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Move by Fed May Help Shore Up Short-Term Borrowing for States and Localities.

The municipal bond market is experiencing a massive crunch as investors react to the coronavirus pandemic.

The Federal Reserve took action this week that could help bolster state and local governments' access to short-term borrowing as the coronavirus crisis pressures their finances.

For some states and localities, short-term debt is an important source of cash for covering expenses at times when tax revenues are not rolling in. But the virus outbreak has been driving turmoil in the municipal bond market, threatening the flow of this type of lending.

Demand for municipal debt has collapsed as the disease outbreak disrupts nearly every corner of the U.S. economy. The pandemic-driven downturn is also stoking worries that state and local tax revenues could take a sizable hit, while at the same time governments spend big to combat the disease.

"Basically there are no buyers for municipal bonds at both the long end and the short end of the curve," said Michael Belsky, executive director of the Center for Municipal Finance at the University of Chicago's Harris Public Policy school.

Fleeing investors caused the roughly $3.8 trillion municipal bond market to hemorrhage a record $12.2 billion from municipal-bond mutual funds during a week's time ending Wednesday.

Some state and local government advocates are making a case that the federal government should intervene deeper into the municipal bond arena to help states and localities weather the pandemic. There's at least one proposal in the U.S. Senate to head that direction.

Emily S. Brock, director of the federal liaison center for the Government Finance Officers Association, applauded the latest move by the Fed. But she added: "We do need to open up the spigot a little bit wider in order to get that shot of adrenaline in our space."

States, cities and other local government entities around the U.S. commonly issue long-term debt to finance things like school construction and highway and mass transit projects. Bonds like these are usually paid off over many years.

But some also borrow on a short-term basis to maintain adequate financial liquidity. Tax payments can come in bursts at different times of year, while on the other side of the ledger governments must have consistent funding on hand to cover wages and other operating costs.

"There's a mismatch," said Bart Hildreth, a budgeting and finance professor at Georgia State University's Andrew Young School of Policy Studies. "You have cash flow deficits during the year."

To deal with this dynamic, states and localities might borrow short-term with the anticipation of collecting tax revenues in the months that follow and then using that money to repay the debt.

Unlike a 20-year bond that might be issued to build a bridge, this sort of short-term “cash flow borrowing” tends to involve debt that matures within the course of a fiscal year.

“It’s a pretty regular feature of the borrowing plans of the moderate- to large-sized governments,” Hildreth said. “Same thing with states.”

But a concern now is that the upheaval in the municipal bond market is causing the investor cash that would normally be available for short-term state and local borrowing to dry up.

“Nobody’s purchasing,” said Brock. “All of the supply is being held on the dealers’ books. And so we have a bit of a challenge.”

This is where a move the Fed announced on Friday could help. Earlier in the week, the central bank announced that it was establishing a new Money Market Mutual Fund Liquidity Facility.

The general idea with this entity is to channel money towards money market mutual funds, supporting the flow of credit, and also keeping the funds functioning smoothly while the economy is in flux and as they meet investor demand for withdrawals. The funds are a common investment for households and businesses.

Under the program, the Federal Reserve plans to offer loans to banks and other financial institutions that purchase certain assets from the funds as collateral. What the Fed did on Friday is expand the list of eligible collateral to include highly-rated, short-term municipal debt, with a maturity of one year or less.

Tim Blake, managing director of public finance at Moody’s Investors Service, said a main benefit for state and local governments from the Fed facility is that it could provide investible money that the money market funds could use to purchase short-term state and local debt.

That could be especially important at a time when states and localities are facing huge uncertainties over how the coronavirus will affect their costs and revenues.

“There are probably going to be many government issuers and not-for-profit issuers that are seeing significant revenue declines in the coming months, and the need for some borrowing,” he said.

“This would allow the funds to purchase cash flow notes issued by governments,” Blake added.

Belsky, at the University of Chicago, said that, “basically the federal government is becoming the investor of last resort.”

Hildreth noted the Federal Reserve did not extend similar programs put in place in response to the Great Recession to cover short-term municipal debt. “Many of us thought they should have done it back then,” he said. “It shows that they have assessed the situation more severely this time that state and local governments are facing.”

But how effective the program will be in aiding state and local governments will depend partly on how banks respond.

“It’s really whether they need to use that asset or not,” said Natalie Cohen, president and founder of National Municipal Research. “How meaningful it’s going to be is questionable.”

Brock suggested there are ways the federal government could go further to help state and local governments through the municipal bond market. For instance, if the federal government were to somehow hold municipal debt of all types and maturity durations, or if it purchased what are known as Variable Rate Demand Notes.

This week, U.S. Sen. Bob Menendez, a New Jersey Democrat who serves on the Senate Banking Committee, introduced a bill that would allow the Federal Reserve's board to authorize federal reserve banks to directly buy and sell muni bonds of any maturity under "unusual and exigent circumstances."

The senator said that his legislation would provide state and local governments with federal support in financing the costs tied to the coronavirus outbreak, and other future emergencies.

But Tom Kozlik, head of municipal strategy and credit with Hilltop securities, said in a brief issued on Friday that there is not enough information available yet to know if the bill would solve the liquidity crunch facing the long- and short-term municipal bond market.

"The devil could be in the details here," he wrote.

Looking ahead, Belsky pointed out that many of the nation's public works projects are financed using municipal bonds. If the nation slips into a full-blown recession due to the coronavirus, he said, infrastructure investment could be key to kickstarting a recovery.

Route Fifty

By Bill Lucia

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