Banking Law News

# Phone Call Signals Fed Treading Cautiously With Muni Lending

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April 17, 2020, 11:01 AM

- $500 billion program to help states, cities amid crisis
- After briefing, local officials see it a ‘backstop’ for market

On April 10, a day after the Federal Reserve rolled out plans to make loans in the $3.9 trillion municipal-debt market for the first time, the central bank’s Kent Hiteshew led a conference call with state and local government officials to explain how it would work.

The takeaway, according to those on the call, was that the $500 billion of loans available to the states and the biggest cities and counties should be seen as a lifeline that’s available if the public markets seize up -- not a first resort for governments desperate for cash to fill the growing shortfalls in their budgets.

Ben Watkins, who oversees debt sales for Florida and was on the call, said the Fed’s short-term loans aren’t meant to act in place of the market. “I would call it not a direct intervention but a tool to be used as backstop,” he said.

The Fed has taken a cautious approach toward the recommendation by Congress in the $2.2 trillion economic stimulus law that it provide liquidity to the muni market. The sell off last month effectively shut off governments’ ability to raise funds. Rather than buy already issued debt to help prop up the market -- as some on Wall Street pushed for -- it has decided to extend loans directly to help government’s through the end of September as the severe economic slowdown pushes them toward what may be the worst fiscal crisis in decades.

The program, however, is only available to states and the approximately two dozen cities and counties that qualify under the Fed’s minimum population limits, and a key element of it -- how the bank will set the interest rates -- has yet to be disclosed. That will be crucial to determining whether governments flood the Fed with requests or do so only as a last resort should the Fed charge a premium to market rates.

### Market Premium

Under Section 13(3) of the Federal Reserve Act, which allows the Fed to make emergency loans, the Fed is supposed to set rates at a “premium to the market rate,” according to a 2015 rule.

Watkins said officials on the call with the Fed last week were told the pricing would be higher than market rates. “We don’t really know what that means,” he said.

A spokesperson for the Fed declined to comment.

The Fed has taken a three-pronged approach in its support for a wide array of markets. In some cases, it is acting as a lender of last resort to short-term financing markets or the firms that are critical to them, such as money market funds. In another set of facilities, including the municipal facility, it is using its balance sheet to accomplish a goal requested by Congress. A third set of facilities is aimed at direct market support, where the Fed is using its balance sheet directly to buy the bonds of individual companies or make loans directly to them.

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The central bank has said it could roll out further lending programs if needed, and its new powers helped end the steep sell-off last month that caused prices to tumble by the most in at least four decades as fearful investors yanked out their funds. The yields on the shortest-dated municipal debt -- which money managers dumped to raise cash to meet withdrawals -- have since tumbled from as much 2.8% last month to about 0.8%, according to Bloomberg's benchmark indexes.

**More Aid**

The $500 billion of available loans promises to prevent governments from flooding the public market with short-term debt, which could have pushed up interest rates. By taking out so much supply, that could also help ensure that smaller cities and counties that can't borrow from the Fed can still raise cash.

They may need quite a lot. The National Governors Association has said the federal government should extend some $500 billion of aid to the states alone to help them close budget shortfalls they will face over the next few years, while cities have sought $250 billion. It's still unclear whether Congress will be able to extend such help with a second stimulus bill.

The governor of New Jersey, one of the states hit hardest by the pandemic, said Thursday that he wants to borrow as much as $9 billion from the Fed. Others, including Massachusetts and Hawaii, have been lining up private loans instead.

The central bank is still ironing out key details of the lending program and asked for market participants to provide feedback through April 16. Lobbying groups like the Bond Dealers of America have sent letters to the Fed with their perspective on the program and potential changes. The central bank is also expected to release a list of questions and answers about the program that will provide more detail.

Kenton Tsoodle, the assistant city manager of Oklahoma City and a Government Finance Officers Association official who was on the Fed call, said he took the bank's comments as a sign that the Fed wants to act as fallback for borrowers who can't otherwise raise what they need on Wall Street.

"I believe the goal would be that folks get out there in the regular market," Tsoodle said.

--With assistance from Craig Torres.

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