HilltopSecurities
A Hilltop Holdings Company

U.S. Municipal Bond Market

Illinois Taps Fed's Municipal Liquidity Facility, Fed Expands Eligibility

Tom Kozlik
Head of Municipal Strategy & Credit
214.859.9439
tom.kozlik@hilltopsecurities.com

Summary

- Illinois will be the first eligible issuer to tap the Fed's Municipal Liquidity Facility (MLF). At this point, we do not expect a rush of eligible issuers to begin applying and use it because the MLF pricing is well above current municipal market yields. However, others are possible in the coming weeks.
- Illinois is going to borrow $1.2 billion of one-year general obligation notes through the MLF and pay 3.82%, per Illinois officials. The sale will close on Friday, June 5, 2020.
- The Federal Reserve's actions to support and stabilize the municipal market in recent months have not only been extraordinary, but welcomed and needed. The MLF is another example of that support.
- Also today, the Federal Reserve expanded the number and type of municipal entities that can directly use its MLF.

Fed's Municipal Liquidity Facility is a Backstop

In the beginning of May, the State of Illinois pulled a $1.2 billion short-term debt offering from the primary market because of a higher than anticipated yield penalty investors tacked onto borrowing costs due to a rise in perceived risk.[1] Yesterday, Illinois announced it was going to access the Federal Reserve's Municipal Liquidity Facility (MLF), a special purpose vehicle set-up by the Fed using funds from the Coronavirus Aid, Relief, and Economic Security (CARES) Act.[2] The MLF was set up as a liquidity backstop for eligible issuers in case the capital markets were not functioning normally, or to address issues concerning the availability or price of credit.[3] The MLF should be considered a destination of last resort for borrowers, not as a compliment to market access like the 2009 Recovery Act's taxable Build America Bond (BAB) program was about a decade ago.

First to Access Federal Reserve's MLF

It was announced that Illinois will be the first eligible issuer to tap the MLF, and at this point we do not expect a rush of eligible issuers to begin applying and use it because the MLF pricing is well above current municipal market yields.[4] The MLF Sample Purchase Rates as of Monday, June 1, 2020 show that a Baa3/BBB- rated credit with a one-year term would price at 3.83%. Although, in recent weeks Illinois' spread to the municipal benchmark was at least 400 basis points on the short end of the yield curve.

It was announced that Illinois will be the first eligible issuer to tap the MLF, and at this point we do not expect a rush of eligible issuers to begin applying and use it because the MLF pricing is well above current municipal market yields.

Illinois is going to borrow $1.2 billion of one-year general obligation notes through the MLF and pay 3.82%, per Illinois officials. The sale will close on Friday, June 5, 2020.[5] "The Federal Reserve Bank worked closely with our team to make this transaction possible through the Municipal Liquidity Facility, which is an important tool the state is using to answer the unprecedented economic challenges posed by the COVID-19 pandemic," said Alexis Sturm, director of the Illinois Governor's Office of Management and Budget.[6]

Please see disclosure starting on page 3.

Municipal Market is Functioning Normally, For Now

At this point, we do not anticipate a rush for eligible entities to access the MLF, as we noted above. There was a market dislocation in March, but there have been no indications that such a liquidity event is likely to occur again in the near-term. Pricings have been planned and executed as normal in recent weeks. We expect municipal market competitive and negotiated pricings to effectively absorb the $7+ billion of primary market volume this week without a hitch. Municipal investor demand is steady, as illustrated by the fact that we have seen positive flows in municipal mutual funds in five of the last seven weeks amounting to a net $2.7 billion.

We expect municipal market competitive and negotiated pricings to effectively absorb the $7+ billion of primary market volume this week without a hitch.

Who Could Be the Next MLF Borrower?

That being said, if there are eligible issuers who can access the MLF at a level more affordable than the market or other traditional creditors will lend to them, then it is quite possible the MLF will be exploited, even if its use is not widespread. Some of the lowest rated eligible issuers, and especially the lowest rated U.S. states, would likely be next candidates to potentially tap the MLF. In addition, the Port Authority of New York and New Jersey is considering borrowing through the Fed's MLF.[7] We also saw that the New York Metropolitan Transit Authority is reportedly considering a short-term borrowing through the MLF.[8]

For Illinois, On the Horizon

The state of Illinois credit ratings, which are currently rated Baa3/BBB-/BBB-, also have "Negative" rating outlooks assigned to them by each of the rating agencies. The state also has been reporting that it could be facing a revenue shortfall of at least $7 billion, a revenue gap that is partially a result of measures taken to limit the spread of COVID-19.[9]

What Could Be Next From the Federal Reserve?

The Federal Reserve's actions to support and stabilize the municipal market in recent months have not only been extraordinary, but welcomed and needed. The MLF is another example of that support.

Illinois has been reporting that it could be facing a revenue shortfall of at least $7 billion, a revenue gap that is partially a result of measures taken to limit the spread of COVID-19.

It could be possible that state and local governments and other municipal entities need additional near-term assistance. Budget shortfalls are building and revenue stress shows no sign of stopping even though state, regional, and local economies are beginning to reopen. Federal lawmakers requested and the Federal Reserve chair said he would consider a potential second facility that may be able to lend with medium- and longer-term terms.[10] The status of a potential longer term or second facility is unknown at this time.

Some have requested for the Fed to purchase municipals directly in the primary and secondary market. Although the calls for such a strategy were louder back in March, we should note that the Fed indicated it "will continue to closely monitor conditions in the primary and secondary markets for municipal securities and will evaluate whether additional measures are needed to support the flow of credit and liquidity to state and local governments."[11]

Federal Reserve Expands Number and Type of Governmental Revenue Entities

Just as we were about to release our publication focusing on the Illinois borrowing, we saw the Federal Reserve expanded the number and type of entities that can directly use the MLF. Now, per the Fed's terms released today, June 3, 2020:

- All U.S. states will be able to have at least two cities or counties eligible to directly issue notes to the MLF regardless of population, and;
- Governors of each state will also be able to designate two issuers in their jurisdictions whose revenues are generally derived from operating government activities (such as public transit, airports, toll facilities, and utilities) to be eligible to directly use the MLF.[12]

Today, the Federal Reserve expanded the number and type of municipal entities that can directly use its MLF.

[1] Singh, Shruti and Danielle Moran; Illinois Delays $1.2 Billion Debt Sale After Penalty Soars; Bloomberg; May 5, 2020.
[2] See more about the creation and set-up of the Fed's MLF: Fed Expands Municipal Liquidity Facility, Provides Details; HilltopSecurities; April 29, 2020.
[3] Please see the answer to the question: For the purposes of participating in the MLF, what does it mean for an Eligible Issuer to certify that it is unable to secure adequate credit accommodations? for more detail at the NY Fed's website.
[4] Please see the most recent Municipal Liquidity Facility Sample Purchase Rates, which are updated each Monday.
[5] Shields, Yvette; Illinois is the first to use Fed MLF program in $1.2 billion deal; The Bond Buyer; June 2, 2020.
[6] Ibid.
[7] See statements in: Port Authority of New York and New Jersey applies for federal help; Port Technology; June 2, 2020.
[8] Kaske, Michelle; New York MTA Asks Federal Reserve to Tap New Lending Program; Bloomberg; May 21, 2020.
[9] Pritzker: COVID-19 to Cause Projected $7 Bill Revenue Shortfall Over Next 2 Fiscal Years; NBC5 Chicago; April 15, 2020.
[10] Tumulty, Brian; Fed considering a second municipal lending facility; The Bond Buyer; May 19, 2020.
[11] FAQ: Municipal Liquidity Facility; Federal Reserve Bank of New York; May 15, 2020.
[12] See more in: Federal Reserve Board announces an expansion in the number and type of entities eligible to directly use its Municipal Liquidity Facility; The Federal Reserve; posted June 1, 2020.

Recent HilltopSecurities COVID-19 Municipal Commentary

- Inherent Conflict in Returning to Normal, June 2, 2020
- More Hurdles to Financial Equilibrium, Recovery, and Growth, June 1, 2020
- Final COVID-19 Relief, New York City to Reopen June 8, 2020, May 29, 2020
- State of Confusion, May 28, 2020
- Municipal Credit Two Months into the New COVID-19 Normal, May 20, 2020.
- The HEROES Act: the House Democrats' Opening Proposition, May 12, 2020
- Updated Pricing Detail: Federal Reserve's Municipal Liquidity Facility, May 11, 2020
- Municipal Credit and Market Update, May 8, 2020
- Single Family Housing Durability Will Help Endure the New COVID-19 Normal, May 6, 2020
- Credit Deteriorating, Moody's Lowers State Outlook to "Negative," May 1, 2020