SOCIETY OF ACTUARIES

Article from:

Risks & Rewards

August 2010 – Issue 56

BASICS OF BUILD AMERICA BONDS

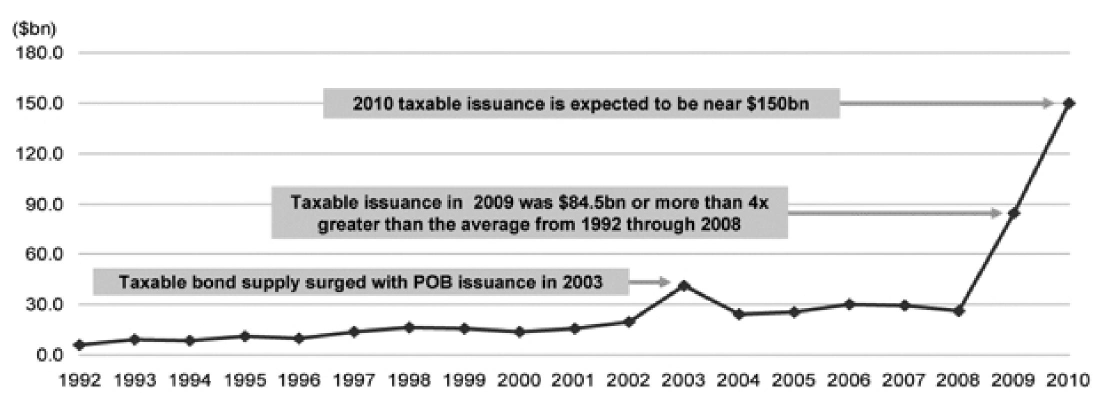
By Keith McCarthy

Build America Bonds (BABs) were created by the American Recovery and Reinvestment Act of 2009 (the "Recovery Act"), which was signed into law by President Barack Obama on Feb. 17, 2009. The interest income on municipal bonds has traditionally been exempt from federal income tax. The Recovery Act authorizes state and local governments to issue Build America Bonds, which are municipal bonds whose interest is taxable on a federal income tax basis. In return, the issuers receive a direct subsidy for 35 percent of their interest costs on the bonds. The program was implemented during the credit crisis, when municipal issuers were having trouble accessing the capital markets at reasonable rates. Currently, BABs can be issued by state or local governments for capital projects. Some examples of projects that would qualify for BAB financing include buildings for public schools, colleges and universities; power plants for publically owned utilities; transportation projects; and water and sewer facilities. There is no limitation on the volume of eligible BABs that can be issued by state and local governments.

In 2009, there was approximately $85 billion in taxable municipal issuance and we expect $125–$150 billion in 2010. With approximately $107 billion in issuance to date, the market for BABs is growing at a rate of $7 billion per month. Year-to-date, BABs account for 25 percent of total municipal issuance. This is significantly higher than the 16 percent of total municipal issuance BABs tallied in 2009.

Structurally, BABs are quite similar to investment-grade corporate bonds. Historically, the municipal bond market has exhibited very low default rates in comparison to corporate-backed credits. Moody's-rated municipal issuers have a very limited default experience with only 54 defaults over the period 1970–2009. The majority of these defaults occurred in the health care and housing project finance sectors. The majority of issuance has been long-dated, noncallable bonds, and over 50 percent of issuance has been made up of bonds with benchmark maturities of 250MM+.

Annual taxable Municipal Issuance (1992-2008) and 2010 Estimates

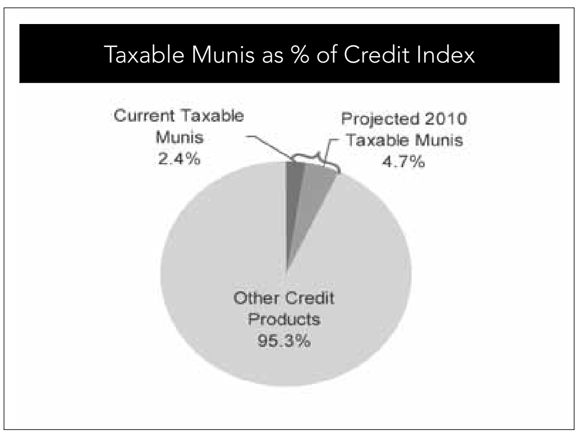


Source: Thomson Financial, Bond Buyer " A Decade of MunicipalBond Finance."

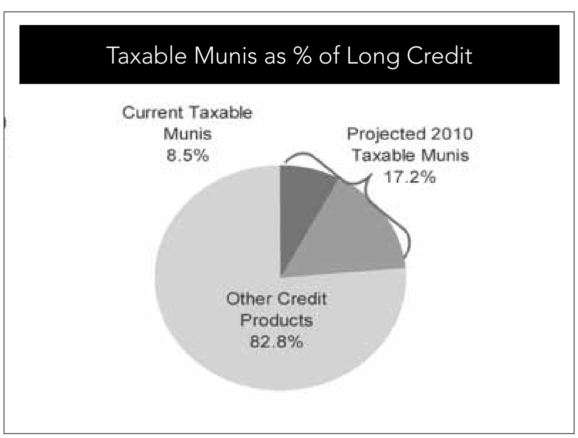
CONTINUED ON **PAGE 10**

"AT THE TIME OF THIS WRITING, THE HOUSE HAS APPROVED LEGISLATION TO EXTEND THE BUILD AMERICA BOND PROGRAM FOR TWO YEARS."

At the time of this writing, the House has approved legislation to extend the Build America Bond program for two years. The program was due to sunset at the end of 2010. The bill was sent to the Senate where it is awaiting approval following the Memorial Day recess. As had been expected, the subsidy payments will be reduced to 32 percent in 2011 and 30 percent in 2012.



Source: Barclays Capital Municipal Strategies and Index Group.



Barclays Capital expects the Build America Bond program to have a very material impact on the composition of its U.S. Credit Indices. Barclays Capital estimates that BABs' share of the U.S. Credit Index will increase from 2.4 percent to approximately 5 percent, and that its representation in the U.S. Long Credit Index will rise from about 8 percent to 17 percent. The Build America Bond program has given municipalities access to a much larger investor base, including pension funds and foreign investors. With the rapid growth in this relatively new asset class, we believe that many investors benchmarked to Barclays Capital U.S. Credit Indices would benefit from including BABs in their portfolios. Otherwise, they risk significant tracking error as a result of their underweight positions in the sector.

Keith McCarthy is a portfolio manager specializing in municipal bonds for Dwight Asset Management Company LLC. Keith is based in Burlington, Vermont and can be reached at kmccarthy@dwight.com.