THE BOND BUYER

Illinois may borrow using MLF after a Fed policy adjustment

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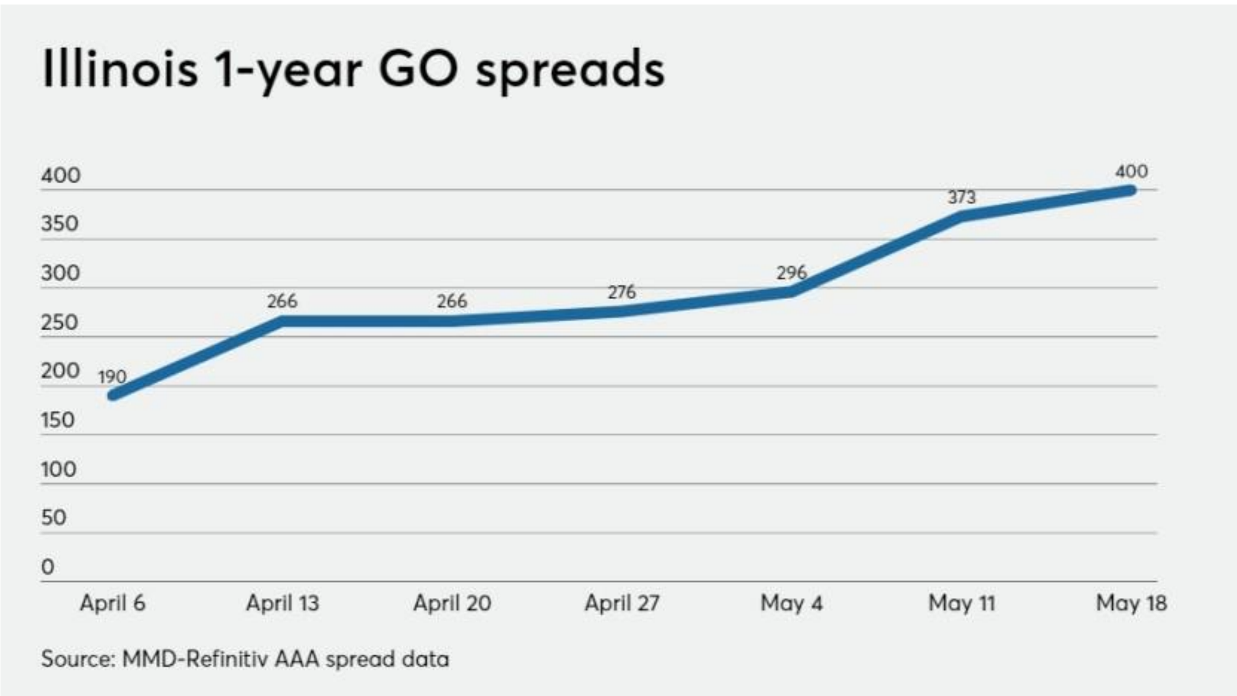

Illinois may use the Federal Reserve's Municipal Liquidity Facility for its $1.2 billion sale of one-year certificates to help manage a fiscal 2020 budget hole caused by the COVID-19-driven economic shutdown.

"The MLF now allows the Fed to participate in a competitive bid process like Illinois requires," so the state is considering the MLF for the deal and will complete a notice of interest form published Friday by the Fed, Carol Knowles, a spokeswoman for the Governor's Office of Management and Budget, said Friday.

"Current Illinois law requires competitive bids for short term borrowing, thus in order for the federal government to participate it would have to be the successful bidder in a competitive offering," Knowles emphasized.

The Fed recently laid out guidelines that allow it to bid on notes when an eligible issuer is required under law to use a competitive bid process. The initial guidelines indicated the program would directly buy competitively sold notes only when they were not purchased by other bidders.

The Fed released on Friday a Notice of Interest form for would-be participants in the $500 billion program, which is up and running as of Monday. “An eligible issuer should submit an NOI only when it has determined its financial needs and schedule,” a Fed press release says.

The state said it would submit a NOI form, but the one-year notes will remain on the day-to-day calendar and may move before the MLF is up and running. “We are continuing to monitor the municipal market and are prepared to enter at any time,” Knowles said.

The Fed, under current guidelines, would offer Illinois the certainty of a price ceiling in the competitive sale process, and potentially entice others to bid lower.

Illinois Gov. J.B. Pritzker announced the state’s plans to issue $1.2 billion of general obligation certificates last month as part of the state’s plan to tackle the loss of $2.7 billion of revenue in the fiscal year that runs through June 30. Another $4.6 billion blow is expected next year.

Fitch Ratings, Moody’s Investors Service, and S&P Global Ratings all assign a negative outlook on the ratings are at BBB-minus level across the board, the lowest among states and just one rung above junk.

The Fed announced the program in April to calm the municipal market and help its recovery from a tumultuous March but initially there were more questions than answers on the process.

As guidelines on eligibility, pricing, and the sale process were fleshed out, many market participants called Illinois an ideal candidate, but the state’s required competitive bidding process remained a sticking point that precluded the state’s participation, state officials said.

Under short-term borrowing statutes, the state can borrow for cash flow when revenues fall short of budgeted estimates with the approval of the governor, comptroller, and treasurer. The bonds must be repaid in the next fiscal year and they must sell through competitive bidding.

The state initially targeted a May 6 sale date, to be followed by a $1 billion long-term issue the following week. The state, two days ahead of the cash-flow deal, moved it to the day-to-day calendar. At the time the state’s one-year was set at 3.73%, a 296 basis point spread to the Municipal Market Data's top benchmark and its 10-year was at a 396 bp spread. Market participants said they expected the market to price the notes at a much higher interest rate.

At the time, the Fed had not released pricing guidance for the MLF and did not allow for the competitive process required by Illinois statutes. The state moved ahead last week with the long-term bond sale.

The MLF program now allows for either a competitive sale process or a direct sale. Previously, the Fed had said if an issuer opted for a competitive sale process that it would not bid but would serve as a backstop and commit to buy notes not purchased by other bidders.

The Fed recently released further guidance saying that it would "arrange to submit a bid in a competitive sale process" in cases where "an eligible issuer is required by law to sell eligible notes through a competitive sale process and does not have the legal authority even following a competitive sale process in which fewer than all of the eligible notes are sold to sell eligible notes directly to the" the program.

The state is eligible for nearly $9.7 billion based on its revenues, according to the Fed.

Just how attractive the program is will depend on where the state's spreads move and market stability.

The one-year maturity in the 25-year bond sale last week landed at a 4.875% yield for a 433 bp spread to the AAA scale. The state's one-year bond is currently at 4.43 %, a 400 bp spread to the MMD AAA benchmark.

Under pricing guidance laid out by the Fed, the state could borrow at a rate around 4% based on a comparable maturity overnight index swap rate that will be used as the base and then a 380 bp spread tied to its ratings level. The fee is 10 basis points.

While the program's term sheet says it is designed to serve as a backstop for eligible issuers struggling with market access, it takes into consideration pricing. "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," the term sheet says.

Update: *The story was updated to reflect a Fed official's Monday statement that the MLF is open for business.*