Tax Credit Bonds are a Flawed Financing Mechanism

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Over the past 10 or so years, Congress has created a number of tax credit bond programs--programs under which the holder of a bond receives a federal tax credit, either in lieu of interest or in addition to taxable interest. These programs are intended to provide a reduced borrowing cost to the issuer of the bonds because the bondholder is receiving a tax credit from the federal government as a substitute for some or all of the interest that the investor would normally demand. Examples of tax credit bonds include qualified zone academy bonds ("QZABs"), which are designed to provide an interest free cost of funds to the issuer, and qualified energy conservation bonds ("QECBs"), which are designed to provide a reduced interest rate-funding source to the issuer (but not an interest free cost of funds). Another type of tax credit bond permits the issuer of the bond to elect to receive a direct interest subsidy payment from the IRS rather than the investor receiving a tax credit. The best known of these "direct payment" tax credit bonds are Build America Bonds ("BABs"), which were permitted to be issued under ARRA during 2009 and 2010. Certain other tax credit bonds were also permitted to be issued as direct payment bonds on a more limited basis and the authority for these bonds did not expire at the end of 2010. Tax credit bonds have flaws that substantially reduce their appeal to issuers and investors and create other inefficiencies with the result that they do not provide a borrowing cost to State and local governments that is comparable to that provided through tax-exempt bonds.

As you know, with the exception of the BABs program, the tax credit bond programs that have been enacted have been very unsuccessful. The primary reason for the success of the BABs program is that the taxable securities issued under the program conformed to existing market conventions and the tax subsidy was not a factor for investors' valuations. The results for other tax credit bonds have been very different. In fact, while discussing tax credit bonds, a Treasury Department official recently stated, "You can't give them away; it is an undeveloped, illiquid market." Set forth below is a brief summary of the problems with tax credit bond programs that have been enacted to date. As indicated below, some of these issues could be addressed but others seem to be serious, fundamental problems that cannot be fixed.

<u>The market for tax credit bonds is narrow</u>. The basic misconception is that tax credit bonds can be issued at rates that are comparable to taxable corporate bonds but this simply is not the case. Underlying this misconception is the belief that tax credit bonds will enable State and local governments to access the vast taxable debt market. Instead, tax credit bonds will only access the much narrower universe of taxable investors who can take full advantage of tax credits, but that narrow universe does not include pension funds and foreign investors. Evidence for the inefficiency of the tax-credit market can be seen in the credits issued in the tax-exempt housing area, which has the longest history of dealing in this product area and where the pricing has little to no transparency. This inefficiency will, in the aggregate, lead to tax credit bonds that are issued with tax credit rates that are "comparable" to the benefit under tax-exempt bonds providing a higher borrowing cost than traditional bonds, either taxable

or tax-exempt. To achieve comparability will require either significantly higher credit rates or the payment of additional interest on these bonds.

Tax credit bond programs are too small. Compared to the taxable bond market and the $3.7 trillion municipal bond market, the tax credit bond programs that have been created are very, very small. As a result, issuers, investors, and investment banks are largely unfamiliar with these programs. This unfamiliarity drives up the cost of using these programs, as potential investors require significant amounts of education. Further, the small size of these programs means that these bonds lack the liquidity that investors seek when making investments which, again, drives up the costs to issuers of these bonds. For institutional investors and mutual funds, the need for clear pricing conventions, relating to their total returns and net asset value calculations, are not conducive to hybrid securities that have embedded or detachable tax credit features. While some might argue that these problems could be addressed through a dramatic increase in the size of these programs, the other issues discussed herein make it extremely unlikely that there is a market for a multi-trillion dollar tax credit bond market.

The mechanics of tax credit bonds are flawed. The tax credit on tax credit bonds is intended to provide different levels of subsidies to issuers, depending on the particular tax credit bond program. As stated above, QZABs are designed to be interest free to the issuer and, as a result, the tax credit is supposed to provide sufficient compensation to the investor that it will not require an interest payment. Other tax credit bonds use the credit rate for QZABs as the base. Treasury sets the rates on tax credit bonds on a daily basis but unfortunately the method by which the amount of the tax credit is set is fundamentally flawed. Thus, for example, issuers of QZABs routinely have to offer a supplemental interest payment to induce investors to purchase these bonds. Since the credit rates on other tax credit bonds utilitze the rate set on QZABs, those other tax credit bonds have the same type of "mispricing" of the tax credit (although it is less obvious since the tax credit rate on those bonds is not intended to produce an interest free loan). Without going into too many details, it is enough to say that Treasury's method of establishing tax credit rates is flawed and does not produce the right rates. To take just one example, the tax credit rates produced by Treasury do not vary depending on the credit of the bond issuer--an AAA rated issuer of QZABs is subject to the same tax credit rate as an issuer with a much lower credit rating with the consequence of creating a credit arbitrage problem for lower rated issuers compared to higher rated ones. We raise this concern not to complain about the credit rate process but to point out a serious flaw with tax credit bonds that would be very difficult to remedy. These inefficiencies reduce the value of the tax credit to investors, and increase the cost of the program to issuers of tax credit bonds, and result in a cost to the Treasury that exceeds the benefit provided to the issuers.

The linkage of a tax credit to the repayment of principal on the bonds severely limits demand. The history of the various tax credit bond programs has demonstrated that there is insufficient overalp between investors in need of tax credits and investors seeking to invest in municipal bonds. The size of the tax credit bond programs and the resulting lack of liquidity is not the only problem for tax credit programs. As long as there is a disconnect between investors seeking tax credits and investors seeking more traditional fixed income investments, there will be a substantial inefficiency in the tax credit bond programs (that is, the full value of the tax credit will not be fairly reflected by the market resulting in too little of the subsidy going to the issuer of the bonds). As indicated above, the best illustration of this is the fact that the strongest marginal investors in taxable bonds are institutional investors, directly or through mutual funds that comingle individual investor funds, and that the substantial pool of investors that pay little or no federal tax, such as pension funds, foreigners and life insurance companies, would have little or no interest in the tax credits. Further, investors who are interested in tax credits must factor in their uncertain long-term need for the credits and potential changes in tax law.

Stripping of tax credits is not a solution. The response to the disconnect between investors seeking tax credits and investors wanting to invest in municipal bonds led to the idea of permitting the principal on the tax credit bonds and the tax credits to be separated or "stripped." The idea is that this mechanism would enable those investors who want tax credits to purchase them without having to purchase the underying security and, correspondingly, investors wishing to invest in municipal bonds could just buy the bonds and whatever reduced interest rate coupon is paid on the bonds (given the tax credit rate). Two problems quickly became evident with the stripping of tax credits. First, the process of stripping tax credits and regulating this process is exceedingly complex, creating costs for both the IRS in administering a tax credit-stripping program, and in the marketing of these credits. Naturally, these costs drive down the benefit of the related tax credit bond program. A more challenging problem is that investors in bonds seem to want bonds that pay a more traditional interest rate, rather than all principal (in the case of a QZAB) or a substantially reduced interest rate (in the case of other tax credit bonds). In other words, investors in bond principal tend to also want a bond that pays a market rate of interest--there is simply not enough demand for bonds that are effectively zero coupon or reduced coupon discount bonds. Once again, this inconsistency with what the market desires (and is able to get from other taxable securities) reduces the pool of potential investors, drives up the cost of borrowing using tax credit bonds, and reduces the subsidy to the issuers of the bonds. These stripped credits -- four per year -- are also very small compared to the associated bond principal amount, further reducing demand for these credits. Moreover, many believe that a successful tax credit stripping program will result in Congress eventually repealing the ability to strip tax credits and point to the experience with “safe harbor leasing” in the early 1980s when there was Congressional condemnation of a program that enabled highly profitable companies to avoid paying taxes by essentially purchasing tax benefits. When these factors are taken together, the result is a discount rate (or borrowing cost) that would have to be considerably higher than that of a traditional taxable security. In the case of small issuers with even smaller tax credits, matters would only get worse.

Investor uncertainty with respect to tax credit bonds. It would also appear to be the case that potential investors are uncertain regarding the future treatment of tax credit bonds and, therefore, factor in a risk premium in the prices that they are willing to pay for these bonds and tax credits. It is believed that investors are concerned that Congress might eliminate the tax credits previously provided on tax cerdit bonds or could make other changes to these tax credits that reduce their value. While these concerns could be said to exist for traditional tax-exempt bonds, the long history of favorable treatment and perceived low risk of retroactive changes in tax law (with the possible exception of the President's recent proposals to cap the value of tax exempt interest at 28 percent for high income taxpayers) provides strong demand and liquidity for this debt structure. Whether rational or not, this perception of investors impacts the value of tax credit bonds and, accordingly, the cost and efficiency of the program. Investors and issuers of bonds also are concerned with the direct involvement of the federal government in tax credit bond programs

Conclusion. For many years, economists and legislators believed that tax credit bonds could provide a more efficient means of subsidizing the borrowing costs of State and local governments as compared to tax-exempt bonds. In fact, the experience with a variety of tax credit bond programs in recent years has proven that this is clearly not the case. Tax credit bonds possess their own inefficiencies for the Treasury Department as well as for issuers of these bonds. For a variety of reasons, the issuers of tax credit bonds (and the Treasury Department) have been getting far less financing assistance from tax credit bonds than the amount of tax credit that is provided by these bonds. While some of these problems might be cured over time, the market's experience with tax credit bonds and nature of the inefficiencies demonstrate that these problems will not go away and that tax credit bonds are not, after all, a better mousetrap. The bottom line analysis should focus not on perceived efficiencies of one program as compared to another but on which program provides the lowest funding cost for State and local governments. Related to this, the fact that some investors may get a greater benefit than others should also be irrelevant in the context of what the best financing program is for municipalities. Finally, tax credit bonds do not provide savings to issuers when compared to tax-exempt bonds.