# Disagreements over the Municipal Liquidity Facility Erupt

**By Sean Fulmer**

*Original post here.*

The Congressional Oversight Commission (COC) released its fifth report on October 21, twenty-five days after the report was legally required to be distributed. The report focuses on the Municipal Liquidity Facility (MLF) established by the Federal Reserve (Fed), which was the subject of a COC hearing on September 17. The MLF, established by the Fed under its emergency authority under Section13(3) of the Federal Reserve Act, was announced on April 9 and became operational on May 26. The program is designed to provide liquidity to states and municipalities by purchasing up to $500 billion of bonds issued by these entities. Thus far the program has only purchased two notes, issued by the State of Illinois and the New York Metropolitan Transportation Authority (MTA). A number of commenters view the program as inaccessible and various legislators, including Senator Elizabeth Warren, have urged the Fed to amend the terms of the program to make it more available to the states and municipalities that are its intended participants and which are currently struggling with the effects of the pandemic on revenue.

The Democrats and Republicans on the Commission disagreed for weeks over the purpose and goals of the MLF, which led to the delayed release of the report. Previous reports from the COC attempted to present a singular opinion by not naming which commissioners approved or dissented from certain sections. This report, however, abandons the common voice of the previous reports by naming specifically what the individual commissioners believe, a reflection of the divided opinions within the COC.

On one side, Representative Donna Shalala and Bharat Ramamurti (the Democrats) believe that the MLF needs to be extended and expanded in order to better serve state and local governments. Conversely, Senator Patrick Toomey and Representative French Hill (the Republicans) state that the MLF has succeeded in its goals and that Congress never intended for the MLF to be an active participant in the municipal bonds market, but rather a backstop.

The COC hearing on the MLF consisted of two panels of expert witnesses. Kent Hiteshew, a Deputy Associate Director at the Fed tasked with creating the MLF, was the first witness. The second panel consisted of:

- Chris Edwards, Director, Tax Policy Studies, Cato Institute
- Marion Gee, President, Government Finance Officers Association & Finance Director, Metropolitan St. Louis Sewer District, Missouri
- Patrick McCoy, Director of Finance, Metropolitan Transportation Authority
- Dr. Mark Zandi, Chief Economist, Moody's Analytics

Additionally, the Treasury Department did not send a representative to the hearing despite a request to do so. The Treasury has provided a $17.5 billion equity investment in the MLF, out of a committed $35 billion. In a response to follow-up questions posed by the COC, the Treasury did not differ from the public statements given by the Fed on the MLF, stating that the MLF does not require any of the changes that were proposed by the Democrats on the COC.

As a result of the hearing and further research, the COC identified seven potential changes to the MLF, of which none have the support of all four commissioners. While discussing the possible need for a facility for the secondary market purchasing of municipal bonds, the COC agreed that another facility operating in the secondary market, the Secondary Market Corporate Credit Facility (SMCCF), should be shut down, as it has fulfilled its purpose in their opinion.

*Expiration*

Currently, the MLF is scheduled to terminate on December 31, 2020. The Fed announced in early October that issuers need to file letters of intent to the MLF at least 30 days before this termination date, further pushing up the timeline.

The Democrats on the COC believe that this expiration date will arrive too soon, before municipal market conditions have normalized. The municipal bond spread to Treasuries remains high relative to pre-pandemic levels, while yields have recently increased as a result of the failed stimulus talks. Furthermore, many state and local governments are required by balanced budget laws to either change their laws or seek voter approval in order to authorize MLF borrowing. In some instances, this may not be able to occur before the expiration date.

Senator Toomey and Representative Hill disagree with the Democrats' proposed extension of the MLF termination date. They believe that liquidity has been restored to the municipal bonds market and the MLF is therefore no longer needed. Additionally, they state that access to credit is currently available due to low interest rates.

*Purpose*

The Fed states on its website that "the immediate purpose of the MLF is to enhance the liquidity of the primary short-term municipal securities market." This positions the Fed as a lender of last resort, rather than extending effective credit subsidies. Treasury Secretary Mnuchin has also affirmed that the MLF, and other facilities authorized under the CARES Act, are solely intended to restore liquidity. However, members of the COC disagree on this interpretation of the MLF's purpose.

The Democratic members of the COC believe that there is no explicit restriction requiring the MLF to provide only short-term liquidity. Other Federal Reserve Section 13(3) programs such as the Main Street Lending Program (MSLP) and the SMCCF have not limited themselves to short-term liquidity purposes. Although the Democratic members do not believe that the MLF is a substitute for fiscal policy, they view the restriction to short-term liquidity as creating a much more punitive program than is offered to corporate borrowers. Several organizations representing potential MLF participants have also noted a lack of parity.

The Republican segment of the COC reiterates the Fed and Secretary Mnuchin's points regarding short-term liquidity. Furthermore, they cite the CARES Act section 4002(c)(3)(E), which states that the implementation of facilities should provide liquidity to the municipal bond markets. However, it is not explicitly clear that providing more affordable loans to state and local governments under the MLF would be inconsistent with the facility's purpose to provide liquidity.

*Term Length of Purchased Notes*

The MLF currently allows the purchase of three-year notes, while the SMCCF, the MSLP, and Primary Market Corporate Credit Facility (PMCCF) allow for four- or five-year terms. Some states are unable to issue debt shorter than three years due to balanced budget restrictions, which would preclude them from the MLF under the current terms. According to the Fed, there is no explicit legal restriction stopping it from amending the MLF's terms to provide for the purchase of longer term notes. However, Mr. Hiteshew stated during the hearing that the Fed has not purchased longer-term municipal debt because that would shift their purpose away from short-term liquidity.

The Democratic members of the COC recommended increasing the term lengths to at least four- or five-year terms, while Dr. Zandi suggests a term length of ten years. Since the Fed does not have any legal restriction from extending the term length, they see no reason why the MLF terms are shorter than those for the corporate bond purchase programs. However, the Republicans members do not see any need to extend the length of eligible debt, considering their interpretation of the MLF as providing short-term liquidity.

*Pricing*

The Fed, under Regulation A in 2015, adopted a penalty-rate requirement applicable to Section 13(3) programs. According to this regulation, the rate offered must be a "rate that is a premium to the market rate in normal circumstances". This penalty rate is not quantitatively defined and is open to interpretation. In response to feedback, the Fed previously reduced the interest rate on MLF loans by 50 basis points across all credit rating categories. (See this YPFS blog discussing the Fed's earlier action reducing pricing under the MLF.)

The Democrats on the COC believe that the penalty rate offered by the MLF is much too punitive on state and local governments. Regulation A states that the penalty rate should be relative to the market rate in normal circumstances, not the current pandemic market. The gaps between the MTA's and Illinois's pre-pandemic and MLF rates are 158 and 61 basis points, respectively. Additionally, the Democratic members state that the pricing offered to corporate borrowers through the SMCCF are much more favorable than those offered to state and local governments. Furthermore, the commissioners raise concerns that the differential in pricing between municipal and corporate borrowers adversely affects minorities, as those laid off in the public sector are 20% more likely to be black than those laid off in the private sector.

The Republican contingent sees no issues with the pricing set up by the Fed for the MLF. They state that interest rate yields for investment-grade municipal debt are below the pre-pandemic levels (although Democrats claim that spreads are a more important factor, which have not yet recovered). Senator Toomey criticizes the MTA in the report for financial mismanagement, which the Democrats note are concerns that he did not voice during the hearing. He documents the financial struggles the MTA has faced, which he believes is cause for the rates charged to the MTA to be even higher. However, the Democrats note that the MTA has never defaulted on a bond.

*Use Restrictions*

The MLF limits the use of proceeds from the purchasing of a note to mitigating cash flow impacts accompanying income tax deferrals, increases in expenses, or declines in revenues as a result of the COVID-19 pandemic. Additionally, proceeds can be used as a conduit to purchase notes issued by political subdivisions that might not be eligible to participate in the MLF. However, state and local governments cannot use the proceeds for longer-term capital investment projects. This ties back to the Fed's position that the MLF is not currently seen as a form of fiscal stimulus, but rather provides liquidity support.

Consistent with the discussions on the purpose of the MLF, there are disagreements within the committee on how flexible the use of loan proceeds should be. As currently constructed, the MLF intends to only provide short-term liquidity to state and local governments. The Democrats believe that proceeds from the MLF should be allowed more flexibility than just liquidity. This could come in the form of long-term capital projects, local and state stimulus funds, or paying off long-term budget issues. However, the Republicans believe that this would shift the Fed into providing fiscal stimulus and continue to believe that the MLF should only be used for short-term liquidity.

*Eligibility Rules*

According to the current eligibility criteria for the MLF, territories and native tribes are unable to access the MLF. Guam reportedly considered utilizing the MLF, but was barred by that restriction. The Fed stated that the MLF eligibility criteria was intended to reach the largest issuers while excluding some of the smaller issuers for administrative reasons. The Democrats on the COC believe that the MLF should be opened up to a wider, more diverse range of issuers. However, the Republicans on the COC believe that the current eligibility criteria are sufficient, since smaller entities can still access the MLF through a conduit. (See this YPFS blog for a discussion of the Fed's earlier actions twice amending the program to broaden the number of eligible entities.)

*Secondary Market Purchases of Municipal Bonds*

After the discussion about differential interest rates between corporate and municipal bonds purchased by the Fed during the hearing, the Fed's Office of General Counsel conferred with the COC to provide further explanation for the differential. In their opinion, that differential is a direct result of the differences between the primary and secondary markets on which the bonds were purchased. The Fed does not interpret Regulation A (which established the penalty-rate requirement) as applying to secondary market purchases, which is why the SMCCF purchased bonds at a lower rate. There is currently no facility for secondary market purchases of municipal bonds.

The entire COC recommends that the SMCCF cease operations, as they believe the Fed's programs have succeeded in buoying corporate bond markets. Despite this consensus, the commissioners disagree when it comes to establishing a facility for secondary market purchases of municipal bonds. The Fed testified that there is no advanced interest in such a facility, which runs counter to both the recommendations of the Democrats on the COC and a coalition of state and local government groups. The Democrats on the COC state that municipal spreads to Treasuries, which they maintain is a more significant factor than rates, still remain higher than pre-pandemic levels and that a facility for the secondary market purchases would push these spreads down, as corporate secondary market purchases did for primary-market corporate bonds.

**ADDITIONAL UPDATES TO CARES ACT PROGRAMS**

*National Security*. The COC requested additional information from the Department of Defense on the loan made by the Treasury to YRC Worldwide on the grounds of national security, despite concerns about YRC's financial conditions. The Department of Defense originally stated that their response would be provided by September 18, but no information or follow-up has been received by the COC.

*Main Street Lending Program*. City National Bank of Florida is responsible for issuing about 40% of the loans made through the MSLP. It recently announced its acquisition of Executive National Bank, which would bring the bank's total asset base to approximately $18 billion. The COC is currently in contact with the bank to understand its outsized involvement in the MSLP; providing over $500 million in loans has stood out in a banking sector that has been hesitant to lend through the MSLP. Pursuant to the terms of the program, the Fed assumed 95% of the loans made through the MSLP, leaving another 5% on lenders.

*Aviation.* The Treasury Department announced that it had closed loans to seven passenger air carriers, after three additional airlines dropped out of consideration. The COC is currently reviewing these loans, which are estimated to total $14.66 billion, out of the $25 billion allocated to such loans by the CARES Act. Of these loans, American Airlines and United Airlines account for approximately three-quarters of the loan total.