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Muni Market Worries Build America Bonds Redux Could Prove Costly.

- **Direct-pay bonds are part of bipartisan infrastructure plan**
- **States, cities want to know size of U.S. subsidy of the debt**

A reprisal of Build America Bonds, the popular Obama-era infrastructure financing tool, is part of a bipartisan plan gaining traction in Congress, but states and cities are reluctant to show support without knowing their share of the cost.

A group of 21 Senators propose including so-called direct-pay municipal bonds in a $579 billion package designed to spur construction on roads, bridges and other projects, and its bipartisan sponsorship is raising hopes of passage. The direct-pay provision is being closely watched by municipal borrowers, investors and bankers because of its similarities to the Build America Bonds program, which spawned $180 billion of debt sales in 2009 and 2010.

But municipal finance has changed in the last decade. Then, the fact that Build America Bonds were taxable, unlike traditional muni bonds that pay tax-free interest, opened the market to a broader group of investors and promised reduced borrowing costs. Now, tax-free bond yields are near historic lows compared to taxable securities, meaning states and municipalities want the federal government to provide a generous subsidy as an incentive to use the borrowing program.

For a taxable bond program to compete with the cost of capital in the tax-free muni market, an average subsidy covering around 50% of interest costs for AA-rated borrowers is needed, said Peter DeGroot, head of municipal strategy for JPMorgan Chase & Co. For BBB rated issuers, the subsidy would need to be around 35%, he estimates.

"The higher the subsidy rate, the lower the cost of capital to the bond issuer," DeGroot said. "Yields in the tax-exempt market are so low relative to taxable rates that issuers would need a very high cost of capital subsidy to compete with the tax-exempt bond market."

He said that those subsidy rates are higher than what was offered in a Senate bill earlier this year. The legislation introduced in April by Senator Roger Wicker, a Republican from Mississippi, and Michael Bennet, a Democrat from Colorado, offered a subsidy of 28% of the bond's interest. In April, JPMorgan released an analysis estimating "modest utilization" of the proposal at current market levels.

Ben Watkins, director of the Florida Division of Bond Finance, said the subsidy rate will help determine the attractiveness of the program.

"They have to sweeten the pot and make it cheaper for me," Watkins said. "It better be deep in the money or otherwise I'm not playing."

The bipartisan Senate plan was scant on details about the direct-pay bonds. The financing mechanisms listed also included the use of private activity bonds, something that businesses can use to raise money in the $3.9 trillion muni bond market.

Getting state and local support for the plan, which would affect its chance of becoming law, is made more difficult by the latter history of the Build America Bonds program. Borrowers shied away from using them after the federal government adopted sequestration that forced budget cuts, including reduction in the subsidy payments that Build America Bond issuers received starting in 2013.

”I think it’s a hard sell,” Watkins said of the current push to revive the bonds. “I think people have been made aware of the risks associated with relying on D.C. to come through on their promises.”

While state and local lobbying groups generally support the revival of a Build America Bonds-type tool, they’ve stressed that they’d like the process to be exempt from sequestration. David Moore, director of municipal research at American Century Investments, said usage of the bonds could depend on it.

“Issuers are still going to have a hard time taking that seriously” if the program doesn’t include an exemption from sequestration, he said.

Moore said that a federally-subsidized bonding plan would provide issuers with more flexibility, which would be helpful to them if the tax-exempt market became weaker, he added. “It really is another tool in the toolbox for them,” he said.

Bloomberg Markets

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June 17, 2021, 11:20 AM PDT

— With assistance by Erik Wasson