A Reintroduction of the American Infrastructure Bonds Act (Build America Bonds 2.0)

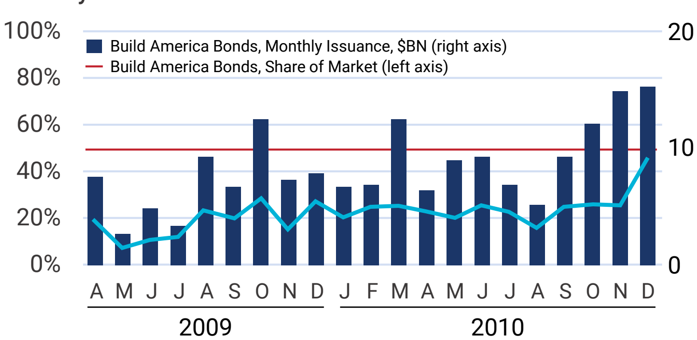
In July 2020 and April 2021, a group of senators reintroduced a bill that would create American Infrastructure Bonds (AIBs), whose interest would be partially covered by the federal government. The program is loosely based on the Build America Bonds (BABs) Program from 2009 and 2010. This perspective will provide a review of the original BABs program, highlight what was learned from BABs, and cover the proposed new AIB program.

History of BABs

BABs are governmental bonds eligible for certain tax advantages under the Internal Revenue Code.[1] BABs were generally issued by states or local political subdivisions. The program was introduced in April 2009 as part of President Obama's American Recovery and Reinvestment Act (ARRA) to create jobs and stimulate the economy after the 2008/2009 financial crisis. The issuing of BABs ended in December 2010 after the program expired, but many BABs are still outstanding today. According to the U.S. Treasury, over $180 billion of BABs were issued through 2,275 separate issues.[2] Insurance companies were heavy investors in BABs along with mutual funds, foreign central banks, and foreign commercial banks.

BABs were introduced to encourage investment in local areas. The interest rates on these bonds are subsidized by the federal government, making the cost of borrowing for infrastructure projects lower for state and local government issuers.

Monthly BABs Issuance



Source: Bloomberg.

The program was open only to new issue capital expenditure bonds issued before January 1, 2011. BABs could not be issued for refinancing old debts. Some tax-exempt issuers, such as private party issuers and 501(c)(3) organizations, were not eligible to use the BAB program. The capital projects these bonds could fund included work on public buildings, courthouses, schools, transportation infrastructure, government hospitals, public safety facilities and equipment, water and sewer projects, environmental projects, energy projects, government housing projects, and public utilities.

Types of BABs

There were two types of BABs:

- **Tax Credit BABs:** Tax credit BABs offered bondholders and lenders a 35% federal subsidy of the interest paid through refundable tax credits, reducing the bondholder's tax liability. If the bondholder's tax liability were insufficient to use the entire credit, it could be carried forward to future years.
- **Direct Payment BABs:** Direct payment BABs offered a similar subsidy, but were paid to the bond issuer. The U.S. Treasury made a direct payment to BAB issuers in the form of a 35% subsidy of the interest it owed to investors. Since the effective cost of borrowing fell for issuers, they were able to offer the bonds to investors at competitive rates in the markets.

One of BABs Biggest Problems: Sequestration

One of the biggest problems with BABs was that there was no exemption from sequestration (automatic cuts in federal spending) for payments to issuers of direct payment bonds. Unlike discretionary programs that are subject to appropriations, state and local governments undertook a large amount of monies in critical, long-term infrastructure obligations through the issuance of direct subsidy bonds, with the understanding that federal payments related to these bonds would not be subject to the appropriation process but would be made at the percentage required by law until the bonds matured.[3] These projects were planned, and the bonds sold in the marketplace, with issuers borrowing based on the law's stated and ongoing direct payment provision. By making the payments subject to sequester, it effectively increased the costs for individual projects and dampened future enthusiasm or commitment to these or similar programs.[4]

The bottom line: The U.S. government changed the original agreement to offer a 35% subsidy for BABs issuance to a lower subsidy rate and the issuers were forced to make up the difference from the original promised subsidy. From the investor perspective, this makes the bond riskier as you now have more exposure to an issuer that is not the U.S. Government.

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AIBs: BABs 2.0

In April 2021, seven U.S. Senators (Roger Wicker, R-Miss., and Michael Bennet, D-Colo., were joined by Senators Roy Blunt, R-Mo., Debbie Stabenow, D-Mich., Shelley Moore Capito, R-W.Va., Tim Kaine, D-Va., and Cynthia Lummis, R-Wyo.) reintroduced the "American Infrastructure Bonds Act of 2021," legislation that would create a new class of "direct-pay" taxable municipal bonds to help governments finance critical public projects as the nation seeks to renew its infrastructure. The senators' proposed AIBs would improve upon the model of **BABs** to attract more investment in public infrastructure.[5]

> The bonds would be modeled as a **"direct-pay"** taxable bond, with the U.S. Treasury paying a percentage of the bond's interest to the issuing entity to reduce costs for state and local governments. These payments would be issued for projects at 28% of the bond's interest.

The AIBs would enable local communities to develop their infrastructure strategically without the burden of a centralized bureaucracy or the constraint of a state cap on allocation. As an additional benefit, the payments from the U.S. Treasury to issuers would be exempt from sequestration (no cut in subsidy), which would increase the confidence in the bonds by the bondholder and bond issuer alike.[6]

Lessons Learned and Recommendations

- **Subsidy Changes:** The U.S. Government can change its mind. Even if the new AIBs are not subject to sequestration, the subsidy can still be at risk. As administrations change, they could enact something else that is not sequestration but still alters the subsidy. CCM only purchased **BABs** that did not rely on the subsidy to make the principal and interest payments. Some of the deals that did rely on the subsidy had problems. In fact, some states chose to not issue or stopped issuing **BABs** because they did not trust the reimbursement. *For the proposed new AIBs, we recommend only purchasing bonds that can continue to pay if the subsidy is cut.*
- **Payment Requests:** Issuers have to request every payment by submitting form 8038 to the IRS, and if they do not, the payment will not be sent. Under **BABs**, if the issuer did not physically request the biannual payment from the government, then it did not get paid. In some instances, the person responsible for requesting the payment was delayed in getting the paperwork, which meant the subsidy was not paid on time. *For the proposed new AIBs, we are hopeful that there will be an automated and automatic system for payments.*
- **Call Risk:** In the **BABs** CCM purchased, we had different levels of call risk introduced as a result of sequestration. We went through and coded which bonds could be called at par and which bonds had "make-whole" language to ensure what the premiums entailed. *For the proposed new AIBs, we strongly recommend investors know the call risk prior to purchase, particularly under what circumstances and at what price.*

Will AIBs Work?

We are hopeful the proposed AIBs will work but there has to be enough support in Washington. Often, politicians have other pressing items on their agendas. Additionally, we think, for AIBs to be cost effective for the issuers, the subsidy should be at least 32% (not 28%). The devil is in the details and a lot of details need to be worked out. Ultimately, it might come down to what can Congress pass and in what form. We are supportive of any assistance to state and local governments to promote investment in infrastructure. However, items that still need to be addressed include (i) language promising the subsidy will not change as it did for **BABs**; (ii) list of eligibility requirements; and (iii) an automated and less cumbersome payment process. Global investors participated in **BABs** and we anticipate them participating in AIBs too. More investors creates a broader, more diverse market. In the end, AIBs could play a vital role in future infrastructure initiatives and job creation opportunities, helping communities around the country.

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[1] *https://www.irs.gov/pub/irs-tege/arra_baba_final_shw_qa.pdf*
[2] *https://www.yumpu.com/en/document/read/12427942/treasury-analysis-of-build-america-bonds-issuance-and-savings-*
[3] *https://www.ncsl.org/research/fiscal-policy/babs-sequestration.aspx*
[4] *Ibid*
[5] *https://www.wicker.senate.gov/public/index.cfm/2021/4/wicker-bennet-colleagues-reintroduce-american-infrastructure-bonds-act*
[6] *Ibid*

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