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COVID-19: The Federal Reserve's Municipal Liquidity Facility

State and local (municipal) governments issue debt (often called bonds) for a variety of purposes, including infrastructure construction. In April 2020, the Federal Reserve (Fed) announced the creation of the Municipal Liquidity Facility (MLF) to ease pressures in municipal debt markets caused by Coronavirus Disease 2019 (COVID-19). Pressures eased around the time the MLF was announced. One municipality has used the MLF to date.

Recent Activity and Outlook

State and local governments faced two financing problems early in the pandemic. First, they faced budgetary pressures caused by COVID-19's effects on revenues and spending. Second, they faced a disruption in municipal bond markets at the onset of the COVID-19 crisis, which hindered their ability to issue debt. This disruption was triggered by a decline in investor demand caused by uncertainty about COVID-19's effects on municipal bond markets and the economy more generally.

Beginning in April, municipal debt market activity has rebounded as investor fears have subsided. **Table 1** shows the volume of new municipal issuances in 2020 in nominal terms and as a reflection of 2019 activity. Following a 31% year-over-year decline in March 2020 issuance volume, new issuances returned to roughly 2019 levels in April and May, before increasing in June and July. The year to date 2020 issuance volume through July is 19% larger than 2019 levels over the same period.

Table 1. New Municipal Issuance Volume, 2020

Month	New Issuance Volume (in billions)	Change from 2019
January 2020	32.9	+16%
February 2020	41.7	+55%
March 2020	19.5	-31%
April 2020	28.7	-4%
May 2020	30.0	-1%
June 2020	60.6	+34%
July 2020	52.9	+54%
Year to Date 2020	**266.3**	**+19%**

Source: Municipal Securities Rulemaking Board.

Some of the recent rebound in activity may be a reflection of broader improvement in market conditions. General interest rates, which were already low by historical standards before the crisis, declined further in the past few months. The Bond Buyer reported an average yield on 25-year municipal revenue bonds of 2.51% for the week of July 30, down from 3.10% in the first week of 2020. Lower yields reduce the interest costs to municipal governments when issuing debt. Over the same period, 30-year (federal) Treasury yields declined from 2.32% to 1.20%.

Despite relatively normal conditions for new debt issuances, there are still concerns about municipalities' abilities to make existing debt payments in the coming months. State and local governments are statutorily required to balance their operating budgets, and COVID-19 has both decreased state and local revenues and increased spending demands on health, education, and other services. Such a situation increases the risk that municipal governments may default on existing obligations if those budgetary gaps are not addressed elsewhere. Late or missed payments would then likely lead to a drop in municipal credit ratings, which could hamper future municipal borrowing efforts.

Municipal Liquidity Facility

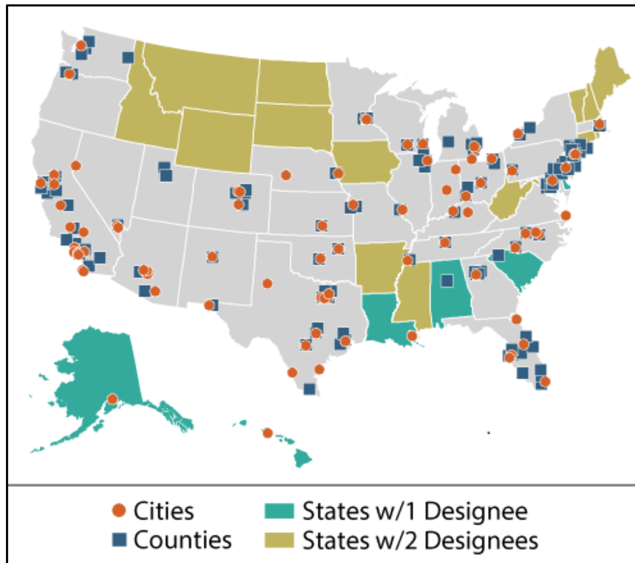
The Fed acts as a lender of last resort, traditionally to banks, to provide liquidity directly to ensure continued access to needed funding. The Fed has set up a series of emergency facilities, including the MLF, in response to COVID-19, expanding its lender of last resort role to other sectors of the economy. This marked the first time the Fed has purchased municipal debt since the 1930s.

The MLF was announced as a $500 billion program. It purchases newly issued debt from eligible issuers, which is backed by anticipated taxes, bonds, or revenues and matures within three years. All states and the District of Columbia are eligible to use the facility, but a limited number of cities and counties are eligible. To be eligible, a city must have at least 250,000 residents, and a county must have at least 500,000 residents. For states that do not have a combination of at least two cities or counties meeting that size threshold, the state may designate two of its largest cities or counties to participate. **Figure 1** shows the eligible issuers. Issuers also had to have an investment grade credit rating before April 8 to be eligible. The interest rate on the debt is based on the issuer's credit rating, with lower rated issuers paying a higher interest rate. There is also a limit on how much debt any issuer may sell to the Fed.

The Fed created the MLF under its emergency authority, found in Section 13(3) of the Federal Reserve Act (12 U.S.C. 343). (The Fed's ability to purchase municipal debt under its normal authority is far more limited.) Under this authority, actions must be temporary and approved by the Treasury Secretary. The interest rate must be higher than normal market rates. Actions also must provide security (e.g., collateral) that is sufficient to protect the taxpayer and be based on sound risk management practices. To absorb

potential losses, Treasury has pledged $35 billion in CARES Act (P.L. 116-136) funding—protecting the Fed, but still exposing taxpayers to future losses. Likewise, any profits from the facility ultimately accrue to taxpayers. Among other requirements, the CARES Act does not permit debt forgiveness.

Figure 1. MLF Designees by State and Locality



Source: CRS, based on information from the Federal Reserve.

The MLF became operational on May 26. The Fed has publicly disclosed users on a monthly basis. In its first two months of operation, one issuer (Illinois) used the facility. The MLF is currently scheduled to stop purchasing debt at the end of 2020.

Policy Issues

The Fed cited two policy rationales for creating the MLF: to ensure that municipal bond markets function smoothly, and to ease funding pressures on municipal governments.

As discussed above, municipalities faced two sources of fiscal pressure in the spring—higher interest rates and heightened borrowing needs. The MLF can help municipalities with the former problem, not the latter. The MLF ensures that municipalities will have a willing buyer of their debt at a predetermined interest rate, but it does not alleviate the fiscal challenges that states face, including rising spending, falling revenues, and balanced budget requirements. In the words of California's deputy state treasurer, "You can't borrow your way out of debt."

Helping ensure that municipalities can borrow inexpensively is not part of the Fed's statutory mandate. At best, one could try to connect municipal bond market stability with the Fed's broader financial stability remit—although the municipal bond market has never caused broader financial instability. Justification for the MLF is probably best understood through a wider lens of the Fed's actions. COVID-19 was an unprecedented emergency, and the Fed threw "everything but the kitchen sink" at ameliorating its economic effects. The Fed generally tries to maintain a neutral effect on the allocation of credit, which might seem to rule out a facility dedicated to buying one type of debt. But by the time the MLF was announced, the Fed had already created several other facilities addressing other parts of the financial system. Thus, extending its purchases to the municipal bond market may have made the Fed's overall actions more credit neutral.

The decline in yields on highly rated debt since the MLF was announced—and before it was operational—suggests that municipal bond markets are no longer stressed for creditworthy borrowers. Some of the improvement, which predated the announcement, may be attributable to other actions by the Fed and Congress (such as aid to states and localities in the CARES Act). The MLF might see greater use if market conditions were to deteriorate again.

For those hoping the Fed would offer a widely used lifeline to struggling municipalities, the MLF so far has not done so. Nevertheless, the facility may be successful despite its limited use, given the decline in private borrowing costs. As the term implies, a lender of last resort is intended to be used when there is no private sector alternative. If issuers find the Fed's rates too high compared with private sector alternatives, then the Fed has succeeded in charging above market rates to discourage its use. These rates would be problematic if market rates were also prohibitively high, but this does not seem to be the case.

Some may be concerned that the facility has been underused because not enough municipalities are eligible. Eligibility could be extended to more municipalities by lowering the minimum size or credit rating or by including other types of issuers, such as U.S. territories or issuers of private activity bonds (such as utilities). The Fed allows states to borrow through the MLF and lend the proceeds to some of these ineligible issuers, with the states bearing the default risk. But states may be unwilling to do so and, according to an April 23 Wells Fargo newsletter, "Unfortunately, most states do not have an established mechanism for this and some are legally barred from doing so." If eligibility criteria were relaxed, it might increase the likelihood of losses—particularly if minimum credit ratings were reduced. This highlights the tradeoff between risk to taxpayers and the program's aim to ease funding pressures on municipalities.

How much risk is the MLF taking on? Reporting to Congress, the Fed said it did not expect losses to the Fed from the MLF. Typically, municipal default rates are very low. The Municipal Securities Rulemaking Board reported a municipal default rate of 0.19% in 2019, well below the corporate default rate of 1.74%. But COVID-19 is placing unprecedented strains on state and local governments, which could make historical default rates a poor predictor.

CRS Resources

CRS Report R46411, *The Federal Reserve's Response to COVID-19: Policy Issues*, by Marc Labonte

CRS In Focus IF11502, *State and Local Government Debt and COVID-19*, by Grant A. Driessen

Grant A. Driessen, Analyst in Public Finance
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