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MSRB Study Points to Impact of Federal Reserve's Pandemic Response

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A significant disparity between how the effective spreads of municipal and corporate bonds declined following the most volatile month early in the pandemic may be at least partly explained by the differential treatment they received from Federal Reserve backstop programs.

That was a conclusion drawn by a new Municipal Securities Rulemaking Board study authored by MSRB Chief Economist Simon Wu and Market Structure Specialist Nicholas Ostroy. The study examined the spring 2020 spike in the effective spreads of tax-exempt munis, taxable munis, high-yield corporate bonds, and investment grade corporate bonds. The findings point toward the Fed's market support programs being a factor, the authors said.

"This disparity could be attributable, at least partially, to the differential treatment by the Board of Governors of the Federal Reserve System's policy initiatives during the COVID-19 crisis, where investment grade corporate bonds received both primary and secondary market support via the Federal Reserve's Primary Market Corporate Credit Facility and Secondary Market Corporate Credit Facility purchasing programs," the study said. "By contrast, the Municipal Liquidity Facility was only available to support primary issuance by eligible municipalities."

Market-related contributing factors to transaction costs, such as market liquidity and volatility, generally impact trading costs across all municipal and corporate bonds, the study explained. Researchers therefore use transaction costs as one measure of market liquidity, with higher transaction costs generally suggesting liquidity deterioration.

The study compared taxable munis to the corporate market because of the similarities those securities have in tax structure and investor base.

The study found that all four groups of bonds experienced a spike in effective spread in March 2020, with tax-exempt municipal securities increasing to 98 basis points from the February 2020 level of 53 basis points. Taxable munis rose to 80 basis points from 64, investment grade corporate bonds to 139 basis points from 35 and high yield corporates to 131 basis points from 47.

By December 2020, the effective spread for both tax-exempt munis and investment grade corporate bonds returned to the pre-pandemic levels of 51 basis points and 33 basis points respectively. But the effective spread for taxable munis was still elevated compared with the February 2020 level. For high yield corporate bonds, while the decline since the spring of 2020 was “swift and drastic,” the average effective spread was also still higher than the pre-pandemic level in February 2020.

“When focusing on the effective spread, it appears that taxable municipal securities behaved very differently from both groups of corporate bonds; if anything, both taxable and tax-exempt municipal markets were more similar to each other than to the corporate bond market, as the effective spread for corporate bonds appeared to rise more sharply than both groups of municipal securities during the peak of the market crisis, and then also appeared to decline more swiftly to revert toward the pre-pandemic level,” the study found.

The authors provided several possible explanations for the findings. Many market participants specialize in either corporate or municipal debt but not both, they noted, and the corporate market is typically more liquid than the muni market. There is also a credit quality disparity, with a far higher percentage of munis being rated in the top credit tiers.

Wu said the difference in recovery speeds between the high-yield and investment grade corporate markets tipped him off that the Fed’s intervention likely played a role, as only investment grade corporate bonds were eligible for the secondary market corporate credit facility program, with some exceptions.

Munis were backstopped by only a single primary market program, the Municipal Liquidity Facility. The Fed created the MLF in April 2020 and it ended at the end of 2020. It was open to counties with populations of 500,000 or more and cities of 250,000 or more. Governors of each state were also able to designate two issuers whose revenues are derived from activities such as public transit and tolls.

Illinois and the New York Metropolitan Transportation Authority were the only issuers to use the MLF, garnering criticism that it wasn’t open to enough issuers. But the Fed concluded that “the announcement of the liquidity option improved overall municipal bond market functioning across the board.”

Wu said he would like to see additional work done on this front.

“It would be nice to have someone else look into the same issue, maybe explore different angles,” Wu said, adding that additional research could also contribute to thinking on future Central Bank policymaking.

The conclusions reached by Wu and Ostroy do not represent an official MSRB position.

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