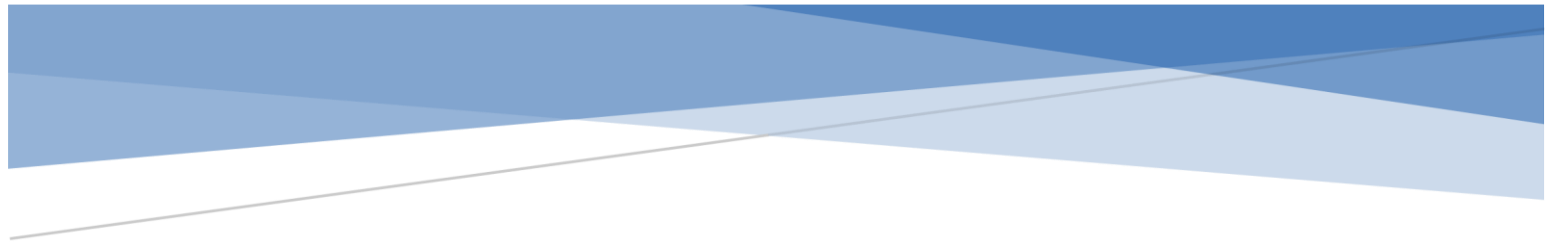

The MTA and the MLF:

COVID Creates New Paradigms of Federal Intervention in Municipal Finance

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Summary:
The unprecedented stresses created by the coronavirus on the largest public transportation agency in the United States drove the agency to seek novel emergency aid vehicles from both the State of New York and the Federal Government. Bond markets spiked the credit spreads of the fourth largest municipal bond issuer overnight, and its access to capital throughout 2020 was challenged by investors' perceptions of its solvency, despite the fact that the MTA is not eligible to file for bankruptcy protection. The State of New York, facing its own downturn in tax revenues, was unable to step in with sufficient cash injections, but did expand the MTA's ability to use deficit financing. The April 2020 CARES Act provided a $3.9bn cash injection to stabilize finances at the agency, but it was another provision that created a new power for the Federal Reserve Bank to provide assistance to the MTA and other municipal borrowers. The Municipal Liquidity Facility ("MLF") rapidly conceived of and crafted in the midst of the crisis has significantly blurred the traditional lines between monetary policy and fiscal policy in order to provide emergency aid to the MTA, and also exposed some inherent tensions in national infrastructure funding done largely through state and local resources.

Background:
COVID-19 Derails Ridership
New York's Metropolitan Transportation Agency directly serves 11 counties across two states (NY & CT), and, indirectly several more counties in a third state (NJ). The combined population of the service area exceeds 15 million and the system provided over 2.4 billion trips annually on average since 2010. While primarily know for the New York City subway system, which provides over 1.5 billion trips per year on average, bus lines provide an additional 540 million trips and commuter rail (LIRR and Metro-North) add another 250 million trips. Additionally, the MTA owns and operates seven bridges and tunnels that control vehicle access from Long Island and between the boroughs.

At the depths of the COVID-19 shut downs in March and April 2020, average ridership fell by 92% on the subway system, 76% for buses, 97% for the LIRR and 94% for Metro-North. Ridership has rebounded as the economy reopened later in 2020, but average daily subway usage was still down 69% year-over-year in December 2020. Overall 2020 ridership was down to 885 million (a 66% decline) and the MTA projects it will not return to over 2 billion rides until calendar 2022.

Like most major transportation systems around the country, Farebox Revenues tied to ridership account for less than half of the operating revenues for the MTA, somewhat dampening the fiscal impact of the shutdown. Several taxes and fees, including the fifty-cent taxicab surcharge, provide over half the annual revenue base. The adopted pre-COVID-19 2020 budget projected $6.8bn in Farebox Revenues, up 3.3% from the actual FY19 level, but only accounted for 47.2% of the budget available for the transportation revenue fund. Estimated actual revenues for 2020 are $2.6bn, down 61.8% from the

budgeted level, creating a $4bn shortfall. These receipts are forecast to rebound to $3.6 billion in the 2021 adopted budget up 38% from 2020, but still 46.5% below the actual 2019 level. [1]

MTA Debt

With a total of $44.7 billion of debt outstanding as of January 2021, the MTA remains one of the top five largest borrowers in the U.S. municipal bond market. In 2020 alone, the MTA's $6.2bn of issuance of new money, refunding and deficit financing placed it as the third largest issuer for the year.[2]

Traditionally, the MTA has used three major security packages to borrow to fund its capital investment program. Chart 1 below shows the amounts outstanding and associated credit ratings as of December 2020 with the largest amount borrowed through the Transportation Revenue Bonds ("TRBs"). The $7.6bn of Triborough Bridge and Tunnel Authority ("TBTA Bonds") are secured by both senior and junior liens on toll revenues from the seven water crossings, and the $5.14bn of Dedicated Tax Funds are secured by a lien on statewide Petroleum Business Tax. Both of those series of bonds have historically received higher credit ratings due to the primacy of the liens laid out in the respective indentures. TRBs receive the residual revenues after those bonds are paid, effectively making those bonds senior to the MTA's main borrowing mechanism. For the purposes of this paper, the only the TRB bond Indenture will be examined as it was the most susceptible to the declines in ridership in 2020.

Chart 1:

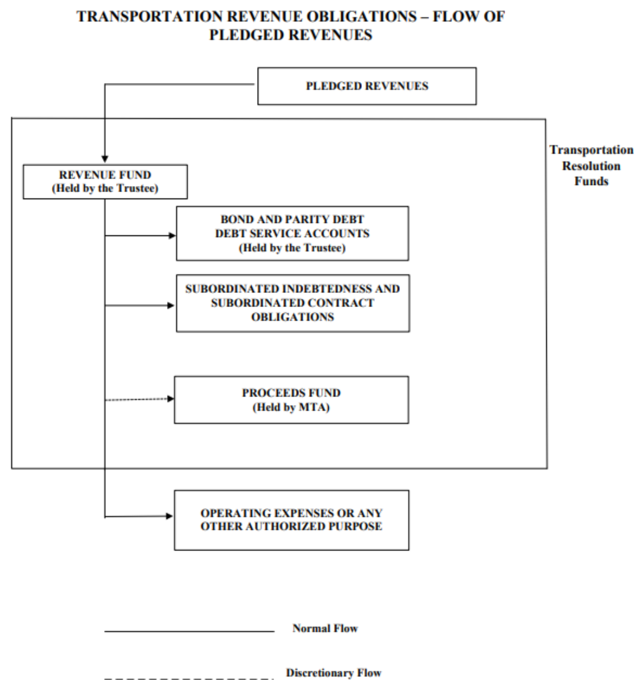
	As of December 31, 2020				
	Debt Outstanding ($, bn)	**Moody's**	**S&P**	**Fitch**	**Kroll**
Transportation Revenue Bonds ("TRBs)	$28.17	A3/MIG 2	BBB+/SP-2	A-/F1	AA/K1+
Triboro Bridge and Tunnel Authority ("TBTA Bonds")	$7.60	Aa3	AA-	AA-	AA
Dedicated Tax Fund Bonds	$5.14	N/A	AA	AA	N/A
Hudson Yards Trust	$0.85	A3	N/A	N/A	A-
MTA Payroll Mobility Tax	$2.90	N/A	N/A	AA+	AA+

Despite the fact that the TRBs revenue sources came under significant pressure, there are some inherent strengths for bondholders that are included in the TRB Indenture. First, as outlined in Chart 2 below, TRBs enjoy a senior lien on revenues received by the system, even prior to the operating expenses of the system. Technically, bondholders should receive due principal and interest before any funds are expended on salaries, benefits, fuel purchases, etc.

[1] https://new.mta.info/document/25281

[2] https://www.bondbuyer.com/broker/bond-buyer-data

Chart 2:



Secondly, due to its status as a public corporation of the State of New York and pursuant to the MTA authorizing statutes, unlike many other municipal issuers, it is prohibited from accessing the municipal restructuring section of the federal bankruptcy code. The Official Statements clearly outline this crucial legal aspect:

> "**No Bankruptcy**. State law specifically prohibits MTA, its Transit System affiliates, its Commuter System subsidiaries or MTA Bus from filing a bankruptcy petition under Chapter 9 of the U.S. Federal Bankruptcy Code. As long as any TRBs are outstanding, the State has covenanted not to change the law to permit MTA of its affiliates or subsidiaries to file such a petition. Chapter 9 does not provide authority for creditors to file involuntary bankruptcy proceedings against MTA or other Related Entities."[3]

Investors frequently ask what recourse, then, the MTA has if it runs out of cash to make bond payments if it does not have access to the court system to adjust its liabilities. In the case of distressed sovereign countries, the International Monetary Fund ("IMF") can step in with a relief package, but there is no contracted legal entity with powers to help an issuer such as the MTA. It is likely that the State of New York would step in to the extent it could, but it is not legally obligated to back bond payments.

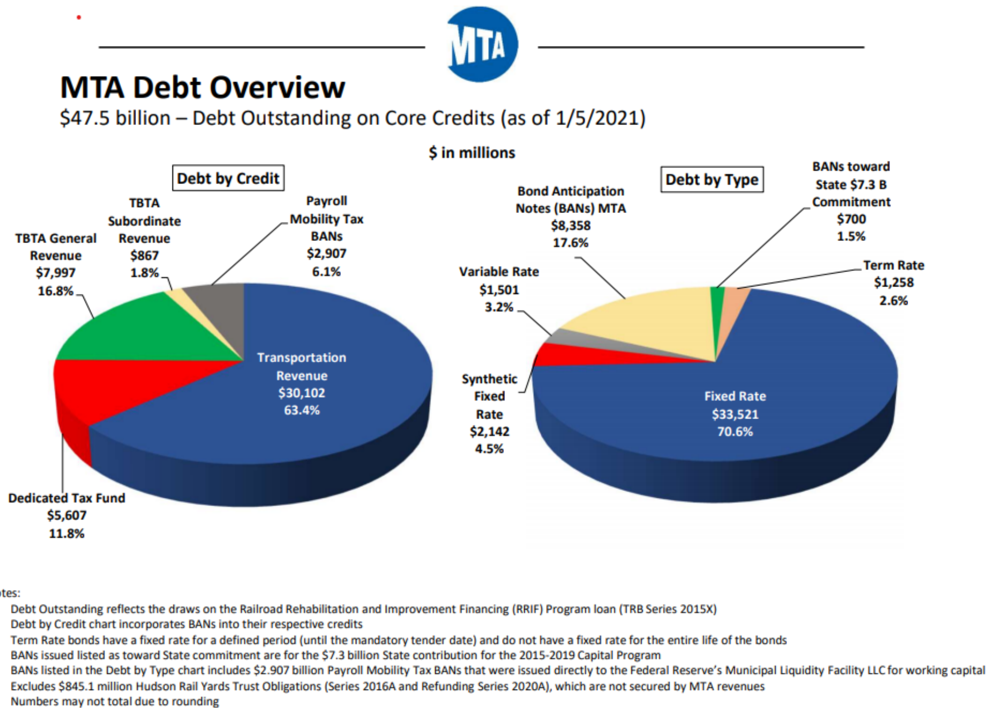
[3] https://emma.msrb.org/P11464795-P11135473-P11547889.pdf p. 28

Debt Structure Risks for MTA

As one of the most sophisticated issuers in the municipal bond market, the MTA has worked with its financing partners to use various advanced financing techniques to lower its overall cost of capital. This debt structure as outlined in Chart 3 below included over $10 billion of variable rate instruments that have rates reset at the “front end of the curve” rather than longer duration fixed rate bonds that have higher coupons. Rating agencies have historically viewed the professionalism of the finance team inside of the MTA as a mitigating factor against the overnight pressures these short-term financing vehicles can impose upon the issuer, but COVID-19 presented a succinct and novel challenge for the MTA.

The MTA has been the largest user over the past decade of a type of borrowing called a Bond Anticipation Note (“BANs”). BANs are tax-exempt like other municipal debt, but generally have a maturity within one-to-three years of issuance and do not amortize. Being short-term instruments, BANs receive lower interest rates as the investor base does not have to be compensated for longer term inflation risks as with 10, 20 or 30 year bonds. The MTA has used BANs during construction periods to lower the cost of projects, with the intent of issuing long-term amortizing bonds upon completion and retiring the BANs. These instruments receive “short term” ratings from the agencies that you can see in Chart 1 above, and can be purchased by short duration mutual funds and even potentially money market funds.

Chart 3 (Source: MTA):



The inherent risk to issuing BANs is that at maturity is that the issuer must have market access to refinance into longer term bonds, hence the name. As Moody's notes in its methodology for rating these instruments: "An issuer's ability to manage refinancing risk is important because a failed or delayed take-out debt issuance may result in late repayment of the debt. Even a short-lived market disruption could push repayment past the due date if the issuer has no funding alternatives in place or if the timing of the issuance is close to the BAN's maturity date, mandatory tender or roll-over date."[4]

In many ways, this is analogous to a classic "run on the bank" where short term funding (deposits/BANs) is withdrawn by investors but the assets are long-term and illiquid (home mortgages/rail and subway infrastructure). Investors became concerned that the MTA would be unable to repay due principal and interest at the maturity of its 2017 BANs on May 15, and September 15, 2020, and the Chart 4 below shows how quickly market rates shot up overnight by over 500 basis points. Interestingly, longer term maturities did not sell off as quickly because the fear was more specific in that the MTA's short term liquidity crunch might lead to a default if it couldn't sell long term bonds to repay BANs' investors.

Chart 4 (Source: Bloomberg):

However, while revenues turned down rapidly in March 2020 as ridership fell, the systems' liquidity profile was actually sufficient to meet short term obligations. First, the MTA ended February 2020 with approximately $3.4bn in cash in its coffers. On March 16, credit markets reacted negatively to the MTA's request to the US federal government

[4] https://www.moodys.com/research/Moodys-updates-its-methodology-for-rating-US-bond-anticipation-notes

for an emergency allocation of $4bn of cash, roughly offsetting the $3.7bn of lost Farebox Revenues the system forecasted through December 31, 2020, plus an additional $300mm to offset increased sanitizing costs.

It's ironic that what might be viewed as prudent long term planning and public fiscal management for the worst case scenario was simultaneously construed as a major concern to investors. Patrick Foye, the CEO of the MTA, was publically requesting federal aid in the middle of the pandemic, as lawmakers in Washington, D.C., were preparing to debate an aid package. Reminiscent of Churchill's admonition, "Don't waste a good crisis," MTA management was raising its hand to ensure an allocation of funding from any package forthcoming from Congress.

As often happens in public finance markets, news headlines exacerbated investors' concerns at the same time, exemplified by a Bloomberg headline on March 31 that read: *New York MTA Chief Says Federal Aid Needed to Avoid Bond Default* while the same story quoted Foye verbatim: "We expect to make every principal and interest payment -- we're not asking for forgiveness from our creditors. We're obviously one of the largest borrowers in the muni market and the MTA making its principal and interest payments is incredibly helpful to the overall market."[5]

DC Jumps On-Board

In response to the rapid economic downturn in March, the United States Congress passed a series of emergency measures in early April to address COVID-19 impacts to households, companies and large transit systems. The first round of the Coronavirus Aid, Relief and Economic Security Act (CARES Act) aid included $25 billion for transportation authorities around the nation. Perhaps vindicating Chairman Foye's request, the MTA was the largest recipient of cash, receiving $3.8bn with the adjacent NJ Transit system received the second largest amount at $1.5bn. The direct federal aid came without any significant stipulations on usage, and thus permitted the MTA to use the cash to pay for operations or to make bond payments. Congress, perhaps, recognized the importance of the MTA to national economic well-being in earmarking such a large percentage of the program. But this unique infusion of cash in an emergency situation calls into question whether a longer-term federal funding mechanism isn't necessary to ensure the health of such crucial infrastructure.

In addition to this fiscal support, the CARES Act also introduced legislation to establish $2.3 trillion of emergency lending powers under section 13(3) of the Federal Reserve Act, including the ability for the Fed to intervene in secondary credit markets for corporate bonds to bolster market liquidity. $850 billion was provided through the Primary and Secondary Market Corporate Credit Facilities to allow the Fed to purchase existing bonds trading across financial markets. However, the $500bn Municipal Liquidity Facility ("MLF"), despite its name, was not structured as a program to support

[5] https://www.bloomberg.com/news/articles/2020-03-31/new-york-mta-chief-says-federal-aid-needed-to-avoid-bond-default

the market for tax-exempt bonds. The municipal bond market is generally less liquid than other secondary bond markets, largely ascribable to the fact that individuals, "mom-and-pop," and not institutional investors (Pension funds, endowment managers, etc.) hold approximately 70% of the bonds in this $3.8 trillion market.[6] As investor concerns spiked in mid-March, municipal mutual funds experienced large withdrawals, and there were no natural buyers to step in.

The MLF did not address these market dislocation issues directly, but was structured as a direct lender-of-last-resort style program to issuers. Launched in April, the MLF went through several iterations over the course of 2020 in response to feedback from multiple participants, but also largely due to pressure applied from elected officials to make the program more workable. The underlying principal throughout, however, was that the Fed would not assume true default risk and losses, but instead a $25bn equity investment by the US Treasury into a Special Purpose Vehicle ("SPV") would absorb first losses. The Fed could lend up to $500bn via direct loans from the SPV to states and local governments, and any potential defaults would be covered by Treasury's equity.

Some key provisions of the MLF were[7]:

- Purchased notes can have a maximum three-year maturity
- Credit spreads are priced according to credit ratings by the issuer on April 9th, 2020, and subsequent downgrades would not increase pricing,
- 50 states and large cities initially in-scope,
    - Smaller issuers and some revenue bonds issuers (MTA, Port Authority of New York/New Jersey) added in later amendments,
    - General Obligation security is preferred, but Fed was granted flexibility in the security on the loans
- Loans principal amount could represent no more than 20% of annual revenues
- Program ended on December 31, 2020

During the summer of 2008, then-Treasury Secretary Hank Paulson famously stated about the powers associated with bailing out Freddie Mac and Fannie Mae, "If you've got a bazooka, and people know you've got it, you're not likely to need to take it out." The MLF immediately assured market participants that there was a backstop to prevent a full melt-down in the municipal bond market, though it's unclear that many people understood the limited functioning of the program. Credit spreads immediately tightened and investor funds flowed back into the mutual fund complex right away.

Importantly, this facility was in place as the MTA's May 15 BAN maturity approached, and the announcement reduced the annualized rate from above 14% per annum to below 6% per annum in Chart 4 above. (Note: the actual return to investors was much smaller as bonds trade with accrued interest, and there was only 30~40 days of interest left on the cusip). However, the MTA retired the 2017 BANs with a long term $1.1bn tax-exempt

[6] https://www.federalreserve.gov/releases/z1/preview/html/l212.htm
[7] https://www.federalreserve.gov/monetarypolicy/muni.htm

municipal bond issue dated May 8, 2020[8], and those bonds priced with yields around the 5% level for 30 year maturities. This proved that the MTA had market access yet at the cost of somewhat elevated borrowing costs due to higher credit spreads.

By its expiry in December 2020, only two borrowers, the MTA and the State of Illinois (BBB- rating at S&P) actually tapped the MLF, a testament to the program being more about "holding a bazooka" than needing to fire it. Municipal bond yields fell throughout the year as the Fed's programs lowered US Treasury bond yields and investors felt more secure knowing there was a backstop mechanism to avoid defaults. The State of New Jersey contemplated issuing a $4bn deficit bond using the facility in September, but its advisor determined that a market based solution would actually provide a lower cost of borrowing than the MLF.[9]

The MTA first tapped the MLF on August 26th for $450.72 million maturing August 1, 2023, at a rate of 1.92%. These funds were utilized to repay the BANs maturing in September, removing risks related to market access a month in advance. As November, press reports indicated that Congress would not extend the emergency powers under section 13(3) of the Federal Reserve Act, the MTA elected to draw down the maximum amount available to it under the MLF, issuing $2.9 billion (included in Chart 1 above) to the Fed on December 17, 2020, due in three years at a rate of just 1.36%. Importantly, the MTA used a new security package leveraging its Payroll Mobility Tax to achieve AA+ ratings at Fitch and Kroll, thus enabling it to receive a much lower credit spread that it would on its A3/BBB+ rated TRBs. [10] This deficit financing will help the MTA maintain sufficient liquidity through 2021, but, as recent press reports indicate, operational measures such as higher MetroCard fees or service cuts will be needed to restore structural budgetary balance unless federal aid becomes a more permanent part of the system's cash-flow.

Conclusion

The coronavirus economic shutdown exposed some inherent flaws in the municipal bond market as a whole, where a thinner investor base can be more easily into a 'risk-off' mindset. In addition, it heavily impacted the operating revenues of one of the largest issuers in the market, the MTA, and focused investors on the potential weakness in its reliance on short-term financing options used to lower its capital costs. We also observe how prudent public management techniques may not be viewed favorably over the short-term by investors, and can readily see the impact of "headline risks" on municipal borrowers.

For the first time in history, the Federal Reserve Bank intervened in the US municipal bond market, but in a way that really kept it on the sidelines rather than as an active participant. Fed officials likely wanted the market to provide solutions rather than be in

[8] https://emma.msrb.org/SS1379049-SS1073823-SS1481002.pdf
[9] https://www.reuters.com/article/usa-new-jersey-fed-bonds/new-jersey-picks-muni-market-over-fed-for-4-billion-bond-sale-idUSL1N2HD1ZD
[10] https://new.mta.info/document/25281

the precarious position of making decisions about how to allocate capital to different states that might be viewed as impinging on its position of being a-political. If the Fed had lent to a "red state" a large amount at a lower rate than a "blue state," the hundred year plus reputation of not making those sorts of fiscal decisions questioned. However, the direct lending structure of the MLF blurred the lines between fiscal policy and the stated goals of the Fed, and it will be interesting to see if Congress revisits granting powers for the central bank to become a lender-of-last-resort for future unexpected exigencies.