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Federal Reserve Reduces Borrowing Costs for States, Municipalities.

The Federal Reserve announced Tuesday that it is reducing borrowing costs by half of a percentage point for state and local governments that use its municipal liquidity facility.

Municipalities that want to borrow from the Fed will now need to pay between 1.0 and 5.4 percentage points above benchmark interest rates for loans of up to three years.

So far, the only state and local government that has used the facility is Illinois. The financially troubled state sold $1.2 billion of debt to the Fed in June.

"Today's changes will ensure the [municipal liquidity facility] continues to provide an effective backstop to assist U.S. states and local governments as they weather the pandemic," the Fed said in its statement.

The Fed's move comes just as technical factors that have supported the market—notably, a wave of cash from investors reinvesting the principal of matured bonds—are expected to start waning. Supply is expected to pick up in coming weeks as well.

As a refresher, the Fed announced in April it would set up a special purpose vehicle to buy up to $500 billion in municipal debt as part of its coronavirus relief efforts.

When it introduced the facility, the central bank said it would charge a "penalty rate" or spread over benchmark interest rates—unlike its corporate bond facilities.

Top-rated tax-exempt municipal debt often yields less than Treasuries, since Treasuries are taxable. For example, 10-year AAA-rated municipal bonds yielded 0.60% on Tuesday, while 10-year Treasuries closed with yields of 0.64%.

So the current costs of the Fed facility remain substantially higher than market rates. Three-year AAA-rated municipal bonds yielded 0.09% on Tuesday, according to Bloomberg data. The implied interest rate for a AAA-rated muni using the Fed's facilities—using benchmark interest rates in derivatives markets and the new pricing schedule—would be about 1.24%.

The Fed also reduced the size of the interest-rate adjustment for taxable municipal debt compared to tax-exempt debt.

Because of the onerous terms and high costs of the Fed's muni facility, strategists such as Citigroup's Vikram Rai have been calling for the central bank to provide more support. The iShares National Muni Bond Exchange-Traded Fund (MUB) is up 2.8% so far this year, while the iShares iBoxx $ Investment Grade Corporate Bond ETF (LQD) is up 7.5%. (To compare, the S&P 500 is up 3.2% year to date.)

Still, considering the concerns about what the pandemic may do to state and local government budgets, the municipal bond market has posted decent returns this year. In a note from mid-July, Tom Kozlik, head of municipal strategy and credit at Hilltop Securities, attributed that performance to a widespread expectation that the Fed would eventually step in to expand its aid to muni markets.

“There has been extensive Federal Reserve support of other markets to date, and we do not think the support for municipals…comes close to what has been provided in those other cases,” he wrote. “More could and should be done by the U.S. Federal Reserve now to prepare for a municipal market dislocation from liquidity concerns or anxiety over credit. Investors could be assuming that because there is room for the Fed to act in support of the municipal market, that it could act, and make up ground in comparison to the support for other markets.”

Barron’s

By Alexandra Scaggs

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