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Dealers, Issuers: Fed Proposal Too Strict on Munis, Would Hurt Market.

WASHINGTON – The Federal Reserve's proposed rule changes are so restrictive that they would either substantially reduce or exclude municipal securities from being considered high-quality liquid assets in banks' liquidity coverage ratios and would hurt the municipal market, dealer groups and issuers are warning.

The Fed proposed modifying its Liquidity Risk Measurement Standards in May to allow some municipal securities to be considered as HQLA. It proposed the changes after muni market participants complained about the rules jointly adopted by the Fed, the Office of the Comptroller of the Currency, and the Federal Deposit Insurance Corporation in September 2014, that exclude munis from HQLA consideration because of concerns they are not liquid or easily marketable.

While the dealer groups and issuers sent the Fed comments letters praising its efforts to try to include some munis as HQLA, they said the proposed conditions for doing so are so strict that they are unhelpful and unworkable in some cases.

The limitations on the types of bonds allowed and the amount of holdings of such bonds the banks could have "negates the ability of an institution to use municipal bonds to comply with the liquidity coverage ratio," Mike Nicholas, the chief executive office of Bond Dealers of America, told the Fed. The dealers and issuers also said the Fed's proposed changes would be of very limited use because the OCC and FDIC have not budged from the rules established in September, which exclude all munis as HQLA. All but two of nine of the largest financial institutions that must comply with the liquidity rules are primarily regulated by the OCC, according to Fed data.

"We are seriously concerned that this amendment was not also jointly proposed by the OCC and FDIC," the Securities and Industry Financial Markets said in a letter signed by Michael Decker, a managing director and co-head of munis for the group.

The liquidity rules are designed to help the nation's largest financial institutions better cope during times of financial stress by requiring them to meet liquidity coverage ratios. An LCR is defined as the ratio of HQLA to total net cash outflows. Assets are considered HQLA if they can be easily and quickly converted to cash with little or no loss of value during a period of liquidity stress.

Under the modifications to the rules the Fed proposed in May, munis would only be eligible as HQLA if they are, at a minimum, uninsured investment grade general obligation bonds. Munis also would not qualify as HQLA if they exceed: 25% of an individual CUSIP; an amount equal to two times the average daily trading volume of an issuer's bonds over the previous four quarters; and 5% of a bank's total stock of HQLA. The "restrictions and limitations are unfounded" and "will discourage bank investment in the U.S. municipal securities market, thereby negatively affecting the ability of state and local governments to finance vital investment in domestic infrastructure," Decker said.

"The effect of these limitations on the inclusion of municipal securities within the definition of HQLAs will be to increase borrowing costs for state and local governments, including [New York

City], because banks will be disincentivized to purchase and hold municipal securities," said Alan Anders, the deputy director for finance in New York City's Office of Management and Budget.

The dealer groups and issuer particularly s took issue with the exclusion of revenue bonds from consideration as HQLA, saying many revenue bonds are backed by revenues from a wide variety of systems or assets. They urged the Fed to include certain investment grade revenue bonds as HQLA.

The failure to include revenue bonds as HQLA is "based on a misconception" and "is unnecessarily excluding many of the highest quality and most liquid and actively traded municipal securities from HQLA consideration permanently," said Nicholas.

Decker and Anders both rejected the idea that a revenue bond is less secure because it is not backed by the full faith and credit of the issuer.

"A general obligation bond can be a very secure form of financing, but it is not inherently or necessarily more secure than a revenue bond," Decker wrote. Anders added it would be "preferable and more accurate" to focus on the investment grade of a bond instead of whether it is a GO or revenue security.

BDA and SIFMA also pushed the Fed to allow insured bonds to qualify as HQLA as long as they would be investment grade if uninsured.

Decker argued the bond issuer is still obligated for all debt service payments even if the bonds are insured and that investors generally look at the ability of the issuer to meet its obligations instead of the insurance "wrapping" the bonds.

"Insurance never makes bonds less liquid … but the proposal seems to reflect that as true," Decker wrote.

Build America Mutual Assurance Company CEO Sean McCarthy also urged insured bonds be considered as HQLA, saying this would "advance the [Fed's] goals for improving the security and stability of the U.S. financial system."

The dealers and issuers pushed the Fed to eliminate its CUSIP and trading volume restrictions. Nicholas said the CUSIP cap would "unreasonably restrict" HQLA status for muni bonds because, unlike corporate bonds, many large bond issues are structured with a mix of serial and term bonds with different maturities that result in multiple CUSIPS. The cap would greatly limit the amount of an overall muni offering that a bank could hold, he said.

"BDA urges the [Fed] to remove the CUSIP restriction and allow financial institutions to include investment grade municipal securities set aside as HQLA in quantities that the regulated institution believes can be sold within a 30 day period," Nicholas wrote.

SIFMA took a similar approach, saying a better way to manage the concentration of risks in bonds would be to eliminate the 25% rule and apply the "sophisticated" systems banks already have that take into account factors like the issuer, the credit quality, and the maturity.

The commenters said the trading volume restriction proposal is not only flawed but also unworkable. BDA said it is unaware of any system or source that would provide access to the kind of trading information needed to comply with the restriction. The group also said the provision is "backwards-looking" from a market perspective because it would ignore times of increased trading volume when opportunistic buyers buy bonds as yields rise.

Decker said investments that may be highly sought after in a stressed market may trade “relatively infrequently because they are held by institutional investors as buy-and-hold investments.” He added that volumes can appear low when holders do not want to sell and expose themselves to taxable gains and that “there is no indication that historic trading volume, even as recent as the preceding four quarters, is an indication of liquidity.”

The dealer groups and issuers also challenged, and urged repeal of, the Fed’s proposed stipulation that municipal bonds only make up 5% of the overall HQLA holdings.

The established rule, which doesn’t take effect until Jan. 1, 2017, already limits the overall holdings of level 2A and 2B HQLA to 40% and 15%, respectively.

Anders said there is “no basis for imposing additional limitation” on top of those “imposed on other HQLAs at the same level as municipal securities.”

In addition, some of the commenters pushed for a reclassification of certain munis as level 2A, saying they are more secure than the level 2B-rated corporate bonds and thus deserve a higher rating.

Decker said it is wrong that Europe treats munis at a higher HQLA level, 2A, than the U.S. He said the discrepancy “creates an awkward situation where U.S.-specific securities are treated worse domestically than internationally.”

THE BOND BUYER

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