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End Nears for Fed's Municipal Lending Program.

The initiative only attracted two borrowers, but experts say it helped to stabilize the municipal bond market following Covid-driven turmoil earlier this year.

The emergency lending program the Federal Reserve launched earlier this year to support short-term borrowing by state and local governments will officially close at the end of this month, and language inserted into the massive spending and coronavirus relief package Congress just passed would ensure that lawmakers will have to give their blessing for it to be revived again.

Back around the time the Municipal Liquidity Facility was announced in early April, the coronavirus outbreak had badly shaken the municipal bond market, with investors pulling out billions of dollars and interest rates soaring. Today, experts say the program played a key role in easing this market turmoil and ensuring that states and localities could go on accessing credit.

"I think it was incredibly important and I think it did help restore confidence in the market among lenders," said Matt Fabian, a partner at Municipal Market Analytics.

The facility's shutdown is a significant shift, he said. This is because while the municipal bond market is generally doing fine now, there is still a great deal of uncertainty among investors and other state and local government stakeholders about the extent of the financial fallout from the virus. It remains to be seen how bad credit downgrades could be next year and how long the budget strain many state and local governments are now under is going to last.

"Without the MLF, we're just less secure," Fabian said. "Hopefully we don't have a shock to the market. In the best case we don't. But if we do, we're just less well prepared now."

The focus of the Fed facility was not long-term bonds, like those used to finance infrastructure, but rather shorter-term "notes" governments depend on to maintain liquidity and pay their bills.

With the Fed facility, the maximum length states and local governments could borrow was three years. States and mainly larger localities were eligible for the program—counties with over 500,000 residents and cities with over 250,000. The lending facility was scheduled to expire on Dec. 31. The new spending and relief package passed by Congress this week and sent to President Trump ensures this will be the case, for now at least.

After suggesting he could veto the package, Trump signed the measure into law on Sunday.

Pennsylvania Sen. Pat Toomey, a Republican, was a leading advocate for embedding language into the legislation to end the municipal lending program, along with other emergency lending initiatives established by the Federal Reserve. The programs were funded by the CARES Act, the large coronavirus aid measure that lawmakers approved in late March.

Toomey has argued that the Fed programs were important during the earlier days of the coronavirus crisis and were effective in preventing financial markets from seizing up. But he has also emphasized that they were designed to lapse at the end of the year and that they don't need to

continue now that they've achieved their initial purpose.

"The purpose was to ensure that creditworthy borrowers could access credit through the normal channels," he said during floor remarks over the weekend. "They worked amazingly well."

Toomey said Democratic proposals raising the possibility of continuing, or eventually reviving, the programs are part of his motivation for wanting to make clear—in law—that the initiatives should be closed. He noted that legislation House Democrats passed earlier this year called for the Fed to offer states and localities longer-term loans, up to 10 years, at low interest rates.

"The Fed wouldn't be playing its role, its traditional role, as the lender of last resort in a financial crisis," he said. "It'd be the lender of first resort."

The Municipal Liquidity Facility became operational on May 26 and borrowers who wanted to participate in the program had to notify the Fed by the start of December—no later than 30 days prior to the scheduled Dec. 31 termination date for the program—to tap it.

During that roughly six month window, two borrowers emerged—the financially troubled state of Illinois and New York's Metropolitan Transportation Authority, an agency that had already been dealing with budget problems in recent years and is now getting slammed by a steep drop in fare revenue brought on by the pandemic.

Fabian said the fact that so few issuers used the program is a sign of its success. It helped keep the municipal bond market functioning and diminished the chances major local governments would default on their financial obligations. Meanwhile, the interest rates the Fed adopted set guideposts, during an uncertain time, for where municipal borrowing costs should be.

"It was an insurance policy," Fabian said. "It was a backstop."

Illinois first turned to the facility in June. The MLF purchased a $1.2 billion one-year general obligation note from the state, with an interest rate of 3.36%. That rate is lower than what Illinois paid for notes it sold on the open market in May, but higher than the cost of a pre-pandemic short-term debt sale in late 2019, a Congressional Oversight Commission report explains.

Last week, the state closed on another $2 billion borrowing through the facility, according to The Bond Buyer. Illinois Comptroller Susana Mendoza said last month that her office would use federal matching dollars to "turn the $2 billion into $3 billion" and to pay down health care-related bills and avoid late-payment interest penalties.

The Municipal Liquidity Facility also purchased a roughly $450 million three-year revenue note with an interest rate of 1.93% from the New York MTA in August. The MTA borrowed again from the facility in early December—$2.9 billion that time.

With the ability to purchase up to $500 billion in notes, the MLF never came close to getting maxed out.

Tom Kozlik, head of municipal strategy and credit for HilltopSecurities Inc., explained that a reason so few states and localities turned to the facility is that, for most of them, it was expensive compared to the very low borrowing costs in the municipal market during the year. "The market normalized after April and it was not really needed," he added.

Democratic lawmakers and state and local advocacy groups pushed during the time the facility was available to loosen some of its guidelines so it would be open to more local governments, and also to

allow for longer-term loans and lower interest rates.

Sen. Elizabeth Warren and two other Democratic senators, for instance, in a letter over the summer, urged the Fed and Treasury Department to extend the maximum loan duration and adjust interest rates for the municipal program to “at least match the generosity” offered through facilities “that lend to businesses that are of even poorer credit quality than the municipal borrowers.”

In this way, the facility began to slide somewhat into the broader, ongoing and highly partisan debate about how to best assist state and local governments during the pandemic. In general, Democrats have favored providing more aid, while Republicans recoil at the idea of “bailing out” mismanaged states.

Kent Hiteshew, a deputy associate director in the division of financial stability at the Fed, earlier this year outlined some of the limits of the Fed program, and the central bank’s approach to it.

“We cannot make grants or forgivable loans, and we cannot lend to insolvent or highly distressed entities,” he told lawmakers in September. “We measure the success of the MLF based not on its volume of lending but, rather, on the condition of the municipal securities market and state and local government access to capital.”

Despite disagreements over the program’s appropriate role and scope, Kozlik said the MLF did accomplish its higher level goals. “It was supposed to be a last-ditch facility that was there in a worst case scenario,” he said, not an alternative to the general bond market.

He predicts that if markets do deteriorate badly again, lawmakers will once more step in and find a way to offer some type of support. “It could be like the programs we saw in 2020,” Kozlik said, “or a revamp of them or something new depending upon the circumstances.”

ROUTE FIFTY

by BILL LUCIA

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