Global Institute for Sustainable Prosperity

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The Fed's Municipal Liquidity Facility:

Community QE at Last

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Introduction

Last week (April 9) the Fed announced it would be opening a new Municipal Liquidity Facility ('MLF,' 'Facility') for States and their Subdivisions now struggling to address the nation's COVID-19 pandemic. This is effectively 'Community QE' in all but name. Because Community QE will constitute a literal lifeline to States and their Subdivisions, and will in light of its novelty be as unfamiliar as it is essential, this policy note briefly summarizes what the new Facility enables now and will likely enable in the future. It also recommends a three-phase 'Game Plan' for States and Cities to put into operation immediately – that is, tomorrow.

I. The New MLF: Key Current Provisions

The MLF will operate under color of Section 13(3) of the Federal Reserve Act ('FRA'), which grants the Federal Reserve emergency lending authority in exigent circumstances. The Fed exercises this authority through purchase and hence 'monetization' of financial instruments. In this case the instruments in question will be what the MLF Term Sheet calls 'Eligible Notes' issued by 'Eligible Issuers.' The following provisions are of the most immediate importance. Present exceptions to, and likely future liberalizations of, terms are highlighted along the way.

(1) **Direct Purchase**. The MLF will purchase securities *directly* from States or their Subdivisions. The securities will not have to be sold first on the 'open market' to private sector financial institutions, as is the case with ordinary Fed purchases under the FRA Section 14 authority.
(2) **Two-Year Maturity**. The months-to-maturity on the State and Municipal paper in question will be, for now, 24 rather than 12 months as originally anticipated. **Crucially, however,** these durations are likely to be extended for reasons provided below.
(3) **Eligible Notes.** Presently the Term Sheet requires that Eligible Notes be 'tax anticipation notes (TANs), tax and revenue anticipation notes (TRANs), bond anticipation notes (BANs), [or] other similar short-term notes issued by Eligible Issuers,' which can secure lending only up to 20% of each relevant issuer's 'general revenue from own sources and utility revenue' for the fiscal year 2017. **Crucially, however,** 'States may request that the SPV purchase Eligible Notes *in excess* of the applicable limit' in order to assist political subdivisions and instrumentalities that are not eligible for the Facility' (emphasis added).

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(4) **Eligible Issuers.** The Term Sheet stipulates that Eligible Issuers will be all U.S. States and the District of Columbia, U.S. Counties with populations exceeding two million, and U.S. Cities with populations exceeding one million. **Crucially, however,** the Term Sheet permits 'States [to] request that the SPV purchase Eligible Notes *in excess* of the applicable limit in order to assist political subdivisions and instrumentalities that are not eligible for the Facility.'

(5) **Eligible Use.** Presently the Term Sheet stipulates that proceeds of Note sales be used 'to help manage the cash flow impact of income tax deferrals resulting from an extension of an income tax filing deadline; potential reductions of tax and other revenues or increases in expenses related to or resulting from the COVID-19 pandemic; and requirements for the payment of principal and interest on obligations...' The Fed seeks in these words to encourage perception of the MLF as a tide-over facility meant to assist counterparties in, as the Term Sheet puts it, 'managing [their] cash flows.' **Crucially, however,** other sections of the Term Sheet emphasize the prospect of longer-term 'rollover' of Note debt, while analysts also anticipate expansion of coverage from 24-month to longer-term paper as explained immediately below.

II. The Next MLF: Further Easing Ahead

Much of the language found in the MLF Term Sheet suggests that present conditionality will be loosened even further than it has been already relative to what was anticipated last month. There are two additional reasons, outside 'the four corners of the document,' which further underwrite expectation of further easing.

(1) **Fed Interpretive Pronouncements.** Chairman Powell and the Fed Board of Governors have publicly encouraged a 'flexible' interpretation of all conditional language found in the MLF's Term Sheet. They have also repeatedly stated that they will be monitoring the municipal debt ('muni') markets for signs of resumed volatility, with an eye to intervening further to stabilize them if and as necessary. Combined with the many openings for extension and exception specified in the Term Sheet itself as described above, these amount to assurances that the MLF is a 'work in progress' whose scope will *expand* if and as the *need* for it expands.

(2) **Analyst Prescriptions & Predictions.** Bond market and public finance experts have called on the Fed to purchase State and Municipal debt with maturities not only in excess of traditional 6-month and 12-month durations, but also in excess of the new 24-month duration. The Fed has done nothing to discourage such calls. Most commentators, not to mention 'smart money' on the markets, seem now to anticipate upwards of three- to five-year State and Municipal debt to find its way onto the MLF balance sheet. While this of course cannot be predicted with certainty, States and Cities faced with serious crises should judge maturity lengthening more likely than not.

III. An April 'Game Plan' for States & Their Subdivisions

In light of the above, States and their Subdivisions should begin planning for use of the new MLF *immediately*. This Facility is unprecedented – the Fed is *improvising* right now. What States and Cities do now in *response* to the improvisation will thus be decisive in determining what shape the MLF takes as it unfolds. States and their Subdivisions are in other words *co-authors* of this new authority. It will ultimately be what *they make* of it. The following three-phase 'Game Plan' is proposed with that 'existential' truth in view.

(1) **Phase One: Immediate 'Quantitative' Legislative Sessions.** All State Governors and Legislatures should go into emergency session at once, 'virtually' if need be, to determine how much funding to seek from the MLF. These sessions should also include (a) representatives of the States' principal Subdivisions, (b) appropriate Public Finance personnel, and (c) representatives of the *regional Federal Reserve Banks* in whose operational jurisdictions the relevant States and Subdivisions are located. Because the need of funds generally is likely to be recognized and agreed upon even more quickly than the full panoply of *uses* of funds, Phase One can be limited to deliberation and decision over *how much* funding to seek and whom to authorize to begin preparations for the new issuances that the States and their Subdivisions will sell to the MLF.

(2) **Phase Two: Subsequent 'Allocative' Sessions.** Once all Phase One decisions have been reached and the appropriate State and Local personnel have been assigned their Note-issuing and Fed-liaising tasks, States and their Subdivisions can proceed directly to Phase Two preparations – gathering information, testimony, advice and all other deliberative 'inputs' necessary to make sensible *allocation* decisions in respect of the new funding that will be incoming from the MLF.

(3) **Phase Three. Later 'Envelope-Pushing' Sessions.** Once Phase Two deliberations end in allocation decisions, States and their Subdivisions might turn to 'Phase Three' deliberations over whether to press the Fed for further easing of the terms of the MLF Term Sheet. It might be decided, for example, that authorization to purchase State and Municipal paper of longer maturity than 24 months should be sought, or that a rollover option should be made more explicit. These questions can presumably wait, however, until current uncertainties 'on the ground' are resolved. With any luck, the pandemic might be contained before we reach any Phase 3.

Conclusion

However that may be, what matters now is that Phase One commence, and that it commence 'with all deliberate speed.' The author of this policy note will continue to watch events unfold, and will follow-up with further reporting and recommendations on an 'as [seems to be] needed' basis. Best wishes to all as we now reassume control of our public and productive health.