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The Fed Goes Local: A Review of the Municipal Liquidity Facility - Milbank

The Board of Governors of the Federal Reserve System (the "Federal Reserve") has taken strong steps to support near-term liquidity in the nearly $4 trillion market for municipal bonds issued by states and local governments. The Federal Reserve's expansion of the Municipal Liquidity Facility (the "MLF") represents the most significant step so far by the Federal government to provide direct financial assistance to cash- strapped states, cities and counties facing a double hit from the COVID-19 pandemic: higher costs to deal with the public health crisis coupled with reduced or delayed revenues from taxes and fees.

More broadly, Congress and the President have enacted multiple emergency relief programs to address the impact of COVID-19 on public health and the economy in the United States.1 None of these legislative packages yet provide the massive financial assistance that state and local governments have sought. In the absence of such funding, given the reliance of state and local governments on debt raised in the tax-exempt municipal bond markets, the Federal Reserve has stepped in under its pre-existing statutory authority under Section 13(3) of the Federal Reserve Act to enable certain state and local governments to borrow directly from the Federal Reserve to bridge current funding shortfalls, subject to newly increased limits, for up to three years.2

On April 9, 2020, the Federal Reserve first announced the MLF, which we summarized in a Client Alert on April 10, 20203. The MLF represents a novel and meaningful attempt to stabilize the municipal bond market and is a clear indicator that the Federal Reserve understands the significance of the state and local sector to the overall economy. Traditionally, the Federal Reserve's programs to inject liquidity into the banking sector or the capital markets have not been used to support public issuers. Now, the Federal Reserve for the first time is providing widespread support to ensure the liquidity of and flow of credit to state and local governments as the economic effects of the COVID-19 crisis continue to deepen.

On April 27, 2020, the Federal Reserve announced an expansion of the scope and duration of the MLF. As detailed further below, this expansion substantially increased the number of eligible cities and counties and extended the maturity date of, and the termination date to purchase, Eligible Notes (as defined below). This expansion of the MLF additionally shows the Federal Reserve's expectation that increased measures are required to stabilize the municipal bond market and casts a considerably wider net geographically on the municipalities to which assistance can be provided. The changes also indicate a willingness to adapt the MLF as the COVID-19 situation unfolds and suggest a growing realization that, at a minimum, the liquidity problems of state and local municipalities will continue beyond Q3 at least to year-end 2020.

Below is a summary of the MLF based on the term sheet4 the ("Term Sheet"), initially effective as of April 9, 2020 as revised on April 27, 2020, issued by the Federal Reserve:

- The Federal Reserve has committed to provide support to States and the District of Columbia, cities with a population exceeding 250,000 residents (i.e., 86 cities) and counties with a population

exceeding 500,00 residents (i.e., 119 counties);
– Previously, the MLF allowed only cities with a population exceeding one million residents (i.e., 10 cities) and counties with a population exceeding two million residents (i.e., 14 counties).

- Such support will (i) come from a Federal Reserve Bank and its commitment to lend on a recourse basis to (ii) a special purpose vehicle ("SPV") that will purchase up to $500 billion5 of "Eligible Notes";
  – The Department of the Treasury will invest $35 billion in the SPV pursuant to funds appropriated by the Coronavirus Aid, Relief, and Economic Security Act, which will likely take "first losses" in the SPV capital structure.
  – While the Term Sheet speaks of an SPV in the singular, it does not identify which Federal Reserve Bank (or Banks) will provide funding to the SPV, leading to an assumption that municipalities will be grouped by the geographic reach of their local Reserve Bank.
- Eligible Notes consist of (i) tax anticipation notes (TANs), tax and revenue anticipation notes (TRANs), (ii) bond anticipation notes (BANs)6 and (iii) other similar short-term notes, set to mature no later than 36 months (extended from 24 months) from the date of issuance;
- Eligible Notes are *newly* issued by "Eligible Issuers" (*i.e.*, a state, city or county);
- Eligible Notes may be issued up to 20% of the general revenue of the applicable governmental entity for fiscal year 2017;
- Proceeds from Eligible Notes may be used to manage the effects of income tax filing deadline extensions, reductions of revenue and increases in expenses resulting from the COVID-19 pandemic and payment of principal and interest on the applicable governmental entity's obligations;
- Eligible Notes may be purchased until December 31, 2020 (extended from September 30, 2020).

The MLF is not designed to bail out insolvent or financially distressed issuers, apart from the impact of COVID-19. Eligible Issuers must meet minimum credit criteria based on at least two major nationally recognized statistical rating organizations (e.g., S&P Global Ratings, Moody's Investor Service, Inc. and Fitch Ratings, Inc.): (1) with respect to Multi-State Entities (i.e., an entity that was created by a compact between two or more states and approved by the United States Congress), ratings of at least A-/A3 as of April 8, 2020 and (2) with respect to entities that are not Multi-State Entities (i.e., a state, city or county), ratings of at least BBB-/Baa3 as of April 8, 2020; provided that if such Eligible Issuers are subsequently downgraded, ratings of at least BBB-/Baa3 and BB-/Ba3, respectively, at the time the SPV makes a purchase of Eligible Notes from such Eligible Issuers.

Though the Term Sheet provides a decent snapshot of the scope of the MLF, it also raises a number of questions that the Federal Reserve will need to provide additional clarification on:

- Though the Term Sheet has specified the criteria for Eligible Issuers, such Eligible Issuers are subject to approval by the Federal Reserve, and issuances of Eligible Notes are subject to review by the Federal Reserve. The Term Sheet requires legal opinions and disclosures prior to purchase of Eligible Notes, and the form and substance of such legal opinions and disclosures are currently unclear, only that they will be determined by the Federal Reserve. In short, two levels of approval appear to be necessary: (i) approval as an Eligible Issuer, and (ii) approval of the Eligible Note itself;
- Given the substance of such approvals have not yet been clearly delineated, the Federal Reserve will need to provide additional guidance, particularly in respect of the requirements for legal opinions and disclosures. Further, such approval is likely to be subject to interpretation by each Federal Reserve Bank, if applicable;
- In situations where both a city and the county can be Eligible Issuers (e.g., Los Angeles County and the City of Los Angeles), "double-dipping" in the issuance of Eligible Notes will likely be prohibited for both the city and the county. If the States and subdivisions cannot agree among themselves, the

Federal Reserve may have to decide which entity is eligible.

It is unclear when the MLF will be activated and will begin purchasing Eligible Notes. It is possible that the MLF terms will be further updated based on public comment and related factors

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