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# The Fed took a big step into the municipal market, but it won't be enough

By Michael Decker

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The Federal Reserve will begin lending money to states and localities in the form of note purchases as a way to help governments manage through the economic fallout from the coronavirus.

It is a welcomed step.

Governments are just now beginning to feel the fiscal crunch, and many will need to undertake short-term cash-flow financing to maintain liquidity. The Fed's action ensures that at least \$500 billion is at their disposal.

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The Fed's new program, however, will not be enough to negate the serious financial consequences that are likely to befall some local governments as they begin to feel the full effects of shutting down the economy. Both the Fed and Congress need to do more.

The Fed had to make some difficult choices in setting the terms of the new Municipal Liquidity Facility, the program under which they will purchase Tax, Revenue, and Bond Anticipation Notes with maturities up to 24 months. Most significantly, the Fed will limit direct access to the program to the 50 states, the District of Columbia, and the two dozen or so largest cities and counties in the country. They did this because the municipal market is so broad and diverse. There are around 20,000 issuers who sell bonds periodically. That can be intimidating to a newcomer to the municipal market like the Fed. Where to even begin?

The Fed has provided a backdoor way for the huge number of local governments excluded from the program to gain access. States can serve as conduits and relend or grant the proceeds to other issuers. Unfortunately, that approach will not work in many cases.

While some states are prepared and eager to serve the role of conduit to the Fed, others are legally or constitutionally prohibited from serving that role. To ensure the facility's success, the Fed should rethink the terms of the program with respect to local borrowers. 20,000 may be too many issuers for the Fed to manage, but 75 is too few to stand up the market.

Congress has begun to weigh on issues surrounding the Fed facility. Last week House Financial Services Committee Chair Maxine Waters (D-CA) wrote to Federal Reserve Chair Jerome Powell about the municipal facility. Chair Waters said "Congress made no distinction regarding the size of a

municipality that should directly benefit from" the Fed program. She concluded that "the facility can be immediately improved by, among other things, including territories and dramatically lowering if not eliminating the arbitrary thresholds set for eligible municipalities."

Most important is the question of who bears the credit risk for the "downstream" local government borrowers who access the Fed facility indirectly through a state. States do not assume credit risk for their local governments in the best of times. They certainly will not be in a position to assume that risk in a recovering economy.

It must be the Fed, not the states, who bears default risk under the Municipal Liquidity Facility. The whole point of the program is for the Fed to contribute its liquidity to strapped local governments. That would not be possible if they rely on states to assume the credit risk for downstream borrowers. The Fed absorbs all the credit risk in its facilities designed to bolster the primary and secondary corporate bond markets. The same issues apply here.

As important as the Fed program will be at ensuring issuers have ready access to liquidity, it will not be enough to prevent credit deterioration in the municipal market. That erosion has already started. Tens of billions of investment grade municipal bonds of well managed issuers have been downgraded since the virus crisis started, and much of the market is on negative watch. The next six months will be critical. Issuers are facing billions in deferred, reduced, or lost revenue. Bankruptcy is not a solution. Bankrupt governments cannot lead us out of the crisis and into the recovery.

The Fed's liquidity facility is a help for this problem, but not a solution. Governments cannot borrow their way out of lost revenue. It will be necessary for Congress to provide additional money to state and local governments in the form of cash grants. The CARES Act provides \$150 billion for states and localities, but it is available only for expenses directly related to virus response. That will not replace lost revenue.

The conversation about state and local fiscal stress has already begun. The National Association of Governors recently told Congress that states need \$500 billion of "additional and immediate fiscal assistance." The National League of Cities, the US Conference of Mayors, and the National Association of Counties recently told Congress and the President that "\$250 billion in robust, dedicated, and flexible funding for all local governments" is needed. And congressional Democrats tried hard to get

\$150 billion of unrestricted funds for states and localities in the coronavirus response bill that will be enacted this week.

The municipal market is at a crossroads. Even issuers with strong credits are facing extraordinary fiscal stress. They cannot navigate this crisis alone. Congress will need to confront this problem through fiscal, not monetary, policy, and the longer they wait, the more acute it becomes.

**Michael Decker** , Bond Dealers of America



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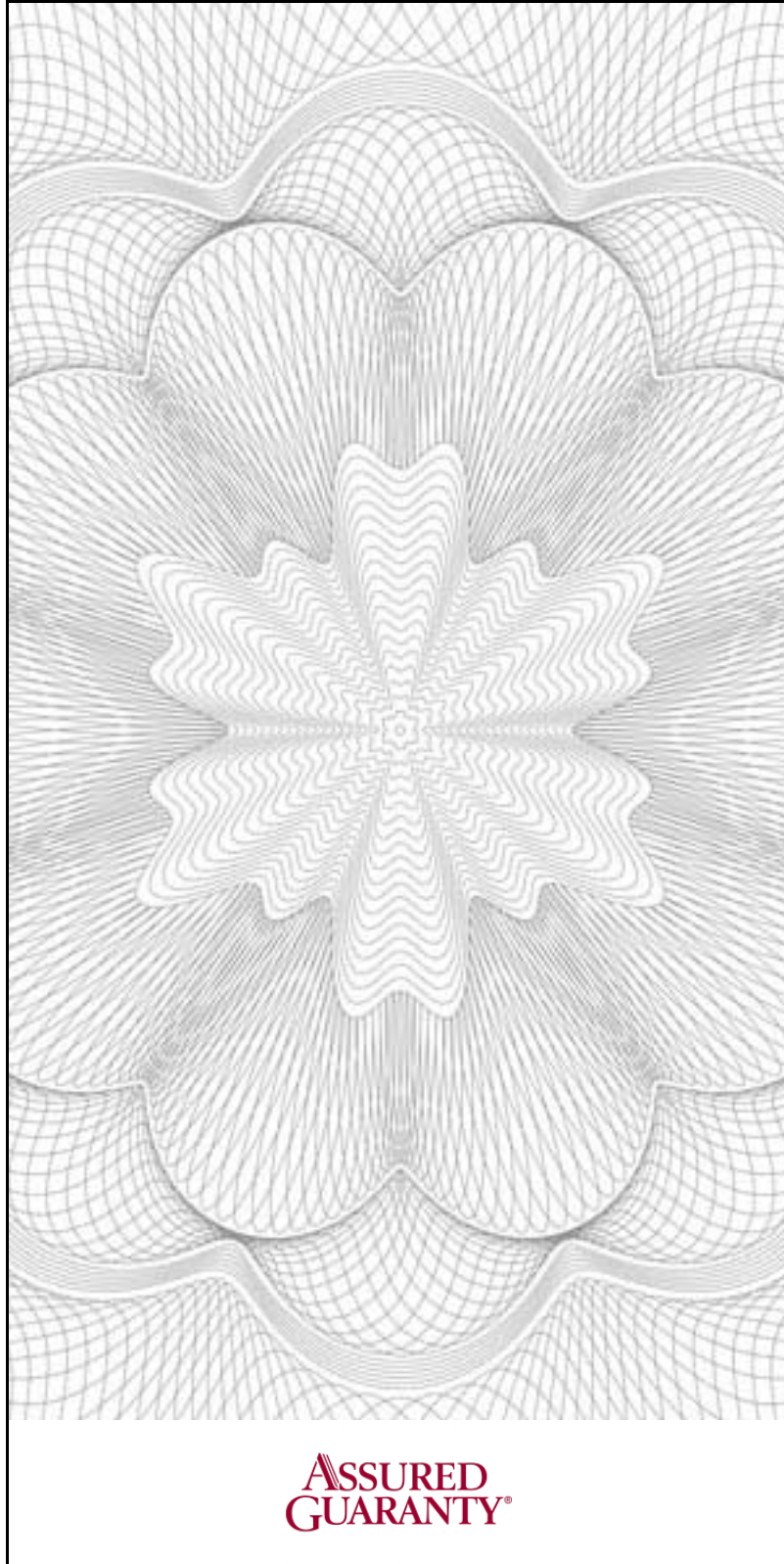
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