Regulatory Spillover: Evidence from Classifying Municipal Bonds as High-Quality Liquid Assets[1]

Jacob Ott, University of Minnesota

Discussant: Ivan Ivanov, Federal Reserve Board

07/08/2020

[1] The views expressed herein are those of the authors and do not necessarily reflect the views of the Federal Reserve Board or the Federal Reserve System.

Main Results/Conclusions

- The paper documents that classifying municipal bonds as high quality liquid assets (HQLA) is associated with:
  - Improved pricing from issuer perspective – municipal bond spreads decrease by approximately 5 basis points.
  - Consequently, issuers raise more financing in the form of HQLA-designated bonds.
- These results are consistent with:
  - Banks increasing demand for HQLA-designated assets, driving spreads down.
  - Issuers responding to the lower financing costs.
  - Real effects?

Comment 1: HQLA Designation and Bond Spreads

- Identification strategy is convincing and empirical work is carefully done:
  - The U.S. implementation of the Basel III LCR provisions designated municipal GO bonds as HQLA.
  - Compare bond pricing before the WSJ announcement of the rule to that after the proposed rule became public.
- The results imply a modest reduction in GO bond spreads after the HQLA designation.
  - It is unclear why the results are concentrated in rating categories AA- and better. Bank preference for ratings AA- or better?
  - The test sample accounts for a minor fraction of all traded municipal bonds. How generalizable are the results? Could you expand the event window?
  - The entropy-balanced regressions are a little difficult to interpret. Could you flexibly control for maturity and bond contract provisions, instead?

Comment 1: HQLA Designation and Bond Spreads

- The HQLA designation for municipal bonds was also updated in August of 2018 (FRB interim final rule) and May 2019 (final rule).
  - The updated designation also included certain rated municipal revenue bonds.
  - The author could conduct an event study/diff-in-diff around the introduction of the rule to test the robustness of the earlier results.
  - Designating revenue bonds may have larger impact on bond spreads (may include smaller issuers).

Comment 2: Issuer Real Effects

- Issuers raise more capital through GO bonds in 2016/2017 relative to 2013/2014.
  - Consistent with a story in which issuers capitalize on the lower spreads as a result of the HQLA rule.
  - Also consistent with better credit market conditions in the post-period (so it is easier to issue GO bonds).
  - The sample size is really small – 1922 issues. Are these results generalizable?
- Could you examine issuance activity in a narrow window (30, 60, 90 days) around the proposal of the HQLA rule in 2015?
  - If the results are driven by bank regulatory demand for HQLA assets you should see this around the proposal date of the legislation.

Effect Heterogeneity

- Who benefits the most from the HQLA designation?
  - Explore differences in terms of types of issuers (state, county, city, district governments).
  - Are there any negative externalities such as crowding out of capital in favor of larger issuers and at the expense of smaller issuers?
- How would the "bank-qualification" of municipal bond issuance affect the conclusions in the paper?
  - To the extent that the majority of the municipal bond demand from banks is for "bank-qualified" bonds, should we still expect the HQLA rule to affect secondary market spreads?
  - You could potentially beef up your story by showing most of the increase in Table 11 comes from HFS bonds.