Bond Case Briefs

Municipal Finance Law Since 1971

Federal Reserve Issues Final Rule on Banks' Municipal Bond Holdings.

In a showdown over who should decide how safe, or sellable, municipal bonds would be in a crisis, the Federal Reserve tilted its position in response to critics, but still left them unsatisfied.

Federal regulators opened the door for banks to count municipal bonds as liquid assets, including those from smaller municipalities.

The Fed adopted a framework that partly responded to industry concerns about a postcrisis rule that could have made it harder for local governments to raise money. But the Fed's action Friday didn't give critics what they wanted most: a definition deeming the bonds safer than corporate debt.

Lawmakers said they welcomed the changes but would continue to pursue legislation that would address the discrepancy. "The Federal Reserve's new rule is a step in the right direction," Sen. Mike Rounds (R., S.D.), a member of the Banking Committee, said in a statement.

The issue had led to an unusual showdown, with Wall Street, Congress and municipal officials challenging bank regulators' skepticism toward municipal debt.

The dispute stems from a 2014 rule 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 salable. The Fed and two other bank regulators had originally decided debt issued by states and localities didn't make the cut. In 2015, the Fed proposed amendments to allow some municipal bonds to qualify, but it met with some criticism for not going far enough.

Under Friday's final rule, banks can count investment-grade state and municipal securities as "high-quality liquid assets" up to certain levels if the securities meet the same criteria as corporate bonds.

The Fed made several changes from last year's proposal. For example, it said bonds that are insured can also qualify as long as they meet criteria that apply to municipal bonds without insurance. The earlier proposal had rejected all insured bonds.

Around 6.7% of the $379 billion in municipal bonds issued in 2015 were insured, according to municipal bond insurer Build America Mutual. That number rises to 15% when looking at the number of transactions, since many small and midsize issuers tend to use insurance more frequently, said spokesman Michael Stanton, who called the final rule a "fair and reasonable outcome."

In another shift, banks can now hold larger portions of certain small issuances.

The ultimate impact of the rule is likely to be somewhat limited because the two other regulators involved—the Office of the Comptroller of the Currency and the Federal Deposit Insurance Corp.—haven't made any changes themselves and don't allow the institutions they regulate to count municipal bonds toward their liquidity buffers. The Fed regulates bank holding companies, while the banks themselves are overseen by either the OCC or the FDIC depending on whether they have national or state charters.

When adopting the final rule in 2014, FDIC Chairman Martin Gruenberg said his agency believed banks generally held municipal securities as longer-term investments, and not for liquidity purposes.

A bipartisan group of lawmakers has advanced legislation to mandate that all three regulators include municipal securities into a safer category that includes debt sold by government-sponsored enterprises like Fannie Mae. Several lawmakers said Friday that they would continue to pursue the legislation.

"While I'm glad to see the Federal Reserve making some progress on this issue, the proposal does not go far enough. Unfortunately, it will continue to discourage investment in our local communities," said Rep. Luke Messer (R., Ind.).

The Securities Industry and Financial Markets Association trade group representing banks, broker-dealers and asset managers warned the rule, even with the changes, would likely raise borrowing costs for state and local governments. That is because they think banks will still buy fewer bonds, leading states and localities to pay higher interest rates to attract investors.

But Justin Hoogendoorn, head of fixed-income strategy and analytics at broker-dealer Piper Jaffray, said the decision to count more municipal bonds as liquid assets underscores the importance of the municipal-bond market.

"The main point is that the regulators are viewing these securities as an important and acceptable component of the balance sheet," he said.

THE WALL STREET JOURNAL

By ARUNA VISWANATHA and HEATHER GILLERS

Updated April 1, 2016 5:49 p.m. ET

Write to Aruna Viswanatha at Aruna.Viswanatha@wsj.com