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Cities, States Tapping $500 Billion Fed Fund Face Penalty.

- **Fed lending program includes spread penalty as high as 590 bps**
- **Issuers expected to push back, call spreads ‘too wide’: Luby**

The Federal Reserve is designing its lending program for U.S. states and cities in a way that will likely deter cash-strapped governments from using it.

Even municipalities with the most pristine finances — bearing AAA ratings — would pay an extra 1.5 percentage points above an overnight indexed swap rate, according to the central bank’s term sheet released Monday. That penalty may not be attractive to cities and states given that the market’s interest rates are back near their lows, with one-year benchmark debt yielding under 0.5%.

The rates on the loans are viewed as a key determinant of how much cities and states would turn to the Fed to cover cash-flow shortages. So far, the Fed’s roll-out of the historic program has signaled that it’s treading cautiously and wants to be viewed as the lender of last resort. Cities and states must also provide written certification that they couldn’t acquire “adequate” credit from a traditional bank before they tap the Fed.

“I would expect issuers, financial advisors and underwriters will push back and say, ‘These spreads are way too wide,’” said Patrick Luby, a strategist at CreditSights.

Mike Nicholas, chief executive officer of the Bond Dealers of America, a lobbying group representing banks, said the above-market pricing is in line with the Fed’s intention for its loans to be “last resort financing.”

The dealers’ group had floated a pricing penalty of benchmark index rates plus 10 basis points for AA borrowers, according to an April letter it sent to the central bank. The Fed’s term sheet says it will institute a 170-basis-point penalty for governments at that grade. Those rated below investment grade will see a 590-basis-point penalty, according to the Fed.

Ben Watkins, Florida’s director of bond finance, said he was surprised by the pricing levels released by the Fed, thinking originally they were going to be lower. He said the rates may deter eligible issuers from tapping the facility and support the view of the Fed as a backstop if the market isn’t working properly.

“From an issuers perspective the first thing we ask ourselves is: ‘What is the cheapest source of funding?” and that is what you go to every-time,” Watkins said.

The central bank has also taken into account feedback from industry participants and shown willingness to alter its plans. Since announcing the facility, the Fed expanded the number of eligible borrowers to 87 cities and 140 counties, according to Census Bureau data.

Luby said the central bank may make similar changes to pricing based on feedback that it receives.

But Barclays Plc strategist Mikhail Foux said the Fed’s terms may still be attractive to mid-rated borrowers that are still investment-grade that could issue notes yielding between 3% to 4% — that may end up being less costly than what they could borrow in the traditional muni market.

“I view today’s developments as positive for the muni market,” he said in an email.

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