Policy Option 2

EXPLORING ACTIONS OF THE FEDERAL RESERVE BANK

Dealing with the Federal Reserve System is not something trustees and managers of public pensions do on a day-to-day basis. But they do monitor Federal Reserve actions as they affect their investment decisions. Could they influence Federal Reserve actions through advocacy, as they do in state legislatures through testimonies?

A recent article by Robert Kuttner, co-founder of *American Prospect* and a speaker at NCPERS Forum, addresses why the Federal Reserve doesn't buy student loan portfolios.[8] Kuttner notes,

> The Federal Reserve is buying about $9 trillion worth of all manner of corporate and Wall Street securities in order to pump up the financial part of the corona economy. In the course of doing this, our central bank has bailed out trillions of dollars of bad financial bets.… A major category of debt not included is the $1.65 trillion in student debt, which was destroying the prospects of two generations of young adults even before the virus struck. A lot of this debt has been securitized, in the same manner that subprime loans were securitized in the run-up to the collapse of 2008.

By the same token, one might say, why doesn't the Federal Reserve buy underperforming or toxic assets of pension funds or even buy the entire unfunded liability of public pensions through plan sponsors' municipal bonds? After all, the Federal Reserve seems to have unlimited capacity and has been creating money out of thin air without causing inflation.

We had explored the role the Federal Reserve can play to address pension funding issues with Dennis Lockhart (former president and CEO of the Federal Reserve Bank of Atlanta) at the 2015 Public Pension Funding Forum. During his speech[9] at the forum, he said the funding status of public pensions does not pose any threat to the US economy or financial markets. Yet there are some actions that the Federal Reserve is now planning to take that pension funds may consider as they address funding issues. For example, in light of the COVID-19 economic downturn, the Federal Reserve has opened a new municipal discount window and is willing to buy municipal assets as well as exchange-traded funds.

5 Robert Kuttner, Kuttner on TAP: E-mail Blast, Student Debt and the Fed (May 1, 2020).

6 Dennis Lockhart, The Interplay of Public Pensions and the Board Economy, Public Pension Funding Forum speech (August 24, 2015), www.frbatlanta.org/news/speeches/2015/0824-lockhart.

Before these recent emergency measures, Federal Reserve actions affected pension funds indirectly. For example, when the Federal Reserve takes actions to stabilize financial markets and stimulate the economy, it affects pension fund investment decisions and returns. Let us examine the actions that indirectly affect public pensions, for example, changes in the federal funds rate target,[10] and then discuss some of the recent actions in response to COVID-19, for example, the municipal discount window and purchase of municipal bonds, toxic assets, and underperforming assets such as exchange-traded funds that may have direct implications for public pension funds.

Federal Reserve Actions That Have Indirect Impact on Public Pensions

The Federal Reserve plays a key role in the economy through various tools, of which the federal funds rate is the best known. It's the rate banks use to borrow funds from each other overnight without collateral. When the Fed lowers the rate, it is conducting expansionary monetary policy. When the funds rate is low, bank lending is cheaper, businesses expand, mortgage rates drop, and housing and stock markets improve. Lowering the funds rate is generally undertaken to stimulate the economy.

By contrast, when the Federal Reserve raises its federal funds rate target, it is putting the brakes on an overheated economy or conducting contractionary monetary policy. A higher federal funds rate makes banks less inclined to borrow money from one another to keep their reserves at the mandated levels. Instead they borrow directly from the Federal Reserve discount window, which requires collateral. Hence, the money that is lent by banks will be lent at a higher rate, which results in a reduction in business borrowing and higher mortgage interest rates. By tempering the economy through federal funds rate hikes, the Federal Reserve is attempting to keep inflation in check.

Federal Reserve Actions That May Directly Affect Public Pensions

When raising or lowering the funds rate does not produce the desired results, the Federal Reserve deploys other tools that are less commonly known. These include quantitative easing and helicopter money. Use of some of these tools by the Federal Reserve can have direct implications for public pensions. For example, in light of the shutdown of the economy due to the COVID-19 pandemic, state and local revenues are likely to fall short. The Federal Reserve, on April 9, 2020, announced it was establishing a Municipal Liquidity Facility,[11,12] to support state and local liquidity needs. Similarly, the Federal Reserve has expanded the asset purchasing program (quantitative easing) to the municipal sector. This program was previously limited to the corporate and banking sectors.

10 The federal funds rate is the interest rate at which depository institutions lend reserve balances to one another on an overnight basis. The Federal Open Market Committee of the Federal Reserve System establishes a target interest rate and influences it by conducting open market operations such as buying and selling government securities.

11 Federal Reserve Board of Governors, "Federal Reserve Takes Additional Actions to Provide up to $2.3 Trillion in Loans to Support the Economy," press release (April 9, 2020).

12 Federal Reserve Board, "Municipal Liquidity Facility," www.federalreserve.gov/monetarypolicy/muni.htm.

Discount windows. The Federal Reserve requires financial institutions to maintain a certain level of reserves for the purpose of liquidity. When banks cannot borrow from each other to maintain the required level of reserves, they turn to the Federal Reserve's discount windows. These loans are usually short term (48 hours to one month), and the borrowers have to offer collateral.

Prior to the COVID-19 pandemic, there were three discount windows: primary, secondary, and seasonal. They have different interest rates depending on the borrower's credit rating – primary being for those institutions with solid credit. The rate for the primary window is 50 basis points higher than the federal funds rate. For the secondary window, the rate is 100 basis points above the prevailing funds rate. During financial emergencies, however, the rate can be lowered or adjusted at the Federal Reserve's discretion. The length of each loan also can be extended. The seasonal window is designed for smaller banks, such as farm banks, with deposits less than $500 million, to help them meet liquidity needs that fluctuate. These banks can borrow money for up to nine months. The interest rate is driven mainly by market conditions.

After the shutdown of the economy due to COVID-19 and the expected drop in state and local revenues, the Federal Reserve has opened the Municipal Liquidity Facility. The purpose of this window is to meet the liquidity needs of state and local governments. A recent article in *Pensions and Investments* underscores that pension funds will increasingly need liquidity to pay benefits as a result of COVID-19.[13] The Municipal Liquidity Facility will come in handy for this purpose. Details may have to be worked out, but pension funds, especially mature plans, might be able to obtain short-term loans to meet their liquidity needs. At this time we do not know details of how this is working and who is using it.

Quantitative easing. Quantitative easing, or the asset purchasing program, is another tool that the Federal Reserve uses to increase the money supply. Quantitative easing is an important tool when traditional tools such as lowering interest rates and adjusting the money supply through the purchase and sale of US treasuries do not work.[14] Quantitative easing expands asset purchasing beyond treasuries to include corporate securities. By purchasing corporate securities, such as troubled or toxic assets (such as subprime-mortgage-backed securities) from the market, the Federal Reserve increases the money supply, which in turn stabilizes financial markets and the economy.

In the wake of the COVID-19 economic downturn, the Federal Reserve plans to extend the asset purchase program to state and local government securities.[15] This approach could provide the added liquidity that state and local governments need when tax revenues fall short. Pension funds can benefit from this new program as it can provide state and local governments an avenue to address the funding needs of public programs, including pensions.

The Federal Reserve potentially could buy toxic and underperforming assets. Pension funds often have resorted to courts to seek settlements on these matters, with mixed results. The following two examples illustrate the mixed results:

- A mortgage-backed security (MBS) class-action suit, led by the Iowa Public Employees Retirement System, resulted in a decision by the US District Court for the Central District of California that granted a $500 million settlement between investors and Countrywide Financial Corporation. The case involved allegations that the plaintiffs and

13 www.pionline.com/investing/after-extinguishing-fires-asset-owners-turning-liquidity.

14 www.investopedia.com/articles/personal-finance/082216/what-difference-between-helicopter-money-and-qe.asp..

15 www.marketwatch.com/story/fed-likely-to-support-municipal-debt-says-former-new-york-fed-president-2020-04-02.

other investors were sold billions of dollars worth of MBS certificates backed primarily with defective Countrywide-originated loans. By late 2008, virtually all of those certificates were downgraded to junk bond status. In addition to Iowa Public Employees Retirement System, which was appointed lead plaintiff, the class included the Maine State Retirement System, Oregon Public Employee Retirement Fund, Orange County Employees' Retirement System, and General Board of Pension and Health Benefits of the United Methodist Church.[16]

- The Oklahoma Police Pension & Retirement System MBS class-action suit against U.S. Bank was not so successful. A federal judge in the US District Court for the Southern District of New York in 2013 dismissed the claim by the Oklahoma pension fund that the bank took shortcuts, including a failure to actually take possession of loan documents underlying MBSs.[17]

The Federal Reserve's action to purchase municipal assets will go a long way and potentially provide a new model for how public pension systems can be assisted when under pressure. No one knows precisely what percentage of the public pension portfolio consists of toxic assets, but an examination of Wilshire data suggests that about 7 percent of pension fund assets consist of investment in real estate or real estate products. Even if 3.5 percent is invested in MBS or other similarly structured products, it amounts to about $100 billion. Such action by the Federal Reserve will relieve some funding pressure on public pensions, as it already has done for private companies.[18]

Helicopter money. Helicopter money is a monetary policy tool that the Federal Reserve may use to stimulate the economy. Economist Milton Friedman introduced the framework for helicopter money in 1969, but former Federal Reserve Chairman Ben Bernanke popularized it in 2002. This policy theoretically should be used in a low-interest-rate environment when an economy's growth remains weak. Helicopter money involves the central bank's or central government's supplying large amounts of money to the public, as if the money were being scattered from a helicopter.

Obviously, helicopter money is targeted at providing the economy a stimulus through consumer spending. It's the equivalent of the $1,200 check for each eligible American recently approved by Congress as part of the 2020 Coronavirus Aid, Relief, and Economic Security Act. Helicopter money has semidirect implications for public pensions. For example, sales tax is the main source of revenue for most states. Helicopter money will have a direct impact on state and local sales tax revenues and hence their capacity to fund public pensions during the COVID-19 economy.

16 For more information about the case, visit www.cohenmilstein.com/cases/224/countrywide-mortgage-backed-securities-mbs-litigation. Editor's note: A copy of the court order is available from Cohen Milstein Sellers & Toll PLLC, Pamela Avery, 402-305-0799, pam@turnerstrategies.com. Published Friday, December 6, 2013, 7:06 PM ET, www.cnbc.com/id/101254492.

17 The case is *Oklahoma Police Pension & Retirement System v. U.S. Bank NA*, case number 1:11-cv-08066, in the US District Court for the Southern District of New York. www.law360.com/articles/446941/us-bank-gets-pension-fund-s-mbs-trustee-suit-pared-down.

18 www.insurancejournal.com/news/national/2010/04/02/108690.htm.