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Community QE - An April Game Plan for States and Cities.

Late last week, just before the holiday weekend, the Fed announced that it would be opening a new financing facility for hard-pressed States and Cities dealing with our COVID-19 pandemic – a facility fully deserving of the name 'Community QE.' This is a truly 'game changing' development that is just as critical for States and Cities as it will be *unfamiliar* to them for a while. Both for that reason, and because it will be crucial for our States and Cities to start using the new Facility *immediately*, this Column will provide a bit of background and then recommend a 'Game Plan' for the coming week for hard-pressed States and Cities.

Background

On April 9, the Board of Governors of the Federal Reserve System ('Fed') announced plans to open a new Municipal Liquidity Facility ('MLF,' 'Facility') to assist U.S. States and Localities suffering acute liquidity shortages while working to address the current COVID-19 pandemic.[1] A number of compelling considerations have prompted the move.

Prominent among the mentioned considerations are three mutually reinforcing developments that have intensified in recent weeks. *First*, States and Cities are facing spikes in required expenditure as they take on the role of front-line responders to the pandemic and its consequences. *Second* and simultaneously, States' and Cities' principal sources of revenue – in particular, sales taxes, income taxes, and property taxes – have dramatically contracted as businesses suspend operations and taxpayers 'shelter in place.' Finally *third*, the $4 trillion municipal bond market, the health of which is critical not only for States and their Subdivisions, but also for other securities markets, has experienced unprecedented volatility since February.

Against the backdrop of these developments, public health officials, State and Local officials, and bond market professionals have called since March for Fed intervention in the markets for State and Municipal securities ('munis') to stabilize prices, restore confidence to muni-investors, and ease the liquidity strains already hampering State and City pandemic response efforts. With passage of the Coronavirus Aid, Relief, and Economic Security ('CARES') Act by Congress last month, it became clear that both our federal legislature and our Fed and Treasury would be heeding these calls.

What remained unclear till the 9th of this month was what precise form the relief to States and their Subdivisions would take. That *remains* at least *somewhat* unclear, inasmuch as (a) U.S. Governors this morning requested that Congress appropriate more funding for States, and (b) the new Fed Facility has only just been announced and is accordingly only beginning its existence even as a 'work in progress.' But we know much more now than we did before the 9th, and it is all very good news for everyone concerned about the three developments enumerated above.

I'll accordingly first lay out what new details we now have, then offer informed predictions as to what more is likely to come, and then lay out the aforementioned Game Plan for States and Cities to follow in making optimal – and *immediate* – use of the new Fed Facility as it currently stands. In effect, as I noted the morning of the Fed's announcement last week, we have entered a world of *Community QE*, which it is critical for States and Cities to master and put to use quickly.

The Municipal Liquidity Facility

The new Municipal Liquidity Facility will operate under the auspices of Section 13(3) of the Federal Reserve Act ('FRA'), which grants the Federal Reserve emergency lending authority in exigent circumstances. The Fed typically exercises this authority through purchase and hence 'monetization' of short-term debt instruments – a practice known in finance parlance as 'discounting.'

In effect, the Fed temporarily swaps its own dollar liabilities, which are legal tender, for liabilities of its counterparties, which are not legal tender. The counterparty is thereby rendered 'liquid' – possessed of sufficient cash to spend on what ever it must spend to work past whatever difficulties it might be facing – until its debt instruments reach maturity. At that point the instruments are either redeemed in full or 'rolled-over' (when such option is available).

Perhaps needless to say, the Fed made abundant use of the Section 13(3) authority to afford liquidity assistance to many institutions and markets during the financial troubles of 2008-14, and thus has considerable experience with this funding mechanism. It is thus not the use of 13(3) that will be new now, but the use of the facility to aid States and their political Subdivisions in particular. That is unprecedented, and its significance is accordingly apt to be under-appreciated at first.

The new Municipal Liquidity Facility (again, MLF) that the Fed will now open under Section 13(3) will, like its predecessor facilities during the last financial crisis, operate through a newly formed special purpose vehicle (SPV) – in essence, a legal trust able to purchase, hold, and sell financial assets. In this case the assets in question will be State and Municipal paper, presently called 'Eligible Notes' in the MLF Term Sheet, whose salient characteristics I will lay out in a moment.[2]

The MLF SPV will be initially capitalized with $35 billion from the U.S. Treasury, Congressionally appropriated for the purpose by the aforementioned CARES Act. On this basis, the Fed will itself lend $500 billion, rendering Treasury the equity investor and hence first risk-bearer in the SPV while the Fed serves as leverage-provider.

While the structure just described has, as noted before, been a familiar one since the last financial crisis, the 'substance' of its particular operations is new and noteworthy – indeed unprecedented and 'game-changing' – in ways that are critically important for States and their Subdivisions now faced with pandemic-caused hardship. At least three features bear special mention in this connection.

First, the MLF SPV will purchase securities *directly* from States or their Subdivisions – they will not have to be sold first on the 'open market' to private sector financial institutions as is the case with Fed purchases under the FRA's Section 14 authority.

Second, the months-to-maturity on the paper in question will, for now at least, be 24 rather than 12 months as originally anticipated.

And *third*, most importantly of all, the Fed will retain discretion (a) to *extend* the mentioned months-to-maturity requirement, (b) to extend the *timeframe* within which it is willing to buy – currently set to expire September 30th – and (c) to *loosen* the qualitative *criteria* that Eligible Notes must meet.

In addition to these three most salient features, several others are also worth bearing in mind at least as background conditions, even though they are subject to change – and, in this observer's view, in some cases *likely* to change – going forward …

First, where *apportionment* of funds is concerned, the Fed appears to intend, at least for the time being, to calculate on a per capita basis. States or Cities with large populations would in that sense be eligible for more funding than States or Cities with smaller populations – but only in proportion to those populations themselves. This means that in effect every citizen and legal resident of the U.S. will be eligible for the same benefit as everyone else. Whether departures from *pro rata* distribution of this kind might be forthcoming if some States or Cities recover quickly from the pandemic while others recover more slowly remains to be determined.

Second, at present Eligible Notes are required, not only to mature within 24 months of issuance, but also, per the Term Sheet, to be 'tax anticipation notes (TANs), tax and revenue anticipation notes (TRANs), bond anticipation notes (BANs), [or] other similar short-term notes issued by Eligible Issuers,' and can only secure lending up to 20% of each relevant issuer's 'general revenue from own sources and utility revenue' for the fiscal year 2017. Crucially, however, 'States may request that the SPV purchase Eligible Notes *in excess* of the applicable limit in order to assist political subdivisions and instrumentalities that are not eligible for the Facility' (emphasis added).

Third, proceeds of Note sales to the MLF SPV are to be used, again per the Term Sheet, 'to help manage the cash flow impact of income tax deferrals resulting from an extension of an income tax filing deadline; potential reductions of tax and other revenues or increases in expenses related to or resulting from the COVID-19 pandemic; and requirements for the payment of principal and interest on obligations of the relevant State, City, or County.' The Fed is in these words encouraging public perception of the MLF as a tide-over liquidity facility meant to assist counterparties in, as the Term Sheet puts it, 'managing [their] cash flows' – even as other sections of the Term Sheet leave open the prospect of longer-term 'rollover' of Note debt should the present pandemic and its sequelae continue to pinch.

Finally *fourth*, Eligible Issuers will be all U.S. States and the District of Columbia, U.S. Counties with populations exceeding two million, and U.S. Cities with populations exceeding one million. The Term Sheet also stipulates in this connection that only one issuer per State, County, or City is eligible. While this requirement might be read to mean that for each State, only it itself or one of its Subdivisions may access the MLF, the fact that the Term Sheet also permits 'States [to] request that the SPV purchase Eligible Notes in excess of the applicable limit in order to assist political subdivisions and instrumentalities that are not eligible for the Facility' suggests that this restricted reading would not be correct. It suggests that instead as many eligible Counties and Cities as there are in a State may access the MLF in *addition* to, and hence in *parallel* with, the State itself.[3]

Two further, what I'll call 'interpretive' points bear noting before we summarize the upshot of the foregoing.

First, Chairman Powell and the Fed Board of Governors have effectively encouraged, in their public pronouncements of the past several weeks generally and the last several days particularly, a 'flexible' interpretation of all restrictive language found in the MLF's Term Sheet. The Chairman and the Board have also stated that they will continue to monitor the secondary muni markets for signs of resumed volatility, with an eye to possibly intervening further to stabilize them. Combined with the many openings for extension and exception specified in that Sheet itself as described above, these amount to assurances that the MLF is not only a 'work in progress,' as noted above, but also a work whose scope will *expand* should the *need* for it expand. We are, in other words, very much in 'whatever it takes' territory right now, and the Fed is prepared to improvise further as necessary.[4]

Second, bond market and public finance experts in recent weeks have been calling upon the Fed to purchase State and Municipal debt with maturities not only in excess of traditional 6-month and 12-month durations, but also in excess of the new 24-month duration. The Fed for its part has said nothing to discourage such calls. Most commentators, not to mention 'smart money' on the markets, seem now to anticipate upwards of three- to five-year State and Municipal debt to find its way onto the MLF balance sheet. While this cannot be predicted with certainty, of course, States and Cities faced with serious crises will do well to judge maturity lengthening on the part of MLF-eligible paper more likely than not – or perhaps better put, to be no less likely than any eventual need to issue it.

The Fed is, in short, keen not to repeat the mistakes of the 1930s, but instead to repeat the successes of 2008-14. That is to say it will err, if it errs, not on the side of caution but on the side of its opposite – bold, decisive, and crisis-ending *action*.

Putting all of the above together, reading it against the backdrop of the aforementioned 'whatever it takes'-style public comments made this week by Fed Chairman Powell, and synthesizing it all into a one-paragraph description of the new MLF, it appears then that we have the following:

The Fed will immediately begin directly monetizing 2-year State and Municipal debt, in order to ensure that all States and their Subdivisions are sufficiently financed to continue their current roles as front-line responders to the nation's ongoing COVID-19 pandemic. While in the immediate term it will supply funding up to 20% of what States and their Subdivisions normally take in through traditional revenue sources, it stands ready to lever-up that amount, as well as to lengthen the maturities of eligible paper, should the pandemic and its collateral damage continue to work hardship for longer than now is anticipated. It also stands ready to 'roll over' even 2-year State and Municipal debt, once it has purchased it, should crisis conditions continue past present expectations.

This is effectively *Quantitative Easing for Communities*, or *Community QE*. Our States and their Subdivisions will do well to begin using it at once.

An April 'Game Plan' for States & Their Subdivisions

In light of the above, it seems to this observer that States and their Subdivisions should begin making use of the new MLF immediately. Because those federal instrumentalities that would normally have taken the lead role in addressing the Coronavirus pandemic have not done so, it has devolved upon our States and Cities to play the role of these federal agencies. What the Fed has effectively just announced is that these *de facto* new federal *instrumentalities* will now receive *de jure* federal financing. *Acting* as federal entities, they will now also be *funded* much like federal entities.

There is not a moment to lose in accessing and using these funds. For one thing, every lost day amounts to hundreds or thousands of lost lives. For another thing, harm to State and Local economies is much easier to do than to undo. Best then to employ all means of 'damage control' now, at the earliest possible opportunity, rather than later – when thousands more will have died and much more productive capacity will have been lost.

It should also be noted that, in addition to all of the reasons elaborated above, there is *another* reason to treat the new MLF as affording us much that is needed right now to address and reverse our pandemic: that is the very fact that the MLF is, as emphasized twice now already, a *'work in progress'* …

The Fed is *improvising* right now. That means that what *we* do in response to the improvisation will be very important in determining the shape it assumes as it unfolds. We – the States and the Cities – are in other words *co-authors* of this new authority. It will ultimately be partly *what we make of it.* That is precisely why this observer is writing this Memorandum.

What, then, to 'make' of the MLF? This author believes all State Governors and Legislatures should be called into emergency session at once, 'virtually' if need be, to begin serious deliberation over how to begin using the MLF immediately. These sessions should also be attended by representatives of the States' largest Counties and Cities, as well as by appropriate personnel from all relevant State and Municipal Public Finance Departments.

Counties and Cities should hold counterpart Mayoral and Council meetings as quickly as possible too. For smaller ones, this will be to determine what aid to seek from their States as the latter tap into the new MLF. For the larger ones, it will be both for that reason and in order to determine what to seek *directly* from the Fed through the MLF.

All States and Cities that go into session as just described should also engage representatives of all regional Federal Reserve Banks in whose operational jurisdictions they are located as quickly as possible – ideally requesting their attendance at the sessions themselves. This will be important because the regional Federal Reserve Banks are the primary 'interface' between our federated Federal Reserve System and the nation's various State, Local, and Regional economies.[5] In virtue of that role it will be easiest for the Federal Reserve System both to learn as quickly as possible what State and Local MLF needs are going to be, and to set into motion all procedures that will be necessary for States and Cities to *access* the Facility, if these regional Fed officials are involved in deliberations – even if only as observers – from the very beginning.

Because the need of funds generally is likely to be recognized and agreed upon even more quickly than the full panoply of specific *uses* of funds, it will probably also be best for State and City officials to 'segment' the deliberations that they commence in the emergency sessions that I am recommending here. First can come deliberation and decision over how much funding to seek and whom to authorize to begin preparations for the new issuances that the States and Cities will sell to the MLF SPV. That will of course involve *preliminary* vetting of specific needs and ongoing crises, if only to ensure everyone is clear on the urgency of the funding need itself. But more detailed decisions as to specific intra-State and intra-City *allocation* of funds then can be deferred to a second deliberative phase commencing immediately after decisions about what funding to seek have been made.

Call the first, *quantitatively* oriented discussion of funding needs and issuance authorization, then, '*Phase One*.' And call the second, more *allocatively* oriented deliberation and decision-making '*Phase Two*.'

If at all possible, this author believes States and Cities should begin holding their *Phase One* sessions immediately following the Easter weekend – that is to say, the week of April 12th – or as soon thereafter as possible. This is, again, both because the public health and economic devastation being wrought by the pandemic is happening quickly, and because the sooner that States and Cities begin weighing-in on how the MLF is implemented, the more influence they will have on its ultimate contours and characteristics. Once these Phase One decisions have been reached and the appropriate State and Local personnel have been assigned their issuing and Fed-liaising tasks, States and Cities can proceed directly to Phase Two preparations – that is, to gathering information, testimony, advice and all other deliberative 'inputs' necessary to make sensible allocation decisions in respect of the new funding that will be coming from the MLF.

Once Phase Two deliberations end in allocation decisions, States and their Subdivisions might next consider what I'll call '*Phase Three*' deliberations over whether to press the Fed for further liberalization of the terms of the MLF Term Sheet. It might be decided, for example, that authorization to purchase State and Municipal paper of longer maturity than 24 months should be sought, or that a rollover option should be made more explicit. These questions can presumably wait, however, until current uncertainties 'on the ground' are resolved. With any luck, for example, the pandemic might be contained before summer ends. Or the States' Governors might succeed in their current effort to secure more direct funding from Congress.

However that may be, what matters now is that Phase One commence, and that it commence ‘with all deliberate speed.’ This observer will continue to watch events unfold, and will follow-up with further reporting and recommendations on an ‘as [seems to be] needed’ basis.

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[1] See Board of Governors of the Federal Reserve System, *Press Release: Federal Reserve Takes Additional Actions to Provide Up to $2.3 Trillion in Loans to Support the Economy*, April 9, 2020, available at. In what follows the terms ‘City,’ ‘Locality,’ and ‘Municipality’ are used more or less interchangeably to refer to what the law labels ‘municipal corporations.’ The terms ‘Subdivision’ and ‘Political Subdivision’ are in turn used to embrace both entities of that first type and Counties, which the new Facility described in this Memorandum distinguishes and treats differently from Cities.

[2] Board of Governors of the Federal Reserve System, Term Sheet: Municipal Liquidity Facility, April 9, 2020, available at.

[3] Hence, for example, in California both the State and the City of Los Angeles would be immediately eligible to borrow under the Facility, while the State would be eligible to petition for additional borrowing on behalf of other cities such as San Diego or San Francisco. New York State and New York City will be similarly enabled. The story will be similar for Texas, save in its case two cities – Dallas and Houston – rather than one will be eligible alongside the State to borrow immediately. The author is currently seeking confirmation of this reading.

[4] ‘Whatever it takes’ has become a catchphrase in central banking parlance since European Central Bank (‘ECB’) President Mario Draghi’s assurance in 2012 that the ECB would do what ever is necessary to stabilize the Eurozone. Use of the phrase in the present context signals a readiness on the part of a monetary authority to interpret terms flexibly or even to rewrite them should the alternative be market collapse.

[5] To recur to the examples mentioned in footnote 3, for instance, officials of the Federal Reserve Bank of New York would be in attendance at State sessions in Albany and City sessions in lower Manhattan. Officials of the Federal Reserve Bank of Dallas would be in attendance at Texas sessions in Austin and Municipal sessions in Dallas and Houston. And so on.

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