# Bond Case Briefs

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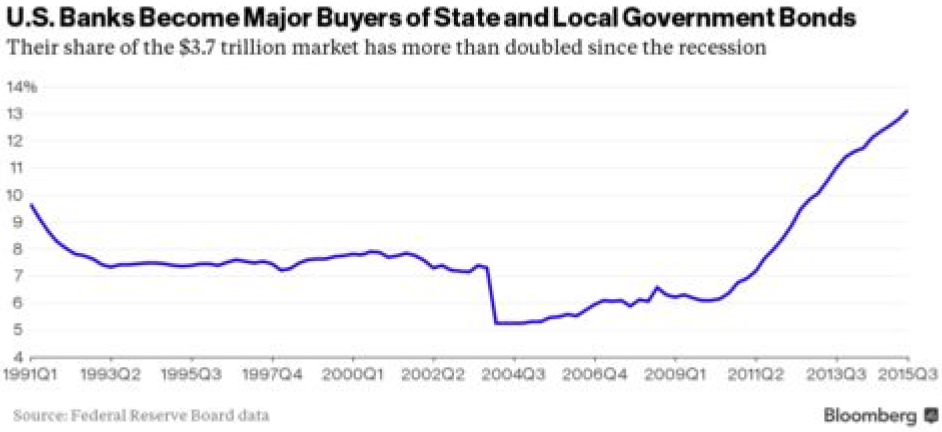
## Main Street's Muni-Market Fight With Fed Gains Force in Congress.

Main Street and Wall Street are fighting the U.S. Federal Reserve over municipal bonds — and they're gaining ground.

Local-government officials and securities-industry lobbyists turned to Congress after regulators including the Fed adopted rules that would restrict or bar banks from including munis among the assets they need to hold to weather a financial shock. The effort has borne rare fruit: Overwhelming bipartisan support in Congress, where a bill forcing regulators to classify munis as liquid assets passed a key House committee by 56-1 last month. Analysts say it may win final approval next year.

"Congress seems to be energized to actually pass the legislation," said Bank of America Merrill Lynch's Philip Fischer, the head of municipal research in New York. "From the Republican side it looks like a clear overreach on the regulatory front, and from the Democratic side it appears as though it will cost the states potentially an unnecessary amount of money."

The regulations threaten to curb demand from banks in the $3.7 trillion muni market, where they've increased their holdings by more than any other buyers since the recession ended in 2009. State and local officials said the new rules, if not changed, will saddle them with higher borrowing costs by eliminating incentives banks have to purchase their bonds.




The regulations from the Fed, the Office of the Comptroller of the Currency and the Federal Deposit Insurance Corp. are part of the effort to avoid a repeat of the 2008 credit crisis, when banks ran short of cash and had to liquidate assets at fire-sale prices as markets seized up. They require lenders to hold enough assets deemed high-quality — such as Treasuries, well-rated corporate bonds and foreign-government debt — to endure 30 days of significant stress. Munis were left out because they trade less frequently than other securities.

Indiana Republican Representative Luke Messer, co-sponsor with New York Democrat Carolyn Maloney of the bill that cleared the House Financial Services committee on Nov. 4, said he's aiming to get the legislation to the floor for a full-vote early next year. In the Senate, New York Democrat Chuck Schumer, a member of banking committee, is among those who've endorsed allowing banks to use munis to meet the high-quality liquid asset rules, known by the acronym HQLA.

"U.S. municipal bonds are considered some of the safest investments in the world," said Messer, whose bill would treat munis the same as debt issued by government-sponsored enterprises including Fannie Mae. "By excluding all these municipal securities from HQLA eligibility, financial institutions are discouraged from holding municipal debt."

Eric Kollig, a Fed spokesman, Stephanie Collins, a spokeswoman for OCC, and Barbara Hagenbaugh, a spokeswoman for the FDIC, declined to comment.

**Fed Proposal**

State and local officials who lobbied the regulators following the approval of a 2014 rule that barred municipal debt from HQLA got some relief in May. In a split from the OCC and FDIC, the Fed proposed allowing certain investment-grade, uninsured general-obligation bonds to be counted toward as much as 5 percent of a bank's liquid assets. Barclays Plc estimated that no more than about $350 billion of munis would be acceptable under that rule, less than one-tenth of the market.

While public officials and their lobbyists acknowledge that the Fed has been more responsive, they said it wasn't sufficient. For example, it left out municipal bonds backed by dedicated tax revenue, which in many cases are more secure than general obligation debt.

Moreover, the Fed only oversees just two banks with more than $250 billion in assets that are subject to the liquidity rules, said Dustin McDonald, federal liaison for the Government Finance Officers Association.

**Big Buyers**

The regulations have so far done little to stop banks from buying state and local securities. Their holdings have more than doubled since June 2009 to $488 billion by the end of September, according to Fed data. That's left them with more than 13 percent of the outstanding debt, the most since 1989.

Banks typically don't buy munis to satisfy liquidity needs, said Matt Fabian, a partner at Concord, Massachusetts-based Municipal Market Analytics. Even so, the change would allow the companies to use state and local holdings to meet the new requirements, instead of shifting money elsewhere.

"It allows their muni position to work a little harder for the bank," said Fabian.

Groups representing state treasurers, budget officers and mayors argue that munis have low default rates and limited price swings, even during times of turmoil. An average of 0.02 percent of rated munis defaulted from 1970 to 2014, compared with 1.66 percent for corporate bonds, according to Moody's Investors Service.

**California Loses Out**

The state and local officials also point to inconsistencies: For example, securities issued by foreign governments are deemed more liquid than those from states such as Washington and California. The Securities Industry and Financial Markets Association, which represents Wall Street firms, has also lobbied against the exclusion of munis.

“It just doesn’t make any sense,” said Washington Treasurer Jim McIntire, who will take over next year as president of the National Association of State Treasurers. “Some of our bonds are much more liquid than a high quality AAA corporate like Microsoft.”

Muni prices usually closely track Treasuries, though the relationship can be upended during financial stress. In late 2008, following the bankruptcy of Lehman Brothers Holdings Inc., some muni prices tumbled as investors plowed into the safest federal-government debt.

McIntire, the Washington treasurer, said the legislation shouldn’t be difficult to pass in an election year.
“I don’t like to have to see legislators brought into the regulatory environment,” McIntire said. “If they’re going to issue regulations affecting us they should know something about the market.”

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