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Fed Wants States to Try Banks Before $500 Billion Credit Line.

- **Require certification that market can't meet funding needs**
- **Fed sees a backstop if there's no 'well-functioning market'**

The Federal Reserve is trying to ensure that states, cities and counties knock on Wall Street's door first.

The central bank's guidance about the details of its $500 billion municipal lending facility, released late Monday, says that states and local governments will need to provide a written certification that they'd tried to raise money elsewhere first. That may curtail its use because the municipal-bond market has largely stabilized since the Fed announced its planned intervention, allowing governments to issue more than $20 billion of debt over the last several weeks.

The provision is indicative of the cautious approach the Fed has taken since Congress extended it the power to wade for the first time into the $3.9 trillion municipal-securities market, where waves of panicked selling set off a liquidity crisis in March. The lending program promises to extend a lifeline to keep governments afloat if markets seize up again — and the mere prospect of the Fed's intervention was enough to pull the market out of its biggest rout in at least four decades.

But it's still uncertain how much it will be used. While the Fed significantly lowered its minimum population limits so it could lend to 87 cities and 140 counties, according to Census Bureau data, the requirement that governments try banks first will ensure that it's only used as a last resort. The loans will also be priced at a premium to market rates in "normal" conditions, potentially penalizing borrowers who draw from it.

Matt Fabian, a partner at Municipal Market Analytics, said the step ensures that governments continue to tap the public markets instead of queuing up at the Fed.

"It guarantees capital markets or commercial lenders an opportunity to provide a loan before the Fed ultimately funds it," Fabian said. "Which is good for the private markets and should return a sense of normalcy faster than otherwise."

Sales of short-term notes like those the Fed will buy — which governments use to cover expenses until tax collections come in — represent a fraction of the overall municipal market, with just $5 billion sold so far this year, according to data compiled by Bloomberg. But such borrowing is poised to increase as states push back their tax filing deadlines until July and the steep economic slowdown causes tens of billions of dollars in sales- and income-tax revenue to disappear.

It's unclear how well the public market could absorb borrowing on the scale that's needed, with prices still steadying from the biggest sell-off in at least four decades. Prices have slipped steadily since the middle of the month, giving back earlier gains, with 10-year yields rising 6 basis points to 1.35% Tuesday.

The pricing of the facility may also represent a way to restrain borrowing, though the Fed didn't detail how large a penalty it will charge, as required under federal law.

The pricing is the "million dollar question," said Emily Brock, director of the federal liaison center for the Government Finance Officers Association, a lobbying group.

Morgan Stanley strategists said in a note on Tuesday that they expect a "majority" of the Fed's municipal lending facility to be used. Still, the pricing could affect the usage of the facility if the penalties are too steep, strategists led by Michael Zezas.

The Fed's guidance said that issuers should look to the Fed if they can't obtain "adequate credit accommodation" from banks, a definition that includes "prices or on conditions that are inconsistent with a normal, well-functioning market."

"Obviously the definition of 'normal' will go a long way to determining how much the facility is used," Zezas said.

Already, the Fed's commitment to backstop the market has helped pushed down yields on the shortest-dated securities, which surged during last month's liquidity crisis. One-year AAA debt is yielding 0.8%, down from 2.8% in late March, according to Bloomberg BVAL benchmarks.

The Fed also extended its lending to the end of the year rather than the end of September, likely in response to concerns that governments might not know the extent of their cash needs for a while. The Fed also increased the eligible maturity date on the notes that it will purchase to three years instead of two.

The Fed made those changes after getting feedback from a variety of stakeholders, Brock said. She said the changes signal that the Fed "earnestly wants to make sure this is used."

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