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Fed Rule Allows Banks to Use Munis as Part of Crisis Buffer.

U.S. cities and states won a partial victory Friday as the Federal Reserve gave final approval to a rule that will let banks include some municipal bonds in stockpiles of easy-to-sell assets meant to serve as a buffer against a financial crisis.

The decision to allow certain investment-grade bonds to be used in meeting liquidity requirements expands the Fed's version of a multiagency rule adopted in 2014, which calls for the biggest banks to hold enough high-quality liquid assets to survive a 30-day period of financial stress. The central bank revisited the idea of including munis after local governments waged a lobbying campaign for the change.

Bank regulators adopted the minimum-liquidity demand as a response to deficiencies highlighted during the 2008 credit crisis, when financial firms were stuck with assets they couldn't sell. The Fed, which announced completion of its revised rule in a statement, said it relied on an analysis that suggested certain munis should qualify because they have liquidity characteristics similar to assets such as corporate debt securities.

Other Regulators

What makes the victory only a partial one for issuers is the fact that a substantial portion of muni activity occurs in the bank units overseen by the Office of the Comptroller of the Currency. So far, neither the OCC nor the Federal Deposit Insurance Corp. has matched the Fed's confidence in the liquidity of the muni market.

"Fundamentally, the rule now makes sense," said Philip Fischer, who heads muni research for Bank of America Corp.'s Merrill Lynch unit. He said the muni market is "extremely high-quality" and that he expects the Fed's action to spur the other regulators to reconsider their positions.

Bryan Hubbard, an OCC spokesman, and Barbara Hagenbaugh, an FDIC spokeswoman, declined to comment.

The Fed's change, which takes effect July 1, applies to Fed-supervised lenders subject to the liquidity coverage ratio requirement. Those bank holding companies will be able to include a limited slice of munis among the Treasuries, highly-rated corporate bonds and foreign-government debt they already count against their liquidity demands.

'Proven Record'

The Fed will allow munis that "have a proven record as a reliable source of liquidity in repurchase or sales markets during a period of significant stress," according to the text of the rule. Such munis can be part of a second tier of liquid assets, which can total no more than 40 percent of the overall liquidity buffer.

The city and state lobbying also targeted lawmakers, and legislation to allow munis in the liquidity rule made some progress through a House committee in 2015.

Dustin McDonald, director of the Government Finance Officers Association, said the Fed’s allowance isn’t wide enough, and that “local government association partners will continue efforts to secure enactment of legislation to truly address the short-sightedness of the rule.”

The phase-in period for the liquidity rule started in 2015 and it is set to go into full effect on Jan. 1. It’s also expected to be joined this year by a separate but related liquidity demand — known as the net stable funding ratio — that considers a longer stress horizon.

Even under the pressure of rules and warnings from municipal lobbyists, banks have increased their muni holdings, which rose to almost $500 billion by the end of 2015, more than twice the levels the industry held at the end of the financial crisis.

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