Build America Bonds, Recovery Zone Bonds, et al

It has been over one year since the federal government created a variety of new categories of debt. Over $100 Billion of Build America Bonds (BABs) have been issued. While the initial authorization sunsets at the end of 2010, it is certain that these debt categories will be extended for some term, although probably not at such favorable conditions.

Briefly, a BAB is a taxable bond issued for a tax exempt capital project, for which the federal government will rebate 35% of the interest cost. Recovery Zone (RZ) bonds for government projects receive a 45% rebate, but are limited to certain authorized amounts. The resulting interest cost is less than the comparable tax exempt rate if the interest rebate is applied, making these types of debt attractive.

Having issued many of these bonds, we have some observations:

BABs and RZ bonds are not black box instruments – normal sale methods work well. We have seen a number of issuers convinced that only negotiated sales work, where a very strong competitive market exists. A number of firms that show little interest in tax exempts bid on taxable bonds.

These bonds are not new authority for debt, but rather go to tax treatment. Debt limits, tax cap limits, normal types of debt instruments and authorizations all apply.

A strong market exists for this debt among non-traditional muni buyers, such as pension funds and foreign investors. However, many of these are used to corporate and national government debt, where bonds tend to be non-callable or have only a “make whole” call, neither of which enables refundings for saving like a traditional tax-exempt bond call of 7 to 10 years at par value. Our experience is that issues of a size less than $50,000,000 are not likely to realize any significant penalty for a normal call in a competitive sale. An issue that is so large as to be a national institutional issue may experience a significant penalty if a normal tax exempt call is used. In such situations, we recommend splitting the larger issues into multiple sales.

Issuers are more likely to get an IRS audit of their issue if these taxable instruments are issued. While the major benefit of such debt is a reduction in net interest rate of some 0.25% to 0.60%, shorter issues benefit less and the overall benefit may not offset the perceived audit risk.

To receive the rebate, the issuer must file a request for each payment. A number of paying agent banks will now do this for a reasonable fee, reducing the risk of loss due to oversight on the part of small or overworked staffs.

Both types of bonds have limits of 2% of the issue for costs of issuance. For large issues, this should not be a burden but very small issues may need supplemental funding for costs, which include underwriting and insurance.

There is a controversy over the initial pricing of these bonds. The issuance rules limit the price to approximately 102% of par between initial sale and bond delivery. In the event the price is exceeded during this time period, the issuer could be penalized, even though it has no control. There is controversy over the policing and enforcement of this.

Recovery Zone bond projects must comply with the Davis Bacon Act on wages. A second type of RZ bonds for private projects was also authorized; these are similar to traditional industrial revenue bonds, that are tax exempt.