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Illinois Fed deal bodes well for future transactions

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The Federal Reserve's first short-term note deal with the state of Illinois is a good start to the federal program that could jump-start its use with more local governments.

Tuesday afternoon, Illinois became the first issuer to use the Fed's $500 billion Municipal Liquidity Facility and as a large issuer, that could bode well for the program's short future.

Transactions should be faster going forward, said Patrick Luby, senior municipal strategist at CreditSights.

“The MLF is being operated as if it’s a start up asset manager so being able to do the credit analysis and the paperwork and everything else on the large state for a large amount of money is a good way to start out the facility,” said Patrick Luby, senior municipal strategist at CreditSights.

A large trade of $1.2 billion of one-year, general obligation notes will be a new experience for the Fed since this marks the first time it has bought municipal notes. Going through it first with a large issuer should make transactions move faster for other issuers going forward, Luby said.

The maximum amount of eligible notes Illinois can sell through the program is just over $9.6 billion, and other states have caps set by the Fed as well. Illinois is choosing to start off borrowing much less than what is available to it.

Illinois has long planned to sell only $1.2 billion certificates to make up for a revenue hit in the current fiscal year. The state legislature late last month approved up to $5 billion of borrowing to aid the fiscal 2021 budget. The budget allows the state to go out to up to 10 years on the $5 billion if the MLF extends its current 36-month term.

“If we see more large issuers come in and borrow and indicate that they don’t need to borrow as much as their maximum, that might free up some lending capacity that the Fed might make available to other issuers,” Luby said.

That could mean the Fed could decide to extend the eligibility of issuers able to take advantage of the program, Luby said. Currently, counties with a population of 500,000 and cities with 250,000 can use the program directly.

On Wednesday, the Fed announced it was expanding the facility by allowing all U.S. states to have at least two cities or counties eligible to directly issue notes to the MLF regardless of population, though the direct access population limits remain in place.

As the program continues to be used and the Fed gets a greater sense of the appetite for borrowing in it, they could decide to widen those parameters further, Luby said.

The Fed recently expanded the maturity of eligible securities to 36 months from 24 months, but Illinois is only borrowing for 12.

“The fact that Illinois is borrowing for a shorter time period than they could is encouraging,” Luby said. “It suggests comfort that they will be able to refinance that on reasonable terms a year from now.”

Illinois could not go out any further with the notes as it issued the certificates with a one-year term as they were selling under the state's short-term borrowing statutes which require that the debt be repaid in the next fiscal year.

Dealer groups were pleased to see the first transaction go through the MLF program and said Illinois' borrowing was exactly the kind of transaction MLF was designed for.

Illinois will pay a rate of 3.82%, based on MLF pricing guidance, based on a comparable maturity overnight index swap. The issue is expected to close June 5, according to state officials.

Michael Imber, former commissioner for the Connecticut Pension Sustainability Commission and managing director at Conway MacKenzie said the MLF program should not be used to save pensions.

Interest rates are calculated through spreads to the curve depending on the issuer's credit rating, ranging from 150 basis points for a triple-A rated issuer to 590 basis points for below investment grade issuers. Pricing aligns with the Fed's notion that it plans to serve as a backstop for issuers.

Financing with the Fed could also bring states like Illinois with pension woes closer to their pension funding goals. With Illinois tapping into the MLF, the extra financing could help Illinois and other states' pensions in the long term to get close to a good funding level for pensions.

Michael Imber, former commissioner for the Connecticut Pension Sustainability Commission and managing director at Conway MacKenzie, said the MLF should not be used as a way to save pensions, calling it a partial bridge to help, but said pension systems still need transformational change.

Imber also noted Illinois' attempt to get to the market in early May. The state initially intended to competitively sell the $1.2 billion in short-term notes last month, but did not go through with it.

The state could have sold the deal but faced a steep borrowing penalty ahead of the competitive sale, according to market participants.

"Their inability to get to the market in early May was a big wake-up call and I think that not just Illinois, but communities all over the country, have an opportunity to take advantage of the crisis," Imber said.

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