

## Updated Guidance on the Federal Reserve’s Municipal Liquidity Facility: A Short-Term Financing Option for State and Local Governments

The Coronavirus Aid, Relief, and Economic Security Act (the “CARES Act”) authorizes the Treasury Secretary to make loans, loan guarantees, and other investments in support of eligible businesses, states, and municipalities<sup>1</sup> to provide liquidity related to losses incurred as a result of COVID-19. The following provides updated information on the Federal Reserve’s Municipal Liquidity Facility (“MLF”) developed pursuant to this authority, based on FAQ guidance released on April 27, 2020.<sup>2</sup>

### Municipal Liquidity Facility

On April 9, 2020, the Treasury Secretary announced<sup>3</sup> the launch of the MLF to provide up to \$500 billion in direct financing to states, counties, and cities to help manage cash flow needs caused by COVID-19.

Through the MLF, the Federal Reserve (“Fed”) commits to lend to a special purpose vehicle (“SPV”) on a recourse basis. The Fed is secured by all of the assets of the SPV. The SPV will purchase up to \$500 billion of “Eligible Notes” directly from “Eligible Issuers.” Treasury provided \$35 billion as an equity investment to support up to \$500 billion in lending through the MLF.

The SPV will cease purchasing Eligible Notes on December 31, 2020 (which represents an extension of the initial program expiration date of September 30, 2020), unless the Fed and Treasury extend the MLF.

### Updated Guidance

Initially, Eligible Issuers included only states, cities with over one million residents, and counties with over two million residents (or an instrumentality thereof that issues on behalf of the state, city, or county for the purpose of managing its cash flows). New FAQ guidance<sup>4</sup> expands the definition of Eligible Issuers to include counties with at least 500,000 residents and cities with at least 250,000 residents as well as certain multi-state issuers. In the Pacific Northwest, for example, the list of Eligible Issuers in Washington now includes the City of Seattle and Pierce, Snohomish and Spokane counties as well as the State of Washington and King County (eligible under the initial definition), the list of Eligible Issuers in Alaska

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<sup>1</sup> The term municipality includes (A) a political subdivision of a state, and (B) an instrumentality of a municipality, a State, or a political subdivision of a state.

<sup>2</sup> <https://www.federalreserve.gov/newsevents/pressreleases/files/monetary20200427a1.pdf>

<sup>3</sup> <https://home.treasury.gov/news/press-releases/sm968>.

<sup>4</sup> <https://www.newyorkfed.org/markets/municipal-liquidity-facility/municipal-liquidity-facility-faq>

includes the State of Alaska and the Municipality of Anchorage, and the list of Eligible Issuers in Oregon includes the State of Oregon, the City of Portland, and Multnomah and Washington counties.<sup>5</sup>

The Fed previously made clear that state-level issuers can use MLF proceeds to support state instrumentalities and political subdivisions. It was unclear whether a county or city Eligible Issuer could issue on behalf of other municipalities that are state political subdivisions. The new guidance adds that *any* Eligible Issuer (including Eligible Issuer counties and cities)<sup>6</sup> can borrow “to purchase the notes of, or otherwise assist, any of their political subdivisions or other governmental entities ... broadly defined as any county, city, municipality, township, village, school district, special district, utility, authority, agency or other unit of government, as determined by the Eligible Issuer.” The Fed encourages Eligible Issuers to make MLF funding available to their political subdivisions and other governmental entities that need liquidity funding.

Although many commenters requested that Eligible Issuers be able to issue on behalf of local governments on a conduit basis, the updated guidance requires that the Eligible Issuer bear “the credit risk associated with any notes it purchased from its political subdivision or other governmental entity.” Accordingly, any Eligible Issuer that uses the MLF to borrow for other governmental entities will need to commit its credit to the MLF note.

Depending on the structure and particular state law, the notes may consume constitutional and statutory debt capacity of the Eligible Issuer. Because the MLF requires that the Eligible Issuer bear credit risk on behalf of other governmental entity borrowers, Eligible Issuers will need assurance of repayment through the loan and security terms with borrowers. In many states, legislation will be required, particularly for state-level programs (for example, to expand existing bond bank programs or develop new programs, and to expand or create security provisions such as intercept mechanisms). Although the program deadline has been extended to December 31, 2020, the timeline remains challenging, particularly for Eligible Issuers that will require authorizing or amendatory legislation. As noted below, the MLF pricing and other terms remain unclear, and Eligible Issuers will need to consider whether to proceed with legislation and other program planning in light of this uncertainty.

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<sup>5</sup> See listing of Eligible Issuers at <https://www.newyorkfed.org/medialibrary/media/markets/municipal-liquidity-facility-eligible-issuers>. Eligible Issuers may not be insolvent and also are subject to minimum ratings requirements: at least BBB-/Baa3 as of April 8, 2020, by two or more major nationally recognized statistical rating organizations (NRSROs). Eligible Issuers that were rated at least BBB-/Baa3 as of April 8, 2020, but are subsequently downgraded, must be rated at least BB-/Ba3 by two or more major NRSROs at the time the Facility makes a purchase (a provision that allows “fallen angels” to participate).

<sup>6</sup> The updated guidance holds open the possibility that additional Eligible Issuers will be named. The Fed is considering expanding the MLF to allow other “governmental entities that provide essential public services on behalf of a State, City, or County” to participate directly in the MLF as Eligible Issuers.

Authorities and other agencies that issue debt on behalf of an Eligible Issuer may, subject to Fed review, constitute an Eligible Issuer if the authority or agency commits the Eligible Issuer's credit or pledges the Eligible Issuer's revenues, or if the Eligible Issuer guarantees the note. Each eligible state, city, and county may use just one issuer (itself or an issuing authority or agency) to access the program, although the Fed has reserved the right to approve additional issuers.

Program Purposes. An Eligible Issuer may use the proceeds of Eligible Notes purchased by the SPV to help manage the cash flow impact of deferrals or reductions of tax and other revenues or increases in expenses related to or resulting from the COVID-19 pandemic (e.g. potential reductions in sales and other taxes related to the COVID-19 pandemic) and debt service requirements on obligations of the relevant Eligible Issuer. Eligible Issuers also may use MLF note proceeds to purchase similar notes issued by, or otherwise to assist, other governmental entities for these purposes. The updated guidance makes clear that proceeds may be used to pay costs of issuance, including the program's 10 basis point origination fee.

Eligible Notes are tax anticipation notes ("TANs"), tax and revenue anticipation notes ("TRANS"), bond anticipation notes ("BANs"), and other similar short-term notes issued by Eligible Issuers.<sup>7</sup> The initial two-year term limit has been extended to three years, so the program can be used to provide a three-year liquidity facility for cash flow purposes.

The updated guidance provides some insight into the security that will be expected. Acknowledging the unique nature of state laws governing the incurrence of debt by states and municipalities, the updated guidance notes that the "source of repayment and security for Eligible Notes will depend on the applicable constitutional and statutory provisions governing the Eligible Issuer and should be generally consistent with the source of repayment and strongest security typically pledged to repay publicly offered obligations of the Eligible Issuer." Thus, Eligible Notes "will generally be expected to represent general obligations of the Eligible Issuer, or be backed by tax or other specified governmental revenues of the applicable State, City, or County." The Fed will require a ratings confirmation of the outstanding long-term ratings of the Eligible Issuer for the same type or source of repayment and security.

Program Size and Terms. The updated guidance specifies the maximum principal amounts for each Eligible Issuer,<sup>8</sup> which may be used by the Eligible Issuer for its benefit and for other governmental entities. A

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<sup>7</sup> The FAQ guidance describes TANs and TRANS as "generally backed by and rated based on the anticipated receipt of tax and other revenues over the course of a fiscal year or longer, in amounts sufficient to pay off the notes by maturity. BANs are issued in anticipation of future bond issuance and are typically not secured by a pledged revenue stream, but are rated based on the long-term credit rating of the issuer and its assumed future market access for refinancing (either as new BANs or long-term bonds)."

<sup>8</sup> <https://www.newyorkfed.org/medialibrary/media/markets/municipal-liquidity-facility-eligible-issuers>.

state or municipal Eligible Issuer may request an additional amount in excess of the limit to assist other governmental entities that are not themselves eligible for direct issuance to the MLF.

### **Uncertain Pricing**

Pricing will be based on the Eligible Issuer's long-term rating at the time of purchase of the Eligible Notes and the Eligible Note's maturity, plus a spread over a publicly available benchmark or index. In other words, pricing information is still largely unknown. Monthly, the Fed will publicly disclose information, including the names of participants, amounts borrowed, interest rates and other costs, so pricing information will be transparent (and pricing spreads should be provided in guidance before then).

The updated guidance does note that the MLF is being provided under Section 13(3) of the Federal Reserve Act and the Fed's Regulation A. Accordingly, the interest rate on the Eligible Notes is required to be a "penalty rate," meaning "a rate that is a premium to the market rate in normal circumstances, affords liquidity in unusual and exigent circumstances, and encourages repayment of the credit and discourages use of the Facility as the unusual and exigent circumstances that motivated the program recede and economic conditions normalize." The rate may, therefore, be attractive in the current environment (for example, if the market features larger than typical spreads to U.S. Treasury obligations) but represent a premium as compared to normal market spreads.

The updated guidance provides that interest may be paid consistent with applicable constitutional and statutory requirements, and will be due no later than the maturity date of the Eligible Notes. To the extent this guidance signals flexibility regarding the timing of principal and interest payments during the Eligible Note term, the amortization structure of Eligible Notes may be helpful.

The Eligible Notes purchased by the SPV are callable by the Eligible Issuer at any time, in whole or in part, at par, with the Fed's approval. The notes need not be tax-exempt.

### **Required Certifications and Documentation**

Eligible Issuers will be required to certify as to their need to access the MLF. Specifically "each Eligible Issuer must also provide a written certification that it is unable to secure adequate credit accommodations from other banking institutions and that it is not insolvent." The following additional considerations are to be taken into account in this certification: "In certifying whether the issuer is unable to secure adequate credit accommodations from other banking institutions, issuers may consider economic or market conditions in the market intended to be addressed by the MLF as compared to normal conditions, including the availability and price of credit. Lack of adequate credit does not mean that no credit is available. Lending may be available, but at prices or on conditions that are inconsistent with a normal, well-functioning market."

Other documentation requirements are to be announced, including requirements for the type and amount of disclosure. A standard bond counsel opinion regarding validity and enforceability of the note will be required.

### Next Steps

We expect to provide updated information as additional guidance is provided regarding the MLF and its terms, including information regarding the application process and requirements.

If you have any questions regarding this information, please contact us. Additional COVID-19 resources are available on our website at <https://www.pacificallawgroup.com/covid-19-resources/>.

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