Federal Reserve muni lending facility charges big premiums

By Sarah Wynn

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The Federal Reserve will charge issuers a premium — a baseline 150 basis points for triple-A issuers to 590 basis points for below investment-grade-rated issuers — to use its short-term municipal note purchasing program in what some analysts said is an effort to keep the Fed out of the municipal market — or at least use the facility as a last resort.

In a release Monday morning, the Fed detailed its pricing details for its Municipal Liquidity Facility, which was announced last month to buy $500 billion of short-term notes from issuers.

"The Fed has said that this is supposed to be last-resort financing," said Michael Decker, senior vice president of policy and research at Bond Dealers of America. "It's not supposed to be competing with commercially available financing. You're supposed to go to the market first, and if you can't get good execution there, then you come to the Fed. They priced it with that in mind, but it looks expensive to me."

Pricing will be at a fixed interest rate based on a comparable maturity overnight index swap (OIS) rate plus the applicable spread based on the long-term rating of the security.

Fed Chair Jerome Powell released a new muni credit facility last month, which the Fed updated on Monday to include more pricing information. *Bloomberg News*

The Fed hasn't specified which index they will use, but Decker said it is likely to be the Secured Overnight Financing Rate. SOFR is replacing the London Interbank Offered Rate, or Libor, which is being phased out at the end of 2021. SOFR is also a Fed program, making it likely to be used in the MLF, Decker said.

Interest rates would be calculated through spreads depending on the issuer's credit rating ranging from 150 basis points for a AAA/Aaa rated issuer to 590 basis points for below investment grade issuers, based on a Fed table.

The Fed's rate is expensive, but it is a good approach, said Patrick Luby, a senior municipal strategist at CreditSights.

"It's expensive, but I also think that it will be easier for the Fed," Luby said. "If they were to misprice this, it's much easier for them to come back and lower the spread than to come back and raise the spread and decide that they came in too low."

The Fed has also been clear that they want to be a last resort for issuers and provide a backstop. The Fed also does not want to be competing with broker-dealers, Luby said.

"The Fed is demonstrating with their actions that a healthy market has the Fed as a backstop, not as a fully fledged participant, side by side with broker-dealers in the marketplace," Luby said.

Dealers appreciated the Fed's new pricing details.

The Securities Industry and Financial Markets Association is reviewing the Fed's changes.

"We appreciate the additional clarification and information offered in today's announcement for state and local governments seeking liquidity," said Leslie Norwood, a managing director, associate general counsel and head of municipals at SIFMA. "We understand the Fed is managing multiple constraints, and the dealer community stands at the ready to facilitate where we can be helpful."

BDA commended the Fed in providing details of pricing for its MLF.

"The facility will provide a much-needed liquidity backstop for states and local governments," BDA said. "The pricing for the facility is above market under current conditions. However, the Fed has said that the facility is intended as last-resort financing, and it is priced as such. We hope the Fed is able to bring the facility online soon."

The Fed created the MLF in early April and it has yet to go into effect. The Fed expanded the parameters for eligibility in the program in late April to cover counties of 500,000 or more and cities of 250,000 or more.

The MLF is scheduled to operate through Dec. 31 and in late April, the Fed expanded the maximum maturity of eligible securities to 36 months from a previously announced 24-month maximum term.

The Fed also clarified on Monday that an issuer that only has one credit rating would still be eligible under the program if it has a rating of at least BBB or Baa3 for a state, city or county. Before, an issuer had to have at least two credit ratings.

Sarah Wynn Reporter

Coronavirus Federal Reserve BDA SIFMA Washington DC

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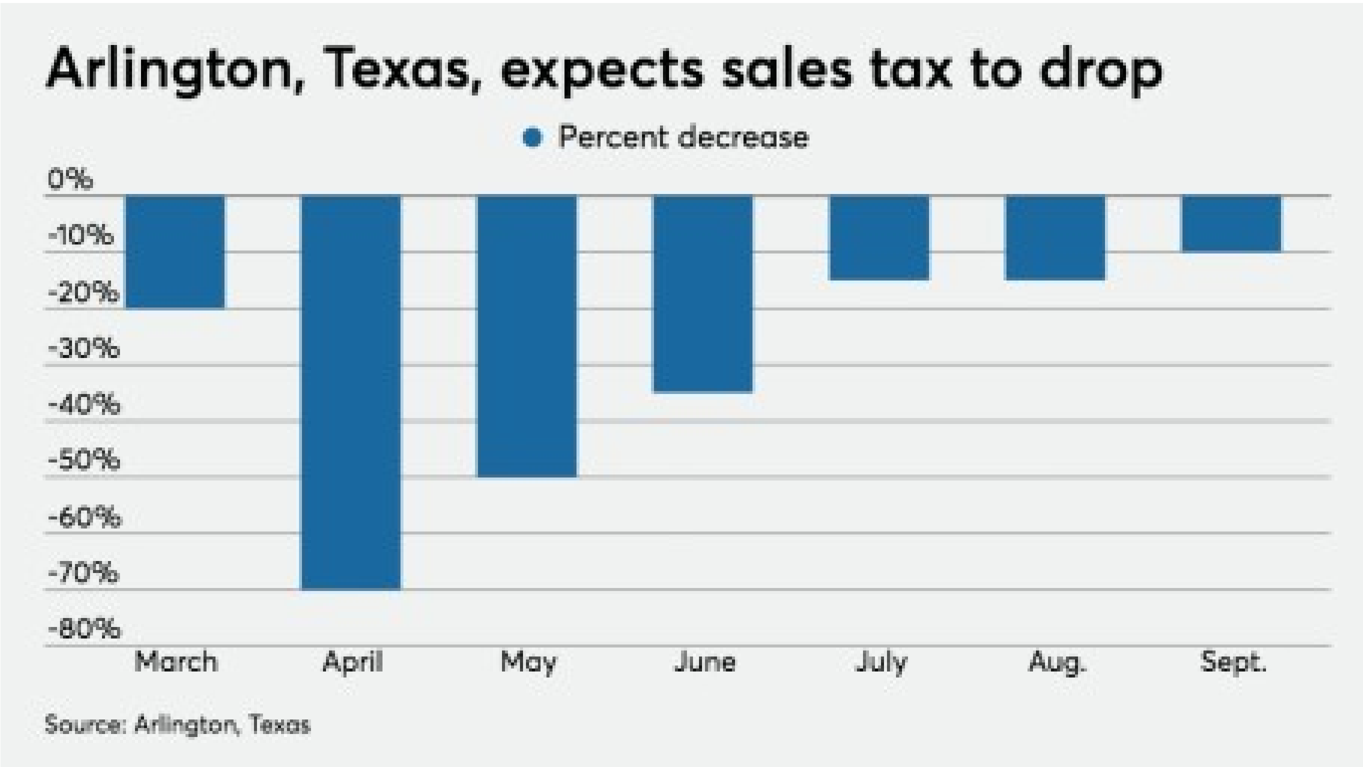

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