show.

"While we appreciate the Fed moving to include munis as high-quality liquid assets and believe it is a step in the right direction, it is important to also ensure the other regulators involved do the same," said Jessica Giroux, general counsel for the Bond Dealers of America, which represents municipal securities dealers and banks. She said the group is "contemplating the limitations" the Fed's proposal puts on munis.

When the Fed, Office of the Comptroller of the Currency and Federal Deposit Insurance Corp. passed the so-called liquidity coverage ratio rule in September, the central bank indicated that it was open to tweaking it to give lenders flexibility to use some municipal debt as part of their easy-t--sell assets.

Large Banks

The proposal released Thursday amends the Fed's part of the September rule and will have the most impact on bank-holding companies with $250 billion or more in assets.

Banks, local governments and lawmakers including U.S. Senator Charles Schumer have pushed for the change, warning that limiting the use of state and local debt could spur an exodus from the $3.6 trillion municipal bond market and make it more expensive to build schools, roads and bridges. The FDIC and OCC haven't agreed to soften the rule.

The September rule was among the measures regulators have taken to try to prevent a repeat of the 2008 financial crisis, when markets froze and large banks including Citigroup Inc. needed government bailouts. It requires lenders to hold enough assets that are deemed high-quality — such as Treasuries, highly-rated corporate bonds and foreign government debt — to be able to endure a 30-day squeeze.

Infrastructure

Many bonds backing infrastructure projects are bought and sold infrequently, but Fed officials are now proposing that banks shouldn't face restrictions on holding munis that trade more often.

Schumer, a New York Democrat, has been a vocal critic of the decision regulators made. At a September hearing, he told officials from the Fed, FDIC and OCC that the rule would undermine "the lifeblood of development in this country."

The prior exclusion of munis as high-quality liquid assets hasn't quelled demand from U.S. banks for the securities.

U.S. banks owned $452 billion of munis as of Dec. 31, twice their holdings at the end of the recession in June 2009, according to Fed data. Banks own about 13 percent of munis, making them the third-largest holder after households and mutual funds.

Municipal market analysts have said inclusion in the new rules would be a boost, though far from essential, for state and local debt.

"Banks almost always buy municipals for their income and safety, not for their liquidity," according to a report last month from Municipal Market Analytics, a Concord, Massachusetts-based research firm.

Bloomberg

by Ian Katz, Jesse Hamilton, and Brian Chappatta

May 21, 2015

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