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Issuers Expected to Call $20B to $30B of BABs This Year.

Clarity from a recent court ruling along with the level of current interest rates will likely lead to a dramatic increase in Build America Bonds being called by issuers this year, market participants say.

While only a small amount of BABs have been called using an "extraordinary redemption provision" since sequestration of BABs subsidies began in 2013, that should change as more issuers look to take advantage of using sequestration as a reason to exercise it, with analysts expecting the largest year of BABs called by the ERP to date.

For over a decade, as the subsidy for direct-pay BABs "has been less than originally promised due to sequestration, issuers have wondered if sequestration constituted an 'extraordinary event' that would trigger their right to seek extraordinary optional redemption," said Orrick partners Charles C. Cardall and Barbara Jane League in a report posted on the firm's website.

While BABs were issued with the expectation that the subsidy would not be reduced retroactively, the 35% subsidy for BABs has been reduced through sequestration numerous times. The current sequestration rate reduction is at 5.7%.

A recently concluded court case, Indiana Municipal Power Agency v. U.S., provides "favorable guidance" for issuers, Cardall and League noted, as it supports the conclusion that sequestration resulted in a materially adverse change to the cash subsidy payment obligation."

Between 2009 and 2010, more than $180 billion of BABs were issued. They were priced with three types of calls – the optional, the make-whole call, and the extraordinary redemption provision call – but the vast majority were issued with embedded extraordinary redemption calls.

"A lot of people are looking at the court language and viewing that as very hopeful" because of what it might mean for the ERP, a lawyer said.

While the specific language has to be reviewed on a case-by-case basis, Cardall and League believe the "extraordinary optional redemption is available for issuers of BABs in most cases."

J.P. Morgan strategists concurred, saying most ERPs are "actionable" after reviewing BAB ERP language from "representative bonds" from BABs 20 largest issuers.

The outstanding BABs universe with ERPs is only about 13% of the taxable muni market, according to a recent Barclays PLC (JJCTF) report.

There is currently around $110 billion of BABs with embedded ERP calls, but $20 billion is "out of the money because the bonds trade at wider spreads, are below par, or have low ERP strikes," they said.

Of the remaining $90 billion, Barclays (JJCTF) strategists expect $20 billion to $30 billion of ERPs to be triggered this year.

From 2018 to 2022, BABs ERPs were “rarely exercised,” J.P. Morgan strategists said.

In 2023, two large deals exercised their ERP, taking $800 million out from the taxable market – $399 million from the Santa Clara Valley Transportation Authority and $386 million from the Ohio Water Development Authority, they said.

And so far this year, several issuers have already called their bonds, and others have given notice to investors that they are considering taking the bonds out, Barclays (JJCTF) strategists said.

The Maryland State Transportation Authority ERP called their BABs bonds last week, worth $721 million, J.P. Morgan strategists said.

Three other issuers, the Bay Area Toll Authority, the Los Angeles Unified School District and the University of California, which represent $5.4 billion of outstanding debt, have announced they plan to do the same later this year, they noted.

J.P. Morgan strategists said “higher-quality (A or better), lower-coupon, shorter-dated (maturity or average-life) bonds have the highest probability of being refunded.” They believe there are $30 billion to $60 billion of BAB bonds outstanding that achieve adequate savings.

“This year looks set to be the largest BAB ERP call year by a large margin,” Barclays (JJCTF) strategists said.

This interest, Barclays (JJCTF) strategists said, has led to BAB spreads “adjusting wider,” though it “may have been just an excuse for investors to take profits after a four-month rally, but there has clearly been a catalyst, as several large deals will likely exercise their ERPs.”

The extraordinary redemption provision can be triggered by an “extraordinary event,” but what constitutes an “extraordinary event” differs, said Vikram Rai, head of municipal markets strategy at Wells Fargo (WFC), in a report from late January.

In “broad” language, the extraordinary event happens if the 35% subsidy is reduced, while in “restrictive” language, the extraordinary event is defined more narrowly and requires a change to a specific section of the Internal Revenue Code, he said.

Some issuers “got lucky” with the use of “broad” language allowing them to “issue new debt, refund the bonds and call it at par instead of this exorbitant price that requires us to make the investor whole, basically pay them all the interest they would have gotten if the bonds had stayed outstanding from maturity,” the lawyer said.

Due to this, many of the BABs with “broad” language have already been called, with others with “restrictive” language are still waiting, the lawyer noted.

In instances when language is “restrictive,” Rai said “there is debate and confusion around whether the reduction in the BABs subsidy payment resulting from sequestration is sufficient to trigger the optional call.”

Until now, most BAB issuers had yet to be exercised due to economics, Rai said.

While the issuer could, in theory, realize long-term savings by “calling these bonds and refunding them at lower rates, the upfront cost made it prohibitive,” he said.

In instances when the ERP language “enabled issuers to call the bonds at par or only at a slight premium, exercising the ERP call made sense and thus issuers did so," Rai said.

Due to higher interest rates, the bond prices are trading closer to par, meaning it makes economic sense for the ERP call, especially for shorter maturity securities, he said.

Additionally, the issuers "would want to reduce the risk of further cuts to the subsidy payments and also reduce the administrative burden," Rai said.

When an issuer triggers an ERP, "it's done in the context of a refinancing deal, which is a new transaction and [has] new underwriters," the lawyer said.

Based on the way rates have moved over the last several years, the lawyer said it has made "potentially invoking these things more attractive than it was five or six years ago," the source said.

While some issuers previously did complete such redemptions, the decision to trigger an ERP is a mix of both reduced subsidy and the right market conditions, which may be why now BABs with ERPs are seeing an increase, given the interest rate movement bonds, said David Erdman, managing director at Baker Tilly Municipal Advisors.

"The market [conditions] are a consideration for implementing or invoking the extraordinary redemption provision," he said.

Furthermore, if there is a correction of the inverted yield curve and a reduction of interest rates in shorter maturities, he believes calling BABs through ERPs could become more attractive for issuers.

Barclays (JJCTF) strategists noted there are some positives and negatives to the resurgence of BABs through ERPs.

Over the past several years, "only ERPs with strikes at T+100bp have been triggered," but there may be "some par ERPs exercised as well, although they are mostly embedded in smaller deals," they said.

However, "even accounting for tighter spreads and low MMD-UST ratios, the economics do not work well for many issuers," they said.

Municipalities will also have to consider "whether calling BABs through ERPs that were triggered because of a technicality might negatively affect investors' desire to participate in future deals," they said.

While the $20 billion to $30 billion of BABs triggered through ERPs this year would lead to even more "robust" tax-exempt issuance, it would have the opposite effect on the already estimated low supply in the taxable market, according to Barclays (JJCTF) strategists.

And even though the "BAB portion of the market might be under pressure, there could be some segmentation, and non-BAB taxables, BABs without ERPs or with much lower ERP strikes, and bonds with corporate CUSIPs might actually outperform," they said.

Additionally, BABs with T+100bp ERPs could "also become more attractive if their spreads widen, and start trading closer to their strikes," they said.

By Jessica Lerner

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