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Community Finance Brief

International Banking Rules Impact Local Borrowing Costs

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If history is to repeat itself, pending regulations will curb bank support for state and local government with the new phase of Basel significantly increasing banks' capital requirements above already historically high levels with an additional focus on regional banks - a major structural component for community finance in the U.S. Further, it took legislative action to protect public finance securities and whether or not the regulators will carve out municipal bonds once again remains unclear. This would have a notable impact on the marketplace.

In the aftermath of the 2008 financial crisis financial regulators, around the world created a new set of rules to mitigate against seeing such upheaval as financial markets saw 15-years ago. Basel III, named for the Basel Committee on Banking Supervision, is the third set of rules designed to prevent bank failures. This third round actually began in 2010 and while phases of implementation began in 2016, we are now at the so-called (and ominous) "Basel End Game" which is to be put into place in totality by the summer of 2025 and enacted by 2028.

If there is one common conversation amongst bond traders, portfolio managers, underwriters and bankers right now that isn't about where the Treasury10-year bond is headed - it is about Basel Endgame. While it does not make much noise in terms of national headlines, it will impact communities and state and local governments in a a few ways that merits a frank discussion about what it is and what it means for community finance.

A BRIEF HISTORY OF "HIGH QUALITY LIQUID ASSETS"

Simply put, banks hold assets against deposits and when deposits are pulled out of the banks they need to liquidate

Quick Takes

As of June 30, 2023 there were 13 banks in the U.S. with assets of $250 billion or more and 44 banks with $100 billion or more.
– Federal Reserve

Banks own 13.5% of all outstanding municipal bonds as of 2Q2023 and have held at least one-tenth of all muni bonds in the last decade, which makes them an important demand element of the marketplace
– Federal Reserve

Broker-dealers that provide liquidity have never recovered from the 2008 crisis holding less than half the amount of bonds at that time then they do today.
– Federal Reserve

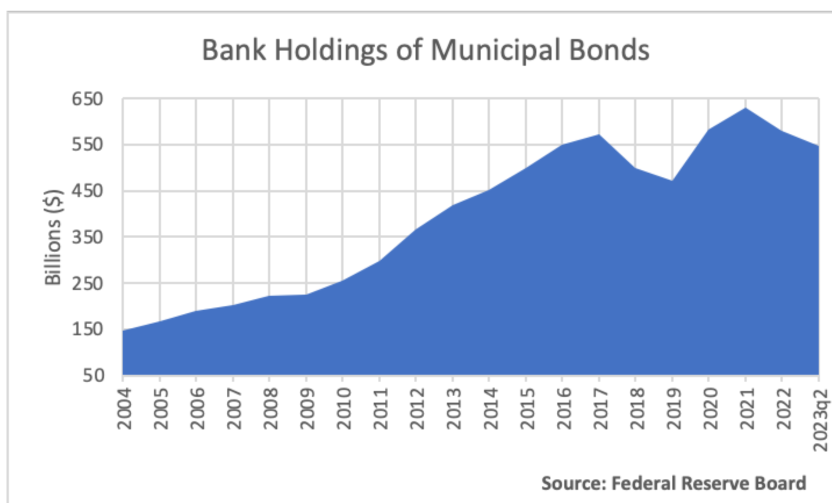
A non-HQLA designation increased borrowing costs for state and local governments as much as 15 basis points when reviewing a brief implementation in the 2017 to 2018 time period
– Brookings Institute white paper

investments to make customers whole. Basel III rules want to ensure that banking institutions are being prudent in how they deploy their capital so as to be able to liquidate appropriately if needed.

When it comes to community finance, the ability of banks to own and trade municipal bonds on their balance sheets and make local investments are impacted by Basel III. Municipal bonds are not qualified in the highest tier of so-called high-quality liquid assets and this impacts on state and local borrowing costs.

At the end of 2014, three of the largest U.S. bank regulators adopted new liquidity coverage ratios (LCR) as part of the process of complying with the international Basel III agreements. They basically looked at all the different assets that banks hold and classified them into different buckets of perceived liquidity - or the ability of a bank to liquidate those assets into cash during a period of market volatility. In the initial ruling, municipal bonds were not considered part of the high quality liquid asset (HQLA) hierarchy and as a result banks would be penalized to a certain extent for holding municipal bonds and would have to apply a large haircut to hold the bonds on their balance sheets - thus discouraging owning and trading these bonds.

The original Basel III applied only to U.S. banks with at least $250 billion in total assets or consolidated on-balance sheet foreign exposure of at least $10 billion (this becomes important when considering the recent Silicon Valley Bank failure as it was below this threshold - **see quote**, right). In this process,



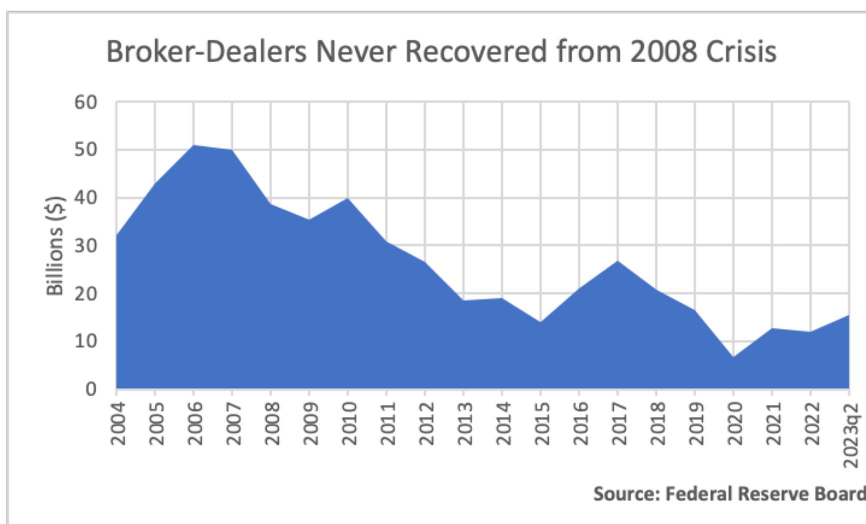
"...it is worth noting that although Silicon Valley Bank's (SVB) failure was caused by a liquidity run, the loss of market confidence that precipitated the run was prompted by the sale of assets at a substantial loss that raised questions about the capital adequacy of the bank," stated FDIC Chairman **Martin Greunberg** at the Peterson Institute for International Economics. "Had the unrealized losses on available for sale securities on the balance sheet of SVB, that were realized once sold, been required to be recognized in capital, as the Basel III framework would do, it might have averted the loss of market confidence and the liquidity run. That is because there would have been more capital held against these assets"

corporate bonds, U.S. Treasuries and foreign sovereign debt were included in the rules HQLA list. Level 1 assets are viewed as the most liquid and least risky and then Level 2a and 2b are considered less liquid but still readily marketing. The lower the scale, the more an asset is penalized for owning them and so on.

Initially, municipal bonds were not considered HQLA - this was and is a big deal. Aside from penalizing banks from holding municipal bonds - the marketing of the security in general to investors would have been a challenge with the Federal Reserve, Office of Comptroller of the Currency and the Federal Deposit Insurance Corp. essentially telling the public that municipal bonds were illiquid and risky. After a back and forth that included breaking down the asset class by the type of security it was (GO versus revenue bonds) the Trump Administration passed a law in 2018 that made all investment-grade municipal bonds level 2B as HQLA. Not the highest liquid asset, but still high-quality.

HQLA AND THE MUNI MARKET

The initial rules were implemented in phases between 2016 and 2018 and, as noted in **the chart above,** bank ownership of municipal bonds declined even as the stringent rules were being implemented. With the new rules, banks paused their investments in municipal bonds and state and local governments lost an important demand element All else being equal, this was punitive for state and local governments selling securities at this time.



"I find that classifying a general obligation municipal bond as a high-quality liquid set in the regulatory accounting for liquidity coverage ratio has a spillover effect by influencing municipal market pricing and behavior," wrote **Jacob Ott** of the University of Minnesota in a Brookings Institute white paper. "First, I find that assigning the HQLA label to a municipal bond has an effect of between 4.5 and 5 basis points on the yield spread, an economically significant change in this market. This effect is closer to 15 basis points in the cross section of highly rated general obligation bonds, which are most likely to be affected ."

One study in particular attempted to quantify the penalty during this period. By reviewing trade and issuance data during the time period where general obligation bonds were considered HQLA and revenues bonds were not, PhD candidate Jacob Ott was able to determine a 5 basis points difference in pricing in favor of GOs that had HQLA status compared to revenue bonds that did not.

This may seem to be an esoteric way to look at the market - two credit types during a specific time period, but it was a moment in history where one could parse how just how important banks were to the cost of capital for state and local governments. When this rule was in place that favored GOs over revenue bonds - there was a clear pricing differential.

Another oft overlooked aspect of HQLA rules is the impact on banks acting in their capacity as broker-dealers. In this role, banks serve as liquidity providers and trading partners to maintain a steady flow of trades in the secondary market. Since 2008 broker-dealer support of the municipal bond market diminished to a level never since has it returned (the brief bump in 2009 and 2010 in **the chart, above,** was the result of the Build America Bond program). Market volatility has been the result of broker-dealers holding municipal bonds on their balance sheet and the new set of rules looks to maintain or grow that trend.

"More of the capital that would otherwise be used for productive economic purposes such as loans to businesses or helping manage risk through derivatives will have to sit idly at banks," **Bill Hulse**, a senior vice president at the U.S. Chamber of Commerce, wrote in a June blog post about the new banking rules.

BASEL ENDGAME & REGIONAL BANKS

This summer, the three U.S. bank regulators released a long-expected rule that would materially increase capital requirements that would be applicable to banking organizations with total assets of $100 billion or more. Prior to this, the HQLA discussion only impacted larger banks with $250 billion or more. This is important for the municipal bond market because regional banks play a much bigger role in the decentralized nature of community finance in the U.S. Banks with more than $100 billion in asset will need to include accumulated other comprehensive income in regulatory calculations starting in 2028. This means that banks with unrealized losses in their available-for-sale bond portfolios will not need hold capital against losses.

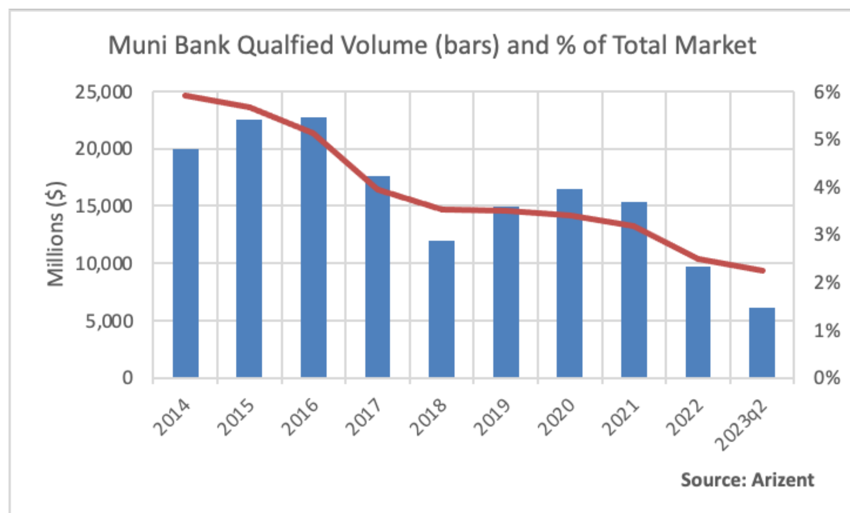
On top of this, and perhaps of the utmost importance, nowhere in the most recent literature does it describe how municipal bond holdings will be addressed. In the last go-around it took Congressional legislative actions to put municipal bonds in the HQLA category. It is not clear

is municipal bonds were get a carve out going forward. **This uncertainty is very problematic.**

These new capital requirements would more than triple the amount of banks covered under the new proposals. That these smaller banks, which have never had such strict capital requirements, comes at a particularly challenging period in the marketplace. Interest rates are near 15-year highs and the year-to-date has seen some of most volatility this century for interest rates. Inflation and broader economic concerns are already impacting small banks support of regional communities and overall this would likely minimize their capital commitments to the U.S. muni market. This will directly impact their role in regional negotiated underwritings, the smaller competitive marketplace where regional banks dominate and affect their engagement in direct loans. All this means borrowing costs for smaller, local governments will be affected at a time when they need their support most. Anecdotally, a state bond bank in the Midwest told **CSG** last week that they are seeing a record level of local governments coming to them for loans as regional banks have limited their engagement due to interest rate volatility.

UNDERSERVED COMMUNITIES AND BASEL RULES

The Community Reinvestment Act (CRA) is a federal law that requires banks to meet credit needs of their communities, including low- and moderate-income communities. Under Basel Endgame the argument has been made that the new regulatory regime will:



1) Reduce lending to low- and moderate-income communities (LMI) because the higher capital requirements for banks make it more expensive to lend to these communities;
2) Lead to bank consolidation and reduce the number of banks competing to lend to LMI communities
3) Have banks focus more on lending to large business and corporation as they are less risky borrowers than LMI.

This is the general argument of the status quo banking establishment and housing associations and it generally makes sense. That being said, smaller community banks and credit unions under this threshold are not impacted by these rules and it may simply reorganize a housing market that is more locally focused. **CSG** tends to favor the prior point of view.

The Urban Institute may have put it most directly, calling the new rules "ironic" in that the current Administration has put homeownership for minority populations on the top of its agenda while moving forward these these new capital requirements that they, and others, believe will hurt the process of promoting homeownership to those that historically have found it challenging.

On to bonds: bank-qualified municipal bonds are municipal bonds that are eligible to be held by banks as HQLA and used to meet their CRA obligations. For example, a bank may invest in a BQ muni bond that is issued by a municipality that has a large low- and moderate-income population. Under current rules, these investments can count toward CRA and HQLA. While BQ bonds only represent about 3.1% of the total market volume (**see chart, above**), the number of deals that represents is much higher as these deals are smaller and only up to $30 million in size (total volume in 2022 was $390 billion through 9,172 issuances - Arizent). In fact, the percentage of the BQ market of the entire marketplace has declined in the last decade as the market has declined with initial Basel rules limited bank engagement in the marketplace overall.

A FINAL THOUGHT

The rules are not final but expect the noise to increase as it we get closer to final rule and headline risk to increase as a result.

Recall that in the period between the last implementation of Basel III rules and now has seen one major liquidity event (Covid) in March of 2020 that required Federal Reserve intervention. The same regulatory body that at one point labeled municipal bonds as non-HQLA and then were forced back to the table by the industry to change that rule, had to create a liquidity facility to support the marketplace during the volatility in the spring of 2020.

Additionally, the failures of Silicon Valley Bank and Signature Bank are fresh in the minds of regulators. Each bank would have been subject to Basel Endgame. Perhaps not fresh in the public's mind is that when each bank sold their municipal bond portfolio after the failure, the sales generally went smoothly despite very difficult low-coupon, long-dated bond structures. The bonds were sold cheap, but there was a bid.