There's A New Investor that's Come to Town in the Municipal Debt Markets

States and municipalities, no less than the private sector, feature prominently within the Coronavirus Aid, Relief, and Economic Security Act[1] (the CARES Act) passed by the U.S. Congress and signed into law by the president on March 27, 2020 to combat economic and financial repercussions related to the coronavirus (COVID-19) pandemic. While the CARES Act provides for a basic framework for the U.S. Treasury and Federal Reserve System to intervene to create purchasing capacity for municipal bonds, that foundation will need to be fleshed out and built up by the U.S. Treasury in guidance that will be forthcoming.

Purpose—Provision of Liquidity

Among other economic and financial responses to the pandemic, including certain grant programs for states, local governments, and elementary, secondary, and higher education,[2] the CARES Act endeavors to provide liquidity to eligible businesses, states, and municipalities related to losses incurred as a result of COVID-19, by authorizing the Secretary of the Treasury to make loans, loan guarantees, and other investments from the Exchange Stabilization Fund in support of those entities in the aggregate, not to exceed $500 billion (CARES loans and investments), as well as providing the related necessary subsidy amounts.[3] At least $454 billion of this fund is specifically intended to provide liquidity to the financial system that supports lending to states and municipalities by allowing both primary and secondary market purchases of obligations. The Federal Reserve expects to start voluntary purchases of municipal securities within 10 days of enactment in an effort to stabilize the municipal bond market.[4]

Broad Eligibility for Municipal Issuers; Questions for Conduit Financings

The CARES Act defines "municipality" fairly broadly — including a political subdivision of a state and an instrumentality of a municipality, a state, or a political subdivision of a state. Conduit financings, however, are not directly addressed in the CARES Act. While certain conduit borrowers are governmental entities, most are not and may need to be analyzed as to whether they qualify as an eligible business under the CARES Act.

No Loan Forgiveness for States and Municipalities

The CARES Act provides that the principal amount of any obligation of a state or municipality shall not be reduced through loan forgiveness.

Rate and Other Provisions

CARES loans and investments by the Treasury Secretary are required to be made in such form and on such terms and conditions and contain such covenants, representations, warranties, and requirements (including requirements for audits) as the Treasury Secretary determines appropriate. Any such loans made by the Secretary are to be at a rate determined by the Secretary based on the risk and the current average yield on outstanding marketable obligations of the United States of comparable maturity.

U.S. Treasury to Publish Procedures and Requirements

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Related Practice Areas

- Public & Project Finance

As soon as practicable, but in no case later than 10 days after the date of enactment of the Act (April 6, 2020), the Treasury Secretary is required publish procedures for application and minimum requirements for making CARES loans and investments.

Significant Takeaways

Critical to the ability of states and municipalities (as well as conduit borrowers) to use these authorized programs will be the specifics procedures and requirements to be published by the Secretary of the Treasury. How the Treasury Department interprets "losses incurred as a result of coronavirus" may be important for determining the types of purposes that can and cannot be financed. For example, short-term and long-term working capital financings to manage budget deficits are different from various refunding and capital purposes, and the CARES Act does not explicitly address the particular types of financings.

Notwithstanding the procedures and requirements that the Treasury Department will provide, applicable state law for borrowings (particularly working capital authorizations where available) will need to be complied with by issuers who should consult with their bond counsel regarding navigating the intersection of federal and state requirements.

The CARES loans and investments may provide relief to a wide range of issuers — both large and small issuers, general purpose governmental entities, and revenue sector entities — and both issuers with existing obligations (variable rates presumably) and those with a need to enter into the new issuance market. The overall dollar amounts authorized for the CARES loans and investments is large and does not appear to be a significant limiting factor on the ability of targeted parties to benefit from the new programs. Whether the Treasury Department's procedures and requirements create other limits remains to be seen.

The CARES Act does not specifically mention tax-exempt versus taxable municipal debt, and we will await the Treasury Department's upcoming procedures and requirements that touch upon this topic, particularly as they may relate to federal guarantee tax rules.

The statutory provisions about CARES loans and investments are not particularly detailed, which suggests some opportunity for creativity on the part of the U.S. Treasury Department and the Federal Reserve. This raises the question whether the Treasury Department and the Federal Reserve would be receptive to providing market and credit support in flexible ways drawing from existing municipal sector structures (e.g., debt service reserve fund sureties, backstops to state school aid intercept funds, standby bond purchase arrangements, repurchase agreements for municipal securities, commitments to make up deficiencies in debt service reserve funds, insurance on all or a layer of underlying bonds within a governmental pool bond issuer, etc …).

Timing and other program considerations for the disbursement of grant funds pursuant to the CARES Act will determine whether, as a practical matter, certain issuers will wish to borrow in anticipation of such funds.

Appendix I

Grants Through Coronavirus Relief Fund and Education Stabilization Fund

Coronavirus Relief Fund

The CARES Act provides $150 billion for a Coronavirus Relief Fund to be administered by the Treasury Secretary for making payment to states, Tribal governments, and units of local government. The fund will provide $139 billion to states and units of local government. Unit of local government is defined as a county, municipality, town, township, village, parish, borough, or other unit of general government below the state level with a population that exceeds 500,000. No state will receive less than $1.25 billion. Amounts above the minimum will be based on each states' population relative to that of all other states. Municipalities with populations that exceed 500,000 may make application to the Treasury Secretary for direct payments from this fund. Any municipality with a population of 500,000 or less will have to request moneys from this fund from its state.

Education Stabilization Fund

The CARES Act provides $30.75 billion for an Education Stabilization Fund that will remain available until September 30, 2021. Moneys in the Education Stabilization Fund will be applied to prevent, prepare for, and respond to coronavirus, domestically or internationally. Of this amount the funds will be apportioned as follows:

> $13.5 billion to the Elementary and Secondary School Emergency Relief Fund to provide grants to assist elementary and secondary schools with planning and coordinating education of students during long-term closures. The Secretary is required to issue notice inviting applications not later than 30 days after enactment (April 26, 2020) and to approve or deny applications not later than 30 days after receipt.
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> $14.25 billion to the Higher Education Relief Fund to provide assistance to institutions of higher education to cover any costs associated with significant changes to the delivery of instruction due to the coronavirus. Institutions of higher education are required to use no less than 50 percent of the funds to provide emergency financial aid grants to students for expenses related to the disruption of campus operations due to coronavirus (including eligible expenses under a student's cost of attendance, such as food, housing, course materials, technology, health care, and child care).
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> $3 billion to the Governor's Emergency Education Relief Fund to provide emergency support through grants to local educational agencies (school districts) and institutions of higher education that the state educational agency or governor deems have been most significantly impacted by coronavirus to support the ability of such local educational agencies to continue to provide educational services to their students and to support the on-going functionality of the local educational agency.

For additional information or assistance with any topic covered by this Alert, feel free to contact any member of our Public and Project Finance Group.

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[1] Senate passed version of H.R. 748.

[2] The CARES Act is the third stimulus package enacted in response to the coronavirus pandemic. The president signed the Coronavirus Preparedness and Response Supplemental Appropriations Act, 2020 into law on March 6, 2020, and the Families First Coronavirus Response Act into law on March 18, 2020. The CARES Act also authorizes a Coronavirus Relief Fund to provide for significant direct aid through payments to states, Tribal governments, and units of local government of $150 billion for fiscal year 2020. The CARES Act also provides $30.75 billion for an Education Stabilization Fund that will remain available until September 30, 2021. These funds are discussed further in Appendix I to this Alert.

[3] The implementation of CARES loans and investments would involve programs or facilities established by the Board of Governors of the Federal Reserve System (the Federal Reserve). The relationship between the Treasury and the Federal Reserve System is generally beyond the scope of this Alert.

[4] Brian Tumulty. "Fed Will Have 10 Days to Begin Muni Purchases." The Bond Buyer, March 26, 2020.