

## Overview of Build America Bonds

With the signing into law of the American Recovery and Reinvestment Act of 2009 an entirely new type of municipal bond was created. The **Build America Bond**, available through 2010, provides an alternative means for state and local governments to issue bonds for capital expenditures such as building or construction projects. The implications of this provision are far-reaching and represent a fundamental shift in the mechanics of municipal bond issuance.

Traditionally, an issuer would enter the tax-exempt municipal bond market to finance capital expenditures. Because these issues meet an Internal Revenue Code definition of “governmental purpose”, the bonds are exempt from Federal income taxes and offer interest cost savings to an issuer (versus taxable financing).

Through the end of 2010, municipalities have the option of issuing either traditional tax-exempt bonds or Build America Bonds for building and construction projects. The key element of this new program is that Build America Bonds pay Federal taxable interest with a form of credit to either the bond holder or the issuer. For all intents and purposes, the bonds are identical to a tax-exempt issue save for the taxability of interest and credit features.

### A Federal Subsidy Program for Municipal Bond Issuers

The Act establishes two distinct types of Build America Bonds (BABs): **Tax Credit** and **Direct Payment**. Both rely on some form of subsidy by the Federal Government.

**Tax Credit BABs** provide an investor with a tax credit equal to 35% of the interest on bonds that can be

applied to Federal income tax liability. Any unused portion of the credit may be carried forward without limit as to amount or time. Also, the credit may be “stripped” from the bond and sold separately.

**Direct Payment BABs** provide the issuer with a refundable credit, equal to 35% of the interest paid to investors, from the Treasury Department. To qualify as a Direct Payment BAB, the issuer must meet stricter requirements for the usage of bond proceeds.

Significantly, either type of BAB retains the tax treatment of municipal bond interest for the state of issuance. Therefore, in those states that treat municipal bond interest as exempt from state income tax, the BAB interest will be treated the same way.

*Comparison of Tax Credit and Direct Payment Build America Bonds*

	Tax Credit	Direct Payment
Credit Incentive	35% tax credit to investor	35% interest subsidy to issuer
Purpose	Capital expenditures, working capital	Only capital expenditures
Federal Taxation	Federally taxable, with credit	Federally taxable
State Taxation	Same as tax-exempt bonds	Same as tax-exempt bonds
Program End Date	12/31/2010	12/31/2010

### Build America Bonds vs Traditional Municipal Bonds

A logical question is: “Why would an issuer consider BABs rather than traditional municipal bonds?” Not surprisingly, the primary reason is financial. The BAB program opens the door to taxable investor demand and allows municipalities to tap into a different fixed income market than traditional tax-exempt bonds allow.

Pension funds, credit unions, life insurers and some

## Overview of Build America Bonds *(continued)*

other investors are not typically buyers of municipal debt because they cannot utilize the tax-exemption of traditional municipal issues. BABs change this equation. Because BABs are taxable bonds, these buyers now have the economic incentive to consider investing in the municipal market.

Similarly, many fixed-income investors may select either tax-exempt or taxable securities based upon an evaluation of the economic benefit and tax consequences. BABs offer municipal issuers a tool to access demand from these types of investors as well. However, it still seems reasonable to assume that a taxable BAB issue would require higher interest rates than a traditional tax-exempt issue (all things being equal). Where, then, is the financial incentive for issuers? The answer is contained in the *Direct Payment* interest subsidy, which contains an interest rebate that reduces the net borrowing cost to issuers. This provision has been included in the majority of deals that have come to market to date.

### Initial Market Response

The response to the BAB program has been dramatic. Within two weeks of the Treasury Department's announcement of the program in the first week of April, 2009, over \$7B of BABs had been brought to market, dwarfing the total amount of non-BAB taxable municipal issuance for 2009 through April 15th. In every case the BAB issues have been structured as interest subsidy to the issuer rather than as tax credit to investor.

The reasons for this immediate embrace of BABs, and specifically the interest subsidy alternative, seem relatively straightforward. For issuers, the economics seem compelling. After factoring in the subsidy, each issue resulted in a net interest cost significantly below prevalent market rates for straight tax-exempt debt, a clearly beneficial choice to make. For investors, the rates were significantly higher than similarly-rated corporate bonds and for United States agency debt.

Given the added benefit of asset class diversification, there is a ready appetite for the influx of supply from this new financing vehicle.

An analysis of secondary market trading immediately following these first deals coming to market shows a consistent pattern of trading to higher prices/ lower yields. This seems to indicate that taxable fixed-income market participants recognized the relative value of the BABs. It stands to reason that as a new type of security class, there is inherent uncertainty about price discovery and assigning value to these issues. It does seem clear, however, that for each of the first few issues to market, the rates paid by the issuers were significantly higher than follow-up trades after the deals broke. While the interest subsidy did achieve net savings versus tax-exempt rates, it appears that the issuers may have paid taxable rates above the levels needed.

### Summary

The Build America Bond program offers municipal issuers a radically different method to raise capital. By making issuance of taxable municipal bonds financially rewarding to issuers through the interest subsidy mechanism, BABs open a new universe of investors to the municipal bond market. The large issues to date have been specifically structured to take advantage of demand from these types of investors. For smaller issuers the ability to structure deals to appeal to some types of taxable bond investors will be limited. At this point it remains to be seen how this will impact marketability and interest costs.

Market commentators have speculated that BAB issuance will constitute a large enough volume to impact issuance of tax-exempt debt to a meaningful degree. One likely implication of this would be an impact on the relative yields of tax-exempt municipal bonds. If, as some predict, BABs siphon off a significant amount of tax exempt issuance, the logical result would be that tax-free municipal yields could

## Overview of Build America Bonds *(continued)*

trade relatively stronger compared to benchmark rates.

Questions about BAB issues interest rate spread to other taxable securities will likely take some time to answer. As noted earlier, the subsidized interest cost to issuers appears compelling, but the taxable rates to investors appear generous when compared to other taxable bonds. How this contradiction is resolved remains to be seen. Given the historical record of few defaults in the municipal bond universe, a case can be made that the credit quality of BABs issuers is quite strong. To date, that does not appear to be reflected in their pricing relative to alternative taxable bond categories. It may be that BABs, at this point,

are just too new to be priced with a high degree of efficiency. It may be that investors are demanding a higher interest rate to compensate for assumed lack of liquidity.

We will continue to monitor developments as more facts become available for analysis.

*- Jeff Westergaard*

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### Recent Build America Bond Issues

Date of Issuance	Issue	Issue Maximum Yield	Net Interest Cost After Subsidy (1)	Estimated Alternative Tax-Exempt Yield (2)	Estimated Net Benefit (Basis Points) (3)	30-Year Treasury Rate at Issuance (4)	BAB Basis Point Spread to Treasury (5)	Yield on First Day of Trading (6)
4/15/2009	University of Minnesota	6.38%	4.15%	4.60%	45	3.71%	2.67%	5.84%
4/16/2009	University of Virginia	6.22%	4.04%	4.81%	77	3.79%	2.43%	5.76%
4/20/2007	New Jersey Turnpike Authority	7.41%	4.82%	5.00%	18	3.68%	3.73%	6.94%
4/21/2009	Milan MI Area Schools	7.14%	4.64%	5.07%	43	3.74%	3.40%	N/A
4/21/2009	State of California	7.43%	4.83%	5.36%	53	3.74%	3.69%	7.00%
4/21/2009	DuPage CO IL CCD	5.75%	3.74%	4.60%	86	3.74%	2.01%	N/A
4/22/2009	RileyCO KS School District	6.68%	4.34%	4.90%	56	3.82%	2.86%	6.30%
4/23/2009	Metropolitan Transit Authority of New York	7.34%	4.77%	5.15%	38	3.80%	3.54%	7.00%

(1) Calculated by multiplying Issue Yield x .65

(2) Based on similar issues trading in the secondary municipal market

(3) Calculated by subtracting Net Interest Cost after subsidy from Estimated Alternative Tax-Exempt Yield

(4) Rates reflect Treasury Department End-of-Day posting

(5) Calculated by subtracting Treasury Rate from Issue Yield

(6) From MSRB EMMA Market Activity website

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