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***before the***

***Subcommittee on Select Revenue Measures  
Committee on Ways and Means  
U.S. House of Representatives***

***Hearing on Tax-exempt and Taxable Governmental Bonds***

***May 21, 2009***

Good morning, Chairman Neal, Ranking Member Tiberi and other members of the subcommittee. Thank you for the opportunity to be here and present the views of the Regional Bond Dealers Association (RBDA)<sup>1</sup> on tax-exempt and taxable governmental bonds and the municipal bond provisions enacted with the American Recovery and Reinvestment Act (ARRA).

Regional bond dealers play a vital role in the municipal market of underwriting new bond issues for states and localities and providing secondary market liquidity to investors. This role has expanded during the financial crisis with the consolidation, downfall or withdrawal from the market of a number of large municipal bond dealers. During the height of the crisis in the fall and winter of 2008, the only source of liquidity available to many investors were regional dealers. We believe the role of regional firms in the municipal market will continue to expand, and we appreciate the opportunity to present our views.

Tax-exempt municipal bonds are one of the most important sources of federal aid to states and localities. The tax-exemption on most municipal bonds means that states and localities can borrow in the capital markets at rates much lower than they otherwise would. The tax revenue that the federal government foregoes on tax-exempt bonds helps state and local governments invest in schools, roads, airports, water and sewer systems, hospitals, parks and a variety of other public assets. The Joint Committee on Taxation estimates that in fiscal year 2009 alone, the federal government will give up nearly \$35 billion in tax revenue so that states and localities can

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<sup>1</sup> The Regional Bond Dealers Association is the organization of securities firms primarily active in the U.S. bond markets and is the only U.S. organization focused exclusively on issues in the domestic fixed-income markets. More information on the Regional Bond Dealers Association is available at [www.regionalbonddealers.com](http://www.regionalbonddealers.com).

borrow more cheaply using tax-exempt bonds to finance vital public investment.<sup>2</sup> Tax-exempt bonds have been a mainstay of municipal finance since the inception of the income tax, and are an effective, efficient means of delivering federal assistance for state and local investment, and this aid is more important than ever in the current economic environment. We commend you, Chairman Neal, for calling this hearing to examine such a vital area of the tax code.

Today, as a result of congressional action earlier this year, state and local governments have at their disposal an even wider variety of federally supported tools to finance public investment. The ARRA (P.L. 111-5) included expanded authority for some existing alternative financing tools for states and localities and added new options for financing such as Build America Bonds that have already saved state and local government millions in capital costs.

### ***Build America Bonds***

The provision from the ARRA that has had the most significant short-term effect on state and local capital finance has been the Build America Bonds (BABs) program. BABs have allowed state and local governments to tap the taxable bond market while still maintaining a generous federal subsidy of their interest expense. Under the BAB authority provided in 2009 and 2010, state and local governments that issue designated taxable bonds for qualified projects receive a cash rebate from the federal government equal to 35 percent of their interest expense.

This subsidy has proven to be an attractive means of financing for state and local governments. Over \$9 billion of BABs have been issued since the first transaction was sold in late March.<sup>3</sup> BAB transactions have ranged from a few million dollars of bonds for small communities to billions of dollars for large state issuers. Estimates of total BAB issuance over this year and next range as high as \$150 billion.

BABs are popular because they often result in a lower cost of borrowing net of the federal interest subsidy than traditional tax-exempt bonds. Cost savings experienced by BAB issuers relative to tax-exempt bonds range from 35 to 185 basis points (0.35 to 1.85 percentage points). This reduction in borrowing rates will translate to billions of dollars of interest savings for states and localities over the life of their bonds.

BABs work well for many municipal bond issuers because they allow states and localities to continue to benefit from a federal subsidy while selling bonds to taxable investors who normally would not consider municipal bonds because they cannot take advantage of tax-exempt interest. These investors include pension funds, foreign investors, life insurance companies, retirement accounts, certain trust accounts and others whose investment income is not taxed in the U.S. or is tax-deferred.

BABs have also had the effect of lowering borrowing costs for issuers of traditional tax-exempt bonds. Because there is less new supply of tax-exempt bonds, investors have bid up prices of

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<sup>2</sup> Staff of the Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 2008-2012*, U.S. Government Printing Office, 2008.

<sup>3</sup> The Bond Buyer, "Build America Bonds' Issues," May 15, 2009, [www.bondbuyer.com/attachments/20090510A6SR01FZ-1-BABs\\_CHART.pdf](http://www.bondbuyer.com/attachments/20090510A6SR01FZ-1-BABs_CHART.pdf).

longer-term bonds and reduced yields and interest rates for issuers. This effect may be responsible for lowering borrowing costs for issuers of long-term tax-exempt bonds by as much as 50 basis points (0.5 percentage point) or more.

So far only a handful of new issues have used BABs, but the experience of state and local governments using BABs has been positive. There are however concerns related to selling taxable municipal bonds.

The taxable bond market is accustomed to bond structures and redemption provisions that are constraining for municipal bond issuers. In particular taxable investors show a preference for bullet maturities, which corporate issuers can more easily accommodate. Municipal bonds are frequently structured to pay down principal and interest over the term of the loan, not with a bullet maturity. Taxable investors typically also expect to have more restrictive early redemption provisions, which can be excessively costly to a municipal bond issuer. Municipal bonds are often sold with a 10-year early redemption option that comes at little or no cost.

It is also worth noting the following observations on the early performance of the BAB market:

- Several BABs that have been sold thus far have exhibited a trend where bond prices in the secondary market increase (and yields fall) significantly shortly after issuance, sometimes the same day the bonds are priced as new issues. While on the one hand this demonstrates the attractiveness of BABs among taxable bond investors, it also suggests inefficient pricing in the primary market. It is possible that at least part of this trend is attributable to the novelty of BABs and that the trend will wane over time, with issuers receiving even more favorable pricing at issuance.
- BABs arguably represent a costlier federal subsidy than traditional tax-exempt bonds. Although theoretically the 35 percent interest subsidy associated with BABs should be offset by tax receipts associated with taxable interest payments, many BABs are bought by investors who do not pay current U.S. income tax on their interest income, so there is a significant net cost to the Treasury of the program. We believe this cost is justified for the temporary period that BAB authority is in place to help states and localities access the capital markets cheaply during the crisis.
- There is some uncertainty about the viability of BABs after the expiration of the two-year interest subsidy provision. After 2010 BABs will be structured so that investors receive a federal income tax credit equal to 35 percent of the bond issuers interest cost. The option for issuers to receive the credit as a cash subsidy will expire. We see little market acceptance of tax credit bonds, and some market participants are concerned that BABs may not represent a viable financing option after 2010.

Overall we believe BABs offer an efficient and cost-effective financing tool for states and localities. Their popularity and growth over the last two months is a clear indication that they are delivering the kind of assistance to state and local governments that the committee intended when BABs were conceived. This is likely even more the case for Recovery Zone Economic Development Bonds (RZEDBs), also authorized in ARRA, since the interest rebate provision is

even more generous than with BABs (45 percent for RZEDBs versus 35 percent for BABs). While we feel that tax-exempt bonds will continue to play a dominant role in state and local finance—if for no other reason than the interest rebate election under the BAB authority is due to expire at the end of 2010—BABs provide an attractive alternative.

### ***Bank investment provisions***

The ARRA includes three provisions designed to encourage greater investment by commercial banks in tax-exempt bonds issued in 2009 and 2010. First, the annual issuance limit for bank qualified tax-exempt bonds has been raised from \$10 to \$30 million. Second, the “two-percent *de minimis* rule” for non-bank corporate investors in municipal bonds has been extended to commercial banks. Third, the small-issuer bank qualified limit has been amended so that the bonds of a borrower falling under the \$30 million annual limit are still bank qualified even if the issuer selling bonds on behalf of that borrower issues more than \$30 million annually.

These provisions represent a positive and important change in policy to increase demand for tax-exempt bonds. Before 1986, commercial banks were active investors in the tax-exempt bond market. The Tax Reform Act of 1986 created significant disincentives for bank investors in tax-exempt bonds in the form of a *pro rata* interest expense disallowance for banks that earned tax-exempt interest from any bonds other than bank qualified bonds. As a result, banks went from holding over half of all outstanding tax-exempt bonds before 1986 to less than 10 percent in recent years.

The bank investment provisions of ARRA have had the effect of enhancing the market for small tax-exempt bond issuers who sell between \$10 and \$30 million of bonds annually. Although the spread between bank qualified and non-bank qualified bonds has shrunk significantly since the enactment of ARRA, it has become easier for issuers whose bonds are now bank qualified to place those bonds with investors.

With regard to the two-percent safe harbor provision for commercial banks, our members have noticed that some bank investment managers have been slow to expand their tax-exempt bond portfolios into non-bank qualified issues even where they are eligible to buy those issues without penalty under the safe harbor. We attribute this reticence to a lack of familiarity with the new law. Bank investment managers for many years have focused their attention on bonds that carry legal opinions designating them as bank qualified. We believe that over time banks will recognize that non-bank qualified bonds are now eligible for bank investment under the two-percent safe harbor and will begin to adjust their portfolios accordingly. In the meantime, we encourage members of the subcommittee to use available opportunities to promote the two-percent safe harbor among bank investment managers and tax directors so that the provision will have as deep an impact on state and local finance as Congress intended.

### ***Alternative minimum tax***

One of the sectors of the municipal bond market hardest hit by the credit crisis has been bonds the interest on which is subject to the individual alternative minimum tax (AMT). Beginning in the second half of 2008 it became exceedingly difficult to price and sell new AMT bond issues,

and consequently many investment projects simply could not obtain financing. The ARRA has suspended the application of both the corporate and individual AMTs to all “new money” municipal bonds issued in 2009 and 2010 and to bonds issued to refund issues that were originally sold in 2004 or later.

Applying the AMT to private-activity bond interest is inefficient and penalizes bond issuers unfairly. Investors who are subject to the AMT simply avoid buying AMT bonds. Meanwhile, issuers pay higher financing costs on their bonds in compensation for the risk that a non-AMT investor, through poor planning or unforeseen circumstances, could end up paying tax on AMT bond interest. The federal government collects very little revenue from applying the AMT to municipal bond interest, but bond issuers pay higher financing costs than they should.

The AMT provision in ARRA has had the effect of reopening the market for bonds that otherwise would have been subject to the AMT. This has made it possible to sell bonds such as small-issue industrial development bonds and bonds for certain airport facilities and other projects that fall under the definition of “private activity.”

One change the subcommittee may want to consider is the limitation on the AMT provision in ARRA related to refunding transactions. ARRA specifies that refunding bonds can qualify for the AMT holiday only if the original bond being refunded was sold after December 31, 2003. Unfortunately, because most municipal bonds are sold with 10-year “call protection” and private activity bonds cannot be advance refunded—or refunded before the original bond becomes callable—this limitation effectively prohibits almost all refundings of outstanding AMT bonds. The only exceptions are variable rate issues which are always callable and issues with unusual or extraordinary call provisions. In order to provide issuers with maximum benefit and flexibility under the AMT provision of ARRA, the subcommittee may want to consider expanding the limitation on refunding AMT bonds outside the AMT. In addition, the subcommittee may want to consider permanently lifting the application of the AMT on tax-exempt bonds. It is an inefficient and unnecessary provision of the tax code that raises little federal revenue but results in higher costs for AMT bond issuers.

### ***Additional tax-exempt bond authority***

The ARRA includes authority for two additional categories of tax-exempt bonds, Recovery Zone Facility Bonds (RZFBs) and Tribal Economic Development Bonds. While we are not aware of any transactions that have come to market under this authority—indeed, the market is still awaiting guidance from the Treasury Department on the allocations of Recovery Zone Facility Bond authority—we believe that authority offers issuers useful new tools to finance needed investment. RZFBs, in particular, are roughly patterned after successful tax-exempt bond authority that was authorized after the September 11, 2001 terrorist attacks (Liberty Zone Bonds) and after Hurricane Katrina (Gulf Opportunity Zone Bonds). Both programs were successful in helping to restore the local economies in devastated areas, and we believe that the RZFB provision will provide similar tools for areas particularly hard hit by the recession.

The ARRA also includes some enhancements to existing tax-exempt bond authority, including:

- Expanded definition of “manufacturing facility” for small-issue Industrial Development Bonds; and
- Expanding qualification for bonds for high-speed rail facilities.

The RBDA supports both these provisions. We believe this additional authority will give states and localities additional flexibility to promote economic development and expansion.

### ***Tax credit bonds***

The ARRA includes several of provisions to establish or expand authority to issue tax credit bonds for a variety of targeted uses. These include:

- Expanded authority for New Clean Renewable Energy Facility Bonds (CREBs)
- Expanded authority for Energy Conservation Bonds
- Extension of Qualified Zone Academy Bond authority (QZABs)
- New authority for Qualified School Construction Bonds

We appreciate Congress’ focus and commitment in exploring new, alternative tools to promote the ability of states and localities to meet their investment obligations. However, the market’s experience with existing tax credit bond programs has demonstrated that this product is in most cases not an efficient way to promote and assist new investment. Our members have worked with issuers to attempt to use the existing authority for QZABs and CREBs, and in our experience, it is exceedingly difficult to use these tools effectively. There is not a broad or deep market for marketable tax credits, and in the case of CREBs, for example, the limited number of transactions that have been done have been inefficiently priced. Also, there is little secondary market liquidity for these structures, which raises costs for borrowers even further.

We believe a better approach for providing assistance and incentives for targeted investments such as renewable energy and energy conservation would be to expand the authority to use traditional private activity tax exempt bonds for these uses. Although the subsidy associated with tax-exempt finance is not as deep as the theoretical subsidy for tax credit bonds, we believe that in the end, expanding private activity tax exempt bond authority would result in more projects being financed.

### ***Conclusion***

The ARRA included a number of important and beneficial provisions designed to help states and localities continue to efficiently access the capital markets in the midst of the credit crisis. BABs, provisions to expand bank investment, the suspension of the AMT and expanded use of private activity tax exempt financing for distressed areas all offer the prospect of reduced financing costs for state and local governments who are facing severe fiscal constraints due to the recession and weakened real estate market. We appreciate and commend the Ways and Means Committee’s work in crafting these important provisions.

We fear that the expansion of various tax credit bond programs will not be as fruitful. Our experience with QZABs and CREBs suggests transactions using these tools are difficult to execute and are often priced inefficiently. While we appreciate the committee's work in offering these tools to states and localities, we feel that the resources dedicated to these programs might be better refocused to expanding tax exempt financing authority.

In addition, we want to call the subcommittee's attention to additional pending municipal bond legislation that includes provisions under Ways and Means Committee jurisdiction. At the same time that this hearing is taking place, the Committee on Financial Services is conducting a hearing on legislation drafted by Chairman Barney Frank and others to aid states and localities in the wake of the financial crisis. Two of those bills include provisions which would amend Internal Revenue Code section 149 in regard to proposed federal credit and liquidity enhancement programs for state and local governments. We urge members of this subcommittee to support Chairman Frank's legislation and we hope that the Ways and Means Committee will act favorably on the tax provisions in those bills when they come before you.

We again appreciate the opportunity to present our views and look forward to your questions.