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Wall Street Vet Guides Fed Plan That Rescued Muni-Bond Market.

- **Even before making any loans, backstop ended a massive selloff**
- **Fed taps former Bear Stearns, JPMorgan banker as adviser**

In the days after America's state and local government bond market nearly froze during a record-setting crash set off by the coronavirus, the Federal Reserve hired Kent Hiteshew to make sure it doesn't happen again.

The 65-year-old former JPMorgan Chase & Co. banker immediately began working the contacts he'd built during nearly three decades on Wall Street and a stint in President Barack Obama's Treasury Department.

The Fed was moving aggressively to prop up other debt markets being hammered, too, as the economic standstill set off panic on Wall Street.

Yet the mere prospect of the central bank's first intervention ever into the $3.9 trillion municipal market — authorized by the stimulus plan enacted in Congress — was enough to stop a mass exodus by investors who were yanking tens of billions of dollars out of mutual funds. Even before its details were announced on April 9, prices rallied. Bond deals shelved during the crisis were sold as buyers came back, and investors have been returning cash to mutual funds as the losses that piled up in March disappeared.

Congress has so far failed to extend more help to states, cities and counties facing massive budget shortfalls as tax revenue disappears. As a result, the only lifeline to come from Washington may be the Fed program Hiteshew is helping to guide.

But it's also a limited one. While the central bank moved aggressively to buy up corporate bonds, the Fed hasn't been buying municipal debt on the open market. Instead, it opted to make $500 billion available for government loans due within three years. It has made it clear that it's a credit line of last resort, one to turn to only if markets seize up again or skittish investors demand excessively high interest rates from states and municipalities. It's set to lapse at the end of the year.

"None of us know today whether the recovery will be V-shaped or take much longer, or how deep it will be," Hiteshew said during a conference event held last month by the Government Finance Officers Association. "The last thing we want to see is have state and local governments' balance sheets loaded up with deficit financing that can hinder their ability to provide the essential services and infrastructure financing that we as a nation depend on going forward."

First Customer

That's meant that the Fed's municipal-lending program has had little direct effect, aside from restoring investors' confidence that it will step in to halt another liquidity crisis.

Illinois, whose bond yields have surged on the risk it could be the first state ever cut to junk, this week became the first to borrow from the Fed. It paid a rate of 3.82% for a $1.2 billion one-year loan. Wall Street analysts have speculated that only struggling municipalities will borrow because those with AAA ratings can borrow for just 0.09% in the public market. The Fed is charging penalties of 1.5 percentage points to 5.9 percentage points over a market benchmark on its loans, depending on the grades assigned by the major rating companies.

That's drawn criticism from some on Wall Street and in Washington that it should be doing more. Analysts at Citigroup Inc. have said the Fed should extend the program to include buying long-term debt, which would give governments more time to recover from the economic downturn.

"The way they've done it is just simply not enough," said U.S. Senator Bob Menendez, a Democrat from New Jersey who sits on the banking committee.

The Fed has said it is monitoring the market and could step in further if needed. It has already shown a willingness to alter the municipal lending program.

Extending Reach

Hiteshew, who started his career at Morgan Stanley in 1988 before moving on to Bear Stearns Cos. and JPMorgan, was hired as an adviser to the Fed for six months. He spent the early weeks of his job on the phone with credit-rating analysts, Wall Street bankers, investors and groups that represent local government officials.

In late April, after the program drew pushback for allowing only the biggest cities and counties to borrow — freezing out some hard hit cities with large black populations — the Fed lowered its population thresholds to give it broader reach. This week, it went even further, allowing governors in the least populous states to pick up to two municipalities that could borrow if they still weren't big enough to qualify.

It also extended the lifeline to agencies like public transit operators or airports — with a limit of two per state — to help alleviate the cash shortfalls as air travel and commuting plunges. That will likely help New York's Metropolitan Transportation Authority, the subway operator that's looking at borrowing from the Fed to help cover a potential deficit of $8.5 billion.

Former colleagues credit Hiteshew for his deep market knowledge and skill at building consensus. When he led the U.S. Treasury's Office of State and Local Finance from 2014 to 2017, he helped create support in Congress for legislation allowing Puerto Rico to go bankrupt to provide an orderly way out of its debt crisis.

"Kent is someone who understands his mandate, the limits of the authorities that the institution can exercise, but also the full weight and breadth of the available authorities," said Antonio Weiss, a counselor to then-Treasury Secretary Jack Lew who oversaw the Puerto Rico rescue. "His creativity and technical expertise will help the Federal Reserve unlock the full extent of its powers in addressing the crisis that states and municipalities face. But it will be within the limits of the mandate, not outside."

Rebound from Crisis

The Fed's backstop so far appears to have been enough to return the municipal-bond market to normalcy. By promising to prevent a flood of short-term debt sales by governments seeking to bridge temporary cash shortfalls, it has driven interest rates down steeply. Top-rated two-year bonds are yielding about 0.17%, down from as much as 2.78% in mid-March.

Investors have added money to municipal debt mutual funds since mid-May, with $1.2 billion flowing in during the week ended Wednesday, according to Refinitiv Lipper US Fund Flows. The interest rates on long-term bonds have also plunged, driving the Bond Buyer 20-year index to the lowest since at least 1960.

That may undercut, at least temporarily, the impetus to make long-term loans.

“It’s not free money,” said Thomas Green, a managing director and public finance banker at Citigroup.

Hiteshew is “setting it up to be helpful to those who need it and that’s a helpful thing from the Fed’s point of view,” he said. “They don’t tend to want to get entangled in state and local affairs if they can avoid it.”

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