ARRA and the Municipal Bond Markets

September 14, 2009

Stone & Youngberg

San Francisco Los Angeles San Diego New York Chicago Phoenix Richmond Annapolis Big Bear

Overview of Presentation

American Recovery and Reinvestment Act of 2009 (ARRA) contains several measures designed to stimulate municipal bond issuance in 2009 and 2010

- **What elements of ARRA have affected the municipal bond markets?**
  - Build America Bonds and Recovery Zone Bonds
  - Tax Credit Bond Programs
  - AMT and Bank Investor Changes
- **How successful have these programs been?**
- **Is the municipal market recovering?**

Build America Bonds: the Idea

- **Overview**
  - Finance *tax-exempt* projects at *taxable* interest rates with *35% federal interest subsidy*
  - Unlimited issuance volume through December 31, 2010
  - Regulations released on April 3, 2009
- **Expectations**
  - Subsidy compensates issuer for higher taxable interest rates
  - Access larger pool of investors beyond those seeking tax-free income
    - Pension funds, corporate buyers, foreign investors
  - Enhance ability of public agencies to proceed with capital investments

Build America Bonds: the Reality

- **Significant Issuance Activity**
  - More than 330 issues totaling nearly $29 billion, year to date
    - About 17% of municipal issuance since April
  - Large issuers demonstrated demand, launched flurry of activity
    - i.e. State of California's $5 billion BAB sale in April

BAB Issuance By Size Through September 3, 2009

	Par in $ Billions		By # of Issues	
$1 billion +	10.4	36%	7	2%
$250 million to < $1 billion	9.4	33%	30	9%
$100 million to < $250 millior	3.4	12%	34	10%
$50 million to <$100 million	2.8	10%	50	15%
Less than $50 million	2.7	9%	209	63%
	$ 28.8	100%	330	100%

- **Actively quoted Secondary Market trading**

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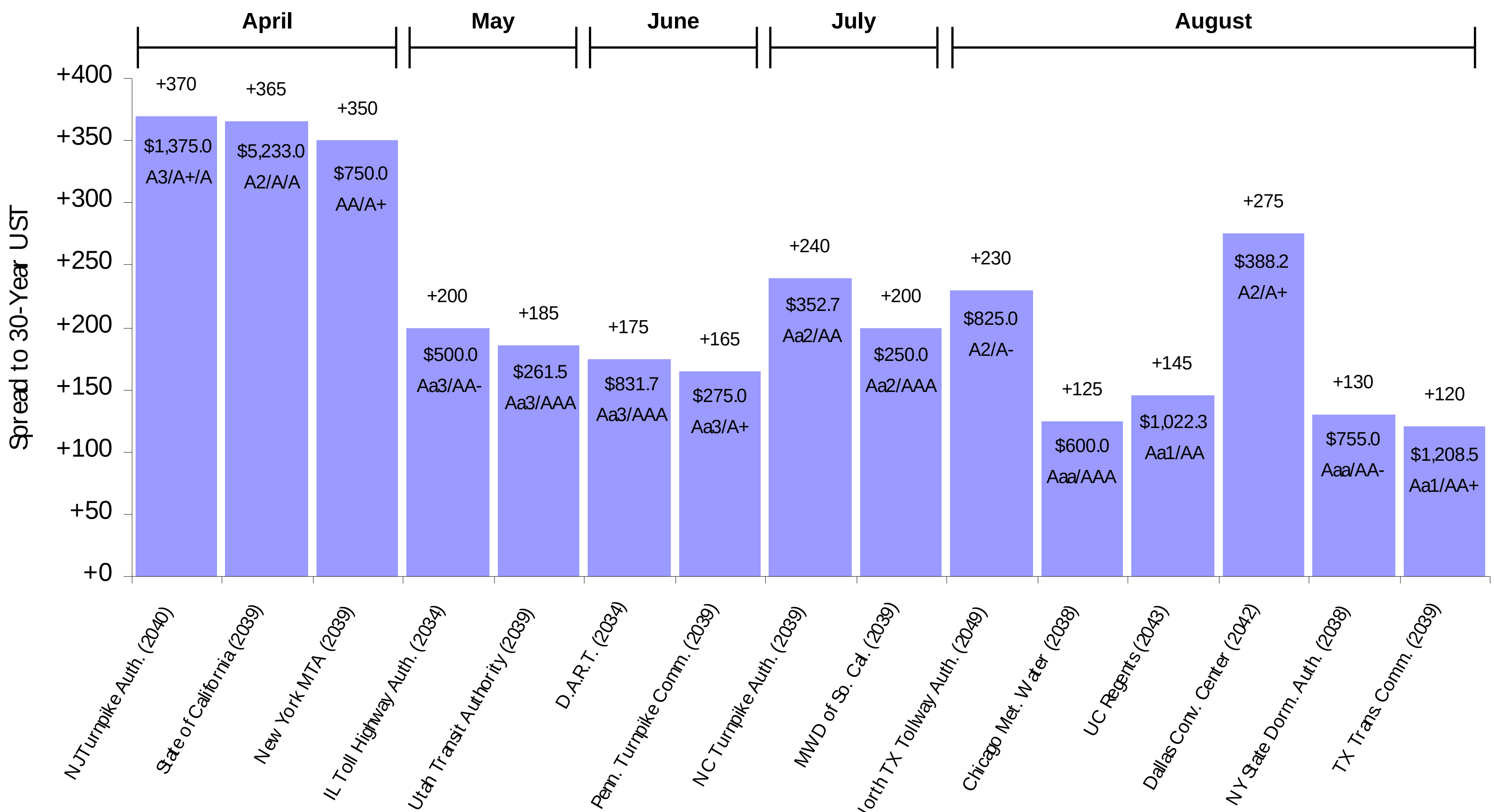
Investors Drawn to BAB Market

- **Predominately Institutions**
  - Insurance companies, pension funds, money managers, corporations
  - Taxable municipal mutual bond funds forming
- **Increasing Retail participation**
  - Initially limited, recently increasing for shorter maturities
- **Investor interests**
  - Liquidity
  - Size of issue, size of maturity
    - Index and/or ETF eligible?
  - Make whole or 10-year par call features
  - Issuer name and ratings
  - Ongoing investor education

BAB Spreads Have Tightened Since April

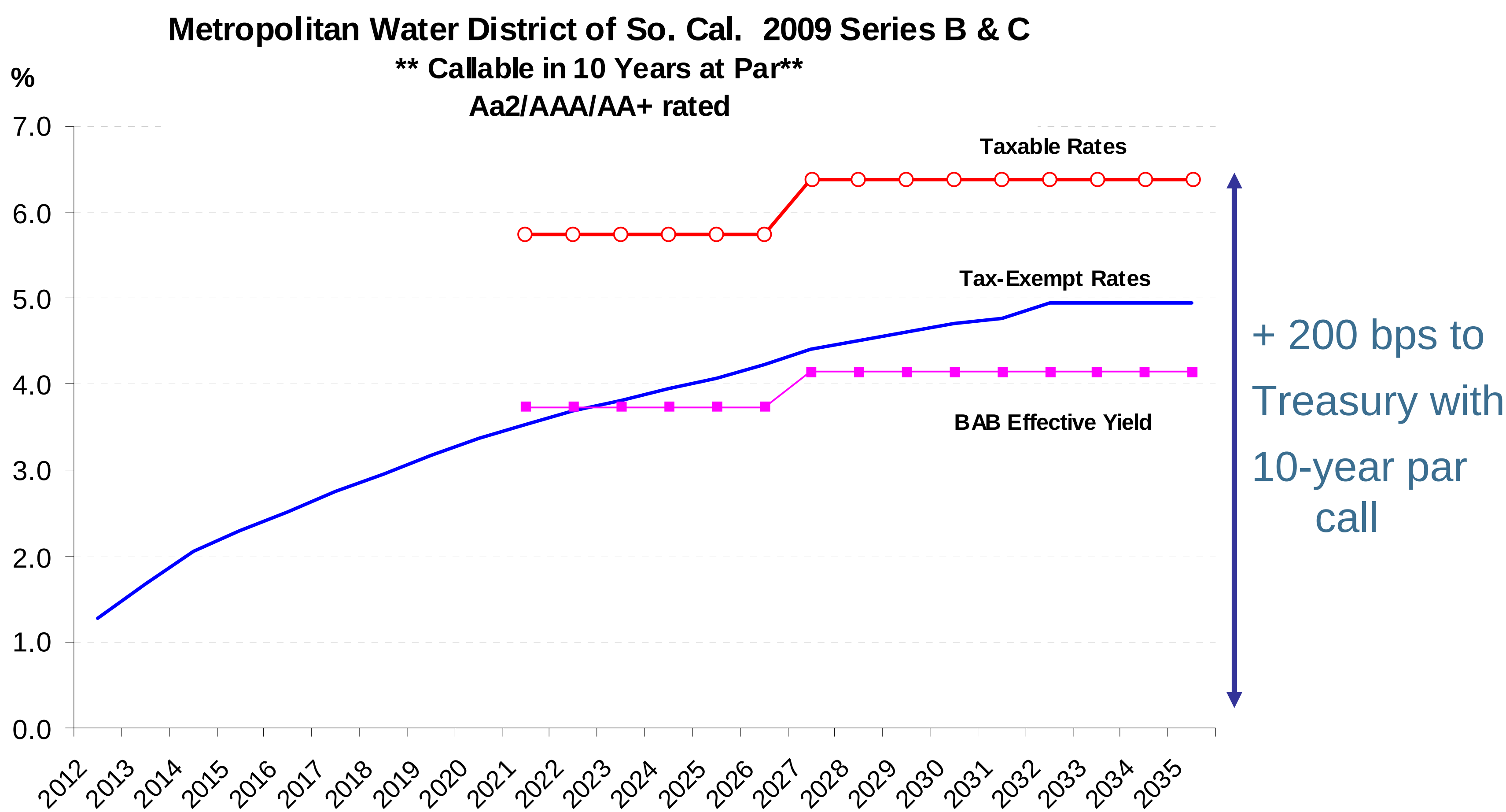
Taxable spreads to 30-year Treasury bond at initial bond pricing



Source: Stone & Youngberg. Par amounts are in $MM.

BABs Can Offer Net Lower Interest Rates

- **Advantage most significant on longer maturities**



Recovery Zone Bonds: the Idea

- **Target Interest Subsidies to Hardest-Hit Areas**
  - Recovery Zones: locally designated areas with economic distress, unemployment, foreclosure activity
  - Volume cap allocated to counties and large cities (>100,000) based on relative job loss in 2008
  - No new revenues, just interest subsidies
- **Recovery Zone Economic Development Bonds (RZEDB)**
  - Like Build America Bonds but with <u>45%</u> interest subsidy
  - $10 billion volume cap
- **Recovery Zone Facility Bonds (RZFB)**
  - Finance taxable private activity projects at tax-exempt rates
  - $15 billion volume cap

Recovery Zone Bonds: the Reality

- **Lagging issuance activity**
  - Regulations and allocations made on June 12, 2009
  - Targeted communities often most financially strapped
  - Issue size limited by allocations
  - Slower timeline for “private activity” financings
- **Recovery Zone Economic Development Bonds**
  - About 4 issues totaling $142.4 million
  - Predominately $131 million for Cook County, Illinois
- **Recovery Zone Facility Bonds**
  - Few or none in public capital markets to date
  - Several public-private projects percolating

Tax Credit Bond Programs: the Idea

- **Overview**
  - Bond structured with principal payment only
  - Tax credit offered to investor in lieu of interest payment
  - U.S. Treasury sets tax credit rate, supplemental coupon may be required
  - Four types of targeted tax credit bond programs
- **Expectations**
  - Expand on prior QZAB and CREB tax credit programs
  - Significantly increased scale of programs would attract investor attention
  - Ability to “strip” tax credit from principal payment for some types should augment appeal

Tax Credit Bond Programs: the Reality

- **Modest Issuance Activity**
  - Recent allocations expected to spur activity this fall
- **Investor Response?**
  - Complex calculation of tax benefits
  - Need predictable taxable income to value and use credit
- **Relatively Thin, Evolving Investor Base**
  - Primarily limited institutional activity
  - Potential interest from money managers and large companies
  - Banks historically active with older tax credit programs
  - Stay tuned. . .

Qualified School Construction Bonds

- **Overview (QSCBs or "Q-scabs")**
  - Can finance a variety of public school improvements
  - Significant allocation caps: $11 billion (2009), $11 billion (2010)
  - Direct allocations to large school districts, lottery to smaller districts in California
- **Activity to Date**
  - About 22 sales totaling over $270 million to date
    - Includes 2 large California school districts: San Diego and Oakland
    - 12 of the 22 required supplemental coupons ranging from 0.70% to 2.82%
  - California conducted lottery for smaller districts in August
  - Wave of QCSB sales expected this fall

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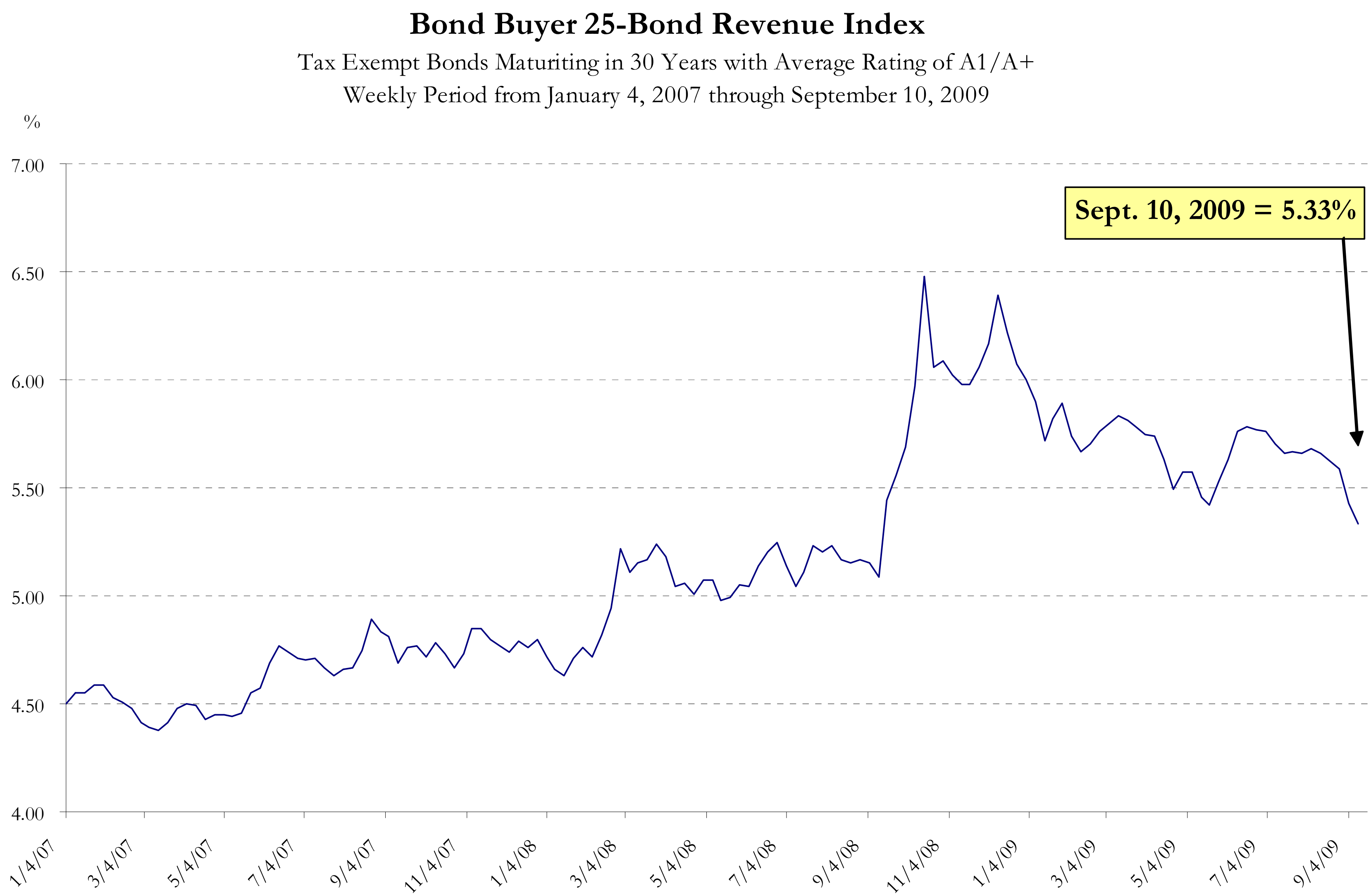
Other Tax Credit Bond Programs

- **Qualified Zone Academy Bonds (QZABs)**
  - Targeted to high povery school districts, requires private partner
  - National: $400 million (2008), $1.4 billion (2009) and $1.4 billion (2010)
- **Qualified Energy Conservation Bonds (QECBs)**
  - Issued by state and large local governments (population ≥ 100,000)
  - $3.2 billion nationally allocated by formula
- **New Clean Renewable Energy Bonds (New CREBs)**
  - $2.4 billion split among three issuer groups
    - Governmental entities, Electric co-ops, Public power providers
  - Applications were due on August 4th
  - “Smallest to largest” allocations likely to disperse usage

AMT and Bank Qualified Changes

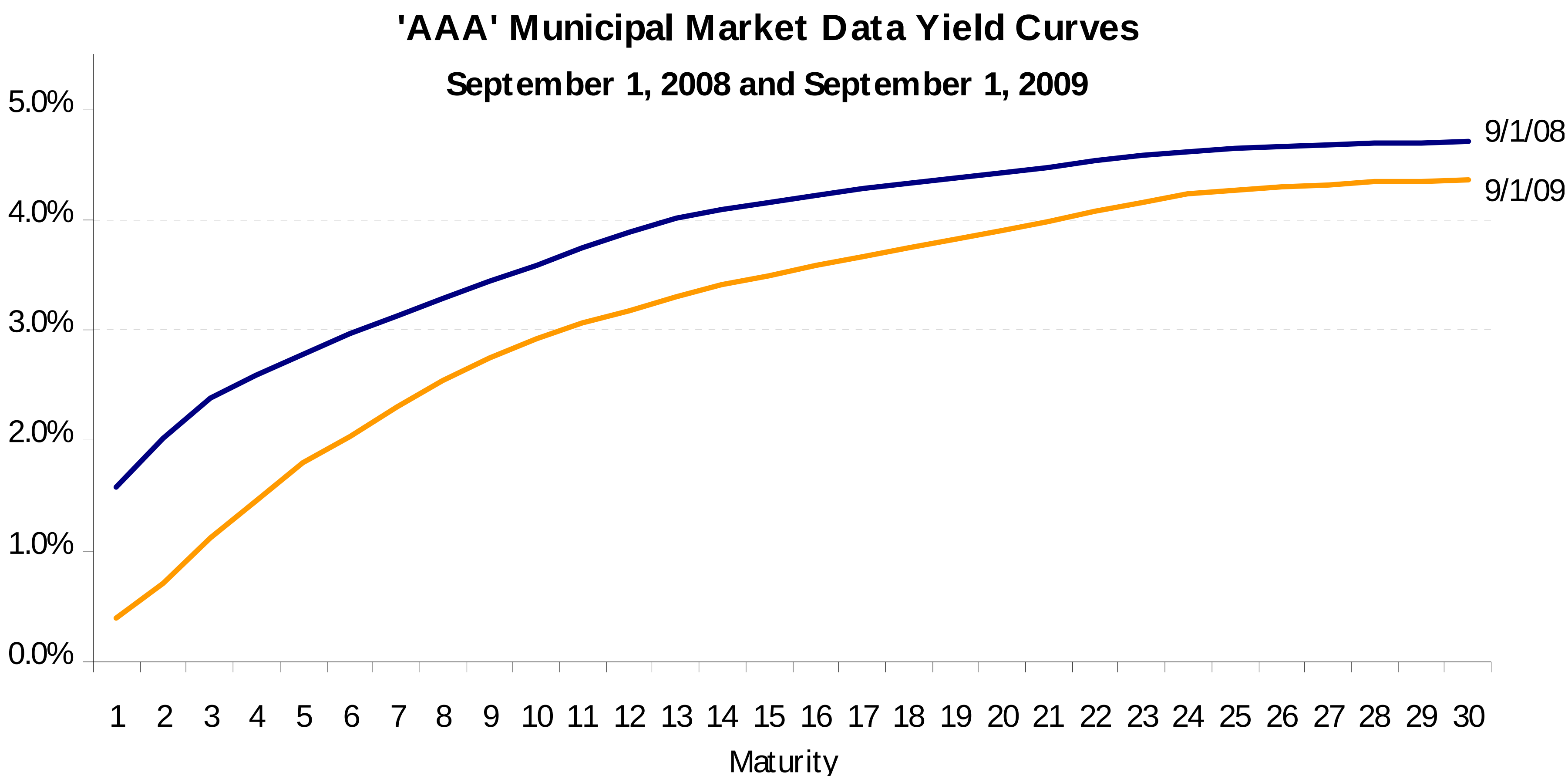
- **Eliminate AMT applicability through 2010**
  - Private activity bonds typically subject to Alternative Minimum Tax
    - Airports, ports, waste disposal, multi-family housing, etc.
  - ➔ Interest savings of about 75 basis points
- **Increase Bank Demand for Municipal Bonds**
  - Banks get preferred tax treatment to buy bonds from small, infrequent issuers designated as “bank qualified” (BQ)
  - Threshold for designation raised from $10 to $30 million
  - ➔ Supply of BQ issuance doubled eroding BQ benefit
  - ➔ Interest rate savings dropped from about 100 basis points to 0 - 25 bps

General Market Rates Recovering



Highest Quality Municipal Credits Fare Well

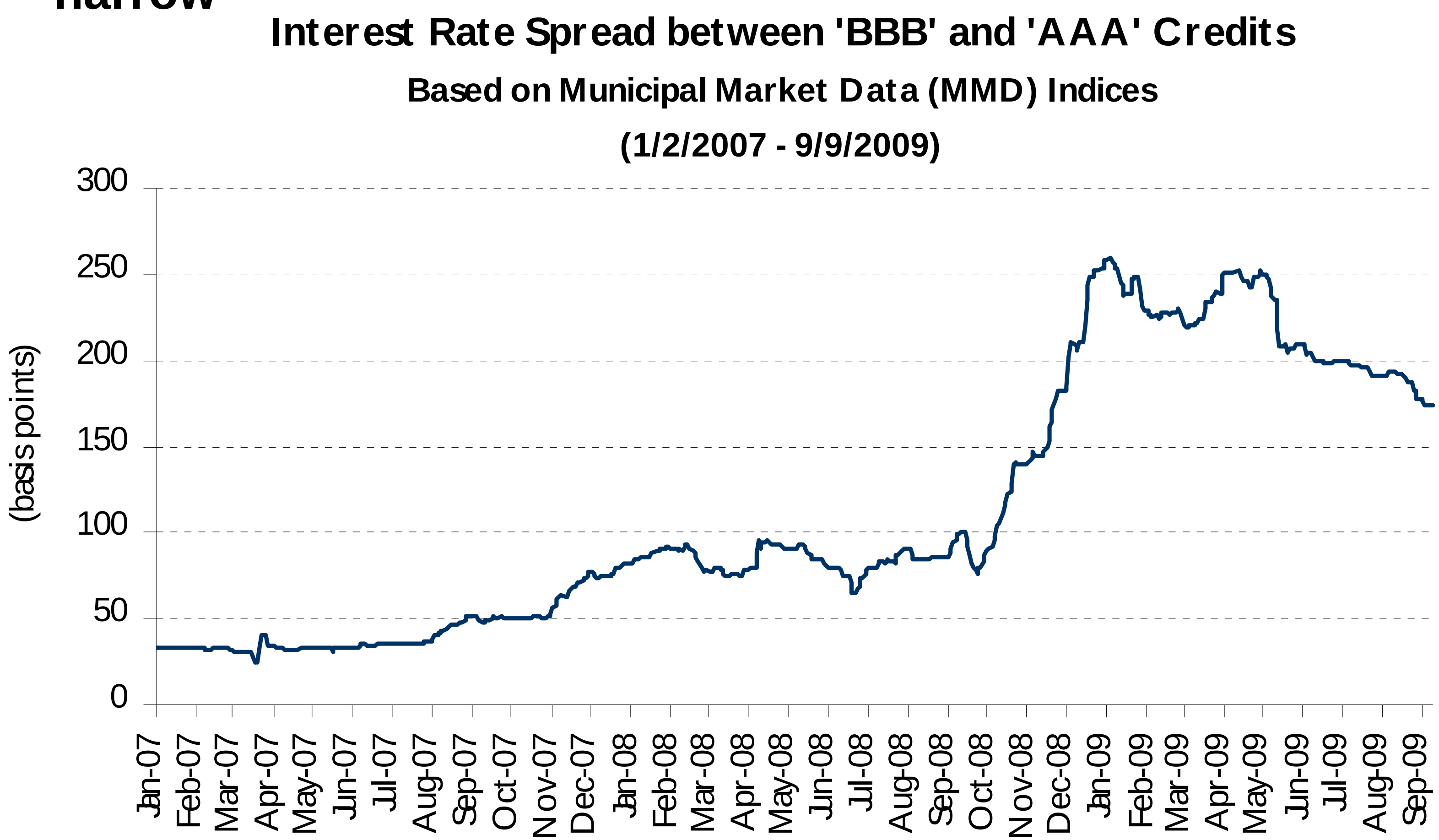
- **Lower tax-exempt rates, steeper yield curve since last fall**



Source: Thomson Financial

Continuing Spread for Lower Quality Credits

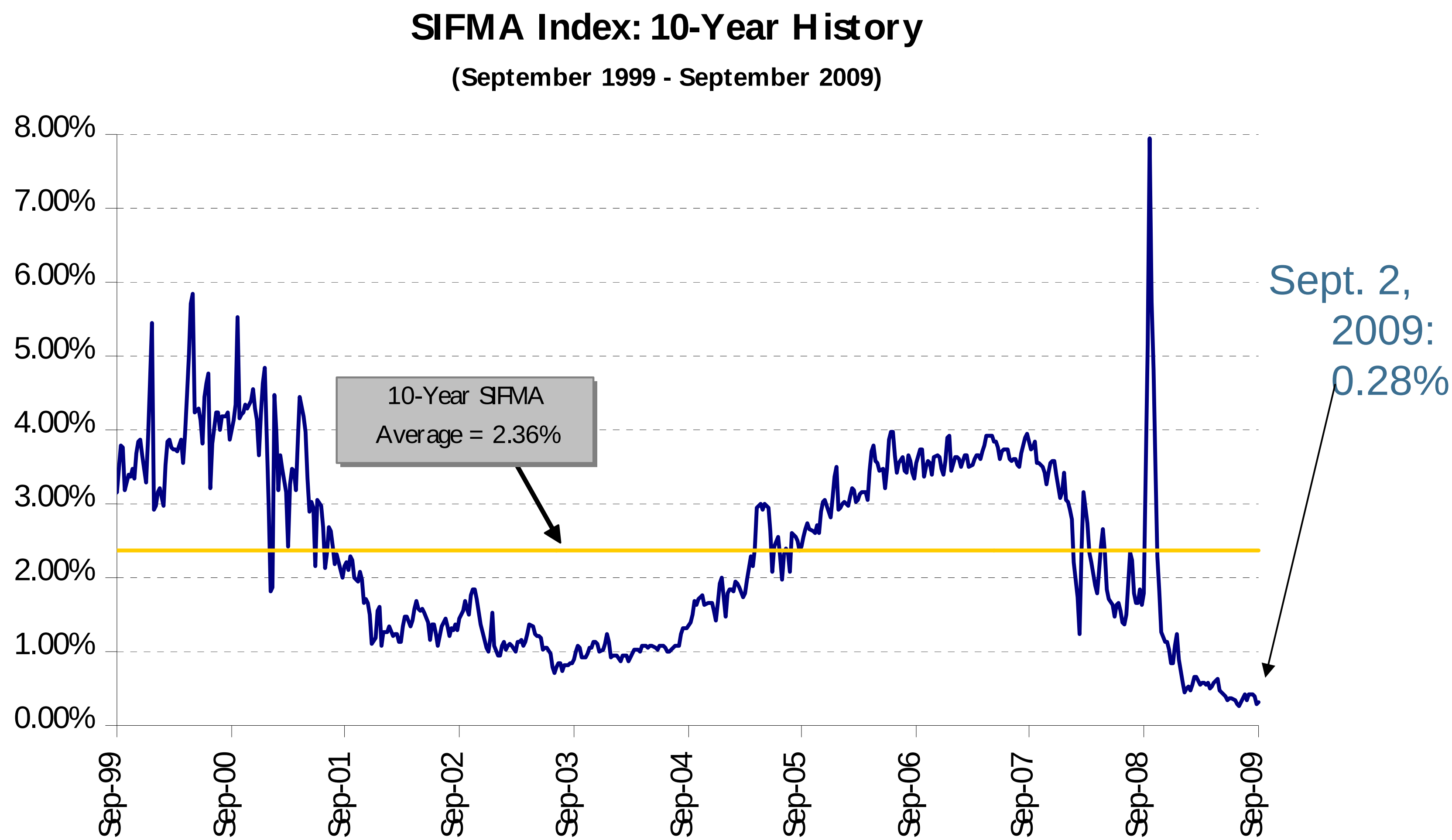
- **Dramatically widened credit spreads have finally begun to narrow**



Source: Thomson Financial

Low Short Term Rates For the Fortunate

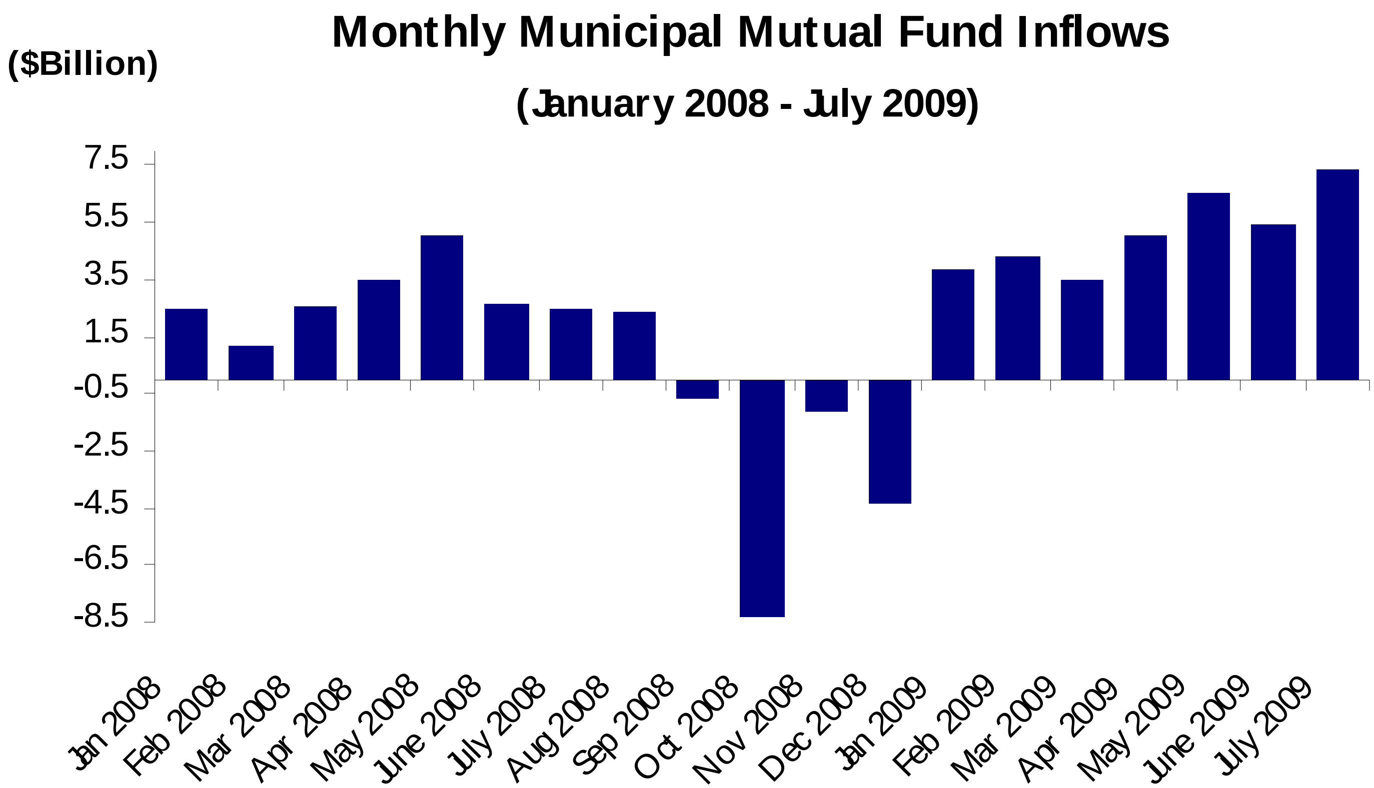
- **Historically low short-term rates. . .**
- **But scarce and expensive letters of credit and liquidity**



Source: SIFMA

Recovery In Investor Demand

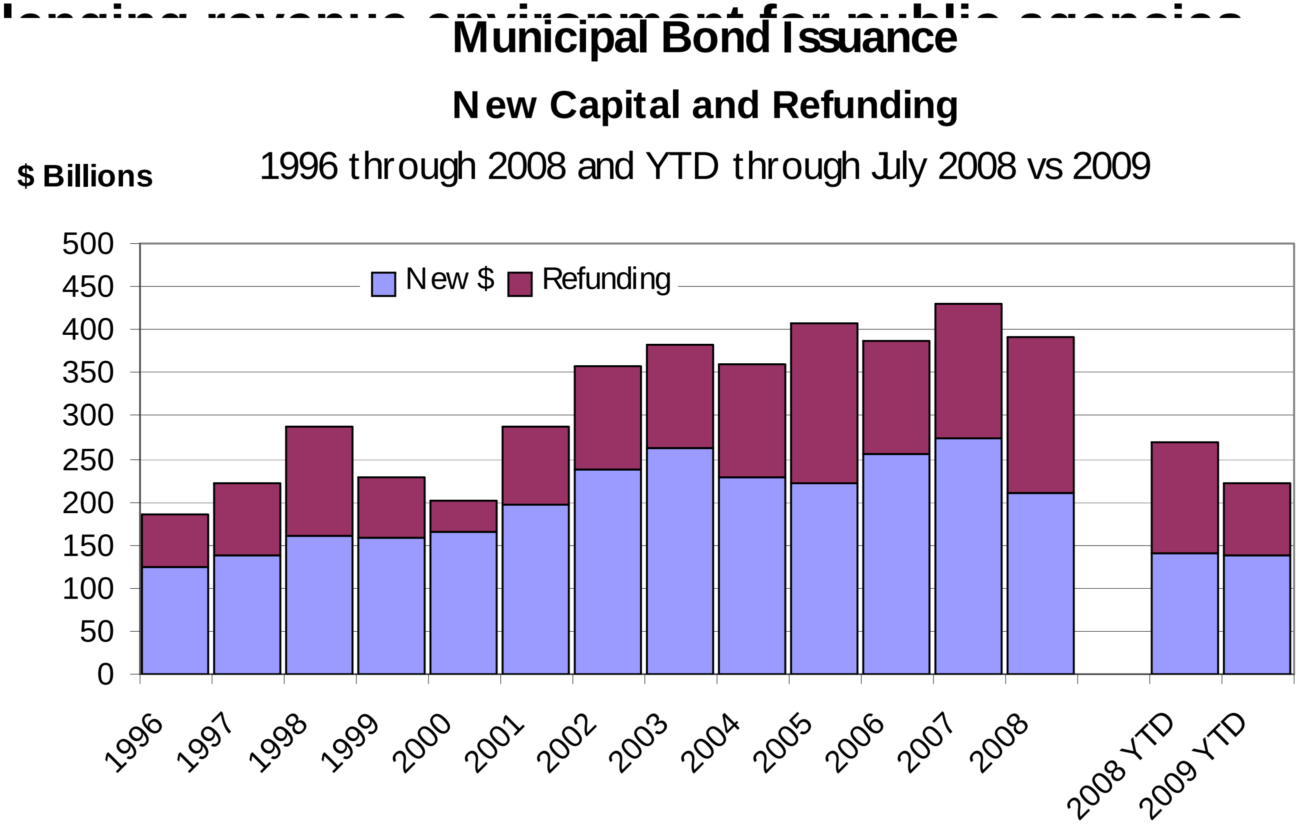
- **Collapse and retrenchment of many leveraged funds**
  - Hedge funds, tender option bond programs, some bond funds
- **Dramatic rebound of municipal mutual fund inflows**



Source: Investment Company Institute

Overall Issuance Volume Remains Down

- **YTD tax-exempt and taxable fixed rate issuance similar to 2008 YTD**
  - Shift in size and nature of borrowings
- **Significant drop in variable rate debt issuance (about $70 billion YTD)**
- **Challenging revenue environment for public agencies**



Questions?

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