Memo Re: Federal Reserve Municipal Lending Facility and Next Steps

From: Americans for Financial Reform Education Fund

In an unprecedented move, the Federal Reserve System, backed by $35 billion of equity from the U.S. Treasury, has committed to direct lending of up to $500 billion to state and local governments. This will be done by authorizing regional Federal Reserve banks to purchase state and local debt up to one-fifth of each jurisdiction's 2017 revenues, through September 30, 2020. The new facility is a badly needed new resource that should provide significant support to states and localities seeking to address revenue gaps and increased costs during the current crisis.

Below we briefly summarize outstanding issues with the facility. Key issues are:

- The number of eligible issuers should be expanded.
- The maturity term of the lending should be extended from two years, or provision should be made to finance refinancing the initial loans for an extended period, or both.
- Pricing should explicitly reflect the low spreads available in the muni market as of the beginning of 2020.
- We strongly support the stated purpose of the facility as including all "potential reductions of tax and other revenues or increases in expenses related to or resulting from the COVID-19 pandemic". This should be made clear in all elements of the term sheet.
- Additional steps to support municipal markets are needed to ensure that the state and local fiscal situation does not impact long-term economic recovery from the crisis.

Below we expand on these points.

Issuer Eligibility for the Facility: Based on the initial sheet, an issuer must be one of the following three types of entities:

- A U.S. State or the District of Columbia -- note territories are not included.
- A county with 2 million population or over – about 15 U.S. counties would qualify.
- A city with 1 million population or over – about 10 U.S. cities would qualify.

No other entities would be eligible for direct lending, and only one issuer per jurisdiction would qualify. However, eligible borrowers may use proceeds for subdivisions or instrumentalities of the entity.

The very narrow direct eligibility criteria for cities and counties presents many potential inter-governmental issues. Eligibility should be broadened. Opening the facility to all cities and counties with over a half million population would include less than one hundred and eighty borrowers as opposed to the current 76. Opening the facility to cities and counties with a population over 100,000 would include fewer than 1000 borrowers. These are small numbers compared to the number of borrowers in private sector facilities.

Another issue is that Puerto Rico and other U.S. territories are not eligible for assistance from this facility. It is true that Puerto Rico presents unique underwriting and governance issues due to its current quasi-bankruptcy situation, in which it is not accessing general debt markets. However, Puerto Rico is like any other jurisdiction in that it is impacted by the revenue interruptions and other financial and human costs of the Covid-19 pandemic. Further, Puerto Rico is within the district of the Federal Reserve Bank of New York which is the largest and most sophisticated regional bank and the best equipped to manage and analyze issues associated with assisting Puerto Rico. It is not equitable or appropriate to simply omit Puerto Rico and its population of over 3 million people from all support for revenue anticipation borrowing.

Borrowing Period / Maturity: The facility is limited to notes that mature with 24 months / two years. This is much too short and will limit real ability to take advantage of the facility even in cases of need. It is likely that the economic aftershocks of this crisis will still be felt two years from now, and certainly the tax revenue consequences will as well. Requiring all municipalities benefiting from these purchases to simultaneously refinance this debt just two years from now will likely create significant strain in the municipal markets at that time. This could become a drag on economic recovery.

One way to address this issue would be to provide guaranteed refinancing of the notes after the two year maturity date. For example, the Federal Reserve System could commit to rolling over borrowing from the facility for up to a ten or twenty year period at the initial interest rate.

The base maturity should also be lengthened. The corporate credit, securitization (TALF), and Main Street Lending facilities announced on April 9th all provide financing with maturities of up to four years. This longer maturity is available despite the fact that these private sector facilities service credits that are significantly inferior to the municipalities serviced by this facility.

Pricing and transaction costs of notes: The term sheet states that pricing will be determined based on the credit ratings of the issuer, with details to be provided later. However, ratings agencies notoriously underrate municipal borrowers, giving lower ratings than they would to private issuers with similar records of repayment. Given the extremely good repayment record of municipal borrowers generally, we suggest that note pricing be tied to a low risk premium over SOFR or the Federal Funds Rate, with premiums similar to the risk premium evident in the municipal markets early in 2020 before the impact of the Coronavirus pandemic.

The 10 basis point origination fee appears reasonable. Since these loans are directly sold to the Federal Reserve, third party underwriting of the sale, which could create large associated fees and pricing distortions, should be strongly discouraged or outright banned. Federal Reserve banks themselves should provide any needed administrative intermediation and technical assistance.

Maximum borrowing and permissible uses of proceeds: Aggregate borrowing for an issuer is limited to twenty percent of total own-source and utility revenue for 2017. States (but not other entities) may apply to borrow in excess of the cap in order to finance subdivisions or instrumentalities. This ability should be extended to counties and cities which may also have relevant instrumentalities affected by the crisis.

As listed in the term sheet, permissible uses of note proceeds include following:

1) the cash flow impact of income tax deferrals resulting from an extension of an income tax filing deadline;
2) potential reductions of tax and other revenues or increases in expenses related to or resulting from the COVID-19 pandemic;
3) and requirements for the payment of principal and interest on obligations of the relevant State, City, or County

The second justification is the broadest and most significant of the three, since it allows municipalities a tool to address any reductions in revenues or increases in expenses resulting from the pandemic that are not met by increased Federal grant assistance. This justification would include borrowing that is not by a narrow definition "revenue anticipation" borrowing, since some reductions in tax revenues due to the pandemic (e.g. sales tax reductions) will not necessarily be made up at a future date, and increases in expenses do not technically fit the definition of revenue anticipation. We believe it is critical that emergency borrowing to fit these pandemic related needs be fully accommodated within the program and suggest that this reference be explicitly incorporated within the definition of "eligible notes" elsewhere in the term sheet, for example in the second paragraph of the term sheet.

Unfinished business: The primary source of assistance to states and localities for crisis-related costs ought to be direct Federal grant aid. But it is critical to have a full lending backstop available for short term urgent needs not covered by grant aid. Assuming that the recommendations above are incorporated this facility goes some distance to providing this kind of backstop.

However, this facility is far less useful in ensuring that states and localities are well positioned to support an economic recovery and do not experience long-term fiscal pressures or constraints on financing due to the aftershocks of the Covid-19 crisis. This is what occurred during the 2009-2011 Great Recession period. The Federal Reserve and Treasury should use a share of their remaining financing to support municipal secondary markets and longer-term credits. We have seen enormous pressures on municipal secondary markets during the past several weeks, with unprecedented liquidity issues and extreme expansion in spreads between municipal and Federal obligations. This facility needs to be supplemented with an additional facility that includes both secondary market support and potentially extended support for selected primary issuances, along the lines of the Primary and Secondary Market Corporate Credit Facilities. This is necessary to ensure that the impact of the crisis does not undermine state and local employment and services over the long run.