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Disagreement on the role of the Fed's Municipal Liquidity Facility

The Municipal Liquidity Facility has contributed to a strong and rapid recovery in the municipal market, said the Fed's Kent Hiteshew.

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Although states and local officials believe the Federal Reserve’s Municipal Liquidity Facility should be more accessible, the Fed says it is working fine as is and its success is being measured on the market’s function, not on how many use the program.

A fundamental philosophical divide became obvious during a Congressional Oversight Commission hearing Thursday morning featuring testimony from, among others, Kent Hiteshew, deputy associate director of the Fed’s Division of Financial Stability. Hiteshew indicated that the Fed regards the MLF as a backstop which is successful so long as the market is functioning properly, while other witnesses and members of the commission painted the program as flawed on the basis of its limited use.

Hiteshew was asked by lawmakers why just two issuers — the state of Illinois and the New York Metropolitan Transportation Authority — had used the program to a tune of $1.65 billion. That means less than 1% of the $500 billion lending program has been issued since its creation in April.

“Does the facility’s use indicate a design flaw of the program?” asked Rep. Donna Shalala, D-Fla.

“We don’t think so,” Hiteshew said. “This is the first time that the Fed has intervened in the municipal market. It’s a complex market made up of 50,000 unique issuers of various sizes, types, purposes and credit ratings.”

Since the MLF’s creation in April, the municipal market has had a sharp recovery, along with increased access for issuers in the municipal market. The Fed’s mission was to ensure that state and local governments had access to liquidity and to restore market confidence, Hiteshew told lawmakers Thursday. Issuers are interested in the program, Hiteshew testified, adding that one unnamed issuer may access the MLF in the next couple of weeks.

The announcement of the program had an immediate positive impact, he said, because long-term investors were “comforted that the Fed was standing by to meet the liquidity needs of state and local governments.”

The program has garnered criticism from issuers, saying the terms of the MLF are too restrictive, citing unattractive rates and limited eligibility.

The MLF is open to counties with populations of 500,000 or more and cities of 250,000 or more. In June, the central bank allowed U.S. states to be able to have at least two cities or counties eligible to directly issue notes through the MLF regardless of population. Governors of each state are also now able to designate two issuers whose revenues are derived from activities such as public transit and tolls. Territories like Guam and Puerto Rico are not eligible.

The Fed does charge issuers a premium, but did reduce interest rates in August by 50 basis points in each credit category. Now it has a baseline of 100 basis points for triple-A issuers to 540 for below investment-grade issuers.

“We don’t believe that the program is rigidly designed,” Hiteshew said. “We believe that it’s carefully calibrated to meet the purpose of the program.”

The maximum maturity of eligible securities under the program is up to 36 months, which some congressional Democrats have pushed to extend to five years. The MLF will be in effect until Dec. 31, 2020. Hiteshew said changes to that will be determined by future market conditions.

“We are not projecting that we’ll see market turbulence like we saw in March. There are warning signs in the muni market that we should all be aware of,” Hiteshew said. “The coming cuts and potential downgrades of state and local governments could affect market conditions.”

Lawmakers and issuers also asked why the Fed did not create a secondary market program for municipalities. Hiteshew said the creation of that would have taken longer and that they were focused on getting a municipal program out quickly. He doesn’t believe a secondary market program is needed currently.

The Fed should create a facility to provide relief by purchasing municipal securities in the secondary market, Marion Gee, president of the Government Finance Officers Association and finance director for the Metropolitan St. Louis Sewer District, said in his testimony.

“There remains some uncertainty in the coming months regarding the duration of the COVID-19 pandemic and whether we might see a second wave of infections,” Gee said. “This may create a replay of what we saw earlier this year of a cashcrunch and selloff in the municipal market. Developing a special purpose vehicle aimed at purchasing municipal securities and thus providing relief to the secondary market should be considered.”

Shalala said many municipalities have had to cut jobs and asked how the Fed pairs unemployment with restrictive terms in the MLF.

“While state and local governments cannot cut their way out of this recession, neither can they borrow their way out of it,” Hiteshew said. “If the legacy is operating deficit financing on state and local balance sheets after this crisis is over, that will limit their ability to finance infrastructure, to educate our students and to care for our elderly.

In a second panel, the commission heard from issuers such as Patrick McCoy, director of finance at the New York MTA. The MTA sold $450 million of transportation revenue bond anticipation notes to the Fed in August. The average true interest cost on its competitive bids was 2.79%, compared to the MLF's 1.93%.

McCoy asked for the program to be extended past Dec. 31, extend the maturity of the bonds, reconsider pricing and expand access.

"Should market conditions change, as they surely will, the Federal Reserve should carefully consider whether the MLF is continuing to support state and local governments as intended by Congress," McCoy wrote in his testimony.

There was some disagreement during the hearing on issuers' true financial state.

Some states and jurisdictions are in trouble, but comparing how governments did in the 2008 recession, local governments did not lose revenue overall due to stable property tax revenue said Chris Edwards, director of tax policy studies at the right-leaning CATO institute.

"It looks again during this recession if things don't get worse — and they seem to be getting better — that local governments will be fine because what we find is that property tax revenues will stay strong," Edwards said.

States and local governments are facing revenue gaps, which the MLF does not address, said George Friedlander, consultant at George Friedlander & Associates, who was not part of the hearing. The MLF solves liquidity issues, but not deep revenue gaps and funding problems many issuers are facing. The Fed can't fix revenue gaps, he said.

Brian Battle, director of trading at Performance Trust Capital Partners, said that the MLF could be extended past December but that he wouldn't change any of its terms.

If the market does return to volatility as it did in March, the MLF still should not be changed, Battle said.

"We don't have to change anything, because the markets worked," he said.

"Even if it happens again, I don't think there should be a public policy response from Washington to fix that, because it fixed itself like it was supposed to," Battle added.