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Whatever Happened to Super-BABs?

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Build America Bonds have been called the success story of 2009 as issuers rush to take advantage of the 35% interest payment subsidy offered by the federal government. Yet few are flocking to an even better offer — recovery zone economic development bonds, which offer certain issuers a 45% subsidy.

The American Recovery and Reinvestment Act that Congress approved and President Obama signed in February authorized the issuance of up to $10 billion of these bonds, dubbed “Super-BABs” by program participants. Each state is allowed at least 0.9% of the total allotted amount, and on June 10 the federal government released specific cap amounts for each state, county and large city according to the area’s decline in employment from December 2007 to December 2008.

The allocations were not handed out without controversy. In July, seven members of Congress complained to the Treasury Department that counties in their districts did not receive recovery zone allocations despite dealing with high levels of unemployment.

Included in that group was Rep. Bob Filner, D-Calif., who represents Imperial County, which as of September had the nation’s highest unemployment rate: 30.1%. But nothing could be done, since ARRA dictated that allocations be based on decreases in employment, and for a variety of reasons, those areas actually experienced increases in their total labor forces during 2008.

But for localities that did receive allocations, the catch is pretty simple. Issuers must be counties or large municipalities that designate themselves “recovery zones,” defined as areas with significant unemployment, poverty, and foreclosure rates, or general distress. The classification occurs at the local level and the tax rules only specify that the designation be made in “good faith.”

Also, the bonds must be issued by the end of 2010.

With Build America Bonds flying off the shelves, one might assume that a debt structure with an even higher subsidy would be met with intense interest, especially given that the prospective issuers are, in theory at least, those most in need of stimulus. But five months into the program, less than 4% of the total allocation, or $384.5 million, has been issued by 27 participating governments. Deals have ranged from $1.0 million to $63.3 million, according to data from Thomson Reuters.

One reason for the slow progress of the bonds, awkwardly abbreviated as RZEDBs, is that they have a reputation for being complicated. Yet many of the program’s perceived disadvantages can be overcome with relative ease, according to people involved in the first deals.

“They are no more complicated than your average BAB. It’s just substitute 45% for 35%,” said Timothy A. Frey, partner at Saul Ewing LLP, who has worked on several issues.

Frey pointed to three primary differences between economic development bonds and BABs. One, BABs can be issued by any government entity, whereas RZEDBs may only be issued by qualified counties and municipalities.

Two, BABs have no cap amount, whereas RZEDBs have finite limits. And three, BABs have a lower subsidy. True, the first two distinctions make the RZEDBs accessible to fewer issuers than BABs, but for eligible issuers the third difference makes the math pretty simple.

Martin Johnson, president of Nevada-based JNA Consulting, worked on a $36.9 million issue from the Washoe County School District in Nevada, an area with a 13.1% unemployment rate as of September. He said the deal went smoothly because projects were shovel-ready.

“We had projects ready to go that we were going to finance one way or another,” he said. “Our initial plan was to do Build America Bonds. Then … we saw the allocations come out and recognized that those can be transferred.” Johnson said the school district simply had to convince Washoe County and Reno to call the area a recovery zone, and the school received authority to issue 93% of the county’s total allocation.

“The true interest cost on the taxable bonds was 5.67%. When you adjust it for the 45% subsidy the TIC goes to 3.14%,” he said of the bonds maturing in 2024. For the school district, he calculated the overall savings versus issuing traditional, tax-exempt munis to total $4.2 million.

Concerns remain, however. From an investor perspective, one question is what happens to that juicy 45% subsidy if the issuer defaults.

The Internal Revenue Service has made clear that if projects funded by BABs or RZEDBs prove to be noncompliant or fraudulent it will block the subsidies, leaving the issuer stuck paying the full interest cost. But in the case of outright default, the subsidy’s fate remains an “open question,” according to Linda Schakel, a partner at Ballard Spahr LLP.

This scenario is also hazy with BABs, but it could be more of a problem with RZEDBs, she added, because the debt service is likely to be dependent on revenue generated by the project in a distressed area, or from taxes in an area with high unemployment.

“You expect if you put this money in, it’s going to generate additional sales taxes, property taxes,” Schackel said. But expectations, as many learned in the credit crunch, are not guarantees.

It’s unclear if the federal government will continue to pay the subsidy, post-default, for the entire length of the bond’s term, or if a default would put a halt to the assistance. More guidance from the Treasury Department on this point would ease investor worries and help with marketing the bonds, Schackel said.

Of course, as with traditional munis, one solution is insurance. Seven of the 27 deals done so far have insured their debt with Assured Guaranty Corp., offering investors confidence that their expected payments won’t dry up down the road.

The insurance covers 100% of the payments, regardless of whether the Treasury continues to subsidize them, according to Bill Hogan, senior managing director of Assured’s public finance group.

Two RZEDB issuers — Itasca County, Minn., and Cary Village, Ill. — have also sold double-barreled bonds. These give investors the added security of an additional income stream backed by an authority with taxing powers, which would step up with funds in case the anticipated revenue source fell short.

Another issue limiting RZEDB activity is that local issuers have to nail down the most vital projects to finance, given the $10 billion limit on the program.

“There’s no volume cap on the BABs, so there aren’t allocations. There isn’t, 'What are we going to use this for? Because if we use it for this we can’t use it for that,’ ” said Thomas Vander Molen, a partner at Dorsey & Whitney LLP in Minneapolis.

Yet that problem, too, can be avoided. Some districts have had success issuing debt using a hybrid structure of BABs and RZEDBs, thus utilizing their full allocation of recovery bonds and funding the rest with a 35% subsidy. The Louisville-Jefferson County Metro Government of Kentucky, for instance, came to market with a $63.3 million hybrid deal.

Squeamishness presents another dilemma.

Multiple participants in the program from around the country said designating a recovery zone has no tangible drawback, but that some people shudder at the idea that the designation suggests a community is destitute.

“There are a lot of counties that have higher exposure and are maybe concerned about painting the community with a brush that says we’re a depressed area, but it shouldn’t be viewed that way — it’s an opportunity, said Bill Reisner, vice president of Stern Brothers & Co., who helped negotiate a deal for Greene County, Mo.

According to Frey of Saul Ewing, “There is no downside, other than the perceptions of the people who read the newspaper and say, 'My neighborhood has just been declared a recovery zone.’ ”

In Passaic County, N.J., public officials avoided that conundrum by simply labeling the entire county, which has an 11.7% jobless rate, a recovery zone rather than any of the 16 individual municipalities there.

“Rather than be accused of being politically biased for choosing certain regions, I think it was just easier for them to designate the whole county and see what [projects] come up, and then base the allocation through the municipalities on project worthiness,” said Nicole S. Fox, executive director of the Passaic County Improvement Authority.

The PCIA expects to save $1.87 million on its upcoming issuance of $10.3 million of RZEDBs. According to their projections, the bonds will be issued through 30 years with a top coupon rate of 6.29%.

Detroit, which has a 17.3% jobless rate, also plans on avoiding painting particular areas red. Instead, the entire city may be designated a recovery zone by the end of this year, said Art Papapanos, vice president of the Detroit Economic Growth Corp., a nonprofit entity working with the city to attract and retain business.

“I’m preparing the procedural issues, obligations, and deadlines for submission of applications for ... public projects that are in the pipeline,” he said. The city is eligible for a $43 million allocation of economic development bonds.
So if communities can avoid the program’s apparent problems, what’s hindering the bonds from being a major success? Several experts attribute the slow start to a lack of publicity.

“Quite frankly, there’s just a lack of education,” Reisner said. “There are several counties that don’t understand what is it or how to make use of it — I’m worried that it’s just going to go to waste.”

Added Johnson, “I have spoken to a couple of counties and their comment was, 'Well, where’s my money, where’s the check?’ ”

Fortunately, for any locality that fails to use their allocation, the money doesn’t simply vanish; it gets re-directed to the state at a state-determined deadline. For example, Virginia required localities to identify how much of their allocations they planned to use by Nov. 2, and reclaimed the rest. From there, the state is supposed to redistribute the funds to districts with proven abilities to utilize the allocation — but still must do so before the Dec. 31, 2010 deadline.

If that occurs, Reisner said there could be some political backlash once residents and industries figure out that stimulus dollars for their community were abandoned.
For counties struggling to use the funds, he offered some advice. “Establish some clear criteria. Assume that demand is going to exceed what you have available. Rate the projects and allocate based on that,” Reisner said. “It’s black and white.”
The awareness problem exists even in a state where Build America Bonds have flourished: California.
“Most city and county officials don’t even know they have these allocations,” said James Hamill, program manager with California Statewide Communities Development Authority. “They’re dealing with the budget issues and everything else going on here, so no one’s really focused on it.”

Plans to issue these bonds in California began about two months ago but no area has yet been labeled a recovery zone, Hamill said. This is surprising considering California is eligible to issue $806 million of the bonds — more than any other state.

Dennis McGuire, a Sacramento banker at Piper Jaffray & Co., who is working on projects in California, said when the bonds are issued capturing market demand won't be difficult.

"It is our assumption that there will be a market that is similar to that which has developed for BABs," he said. Labeling an area a recovery zone has another benefit. In addition to RZEDBs, the federal stimulus package authorized $15 billion for recovery zone facility bonds, or RZFBs. These are tax-exempt private-activity bonds that can be used to finance projects involving private parties, including private-public partnerships.

The facility bonds largely follow the tried-and-true path of private-activity bonds, but with one caveat: 95% of the bond proceeds must be used to finance "recovery zone property" in designated zones.

To qualify, a project must be constructed, renovated, or purchased after the area was designated as a recovery zone. Golf courses, massage parlors or gambling facilities are not eligible.

As with the RZEDBs, those who have dealt with the facility bonds say using the allocations are not difficult.
"If you have a shovel-ready project, you're golden," Reisner said.

But according to data from Thomson Reuters, only 0.25% of the total RZFB allocation — or $37.3 million of the $15 billion available — has been issued so far. Only seven issuers have sold the debt.

However, because the issuances tend to be on a small-scale — all have been less than $10 million — some may have slipped under Thomson's radar, sources said.

Data could become more available in the near future as some prospective issuers, including California and Passaic County, are working on financings that pool authorizations from both recovery zone bond structures.

"So much of what came out of the stimulus act has taken some time because it's different and there are all these new tools," Reisner said. "You know, we didn't see the first Build America Bonds until a couple of months after February, and then there was a trickling of BABs completed. Then, it was exponential."