# Bond Case Briefs

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## Regulatory Spillover: Evidence from Classifying Municipal Bonds as High-Quality Liquid Assets

In the aftermath of the 2008-2009 financial crisis, the Basel Committee on Banking Supervision (BCBS) strengthened banks' liquidity regulation by requiring banks to maintain a minimum liquidity coverage ratio (LCR). This ratio is defined as high-quality liquid assets (HQLA) divided by estimated total net cash outflows during a 30-day stress period. Whether municipal bonds should be classified as HQLA in computing this ratio and the resulting economic consequences are subject to intense debate. Issuers of municipal bonds contend that municipal bonds should be classified as HQLA based upon their safety and liquidity profiles. In contrast, the U.S. banking regulators questioned both the liquidity of these bonds and the claim that municipalities would be affected and excluded municipal bonds from HQLA in the final rule issued in 2014. However, less than a year later, in an abrupt reversal, the Federal Reserve Board (FRB) unilaterally decided to include general obligation municipal bonds in the measurement of HQLA while continuing to exclude revenue municipal bonds. Exploiting this policy reversal, Jacob Ott of the University of Minnesota examines two potential spillover effects of the classification of general obligation municipal bonds as HQLA: (1) if there is a change in the yield spread of general obligation bonds relative to revenue bonds; and (2) if municipalities change their pattern of issuance of general obligation bonds relative to revenue bonds.

Ott finds that changing the measurements used in bank liquidity management can have spillover effects, specifically that classifying a general obligation municipal bond as a high-quality liquid asset in the regulatory accounting for the liquidity coverage ratio has a spillover effect by influencing municipal market pricing and behavior. In addition, the reduction in financing costs of general obligation bonds appears to influence municipalities' issuance decisions. This effect is magnified in the cross section of highly rated municipalities. Finally, Ott finds some indirect evidence for the proposed mechanism: a change in banks' investment behavior.

This paper contributes to several veins of literature, but also has important policy implications. The effects this paper discusses are the result of changing municipal bonds to Level 2B assets. Many different entities (e.g., banks, politicians, trade groups, etc.) have requested Level 2A treatment. It may be the case that the results of this paper would be strengthened in magnitude if this change was made. For example, municipalities could potentially be able to borrow at even lower rates under Level 2A treatment. The lack of Level 2A treatment may put U.S. domiciled municipalities at a disadvantage in maintaining and improving infrastructure relative to municipalities in other countries who do treat municipal bonds as Level 2A in their liquidity management regulations. However, it is important to note that this study does not examine if classifying general obligation bonds as high-quality liquid assets is an optimal decision for the purposes of liquidity management.

[Read the full paper here»]

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September 21, 2020