



UNITED STATES
DEPARTMENT OF
THE TREASURY



Overview of State and Local Bond Programs under the American Recovery and Reinvestment Act of 2009

December 3, 2009

Build America Bonds--Overview

Broadest New Bond Program—Build America Bonds. The broadest new bond program is Build America Bonds (sometimes called “BABs”). Build America Bonds may be issued in 2009 and 2010 in unlimited amounts. These bonds are an optional alternative to traditional tax-exempt bonds. Treasury provided implementing guidance in IRS Notice 2009-26 (2009-16 I.R.B. (April 20, 2009)).

What are Build America Bonds. Build America Bonds are conventional taxable bonds. Treasury pays State and local governments a direct payment subsidy for a portion of the borrowing costs in an amount equal to 35% of the coupon interest on the bonds.

Deeper Subsidy Than Tax-exempt Bonds for Stimulus Purposes. This Federal subsidy of 35 percent of the coupon interest on Build America Bonds covers more of the borrowing costs than the Federal subsidy for traditional tax-exempt bonds. The purpose here was stimulus—to encourage new public capital projects. By comparison, traditional tax-exempt bonds typically have had borrowing costs about 20% lower than conventional debt.

What Can Build America Bonds Be Used To Finance. Build America Bonds can be used to finance new money capital projects for which State and local governments could issue tax-exempt governmental bonds (as contrasted with “private activity bonds”).

Build America Bonds--Overview

Key Structural Point: Broader Market. Since Build America Bonds are taxable bonds which are sold without regard to tax preferences, they may appeal to a broader investor market (e.g., pension funds which have no need for tax benefits) than tax-exempt bonds. \$30 trillion taxable debt market.

Economic Efficiency. Economists view tax-exempt bonds as inefficient because they are more valuable to investors in highest marginal tax bracket. Both Build America Bonds and tax credit bonds are viewed as more efficient because they should have the same value to investors regardless of tax brackets.

Permanent Appropriation. There is a permanent continuing appropriation for the 35 percent direct payment subsidy on Build America Bonds, similar to tax refunds.

Future Plans for Direct Payment Procedures. Treasury and the IRS plan to move to an electronic platform to make the direct subsidy payments on Build America Bonds as efficiently and timely as possible, similar to the Bureau of Public Debt system. There will be compliance safeguards and periodic information returns.

Potential Streamlined Compliance Framework. Build America Bonds offer a potential streamlined tax compliance framework that focuses directly on State and local governments. Tax-exempt bonds and tax credit bonds have a more awkward framework using tax benefits to third-party investors to deliver the subsidy.

Build America Bonds—Widespread Usage—Market Data

Positive Market Reception.

Build America Bonds have had a positive market reception. According to Bloomberg data compiled by Treasury, from the time the program launched in early April 2009 through the end of November 2009, the usage of Build America Bonds was as follows:

- Over \$55 billion in BABs issued.
- Over 650 bond issue transactions in BABs.
- At least 42 states participated in the BABs program.
- BABs were 21.3 percent of the total municipal bond market.

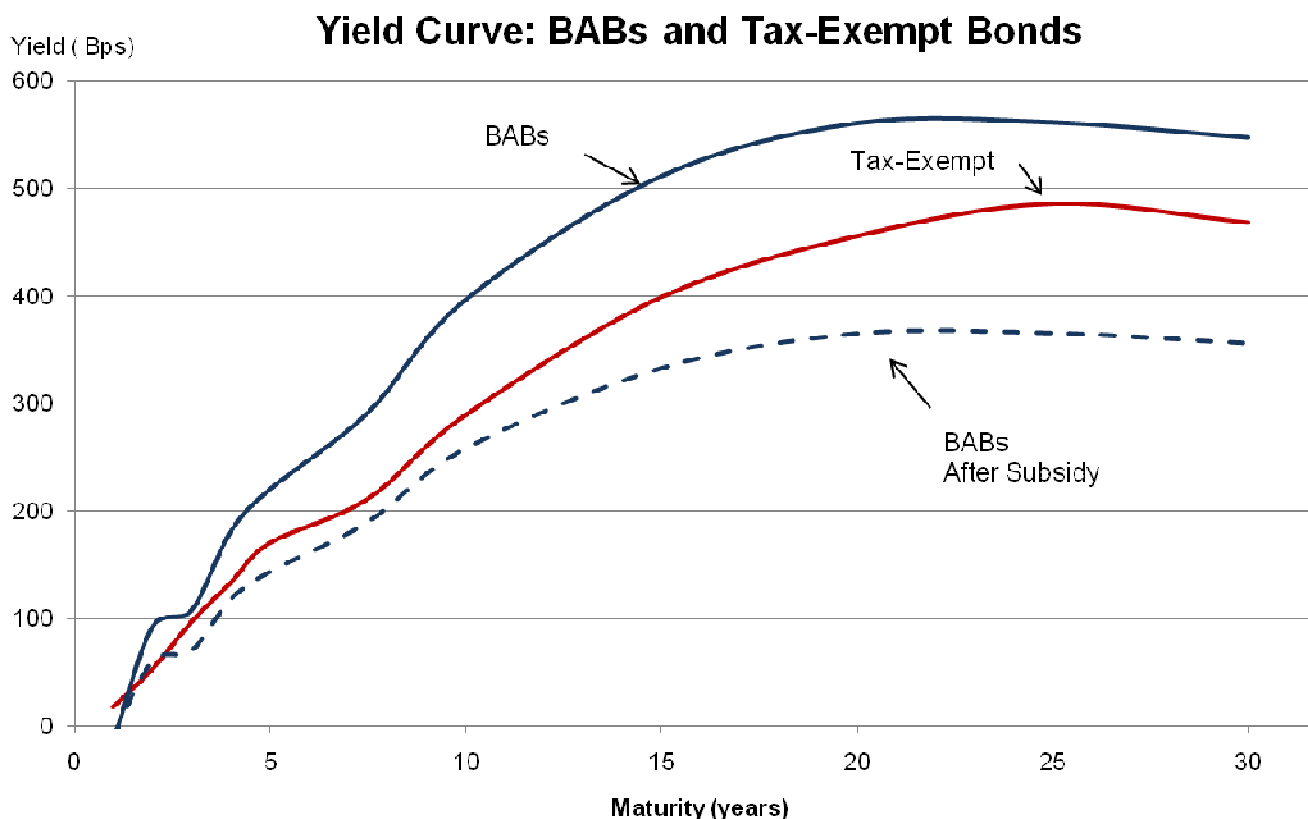
Build America Bonds generally have had longer average maturities than tax-exempt bonds (about six years longer) and have attracted more institutional investors.

Lower Borrowing Costs than Tax-exempt Bonds. In general, Build America Bonds have provided lower borrowing costs than traditional tax-exempt bonds.

Impact in Lowering Tax-exempt Bond Rates. In addition, Build America Bonds also have relieved supply pressures in the tax-exempt bond market and probably have helped to provide lower tax-exempt bond rates.

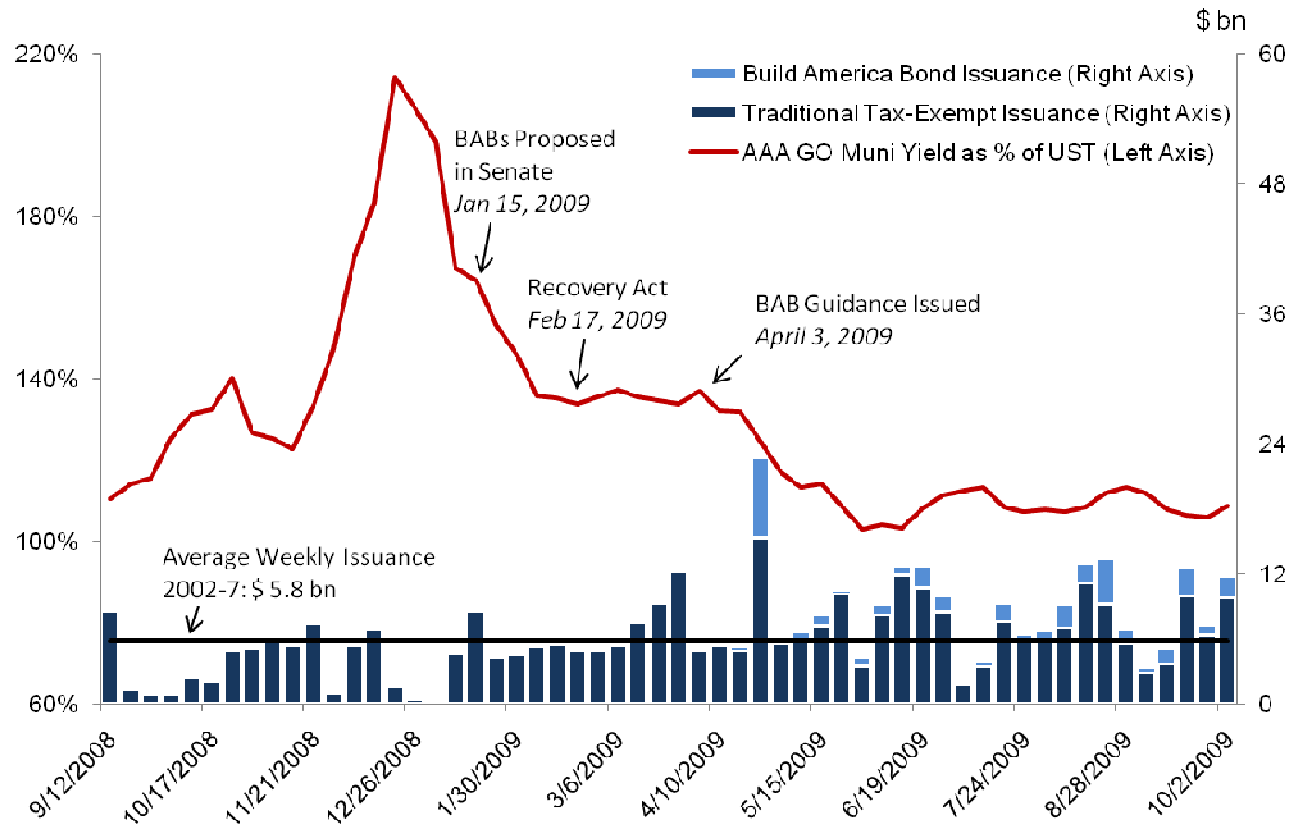
The next two slides show some additional market data on BABs.

Build America Bonds Provide Lower Borrowing Costs than Traditional Tax-exempt Bonds



- On average, BABs have provided savings at all maturities on the yield curve, although the savings are greater at the longer maturities. (See dashed line.)
 - The savings for a 10 year bond are estimated to be 31 bps and the savings for a 30 year bond are estimated to be 112 bps.

BABs Probably Have Helped Bring Down Yields on Tax-Exempt Bonds



- BABs have made municipal debt attractive to new investors. By bringing in new investors, BABs have relieved supply pressure and have helped to reduce borrowing costs on tax-exempt bonds.
- “By reducing new-issue supply in the tax-exempt market, they have had the effect of lowering yields there. Estimates of the effect of BABs on tax-exempt yields are in the neighborhood of 20 to 30 basis points or more.” *The Bond Buyer* (11/2/09).

Tax Credit Bonds--Overview

Tax Credit Bonds In General. The other main type of novel bond program under the Recovery Act is Tax Credit Bonds. Tax Credit Bonds are taxable bonds that provide Federal subsidies for borrowing costs through tax credits to investors. Tax Credit Bonds generally have volume caps. The Recovery Act authorized over \$30 Billion in Tax Credit Bond programs for school and energy purposes, including:

- Qualified School Construction Bonds
- Qualified Zone Academy Bonds
- Qualified Energy Conservation Bonds
- New Clean Renewable Energy Bonds (not old)

Key structuring feature. Tax Credit Bonds deliver the Federal subsidy for State and local borrowing costs by providing Federal tax credits to investors in lieu of all or a large portion of interest payments. To the extent that tax credits replace interest, State and local governments have lower borrowing costs.

Deeper Federal Subsidy Covers Greater Share of Borrowing Costs. The present Tax Credit Bond programs provide Federal tax credits designed to cover 100 percent of the interest on school bonds and 70 of the interest on energy bonds.

Bond Maturity Limit. Tax Credit Bonds have a maturity limit under a formula that results roughly in about a 15-17 year maximum maturity (maturity at which present value of bond principal is one-half of total bond principal).

Tax Credit Bonds--Overview

Tax Credit Bond Rate-Setting Method. Unlike Build America Bonds in which the market sets interest rates, Tax Credit Bonds have a rate-setting method in which the U.S. Treasury Department is directed to set the rates to allow the bonds to sell at par. This method requires assumptions about issuer credits and demand for tax credit bonds. In early 2009, in Notice 2009-15, Treasury modified its assumptions to change from a AA taxable rate to a basket of indexes at a blended A/BBB rate (which resulted in an immediate increase in the rates from 5.92 percent to 8.19 percent in January 2009). Issuers recently have raised more concerns about Tax Credit Bond rates. Treasury will continue to monitor the rate-setting method, Treasury is constrained by the program structure.

Challenges for Tax Credit Bonds. The market for tax credit bonds presently faces several challenges, including a small, illiquid, undeveloped market, uncertain investor demand for tax credits, and unattractive financial accounting treatment.

Stripping Tax Credits to Broaden the Market. The Recovery Act authorizes Treasury to provide regulatory guidance to allow “stripping” and separate sales of tax credits on tax credit bonds. This may help to broaden the market for tax credit bonds, but it still will take time for this market to develop. Treasury has a high priority guidance project on this topic. This project raises some difficult IRS information reporting issues to track the tax credits and associated income.

Tax Credit Bonds—School Bond Programs

Qualified School Construction Bonds. Set forth below is summary information:

- National volume cap of \$11.2 billion for 2009 and \$11.2 billion for 2010.
- Unused volume cap may be “carried over” to the next year.
- Federal tax credit: 100% of borrowing costs.
- Projects: public school construction, renovation, and repair.
- Guidance: IRS Notice 2009-35 (2009-17 I.R.B. (4-27-09)).
- Allocations (40% 100 largest school districts; 60% States).
- About \$1.6 billion of these bonds were issued through November 2009.

- PA state 2009 volume cap allocation of \$315,737,000.
- Philadelphia City School District 2009 allocation of \$146,897,000.

Qualified Zone Academy Bonds. Set forth below is summary information:

- National volume cap of \$1.4 billion in 2009 and \$1.4 billion in 2010.
- Unused volume cap may be “carried over” to the next year.
- Federal tax credit: 100% of borrowing costs.
- Projects: public school renovation, repair, course materials, and teacher training.
- 10% private business contribution.
- Guidance: IRS Notice 2009-30 (2009-16 I.R.B. (4-20-09)).
- PA state 2009 volume cap allocation of \$13,941,000.

Tax Credit Bonds—Energy Bond Programs

Qualified Energy Conservation Bonds. Set forth below is summary information:

- National volume cap of \$3.2 billion.
- Federal tax credit: 70% of borrowing costs.
- Projects: broad range of qualified energy conservation purposes, including capital projects to reduce energy use, research, mass transit, green community programs, and public education campaigns.
- 70% of projects must be governmental (versus private).
- Guidance: IRS Notice 2009-29 (2009-17 I.R.B. (4-20-09))
- Allocates volume cap among states by population.
- State to-do lists: mandatory suballocations of this volume cap to large local governments (cities and counties greater than 100,000 people). Also allocate state share to projects.

- PA state volume cap allocation of \$315,737,000.

New Clean Renewable Energy Bonds. Set forth below is summary information:

- National volume cap of \$2.4 billion.
- Federal tax credit: 70% of borrowing costs.
- Projects: clean renewable energy capital projects.
- Guidance: IRS Notice 2009-33 (2009-17 I.R.B. (4-27-09))
- IRS allocations to projects in October 2009.

Recovery Zone Bonds—Two Types: Recovery Zone Economic Development Bonds and Recovery Zone Facility Bonds

Recovery Zone Economic Development Bonds.

Recovery Zone Economic Development Bonds are a type of Build America Bond, with a deeper Federal subsidy payment of 45% of the interest on the bonds. These bonds may be issued in 2009 and 2010 for use broadly for public governmental projects to promote economic development in designated recovery zones, including capital expenditures paid or incurred with respect to property located in such zone, expenditures for public infrastructure and construction of public facilities, and expenditures for job training and educational programs.

--A \$10 billion national volume cap applies to these bonds.

--PA's share of this volume cap is \$154,008,000.

--About \$431 million of these bonds were issued nationally through November 2009.

Recovery Zone Facility Bonds.

Recovery Zone Facility Bonds are a type of traditional tax-exempt private activity bond, which may be used by private businesses for depreciable capital projects under Code Section 168 for original use in active businesses conducted in designated recovery zones, excluding residential rental housing.

--A \$15 billion national volume cap applies to these bonds.

--PA's share of this volume cap is \$231,012,000.

Recovery Zone Bonds—Certain Considerations on Local Volume Cap Allocations

Background. In general, the Recovery Zone Bond program is targeted to help areas affected by job losses. The statutory formula for the Recovery Zone Bond program requires direct local allocations of the bond-issuing authority among over 3,000 counties and large cities based in individual declines in employment in 2008.

Treasury Guidance. In June 2009, Treasury provided guidance in IRS Notice 2009-50 (2009-26 IRB 6/29/09) to implement the Recovery Zone Bond program. This guidance provided all the local allocations of bond authority. The Treasury guidance also gave maximum flexibility to local governments to administer this program reasonably, in good faith, in their discretion.

Certain Administrative Considerations.

--Despite good intentions, the Congressional mandate for local allocations of this bond authority resulted in widely-distributed small local allocations which in some cases are unfeasible amounts for projects.

--Some localities have no procedures in place to assign their authority for Recovery Zone Facility Bonds to private business development projects. In some New England states, there are no operating local county governments at all.

--States should try to raise awareness about the scattered local allocations of Recovery Zone Bond authority and work with localities to consider ways to balance local needs and maximum usage of this program. The statute permits, but does not require, localities to waive their unused bond allocations.