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Washington Battles Over Munis: Safe or Hard to Sell?

WASHINGTON — Many investors flock to municipal bonds for security. But some federal regulators trying to shore up the banking system aren't convinced the bonds would be easy to sell in a crisis.

The contrast has led to an unusual showdown, with Wall Street, Congress and municipal officials—all of whom are vested in a robust muni-bond market—challenging bank regulators' skepticism toward municipal debt.

At issue are new rules aimed at ensuring banks can raise enough cash during a financial-market meltdown to fund their operations for 30 days. The requirements mean banks have to hold more cash or securities that are easily sellable.

The Federal Reserve and two other bank regulators decided debt issued by states and localities didn't make the cut, when they crafted the rules in 2014. Now, Republicans and Democrats alike are advancing legislation to mandate regulators include municipal securities among the rule's definition of "high quality liquid assets," a category that currently includes cash, Treasury bonds and debt sold by government-sponsored enterprises like Fannie Mae.

The House passed such a bill last month. Senators, led by Sen. Mike Rounds (R., S.D.), Charles Schumer (D., N.Y.) and Mark Warner (D., Va.), are working on related legislation.

"We shouldn't make it more expensive for local governments to finance essential investments such as school and road construction by making it harder to access capital markets," Mr. Warner said in a statement.

He added the Senate bill's provisions would be tailored to "appropriately address financial stability concerns while preserving states and municipalities' access to bond markets."

Regulators don't think it is the place of Congress to second guess how they size up securities. Fed Chairwoman Janet Yellen, at a congressional hearing Feb. 11, said legislation would "interfere with our supervisory judgments."

Big banks such as Citigroup Inc. and Wells Fargo & Co. have sprung into action in lobbying Congress, along with municipal leaders who fret the rules will diminish bank bond-buying which could raise borrowing costs on infrastructure projects.

Banks underwrite muni bonds, buy them as investments and sell them to clients. The lenders have played an increasingly central role in the thinly-traded, $3.7 trillion market.

Banks are the biggest buyers of municipal bonds, according to Matt Fabian of Municipal Market Analytics Inc., a research firm.

Since 2013, banks have collectively purchased about $11 billion of the bonds each quarter and now own about $500 billion of the securities, making them the third-largest holders after individuals and mutual funds, he said.

The Fed last summer tried to defuse the criticism by offering a concession, saying it would reconsider its earlier version of the rules, and include some investment-grade municipal debt.

Municipal officials retort that those adjustments would cover only a narrow sliver of the securities, and those that do qualify would still receive unfavorable treatment compared with debt issued by government-backed mortgage giants and Treasury debt.

Municipal officials also say legislation is necessary because the two other regulators involved—the Office of the Comptroller of the Currency and the Federal Deposit Insurance Corp.—have yet to make any changes themselves.

Officials at the OCC remain dismissive of including the muni bonds in the rule, according to people familiar with their thinking, while the FDIC is waiting until the rules go into effect next year before considering amending its version.

Some economists also say the legislation would weaken the bank-funding rule, by allowing banks to rely on thinly-traded securities that they worry won't be easy to sell in another crisis.

While default rates on municipal bonds are tiny, the majority of the debt doesn't trade much, according to a Securities and Exchange Commission report from 2004. It found that less than 1% of municipal securities traded more than one hundred times in a roughly 10-month period. Seventy percent of the bonds didn't trade at all.

Economists note that some of the most-traded municipal debt in recent months are securities issued by Puerto Rican borrowers. The island's unsustainable habit of running chronic deficits has left it with some $72 billion of debt it now says it can't repay—not what most regulators would consider a "high quality" asset.

"The Fed in its proposal went too far in allowing risky securities to be treated as safe, and the legislation would go yet further," said Phillip Swagel, a University of Maryland economist who served in the George W. Bush Treasury. He said Congress's moves illustrate the danger of letting political forces influence safety-and-soundness regulations. And he thinks the Fed should have stood its ground.

James McIntire, treasurer for the state of Washington, rejects arguments munis aren't safe or easily traded. Mr. McIntire, president of the National Association of State Treasurers, cited analysis conducted with the state's financial adviser showing Washington's general obligation debt is at least as liquid as top-rated corporate bonds, which are included in the rules.

Regulators have ignored or dismissed this data, which means Congress must act, he said.

"We really have no alternative," he said, but "to resort to some sort of legislative intervention."

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