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Federal Budget Cuts Could Impact BABs Market

Build America Bonds, or BABs, are taxable bonds that were issued by municipal issuers in 2009 and 2010 under the provisions of the American Recovery and Reinvestment Act (ARRA). BABs were attractive to issuers because the federal government rebates 35% of the taxable interest issuers pay on the bonds. That issuer rebate has now come into question as mandatory federal budget cuts loom in 2013.

Congress passed the Budget Control Act of 2011 to end the August 2011 debt ceiling crisis – the fight which prompted S&P to downgrade the rating of the United States to AA+ from AAA. Included in the Act was the provision that if the Congressional Joint Select Committee on Deficit Reduction (the “Congressional Supercommittee”) was unable to agree on a deficit reduction plan, automatic spending cuts, known in the Act as “sequestrations,” would be implemented in the federal budget beginning in January 2013. Because Congress has made no progress on cutting the federal budget deficit and satisfying the requirements of the Act, the sequestration provision of the Act now risks being triggered on Jan. 1, 2013. The White House Office of Management and Budget (OMB) recently announced that under sequestration, \$322 million of the \$4.2 billion of interest subsidy payments due to issuers of BABs and other ARRA tax-credit bonds would be cut from the 2013 budget. If implemented, issuers would see their federal interest subsidy reduced by 7.6%.

We do not believe that the subsidy cuts outlined by the OMB would have a significant negative impact on BABs credit quality generally. Most BABs (measured by par amount issued) were sold by highly rated issuers, and the projected cuts would not have a material impact on their financial positions or ability to make scheduled payments. We do view some smaller BABs issues as potentially being at risk, however. Issuers with limited financial resources could face more pressure from the loss of subsidy. Investors holding tax-credit structure bonds (BABs, QZABs, QSCABs, etc.) sold by issuers rated in the triple-B category or non-rated, should carefully review these issuers to evaluate the potential credit impacts.

BABs have been attractive with investors because they have offered a high-credit-quality alternative to corporate bonds and Agencies while also providing higher yields than can generally be found in alternative taxable fixed-income products. As a result of the demand for BABs, and the significant decline in interest rates from the 2009-2010 period to today, most BABs currently trade at substantial premiums to their face value. In our opinion, of

greater concern for investors than credit impacts is the potential that federal subsidy cuts could trigger extraordinary redemption provisions built into these bond issues. BABs and other tax credit bonds contain provisions that allow the issuer the option to call the bonds in the event that federal interest subsidy payments are reduced or eliminated. These calls are generally structured one of two ways:

1. Make-whole calls, which determine the redemption price based on current Treasury yields plus some yield premium (e.g. bonds might be callable at Treasury yield plus 100 basis points (100 bps, or 1.00%)). These calls provide investors some protection, as the issuer must pay a redemption price that is currently a premium over par for the right to call bonds.
2. Par calls, which pay the bonds off at face value.

The majority of BABs we have reviewed contain make-whole calls with provisions ranging from T+20bps to T+100bps that would make it uneconomical for issuers to exercise the optional call to refund them, even in today's extremely low interest rate environment. According to an analysis by Morgan Stanley, BABs subsidies would have to be cut by more than 70% (to 10% or less of interest payments from the current 35%) for the economics of the majority of make-whole calls to make sense for issuers at current market interest rates.

In contrast, issuers might be highly incentivized to exercise extraordinary par calls on outstanding BABs. In some cases, current market yields for high-grade taxable municipal issuers are 50bps (0.50%) to 100bps (1.00%) lower than the current subsidized interest rates issuer are paying on outstanding BABs. On a tax-exempt basis, if allowed under IRS rules, issuers could save 150bps (1.50%) or more versus the subsidized BABs rates they are currently paying by refunding outstanding BABs with tax-exempt bonds.

For BABs issues containing par calls, we expect issuers with solid credit ratings and good market access would seek to take advantage, if an opportunity is created by a subsidy reduction, of refunding outstanding BABs with lower-cost bonds. We recommend that investors review the call provisions of any BABs or other federal tax subsidy bonds they hold. Depending on the specific credit quality and structural characteristics of these holdings, investors may want to consider selling premium BABs that contain extraordinary optional par calls.



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