Direct vs. Indirect Federal Bond Subsidies: New Evidence on Cost of Capital

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Key Historical Observations

- It is important to recognize the major structural differences in the tax-exempt market and taxable markets with respect to optionality

- Higher percentage of BABs were issued with make-whole call due to the lower acceptance of call options from investors of taxable bonds

- Make-whole calls forgo value of call option for future potential refundings for savings

- BABs issued in 2009 were predominantly issued with the make-whole call and then as 10-year par calls gained more acceptance more deals were issued with them in 2010

- Evaluating life cycle is important as municipal issuers have a history of issuing callable bonds that they anticipate refunding – over the last 10 years nearly 50% of issuance has been refundings

- BABs were impacted by Federal Sequestration – reducing their “savings” and increasing budget uncertainty for municipal issuers

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1 Source: SDC, includes categories both refundings and those with multi-purpose
Considerations for Reauthorizing Direct Subsidy Bonds

- Overall low interest rate environment
- Healthy tax-exempt municipal market with strong investor participation
- Ratios of taxable interest rates versus tax-exempt
- Tightening of credit spreads for municipal issuers
- Taxable issuance in 2021 and 2020 is at similar issuance levels as during 2009/2010 (20-30%) compared to the average of 8%\(^1\)
- With the increase in taxable issuance, the buyer base for taxable debt has grown
- Increased acceptance of par call options on non-index eligible taxable bonds
- Cost of par call options has decreased on non-index eligible taxable bonds
- Level of subsidy offered to issuers – 28% may not work for a higher rated issuer
- Historical use of sequestration on BABs and the lack of “trust” in the use of Federal government programs
- Incorporating direct subsidy into pledged revenues as defined by bond documents

\(^1\) Source: SDC
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