Timely insights on the issues that matter most to investors.

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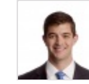
Municipal Bonds | Volatility

Fed's muni aid program treats the symptom, not the cause



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"It's important to note that borrowing under this facility is a short-term recourse loan, not a grant."

New York - The Municipal Liquidity Facility (MLF) announced by the Federal Reserve on April 9 has captured the attention of market participants and investors alike. This program is a significant step toward normalcy in our market and toward helping municipalities manage the economic impact of government orders for large swaths of the US population to remain at home.

The MLF is a $500 billion purchase program seeded by a $35 billion investment from the US Treasury via the Coronavirus Aid, Relief, and Economic Security (CARES) Act. Working directly with issuers, the Fed will purchase all types of new-issue anticipation notes with maturities of 36 months or less and a credit rating of investment grade as of April 8, 2020. These purchases are intended to help with short-term financing in anticipation of future cash receipts from taxes, general revenues, planned debt issuance and other revenue streams. Pricing will be dictated by the issuer rating at the time of purchase and will reflect an appropriate credit spread plus an additional 10 basis points origination fee.

It's important to note that borrowing under this facility is a short-term recourse loan, not a grant. The proceeds from these loans are unrestricted and can be used for general purposes, which shores up short-term liquidity for issuers.

Eligibility is limited to general governments such as cities, states, and counties, constrained to one issuer per, for an amount up to 20% of "own-source revenues." Under the original proposal, all states would be eligible as well as cities with a population greater than one million and counties with a population greater than two million. In the face of political and media pressure, the scope was broadened on April 27 to cities and counties with 250,000 and 500,000 residents, respectively. As well, the window for borrowing was extended from September 30, 2020, to December 31, 2020.

Other issuers could indirectly benefit from the MLF, since eligible entities can request to issue additional notes on behalf of "political subdivisions and instrumentalities that are not eligible for the facility," according to the Fed press release on April 9. In our interpretation of the rule, these additional funds wouldn't count toward the own-source revenues cap. It also puts the credit decisions down to the cities, states, and counties rather than forcing the Fed to judge the relative importance of the tens of thousands of active municipal issuers.

Because of the crisis, tax revenues should be significantly impaired. This is nothing new for municipal issuers; according to the Brookings Institution, state taxes fell 17% and personal income taxes fell 27% in the second quarter of 2009. The MLF should provide issuers the liquidity to continue to pay bills and employees and to manage through the period until the economy is fully functioning again and revenues begin to ascend to pre-coronavirus levels — asuming the US will return to some economic activity by mid- to late 2020 and gradually improve through 2021.

In the immediate future, this is also an important stopgap for municipal issuers, who have experienced an unexpected delay in tax revenues due to the extension of the

filing deadline from April 15 to July 15 of this year. The MLF also should bolster investor confidence due to the implicit assurance of debt service for the next two years. This has helped reestablish a sense of normalcy to both primary and secondary markets.

What the MLF doesn't resolve are potential long-term fiscal health problems brought on by sustained underwhelming revenues. Bear in mind that these are loans, which give the Fed a future claim on the resources of issuers accessing the MLF. State and local governments experiencing significant revenue declines will have to either practice austerity or deplete reserves — or even do both — to help make up for any lingering decline.

In addition, the MLF doesn't address issuers' long-term liabilities, such as pensions and other post-employment benefits. Funded ratios at the outset of this crisis stood at peak post-2008 levels, and many funds have adjusted their discount rate assumptions lower, which are positive tailwinds for issuers entering this period. However, many pension systems remained significantly underfunded. A 15% to 20% stock market decline increases those liabilities.

Some details still need to be clarified. For example, we believe that if the Metropolitan Transit Authority — a nongovernmental agency — gets $4 billion under the terms of the MLF, it wouldn't count toward the 20% revenue cap for the state of New York. If it does, or if there's no workaround, that would limit New York's flexibility. How will states account for this debt? Do these loans count toward this limit for states with balanced-budget statutes? Will this impact technicals in the muni market by reducing new issuance on top of the month-long hiatus we just experienced? These are details we're watching closely.

Bottom line: While this package is significant, swift and a step in the right direction, it will ultimately prove to treat the symptom rather than the cause. This further underscores the need for in-depth, expert fundamental analysis when investing in municipals. Proceed, but do so with caution.

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