Muni Market Gets Support from Fed as Part of Wide Effort to Curb Virus Fallout, Self-Regulator Warns to Review Compliance.

New York (Thomson Reuters Regulatory Intelligence) – The Federal Reserve on Friday provided support for the $4 trillion municipal bond market as it extended its support of a credit market hit by a flight to safe havens due to the coronavirus health crisis. The move came after muni bond dealers sought help and the industry self-regulator warned firms to bolster controls.

The Fed has stepped in by offering support for firms hit by virus turmoil with direct purchases of short-term securities that make up money market funds and ultra-low interest rates to stem the most severe financial turmoil to hit the U.S. economy since the financial crisis in 2008.

As part of its effort, the Fed and other U.S. banking agencies on Sunday said they were encouraging banks to restructure loans to borrowers hit by the COVID-19 virus that has shut down a widening swath of the U.S. economy as businesses close and consumers stay home to slow its spread.

"The agencies encourage financial institutions to work with borrowers, will not criticize institutions for doing so in a safe and sound manner, and will not direct supervised institutions to automatically categorize loan modifications as troubled debt restructurings," a Fed statement said here.

The municipal market has separate funding mechanisms that were not included in the Fed's money-market and commercial paper programs. An even larger pool of investment money than money-market funds, the muni market fell under intense pressure in March when it was hit by the biggest wave of fund redemptions on record despite the Fed's actions to shore up short-term credit.

The muni market had seen record inflows in February in the early stages of the market turmoil caused by the spreading health crisis, as investors moved funds from riskier assets to munis, considered safe haven in which defaults have been rare.

The subsequent turnaround in sentiment came in part from a warning in early March in a California municipal bond offering from the state's general fund. California was among the first states to report incidents of the virus. California said in early March that there could be "no assurances that the spread of a novel strain of coronavirus called COVID-19 will not materially impact the state and national economies and, accordingly, materially adversely impact the general fund."

The market in the second week of March was overwhelmed by selling amid fear that California might soon be joined by other state and local governments facing resource constraints from the pandemic and would face financial stress.

The industry self-regulator, the Municipal Securities Rulemaking Board, issued an alert to firms in early March saying that they should review compliance and oversight "in light of the coronavirus" in early March said it was "closely monitoring the impact of the coronavirus disease (COVID-19) on municipal market participants."

With losses mounting and liquidity falling through the end of last week, the Bond Dealers of America on Thursday called on Fed Chairman Jerome Powell to extend its direct purchases of securities to the most-stressed parts of the market and consider easing rules. The trade group sought Fed support to ease liquidity shortages in Variable Rate Demand Notes that play a key role in short-term funding operations for municipals.

"Liquidity has waned significantly as measured by bid-ask spreads and price volatility has been perhaps the most severe ever in the history of the market," Mike Nicholas, the group's chief executive officer said in a letter sent to the Fed last Thursday here. The group had added that the market would be crippled without Fed support since firms would "effectively prevented them from taking on more municipal inventory."

The Fed action looked likely to help the central bank stabilize the short-term rates that provide liquidity, said Matt Fabian, the head of market and credit research at Municipal Market Analytics.

While the Fed action did not directly impact the trillions of dollars long-term municipal bonds held by individuals in hundreds of thousands of issues from state and local government, it would support the top rated short-term securities such as the variable rate notes that are derived from the long-term debt and used in muni-funding operations.

"It will greatly reduce the pressure on the muni money markets to cover investor redemptions while not tanking the value of the underlying municipal bonds they hold, specifically short maturity bonds and notes," he said in an email.

He added that most of the market's liquidity pressure "is exactly in this part of the curve, because investors are converting many of their financial assets to cash without regard to what those assets are," he added.

Self-regulator MSRB said in its coronavirus alert in early March that "the coronavirus may present operational challenges and business disruption for regulated entities." But it added that the firms can do required supervisory reviews remotely.

Its supervisory process "does not mandate that supervision be done in-person, recognizing that technology plays a prominent role in how dealers conduct their supervisory reviews and a reasonably designed supervisory system could incorporate remote supervision."

FINRA's general guidance for firms notes that municipal dealers must observe a fiduciary standard of care under the Securities Exchange Act of 1934. The standard requires firms to deal fairly, make suitable recommendations, clearly disclose pricing that is reasonable and in line with market prices and have supervision that's "reasonably designed to achieve compliance with applicable rules and regulations."

by Richard Satran

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