Federal Reserve further expands access to Municipal Liquidity Facility

By Corey Runkel

Original post here.

On June 3, the Federal Reserve Board of Governors unanimously approved a second expansion of eligibility under its Municipal Liquidity Facility (MLF).

Authorized by the CARES Act, the MLF can purchase up to $500 billion of newly-issued bonds from qualifying municipalities, using funds from the Fed and Treasury. Until this latest action, the MLF had restricted the eligibility of cities and counties based only on their population. The newest terms guarantee the eligibility of at least two political subdivisions and two revenue-bond issuers from each state.

The expansion comes after the Fed once again weathered criticism from state governors and representatives that the MLF's eligibility criteria were too narrow. The original MLF criteria designated states, the District of Columbia, cities larger than one million residents, counties larger than two million residents, and one revenue-bond issuer (such as a utility or transit authority) per state as the only eligible recipients.

In effect, the original term sheet ceded borrowing privileges to just 10 cities and 16 counties. The Federal Reserve at the time said states could funnel the proceeds from bond sales to smaller cities and counties whose budgets had been strained by the effects of the novel coronavirus.

But this approach, while preserving the Fed's historical distance from small borrowers, ran into several issues. For instance, some states lack the organizational infrastructure to lend to cities and counties. More importantly, several states face legal impediments to borrowing. Twenty-one states require referenda to issue debt at levels demanded by COVID-19 disruptions, while a previous YPFS blogpost noted that several more states require legislative supermajorities to push through bond issuances. The current situation presents unique challenges to meeting such requirements, given that social distancing demands have closed many governing bodies and forestalled the possibilities of voting. In many cases, safe alternatives have not yet been designed.

Members of Congress criticized the Fed's narrow interpretation of the CARES Act, which did not specify eligibility criteria for the MLF. The Fed's first expansion on April 27 extended the program from September 30 to December 31, and lowered the eligibility thresholds from 1 million residents per city and 2 million residents per county to 500,000 and 1 million, respectively. As a result, the total number of eligible cities and counties increased from 26 to 227. However, even under the amended criteria, several states still lacked a single municipality that met the population threshold.

The June 3 terms lowered the thresholds again to 250,000 residents per city and 500,000 residents per county. Should a state lack one or two municipalities that meet these thresholds, governors may designate one or two of the largest ineligible cities or counties. Governors may also designate two non-governing entities that currently issue bonds secured by government revenue. Additionally, multi-state revenue-bond issuers, such as the Port Authority of New York and New Jersey and the Washington Metropolitan Area Transit Authority, are now also eligible issuers, provided that minimum credit rating thresholds are met.

The Fed has not changed the original terms regarding the MLF's size, and eligible uses of funds. The facility is authorized to purchase up to $500 billion in eligible bonds (allocated among the states as proportions of FY2017 general revenue), and is backstopped by an equity investment of $35 billion from the Treasury's Exchange Stabilization Fund, as authorized by the CARES Act. The facility takes the form of a special purpose vehicle (SPV) established by the Fed under Section 13(3) of the Federal Reserve Act. The facility may purchase "tax anticipation notes (TANs), tax and revenue anticipation notes (TRANs), bond anticipation notes (BANs), revenue anticipation notes (RANs)," and similar bonds with maturities no longer than 36 months, funding up to 20% of a state, county, city, or revenue-bond issuer's revenue.

Small cities are particularly sensitive to economic shocks due to their dependence on sales tax. Brookings reported that cities in the Midwest, generally smaller than those in the dense East and heavily urbanized West, rely more on sales taxes. Whereas property values are assessed not more than once a year, and income taxes are filed annually, sales tax receipts enter municipal finances at frequencies varying between once a month and once a year. These higher-frequency collections mean that shocks affect sales tax revenues much more quickly than other types of taxes.

Compounding pressure on the MLF to purchase small-city debt are high-population thresholds and use restrictions on CARES Act grants. Under the Coronavirus Relief Fund, only municipalities with 500,000 residents or more are eligible and funds may only be used for necessary and unexpected expenditures demanded by COVID-19. Thus, monies cannot be used to compensate for reduced sales tax receipts, a use that is permissable for proceeds from MLF bond purchases.

The MLF marks the first time the Federal Reserve has waded into direct purchases of municipal bonds. In 2011, in the wake of the Global Financial Crisis, Republicans in both chambers balked at suggestions from Democrats that the federal government bail out municipalities. The then-Chair of the Federal Reserve, Ben Bernanke, said that the Fed had "no expectation or intention to get involved in state and local finance." The Fed's legal authority to buy municipal bonds extended to only 2% of the market, and Bernanke noted that there might be other legal restrictions under the Dodd-Frank Act.

But, in spite of the Fed's historic distance from municipal debt, the efficacy of the MLF may lead to deeper involvement in municipal finances. The initial announcement of the MLF in April immediately stabilized a $4 trillion market that saw AAA yields jump from just under 1% to just under 3% in a matter of days.

Politico pointed to House Ways & Means Chair Richard Neal as a catalyst for more intervention in munis. Even before the novel coronavirus, the former mayor of Springfield, Massachusetts, had established himself as a supporter of municipal bonds. However, aid may instead come from traditional fiscal policy routes should the Fed hold firm on its new eligibility thresholds. Neal represents Springfield and its enclosing county Hampden, each of which just miss these newest MLF population thresholds.

Thus far, Illinois is the only state to announce its participation in the MLF, issuing $1.2 billion in 12-month maturities at 3.82%.The MLF became operational on May 26.