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Federal Reserve Considering Additional Support for State, Local Government Finance.

Central bank hires former Treasury official to assist with potential municipal-lending program

Federal Reserve officials are reviewing new ways to support financing for state and local governments, many of which are on the front lines of the coronavirus pandemic and will face huge borrowing needs as revenues plunge, according to people familiar with the matter.

The economic-rescue legislation Congress approved this week asks the Fed to charge headlong into areas it has long considered taboo—supporting lending to businesses, cities and states. The Fed traditionally avoided intervening directly in credit and fiscal policy, preferring to leave such matters to Congress and the White House.

That is changing now because of the fast-moving economic crisis—and because Congress has essentially directed the Fed to get more involved by providing \$454 billion to the Treasury to cover any losses in new Fed lending programs.

The Fed has dramatically expanded its balance sheet over the past two weeks, by nearly \$942 billion to \$5.25 trillion as of Wednesday. The central bank has lent freely to help firms avoid a wave of defaults that could turn a recession into something much worse.

Over two weeks, the Fed has unveiled six lending facilities, five of them enjoying a total of \$50 billion in support from the Treasury. Those programs have freed up cash for major Wall Street institutions and will backstop money-market funds and markets for commercial debt.

Democratic lawmakers have made support for city and state borrowing a priority in recent legislative talks, and the latest bill directs the Treasury secretary to seek a Fed lending program for municipal finance.

State and local governments are confronting skyrocketing borrowing costs even as they are straining to pay expenses associated with the spread of the virus. House Speaker Nancy Pelosi told Fed Chairman Jerome Powell last week “to think big and help our states,” she said in an interview on PBS this week. “They are taking a big bite of this wormy apple and they need much more in terms of resources.”

Under its governing law, the Fed can’t directly buy corporate debt, and it is limited to purchasing municipal debt of six months or less. But it can work around these restrictions by creating lending facilities that lend or purchase debt, subject to approval of the Treasury secretary.

The Fed has already dipped a toe into muni-debt markets by expanding a money-market lending backstop to include certain types of municipal debt—and by purchasing some highly rated municipal debt in a facility backing the market for very short-term commercial debt.

As of Wednesday, short-term interest costs on variable-rate municipal bonds have more than tripled compared with two weeks ago and are now higher than the rates governments typically pay on 30-year bonds, according to an index maintained by the Securities Industry and Financial Markets Association.

Monday's announcement by the Fed to include more municipal debt in existing lending facilities appears to have made only a small dent, bringing the index, which tracks bonds that adjust their rates weekly according to what investors are willing to pay, to 4.7% down from 5.2% the prior Wednesday.

Interest rates on other short-term muni debt that spiked last week have fallen after the Fed said Monday it would purchase some municipal variable rate debt. Rates on water, power and sewer bonds issued by New York City and Los Angeles fell back to their typical rates of between 1% and 2% Thursday after hitting nearly 8% on Friday.

Kent Hiteshow, who established an office of state and local finance at the Treasury Department in the Obama administration, has been hired by the Fed for a six-month appointment to advise on muni markets, according to people familiar with the matter.

Among the questions Fed officials are considering: Whether to expand existing facilities to accommodate other municipal debt or to launch a new facility devoted to state and local finance. Fed officials will have to decide which municipal debt might be eligible for support and on what terms.

There are limits to how far the Fed can lend using its emergency authorities. Its loans must be well secured, which the Fed typically satisfies by restricting borrowing to highly-rated issuers.

"The states and localities that need the most help are the most risky by definition," said Ernie Tedeschi, an economist at Evercore ISI, an investment research firm, who previously worked in the Treasury Department during the Obama administration.

The Fed and Treasury brainstormed ways to support hard-hit state and local treasuries after the 2008 financial crisis, but opted against doing so.

Governments have been canceling almost all planned long-term muni deals, borrowing they typically rely on for infrastructure needs and budget management, after investors fled muni mutual funds last week and prices plummeted. There was \$761.7 million in total muni issuance last week, according to Refinitiv, compared to around \$8 billion during a typical week earlier in the year.

Government borrowers include states facing high Medicaid costs, delayed income tax collections and huge drop-offs in sales taxes as commerce has slowed to a standstill—and municipalities that run hospital systems, nursing homes, jails and public-health departments.

"As our borrowing costs go up, that's fewer dollars they have to allocate to the crisis," said Matthew Chase, executive director of the National Association of Counties.

Fed officials have long had broader philosophical objections to intervening in financial affairs of subnational entities. The central bank is the fiscal agent of the federal government, and they have viewed state and local finance as the domain of Congress and the Treasury Department.

"The Fed's response has typically been, 'Look, if the federal government wants to support state and local finance, they can do that directly,'" said Lewis Alexander, who served as an economic adviser at the Treasury Department from 2009-11 and is now chief U.S. economist at Nomura Securities.

“There is a real reluctance to blur the line between the federal government and the state and locals. You start going down that road, it’s hard to know where to stop.”

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