

March 18, 2020

The Honorable Jerome H. Powell  
Chair, Board of Governors of the Federal Reserve  
20th Street and Constitution Avenue NW  
Washington DC 20551

Dear Chairman Powell,

I read with interest the Federal Reserve's announcement yesterday of the establishment of a Primary Dealer Credit Facility (PDCF). The Bond Dealers of America (BDA) supports this concept, and we write today to urge you to expand the facility to include a broader group of firms active in the municipal securities market. The Fed also recently announced a Commercial Paper Funding Facility (CPFF), which we also support and encourage you to expand. BDA is the only DC-based group exclusively representing the interests of securities dealers and banks focused on the US fixed income markets.

The municipal market is idiosyncratic in several respects.

- The market is dominated by a large number of issuers, many quite small in size, and a very large number of individual CUSIPs, making the market more fragmented than some other fixed income sectors;
- The fact that the interest on most municipal securities is exempt from federal taxation, while extremely beneficial for issuers, creates market anomalies like the inability to short tax-exempt bonds, which in turn makes hedging difficult and imprecise;
- There is a high degree of retail participation with nearly half the market owned directly by individual investors; and
- Tax and other market issues act to strongly discourage municipal issuers from using program issuance like commercial paper. Instead, to meet their short-term borrowing needs, municipal issuers generally sell puttable, variable-rate bonds called Variable Rate Demand Notes (VRDNs) which have nominally long maturities but are generally money-market eligible because of their periodic put feature.

The municipal market, like all sectors of the capital markets, has been hit hard by the economic uncertainty associated with the coronavirus pandemic. Liquidity has waned significantly as measured by bid-ask spreads and price volatility has been perhaps the most severe ever in the history of the market. Some dealers have reported that internal and regulatory risk control systems have effectively prevented them from taking on more municipal inventory. One of the hardest hit sectors of the market has been VRDNs. As we saw during the financial crisis, there has been a recent spike in bonds held by remarketing agents and liquidity banks.

In the long run, the municipal market is sound. Long-term default rates among municipals are among the lowest of any asset class. And of course, the municipal securities market enables financing for much of the nation's infrastructure, making the market a vital national asset. However, given the uncertainty brought about by the coronavirus outbreak, the market is in need of short-term, temporary support from the Federal Reserve. We ask that you consider two initiatives.

**Expand the PDCF to include non-Primary Dealers of municipal securities.** The municipal market is more decentralized and fragmented than other sectors of the capital markets. The fact that municipal interest is often exempt from state income taxation for investors in the state where the bonds are issued but not in other states contributes to the fragmented nature of the market—investors often prefer bonds issued in their own states. The retail nature of the municipal market means that rather than a small number of large institutional customers spread among a few Primary Dealers as in other market sectors, the market is characterized by a large number of small retail customers serviced by retail-focused dealers, most of whom are not among the 24 Primary Dealers. Indeed, many of the banks and dealers on the New York Fed’s Primary Dealer list do not even participate actively in the municipal market. Limiting financing for municipal inventories only to Primary Dealers would exclude a large number of municipal securities dealers committed to supporting market liquidity as well as, of course, their customers. For the PDCF to be effective in supporting municipal market liquidity, it needs to be expanded to include non-Primary Dealers active in the municipal market.

**Expand the CPFF to include municipal VRDNs.** While commercial paper is not unheard of in the municipal market, as stated above, it is not popular among issuers in the municipal market. [The persistent reissuance of new CP to redeem maturing CP creates difficult tax compliance issues for issuers]. So instead of CP, municipal issuers have come to depend on VRDNs to appeal to investors seeking money market eligible securities, to access short-term rates, and meet their short-maturity funding needs. VRDNs are long-term, variable-rate securities that are puttable on each periodic interest rate reset date, with the put supported by a standby bank liquidity facility such as a Letter of Credit. Rates on VRDNs are adjusted periodically, often weekly, through a remarketing process, which is also the primary source of liquidity for VRDN holders. A designated remarketing agent sets the periodic rate such that there are sufficient buyers for all those seeking to sell VRDNs on the reset day. If the remarketing process fails and there are not sufficient buyers to meet all liquidity demands, remarketing agents often take the bonds into their own inventories. As a last resort, investors can put their bonds to the standby liquidity bank, which results in a significantly higher interest cost to the issuer.

VRDN issuers and dealers and banks who support the VRDN market today face some of the same issues as issuers and intermediaries in the CP market, including expensive backup bank facilities, skittish investors concerned about the virus, and dealer inventories that are “full.” The same dynamics in play in the CP market are also in play in the VRDN market. In that context, we ask you to expand the CPFF to include investment grade, municipal VRDNs.

We have every expectation that once the virus scare is over, conditions in the municipal market and the rest of the capital markets will return to normal. In the meantime, however, liquidity is constrained, and investors are at risk. We believe the changes we outline here would help address these acute and short-term market issues.

Thank you for your consideration. We would welcome the opportunity to discuss these issues further.

Sincerely,



Mike Nicholas  
Chief Executive Officer  
Bond Dealers of America