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Fed to Buy Municipal Debt for First Time, Underscoring Peril Facing Cities.

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The Federal Reserve will directly buy bonds issued by states and cities for the first time, in a move that highlights the danger faced by local governments as the fallout from the coronavirus pandemic slams their budgets.

The Fed said Thursday it would purchase up to $500 billion in short-term municipal debt to ease turmoil in the market. It was part of a slew of emergency facilities totaling more than $2 trillion that the central bank unveiled, mainly to boost small and medium-sized companies that are especially vulnerable to a severe economic slump.

The central bank is targeting short-term debt because states and cities nationwide have seen an alarming drop-off in revenue as businesses shutter due to the virus outbreak. Job losses have cut deeply into sales tax income, with the federal government announcing Thursday that more than 16 million Americans have filed jobless claims in the last three weeks. A shift in the federal tax deadline also created unexpected holes in local budgets as officials chose to delay their own deadlines in tandem.

“This is a significant move by the feds to enter the municipal market and in a pretty big way,” said Micah Green, a partner at Steptoe & Johnson and former co-head of the Securities Industry and Financial Markets Association. Still, he said, “There’s much more to be seen as to what role, if any, they will play in the longer-term debt market, which would be an even further step of unprecedented activity by the Federal Reserve.”

The Fed has come under increasing pressure to help out municipalities, but it has long resisted that because of concern about getting involved in political issues that come along with local financing decisions. But now it is skirting the need to make political decisions about which debt to buy by setting up a program under its emergency powers that will allow any state or large city that meets the qualifications to participate.

Federal Reserve Chair Jerome Powell said in February at a House oversight hearing that the Fed has “limited authority” to buy short-term municipal debt and historically hasn’t waded very deeply into state and local government finance. And nine years ago, then-Chair Ben Bernanke told the Senate Budget Committee that “we have no expectation or intention to get involved in state and local finance,” as local budgets were flailing after the Great Recession.

Regulators sounded a different note today, saying the emergency lending would be accessible to states and the District of Columbia, as well as cities with populations over 1 million residents and counties with populations over 2 million residents. The Treasury Department will use $35 billion from the stimulus package enacted in late March to cover any losses from states or cities that default.

Eligible kinds of debt include tax anticipation notes, tax and revenue anticipation notes, bond anticipation notes and “other similar short-term notes” with maturities no longer than 24 months.

Generally, those kinds of notes allow governments to access a larger amount of money upfront in the form of debt instruments using estimations of future revenue. Each debt issuance will be subject to Fed review.

Total debt issuance will be capped at 20 percent of the “general revenue from own sources and utility revenue” of each government applying for the aid, based on fiscal year 2017, the Fed said.

Some issues to watch as this facility rolls out include which individual states the central bank will allow to seek debt purchases in excess of the cap, an exception it provided to help ineligible governments access credit. And the Fed said in its announcement that pricing details for issuing this debt will be provided later.

Analysts and research groups have cited Tennessee, Illinois and New Jersey as among the states at particular risk in the downturn, citing a heavy dependence on sales tax revenue, low level of reserves or high levels of debt.

“We are hopeful this facility will provide needed help to municipal issuers,” the Bond Dealers of America, a Washington-based trade group representing banks and securities firms active in the bond market, said in a statement. “We are looking particularly at how smaller issuers will access the facility.”

Looking beyond the short-term lending action, the Bond Dealers of America urged the central bank “to use its CARES Act authority to provide support as needed for the secondary market for municipal bonds — providing much needed liquidity, benefiting the overall market,” referring to the stimulus bill that President Donald Trump signed into law last month.

Bolstering state and local balance sheets will help the secondary market, but the Fed clearly left open the possibility of broader action, according to its announcement.

“The Federal Reserve will continue to closely monitor conditions in the primary and secondary markets for municipal securities and will evaluate whether additional measures are needed to support the flow of credit and liquidity to state and local governments,” the central bank said.

Unless extended, purchases established by this facility cease on Sept. 30, 2020.

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