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Big Banks Get a Big Win in Senate Rollback Bill.

Nation's largest banks would gain incentive to buy more municipal bonds in legislation targeting smaller banks

WASHINGTON—Bipartisan legislation expected to clear the Senate as early as this week has just one provision that is set to directly benefit the nation's megabanks: a section aimed at making it easier for them to buy state and local bonds.

The provision, championed by Citigroup Inc. and other large banks, would ease a new rule aimed at ensuring banks can raise enough cash during a financial-market meltdown to fund their operations for 30 days, requiring them to hold more cash or securities that are easily salable.

Under federal banking rules approved in 2014, those "high quality liquid assets" included cash, Treasury bonds and corporate debt—but not municipal debt. Banks historically like to hold municipal bonds because of their safety and tax advantages.

The Senate on Tuesday voted 67-32 to formally begin debate on the bill, which primarily benefits small and medium-size banks, easily reaching the 60 votes needed and signaling that the measure has enough support from Democrats to pass by a comfortable margin. The legislation was backed by 16 Democrats and one independent, Maine Sen. Angus King, bucking Massachusetts Sen. Elizabeth Warren and 31 other Democrats who opposed the procedural vote.

Including the municipal-bond provision in the deregulatory bill was a priority for the nation's biggest banks that buy a lot of municipal securities as investments. A Citi lobbyist recently told a Senate staffer that the firm would be pleased if easing the treatment of municipal debt under the bank-funding rule was the one thing it could accomplish during the current Congress, according to a person familiar with the conversation.

State and local officials have praised the move, saying their securities could suffer if banks begin to shun them.

A Citi spokesman said the bond provision "is supported by a wide array of groups focused on helping cities and states address critical infrastructure needs."

While the provision is a victory for Citi, the biggest U.S. banks haven't lobbied extensively on the Senate bill, according to congressional aides. Big firms have spent billions to comply with a gamut of postcrisis rules and generally aren't eager to tear them down.

Analysts have said changing the rule for municipal products would be a mistake because it would erode the core of a bank-safety rule put in place after the 2010 Dodd-Frank law. While municipal securities have relatively low default rates, they are traded thinly and shouldn't count as liquid assets, critics say.

"It's an outrageously bad idea," said Phillip Swagel, a professor at the University of Maryland who served in the George W. Bush Treasury, characterizing the provision as an implicit federal guarantee of the municipal market. In the next crisis, banks will have trouble selling their municipal securities, freezing up the market for them and requiring the government to step in to backstop it, he predicted.

While lawmakers agreed to include the municipal debt measure, they rebuffed Citi and JPMorgan Chase & Co. efforts to water down a separate postcrisis capital requirement known as the supplementary leverage ratio. That regulation effectively restricts banks from making too many loans without adding new capital, forcing firms to maintain a proportion of capital to fund their assets—including loans, investments and even the collateral clients post on derivatives transactions.

The legislation includes a provision to diminish the leverage ratio in a way that lawmakers say would only benefit financial institutions primarily engaged in "custody services," in which they hold assets on behalf of other banks. Citi and JPMorgan, global banks that don't fit the definition but still offer custody services, have argued it is unfair to carve out certain banks from the provision and not others.

"As Congress has sought to make a common sense change to the way capital rules treat custody assets, we have asked that they apply that change to all custody banks to maintain a level playing field in this important business," a Citi spokesman said.

Senate aides said lawmakers crafted a delicate compromise that can pass the chamber and don't want to broaden the bill with more provisions helping big banks—which became a target of criticism during the crisis—and risk having the bill fail. "That is not happening," said one Senate Democratic aide.

Federal Reserve Chairman Jerome Powell said on Feb. 27 that the Fed would prefer that Congress allow regulators to rewrite the leverage ratio rule. Instead, the bill directs regulators to exclude certain assets from the calculation of the leverage ratio for custody banks such as Bank of New York Mellon Corp. and State Street Corp.

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—Ryan Tracy contributed to this article.