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Fed to Allow Some Muni Bonds in Banks' Liquidity Levels.

Law360, New York (May 21, 2015, 3:38 PM ET) — The Federal Reserve on Thursday proposed allowing banks to include top-rated municipal and state-issued bonds in their accounting of liquid assets needed to meet regulatory requirements, in a change to a policy that had been blasted by local governments and federal lawmakers.

The central bank's proposal to include some municipal and state-issued debt into banks' calculations of what are known as high-quality liquid assets, under a regulation requiring them to maintain required levels of assets that could easily be converted into cash, comes after an outcry from lawmakers when such debt was excluded from the Fed's final liquidity coverage ratio rule adopted in September.

The new proposal, which is open to comments until July 24, would allow banks that are regulated by the Fed with $250 billion in total assets to include municipal and state debt in their HQLA calculations if those bonds have liquidity characteristics comparable to corporate debt, the Fed said.

Any limits on the amount of municipal and state debt securities banks could hold under the proposal would be based on the bonds' liquidity characteristics, the Fed said.

The liquidity coverage ratio adopted by the Fed, the Federal Deposit Insurance Corp. and the Office of the Comptroller of the Currency in September requires the largest U.S. banks to hold enough liquid assets to survive a major financial shock by implementing the so-called liquidity coverage ratio, or LCR, requiring banks to hold enough easily convertible, high-quality liquid assets to cover their cash needs for 30 days in case a sudden crisis strikes.

The final rule excluded municipal and state debt, with regulators at the time saying that such securities were not sufficiently liquid to be included in the calculation of liquid assets despite concerns from financial reform advocates that the rule would be watered down.

That stance was applauded by advocates of tough financial regulations even as it was derided by backers of local government bonds, who said that not including top-rated muni bonds among high-quality liquid assets made them less attractive for banks to underwrite and investors to purchase, and driving up costs for infrastructure projects.

However, the Fed said Thursday that a recent study found that some state and municipal securities do have "liquidity characteristics sufficiently similar to investment-grade corporate bonds and other HQLA asset classes" and should be included in the calculation.

Rep. Carolyn Maloney, D-N.Y., said that the proposed change was a welcome about-face from the Fed.

"The Fed's change helps ensure that municipal bonds — which are among the safest investments available — are treated fairly by the regulators. We should not be discouraging financial institutions from investing in our communities, and the Fed's proposed rule will help level the playing field for our states and cities," she said in a statement.

The New York lawmaker, a member of the House Financial Services Committee, urged the FDIC and OCC to follow suit. Thursday's change only applies to banks regulated by the Fed, and neither the FDIC nor the OCC have shown any inclination to make a change to date.

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