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MUNI MARKET UPDATE

May 17, 2010

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TAX CREDIT BONDS: A NICHE MARKET?

By Larry Levitz

Investors may have heard of tax credit bonds from the Stimulus Act, also known as the American Recovery and Re-investment Act of 2009 (ARRA). Instead of interest, tax credit bond investors receive tax credits that they can use to offset their tax liabilities. ARRA authorized almost $30 billion of tax credit bonds for 2009 - 2010, a substantial increase over the $1.6 billion of tax credit bonds sold since 1997. One of goals for the tax credit program was to foster capital spending for specific purposes: school construction, school improvements, clean renewable energy projects, and energy conservation. Another innovative product of

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THIS WEEK'S CALENDAR

E.D.T.	Amount	Ratings	Issuer	State	Structure	
Monday, May 17						
ROP	380,000M	AA1/AAA/AAA	NYC TFA Fut Tax Secured Fisc 2010 Sub Ser H Ser I-2	NY	2010-2021 2011-2027	
11:00AM	5,322M	UR/UR	T/O Wilbraham	MA	2012-2016	BQ
11:15AM	9,540M	UR/UR	State Pub Sch Bldg Auth	PA	2012-2031	BQ
Tuesday, May 18						
ROP	380,000M	AA1/AAA/AAA	NYC TFA Fut Tax Secured Fisc 2010 Sub Ser H Ser I-2	NY	2010-2021 2011-2027	
10:45AM	70,000M	UR/UR	NYC TFA - TAXABLE	NY	2012-2015	
11:00AM	1,389M	UR/UR	Magnolia Borough	NJ	2011-2022	BQ
11:15AM	20,000M	UR/UR	NYC TFA - TAXABLE	NY	2011-2012	
11:00AM	1,876M	UR/UR	Tuckahoe UFSD	NY	2011-2030	BQ
11:00AM	44,900M	UR/UR	Sumter Co	SC	2011-2017	
11:00AM	55,460M	UR/UR	VA College Bldg Auth	VA	2011-2017	
11:30AM	8,415M	UR/UR	Locust Valley CSD	NY	2011-2018	BQ
11:00AM	7,860M	UR/UR	Washington Co - SERIES A	MD	2011-2020	BQ
11:00AM	14,295M	UR/UR	Washington Co - RFDG	MD	2011-2021	BQ
11:30AM	22,310M	UR/UR	MD Econ Dev Auth	MD	2011-2022	
Wednesday, May 19						
Neg	380,000M	AA1/AAA/AAA	NYC TFA Fut Tax Secured Fisc 2010 Sub Ser H Ser I-2	NY	2010-2021 2011-2027	
11:15AM	9,749M	UR/UR	Park Ridge Boro	NJ	2010-2030	BQ
11:00AM	451,100M	UR/AA	S/O Pennsylvania GO	PA	2011-2021	
11:30AM	96,205M	Aa2/UR	Suffolk Co	NY	2011-2028	
12:00PM	548,900M	UR/AA	S/O Pennsylvania - BABs	PA	2022-2030	
Thursday, May 20						
11:00AM	13,680M	UR/UR	Hartford Co Met Dist	CT	2011-2022	
11:00AM	253,980M	UR/UR	NY Local Govt Assistance Corp	NY	2011-2025	
11:15AM	2,514M	UR/AA+	Pennington Borough	NJ	2013-2030	BQ
11:30AM	2,960M	UR/AA	North Colonie	NY	2010-2021	BQ
11:30AM	10,394M	UR/UR	C/O Utica - 8,664M T/E 1,730M TAXABLE	NY	2011-2024 2011-2020	BQ
12:15PM	6,810M	UR/UR	Colonial SD	PA	2010-2018	BQ

Click here for calendar updates.

TAX CREDIT BONDS: A NICHE MARKET? (CONT'D)

the Stimulus Act was Build America Bonds (BABs). BABs can be issued as either tax credit bonds or direct subsidy bonds. Direct subsidy BABs are bonds that pay taxable interest issued by state and local governments in which the federal government directly subsidizes issuers' interest payments. Direct subsidy BABs were intended to revive the then-moribund municipal market by targeting investors who do not usually participate in the tax-exempt market such as pension funds and foreign investors. Since passage of ARRA in February 2009, direct subsidy BABs have become extremely popular with investors, as over $100 billion of bonds have sold so far. Tax credit bonds, including tax credit BABS, on the other hand, have fizzled. Only $2.7 billion of tax credit bonds were sold in 2009.

This past March, Congress acknowledged the anemic state of the tax-credit market by allowing issuers in the major tax credit bond programs the option of issuing a BABs-like federal subsidy bond instead of a tax credit bond. The subsidy would be equal to the permitted tax credit. Since the announced change, most issuers are choosing the BABs approach. Why did tax-credit bonds fail to catch on with both issuers and investors? Do tax credit bonds have a future? This article will provide some basic information on tax-credit bonds, discuss how they work, explore why a significant market has yet to develop and speculate on future prospects for a viable tax-credit bond market.

How Tax Credit Bonds Work

Tax credit bonds are municipal obligations that are issued by state and local governments. Instead of paying interest, tax credit bonds compensate investors by allowing them to claim a federal tax credit. The issuer pays zero or little interest.

The Treasury Department calculates the size of the tax credit by multiplying the credit rate against the outstanding bond principal. The credit rate is set daily based on the Treasury's estimate of the yields of certain similar investment grade taxable bonds. The credit rate listed on the day before the bond sale will be the applicable credit rate for the entire term of the bonds.

At the same time, Treasury sets the maximum term of the bonds according to a formula such that the bond term usually averages between

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VISIBLE SUPPLY

The 30-day visible supply of municipal bonds totaled $13.012 billion, up $3.671 billion from the previous session, according to The Bond Buyer.

That comprises $2.768 billion of competitive bonds, which is up $517.9 million and $10.244 billion of negotiated bonds, which is up $3.153 billion.

Week of May 10, 2010

Total supply: $7.57B

Taxable/BABs: $2.08B

Tax-Exempt: $5.48B

Week of May 17, 2010

Total supply: $8.07B

Taxable/BABs: $2.39B

Tax-Exempt: $5.68B

The 30-day visible supply is calculated by The Bond Buyer and reflects the total dollar volume of bonds to be offered at competitive bidding and through negotiation over the next 30 days.

Source: Thomson Reuters. 5/14/2010.

STIMULUS SPEED CHART

ProPublic has on its web site a chart tracking how fast federal agencies are getting stimulus money out the door.

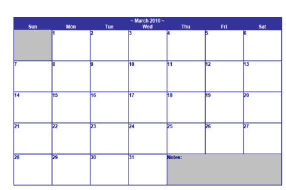
The data trace what portion of an agency's total appropriation under the American Recovery and Reinvestment Act has been spent or is in process. Users can drill down by agency. ♣

MUNI MARKET UPDATE

This week saw a flight to quality, with Treasuries climbing after falling earlier in the week. The euro weakened, closing at 1.2355, while the stock market closed at 10,620.16.

The municipal market did not see benefits from the taxable bond market rally. Munis traded slightly stronger in the short end and intermediate range. ♣

ECONOMIC CALENDAR



TAX CREDIT BONDS: A NICHE MARKET? (CONT'D)

14 to 17 years. Congress intended the credit rate to be set so that bonds would sell at par without additional interest expense. In practice, however, the credit rate assigned to the bonds is often not sufficient to attract investors. In those situations, either the bonds are sold at a discount or with supplemental interest payments or are not sold at all.

Tax Treatment for Buyers

The investor treats the tax credit as taxable income similar to other taxable interest receipts on the investor's tax returns. For example, if an investor with a marginal 30% tax rate holds a $5,000 tax credit bond with a 5% credit rate, then the actual annual tax credit of $250 (5% of $5,000) would be reported as taxable income with an associated tax liability of $75 (30% tax rate multiplied by $250). The investor would then offset this $75 tax liability with the $250 tax credit for a net gain of $175 ($250 less $75). This represents an equivalent net benefit to the investor as owning a $5,000 taxable bond with a 5% interest rate.

Limited Buyer Demand

Theoretically, the circumstances under which investors should prefer tax credit bonds to other bonds of similar terms and credit quality would be if the tax credit rate is greater than either the after-tax yield on municipal bonds or the actual yield on corporate bonds. In practice, other factors such as the thin market for tax-credit bonds or their complexity weigh in on the investor's decision.

Stripping the Tax Credit

The tax credit can be taken proportionately on a quarterly basis and is reduced to the investor's total tax liability if that liability is less than the tax credit. In such a case, the excess tax credit can be carried forward to the next year. Investors can "strip" or in other words separate the tax credit from the bond principal and either sell or transfer them to other parties. Conversely they can keep the tax credits and sell the principal.

ARRA New and Expanded Programs

ARRA created or expanded a number of existing tax credit bond programs with new bonding authorizations, as shown in the chart on the following page.

Investors in QECBs and CREBs receive 70% of the tax credit while QZABs and QSCBs receive 100% of the tax credit. Investors in tax credit BABs would receive a tax credit equal to 35% of the taxable interest payment.

Bullet Maturities Maximize Tax Credits

An example of a tax credit transaction is the $30 million West Virginia School Building Authority Excess Lottery Revenue Bonds, Series 2009A (Tax Credit Bonds), the first state-issued QSCB. The bonds were sold in July 2009 and proceeds are used to construct, rehabilitate, and repair public schools around the State. The issue was underwritten by Citigroup and sold to Guggenheim Partners, LLP, a privately held financial services firm. The Bonds are structured as a 15 year bullet with the entire $30 million principal coming due on June 15, 2024.

Most tax credit bonds have bullet maturities in order to maximize the amount of tax credits available to investors. As is typical with tax credit bonds, the issuer covenants to make equal annual payments into a sinking fund so that the accumulated funds will be sufficient to redeem principal at maturity. For the Authority, its required annual payment is $2 million a year for each of the next fifteen years.

Treasury regulations limit the amount of arbitrage that can be earned on monies in the dedicated

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Tax Liability			
Other Income	$5,000.00	Other Income	$5,000.00
Interest Coupon	5%	Tax Credit	5%
Taxable Income	$5,250.00	Taxable Income	$5,250.00
@ 35% Tax Rate	$1,837.50	@ 35% Tax Rate	$1,837.50
Less: Tax Credit	$0.00	Less: Tax Credit	$250.00
Tax Liability	$1,837.50	Tax Liability	$1,587.50
After-Tax Income			
Cash Income	$5,250.00	Cash Income	$5,000.00
Less: Tax Liability	$1,837.50	Less: Tax Liability	$1,587.50
After-Tax Cash	$3,412.50	After-Tax Cash	$3,412.50

TAX CREDIT BONDS: A NICHE MARKET? (CONT'D)

sinking fund account. The tax credit rate for the issue is 6.92% so that the annual tax credit amount of $2.076 million is divided into quarterly tax credit allowances of $519,000 on September 15, December 15, March 15, and June 15, of each year.

The tax credits can be used to reduce the amount of the holder's tax liability either on its subsequent quarterly payments or its final tax liability in the related tax year. The tax credits can be stripped and sold. The bonds are not subject to optional redemption but are subject to extraordinary mandatory redemption if bond proceeds are not fully spent in three years.

Limited Investor Interest

Given that only a small fraction of tax credit bonds authorized by ARRA have been issued and the great majority

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Program	Purpose	American Recovery and Reinvestment Act	Hiring Incentives to Restore Employment Act	Small Business and Infrastructure Jobs Tax Act
Status		■ Signed into law on 2/17/2009	■ Signed into law on 3/18/2010	■ Pending Senate Vote
Qualified School Construction Bonds ("QSCBs")	■ New public school construction and rehabilitation	■ $11 billion authorized each in 2009 and 2010 ■ Tax credit is 100% of tax credit rate	■ Can be issued as direct-payment instead of tax-credit bonds ■ Issuers would get payments equal to the lesser of the actual interest rate of the bonds or the tax-credit rate for municipal tax-credit bonds, which the Treasury sets daily	■ Extends through 4/1/13
Qualified Zone Academy Bonds ("QZABs")	■ School renovation in needy areas	■ $1.4 billion authorized each in 2009 and 2010 ■ Tax credit is 100% of tax credit rate	■ Can be issued as direct-payment instead of tax-credit bonds ■ Issuers would get payments equal to the lesser of the actual interest rate of the bonds or the tax-credit rate for municipal tax-credit bonds, which the Treasury sets daily	■ Extends through 4/1/13
Clean Renewable Energy Bonds ("CREBs")	■ Wind, biomass, geothermal and other clean energy project	■ $2.4 billion authorized ■ Tax credit is 70% of tax credit rate	■ Can be issued as direct-payment instead of tax-credit bonds ■ Issuers would receive payments equal to 70% of interest costs	■ Extends through 4/1/13
Qualified Energy Conservation Bonds ("QECBs")	■ Projects which reduce energy consumption	■ $3.2 billion authorized ■ Tax credit is 70% of tax credit rate	■ Can be issued as direct-payment instead of tax-credit bonds ■ Issuers would receive payments equal to 70% of interest costs	■ Extends through 4/1/13
Recovery Zone Economic Development Bonds ("RZEDBs")	■ Public infrastructure and facilities projects in recovery zones	■ $10 billion authorized ■ Tax credit is 45% of taxable coupon		■ Extends authority to issue RZEDBs for one year through 12/31/11 ■ $10 billion authorized

TAX CREDIT BONDS: A NICHE MARKET? (CONT'D)

have been QSCBs, why have tax credit bonds received such a poor reception? Reasons include the general unfamiliarity with the product and the complexity of the tax credit mechanism. Two factors cited by market participants may have been critical in preventing the development of a bona fide tax credit bond market -- the inadequacy of tax credit rates and the long delay in issuing federal guidelines for tax credit bond stripping.

Inadequacy of Treasury-Set Tax Credit Rates

The methods by which The Treasury Department determines tax credit rates fail to account for differences in credit quality, deal structure, and market characteristics between the referenced bonds and the actual bonds.

In addition, the thinness of the investor base and absence of a vital secondary market compel investors to demand higher yields, especially for lower rated issuers. Also, tax credit rates have been dropping since the middle of 2009 from the 7.5% to 8% range to 6%. As a consequence, most tax credit issues after mid-2009 could only be sold with taxable supplemental interest payments.

The largest QSCB issuer, the Los Angeles Unified School District (LAUSD) sold $318 million of QSCB tax credit bonds in October 2009. The fifteen-year bonds carried a credit rate of 5.96% but the School District was forced to offer a supplemental interest payment at a 1.54% rate.

Oakland, CA Unified School District added a 2.82% supplemental coupon while Stockton USD had to pay 2.19% in supplemental interest.

A change in the Treasury Department's methodology for establishing a credit rate, which better reflects specific market pricing, should help minimize or eliminate the supplemental payments and bring more investors into the mix.

Treasury's Guidance for Tax Credit Stripping

The second factor, the federal government's long lag in issuing guidance for tax credit bond stripping, has hindered the growth of an active tax credit market.

By enabling tax credit issues to be structured with both debt and tax credit equity, stripping expands the investor base by appealing to different investor needs. Stripped tax credits are attractive to insurance companies, banks, hedge funds, high net worth individuals, and others with substantial tax obligations. On the other hand, the stripped principal, essentially a zero-coupon bond, may interest investors looking for diversification and longer duration investments such as pension funds.

Guggenheim Partners LLP, has purchased about $1.2 billion of QSCB bonds, nearly half of the total sold for placement. Its intent was to strip the bonds and sell some or all of the components to investors, particularly to its insurance company clients. The lack of federal guidance on stripping prevented the firm from implementing its plan.

Scott Minerd, chief investment officer at Guggenheim, discussed the importance of stripping to an expanded tax credit bond market in the Bond Buyer. *"Allowing stripping for QSCBs would be hugely beneficial to the program and ultimately to the schools,"* He continued, *"Without stripping, there's a limited appetite for these securities in the long run ... You've eliminated at least 85%-90% of all the buyers of bonds in the world, if not more."*

More than one year after the passage of ARRA on March 23, 2010, the Treasury Department released its interim guidelines on stripping tax credit transactions.

At the same time, Congress recognized the paucity of tax credit bond issuance by providing the direct subsidy option on tax credit bonds.

It is instructive that even before ARRA, observers identified many of the difficulties involved in creating a functioning tax credit bond market. In a 2002 report, Sara Mead of the Progressive Policy Institute analyzed the small QZAB program then in effect. She cited the complex nature of the program and low tax credit rates as important investor concerns. Mead concluded by expressing skepticism as to whether sufficient buyers would be available if tax-credit bond programs were scaled up significantly.

Future of the Tax Credit Bond Market

Will a sustainable tax credit bond market ever exist? Many municipal market participants think it might. In the Securities Industry and Financial Markets Association (SIFMA) 2010 Municipal Issuance Survey conducted during November 2009, respondents representing the top securities firms projected that tax credit bond issuance would total $5 billion in

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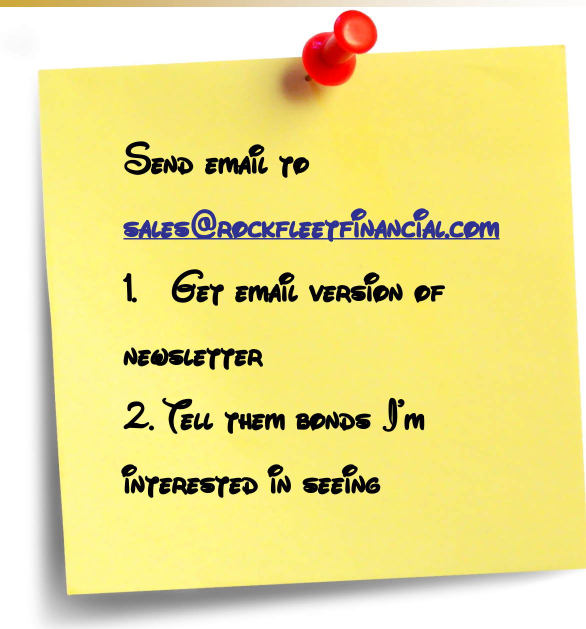

TAX CREDIT BONDS: A NICHE MARKET? (CONT'D)

2010, double the actual issuance in 2009.

The appeal of tax credit bonds may be enhanced if the federal government continues to reduce or eliminate interest rate subsidies. Congress is considering lowering its payment rate for direct subsidy BABs and federal deficit issues may put additional pressure on the program. If that should occur, the tax-credit bond alternative may start to look better.

The recently issued federal guidance on tax stripping could further spur the development of an active market as a recovering economy produces higher tax liabilities.

This past February, Senators Ron Wyden and Judd Gregg proposed the elimination of tax-exempt bonds, to be replaced with tax-credit bonds. The proposal aroused strong negative reactions from the municipal bond community who pointed to the disappointing state of the tax-credit bond markets as major argument against the proposal. While the bill is unlikely to pass as proposed, it does keep the idea of tax-credit bonds in the spotlight.

Tax credit bonds will remain a niche product for a specialized group of investors. These investors are generally sophisticated with specific tax-reduction needs.

Investors should enter into tax-credit bond market only if they fully understand the mechanics of the tax credit and have a reasonable expectation of ongoing future federal tax liabilities. Given the current lack of a viable secondary market, these bonds should be considered as part of an investor's buy and hold strategy. ♣