# Bond Case Briefs

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## Municipal Bond Market Faces New Pressure.

Selling government bonds could become more difficult during the next credit crunch, thanks to a new federal rule outlining the kind of liquid assets that banks must hold in case of an emergency.

The rule, issued Friday, greatly limits the kinds of municipal bonds that qualify in a big bank's investment portfolio as "highly liquid" — in other words, assets that can be sold quickly for cash. The new regulation was issued by the U.S. Federal Reserve, and is a modification of its previous proposal with the Office of the Comptroller of the Currency and the Federal Deposit Insurance Corporation.

There's no immediate negative effect for government issuers. But if and when the next credit crunch hits, it could become more expensive for states and localities to issue debt. That's because if fewer bonds qualify as highly liquid, there would be less market demand for them. And lower demand would mean higher interest rates for governments.

"As long as munis continue to have a good risk-adjusted return for banks, they'll continue to invest," said Chris Mauro, who leads RBC Capital Markets' municipal strategy team. "It's really when you're entering a liquidity crisis and banks are running up against their limit: Unfortunately they may liquidate some of their municipal [bonds] as a result. And they'll use those proceeds to buy highly liquid assets."

Such assets are designated as "high-quality liquid assets," or HQLA. Easily sellable securities like Treasuries or highly rated corporate bonds were included in the rule when the draft was first released in 2013. Bonds issued by state and local governments were not.

Ever since then, public finance officials and other stakeholders in the municipal market have been lobbying hard to make the case for municipal bonds. They seemed to make some headway in February, when the U.S. House of Representatives passed a bill that would have forced banking regulators to classify investment-grade municipal bonds as highly liquid assets. But the Senate has not introduced its own version of the bill. Now that the final rule is out and will go into effect in July, it's unclear whether the Senate's companion bill would mirror the House or be more in line with the Fed.

Under the new rule, to earn the HQLA designation, a municipal security has to meet several requirements. It must be a General Obligation bond (backed by the full faith and credit of a state or municipality), be investment grade and have been issued by an entity "whose obligations have a proven track record as a reliable source of liquidity during periods of significant stress."

The wording is vague, said Mauro. So it will be up to banks to flesh out which municipal assets they believe qualify as highly liquid. Reason suggests, he added, that large governments that issue debt regularly would likely be easily marketable in a credit crunch because investors are familiar with them.

Still, it's a bit of a guessing game. Much like in a housing crisis, one would assume that the nicest homes in the best neighborhoods would still sell quickly while the more average homes sit on the market for months. But a homeowner is never sure until that time comes.

“At this point, no one really knows how [banks] are supposed to prove if there is a ready and liquid market for these securities,” said Mauro. “It’s a gray area.”

Groups that advocate for the municipal market are speaking out in frustration at the final rule’s limitations. In particular, some were upset that revenue bonds — which are paid back via a dedicated government revenue stream — were not included as an HQLA.

Additionally, banks can’t allocate more than 5 percent of their HQLA portfolio to municipal securities. That’s far off from the 40 percent allocation in the bill passed by the U.S. House.

Groups have said they will continue to work with lawmakers on Capitol Hill to loosen up the designation.

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