

PROVIDING DIRECTION  
PRODUCING RESULTS

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## Some Intelligent BABling

**B**uild America Bonds (BABs) were the “big thing” for public finance in 2009. Consider the following results reported by *The Bond Buyer*:

- More than \$64 billion in BABs were issued in 2009.
- BABs significantly increased the use of taxable bonds. One-fifth of all municipal debt issuance (\$84.47 billion) was in the form of taxable bonds. This market share is double the next highest year (10.7% in 2003).
- Issuance of tax-exempt bonds fell by 5.3% in 2009.

If you issued bonds in 2009 or plan to issue in 2010, BABs should be on your planning checklist. Here are some things you need to know.

### Requesting Payment

BABs allow issuers to receive federal payment equal to 35% of the interest expense. The payment is not automatic and must be requested by the issuer. Issuers must submit IRS Form 8038-CP to request an

interest subsidy payment. Form 8038-CP was revised in January 2010. This form can be found at <http://www.irs.gov/pub/irs-pdf/f8038cp.pdf>. The new form allows for direct deposit of subsidy payments. An electronic payment system is under development.

It is important to understand the timing connected with the subsidy payments. To ensure timely payment, the Form 3038-CP should be filed no later than 45 days prior to the interest payment date. The Form may not be filed more than 90 days in advance.

### Compliance Check Questionnaire

The IRS has started collecting information on “the post-issuance and record retention policies, procedures and practices of issuers of Direct Pay Build America Bonds”. This information is being collected through Form 14127 – “Direct Pay Bonds Compliance Check Questionnaire”. Distribution of this Form began in early February and will continue on an ongoing basis.

Pay close attention to the cover letter that accompanies the Form. The top right section of the

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## Refunding Review

**W**ith the exception of a large hiccup in 2008 and 2009, long-term tax-exempt interest rates have followed a consistent pattern. Rates have been a roller coaster of peaks and valleys (see chart on right). These valleys create opportunities to refinance existing debt. In these times of limited financial resources, it has never been more important to make the most effective use of the savings from refinancing. This is a good time for a brief refresher course on the ins and outs of refunding.

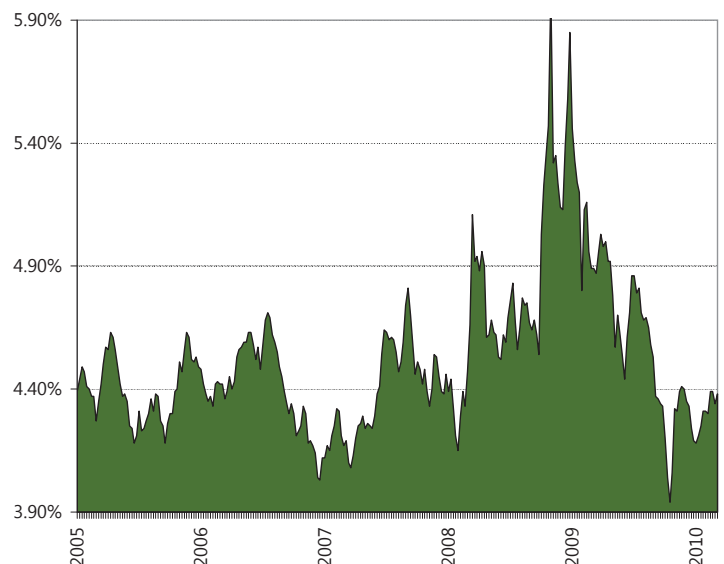
### Basic Terms

Before discussing the intricacies of refunding, some basic terms need to be defined.

- **Call Date.** Unlike your home mortgage, municipal bonds cannot be prepaid at any time. As part of the original offering terms, the issuer sets a “call date”. This is the first opportunity to prepay outstanding principal, calling bonds back from the investor.
- **Advance Refunding.** Just because the call date occurs in the future does not mean that the issuer must wait before refinancing. An advance refunding allows the issuer to issue refunding bonds

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## Qualified School Construction Bonds

When the American Recovery and Reinvestment Act (ARRA) was passed in February of 2009, it introduced new opportunities for public entities to borrow at reduced cost. The ARRA introduced a series of interest subsidy, tax credit and conduit bond options. The direct payment form of Build America Bonds (BABs) has been the most widely used of these options. An important, but little used, ARRA tool is Qualified School Construction Bonds (QSCBs).

The intent of QSCBs is to allow school districts to borrow money at a 0% interest rate. The school district would issue bonds and instead of paying interest on these bonds, the Federal Government would provide a tax credit to the bond holder in lieu of an interest payment. This turned out to be a great concept that is unfortunately mismatched with the financial realities of 2010. There are very few buyers of tax credits in a normal economy (even fewer in a distressed economy) and the typical buyers of tax credits (financial institutions) currently have their own financial issues that limit their appetite for tax credits.

Nonetheless, limited markets evolved and QSCBs began to sell late in 2009. Unfortunately, the bonds failed to realize the 0% interest

rate originally intended by Congress. QSCBs encountered two basic problems. The first problem was the inability to strip off the tax credits for sale to an investor, like prior tax credit bonds. This limitation required QSCBs with tax credits to be sold to a single investor interested in both tax credits and interest-paying bonds. This condition led to the second problem. The depressed value of tax credits required issuers to provide a supplemental interest payment in order for the investor to receive an acceptable return.

These factors contributed to the limited use of QSCBs. The ARRA authorized \$11 billion of QSCB allocation for 2009. When the allocations were given to each State in the Spring of 2009, it was understood that the same amount would be given to each state in 2010. By the end of 2009, only \$2.4 billion (22% of the authorized allocation) had been sold.

Congress has now proposed an amendment to address these problems. Instead of giving a tax credit to the bond holder, the issuer would issue a taxable bond and the Federal Government would reimburse the issuer 45% to 65% of their interest expense. This approach mirrors other ARRA options - Build America Bonds (35% interest subsidy) or Recovery Zone

Economic Development Bonds (45% interest subsidy).

The amendment is moving slowly through Congress. The Qualified Tax Credit amendment to the ARRA was attached to the Jobs Bill. The House of Representatives passed their version of the Bill in December of 2009. The amendments were expected to pass the Senate in early 2010. Unfortunately, the amendment was attached to another large piece of legislation, has gotten stalled and experienced several revisions. Work continues on the Jobs Bill with adoption hoped for in the coming weeks.

Like many aspects of ARRA public finance initiatives, QSCBs bring intriguing opportunities with often frustrating details. In these challenging economic times, all opportunities to reduce the cost of public debt must be carefully explored and evaluated. Northland continues to seek markets for the current form of QSCBs. We will have information on amendments to the program as soon as possible following adoption and subsequent distribution of issuing guidance. For more information on QSCBs, please contact Toby Morris at (605) 224-5557.

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cover letter includes the response due date for the Form. We strongly encourage you to promptly complete and return the Compliance Check Questionnaire. It is likely that you will have questions about the appropriate responses to Form 14127. Do not hesitate to contact your bond counsel or financial advisor with your questions.

#### Points to Remember

While simple in concept, the use of BABs is subject to some requirements not part of your typical tax-exempt bond issues.

- Bond proceeds may not pay for costs of issuance exceeding 2% of the bonds.
- The issue cannot include capitalized interest beyond the date the improvements are placed in service.
- In addition, only 65% of needed capitalized interest can be included in the issue since federal reimbursement will cover the other 35%.
- The terms of sale must include specific restrictions on the ability to reoffer the bonds at a premium.
- Issues should contain an "extraordinary

call" provision that allows the issuer to immediately call and prepay all outstanding principal in the event that, for any reason, the issue becomes ineligible as a BAB or the federal government no longer provides the subsidy. Taxable BABs may be refunded with tax-exempt bonds.

#### Market Conditions

The economics of BABs varies over time with changes in taxable and tax-exempt interest rates. Issuers should make some form of market check a part of the sale process. For competitive sales, bidders should be able to submit taxable BABs and tax-exempt bids. For negotiated sales, a pre-pricing comparison of BABs and tax-exempt should be performed. These steps help the issuer to be assured that the sale will achieve the lowest effective interest expense.

#### Looking Ahead

The *current* authorization for the issuance of BABs ends on December 31, 2010. There appears to be growing support for extending the BAB program. Extension does not mean that the program will be the same. One area

of discussion is the amount of the subsidy rate for future BABs. The Administration's FY 2011 budget proposed dropping the rate to 28%. There does not appear to be congressional support for a drastic change in the subsidy rate. At some point, a reduction in interest subsidy eliminates the economic advantage of BABs over tax-exempt bonds.

Extension of the BABs may also come with new procedures. The contents of the Compliance Check Questionnaire suggest some potential areas of interest to the IRS. Interest subsidy and direct payment options are being explored as alternatives to tax credit programs. Few issuers have used the option to issue the current version of BABs as tax credit bonds.

The information in this newsletter is based on sources believed to be reliable, but does not purport to be complete and is not warranted by Northland Securities, Inc.

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and lock in low rates prior to the Call Date. The proceeds of the new, refunding bonds are set aside and used to prepay the existing bonds on the call date. Some different types of advance refunding are described below.

- **Refunding Escrow.** The proceeds of an advance refunding bond are placed in an escrow account. Monies in the Refunding Escrow are used to retire existing debt on the Call Date. Depending on the type of refunding, money in the Refunding Escrow is also used to pay debt service on the refunding or the refunded bonds. The ability to invest monies in the refunding escrow is an important factor in the economics of refunding.

### Types of Refundings

There are several basic types of refundings and it is important to know the characteristics of each.

The most economically efficient option is the **Crossover Refunding**. This refunding only refinances the principal maturing after the call date. The monies in the Refunding Escrow are used to pay interest on the refunding (new) bonds until the Call Date and then "crossover" to pay off the existing bonds at the Call Date. The issuer continues to pay on the existing debt until the Call Date and then crosses over to begin paying on the lower cost refunding bonds.

The Crossover Refunding typically produces the greatest amount of total savings. Issuers should note that the savings do not occur until after the Call Date.

It is possible to create immediate savings from an advance refunding. A **Full Net Defeasance Refunding** effectively takes existing debt off of the books (as of the closing date for the refunding). The advance refunding bonds borrow enough money to fund the Refunding Escrow at a level that will pay all interest and principal on the existing bonds prior to the Call Date as well as prepay the outstanding principal on the Call Date. Since the existing bonds are "defeased" the issuer immediately begins to pay on the new, lower rate refunding bonds.

Not all refundings occur prior to the Call Date. A **Current Refunding** can be used if the bonds are at or after the earliest Call Date. No Refunding Escrow is needed for a Current Refunding. Bond proceeds are immediately used to call and prepay existing debt.

### Evaluating the Opportunity

Issuers should remember that every issue of governmental purpose tax-exempt bonds is eligible for a single advance refunding. Careful planning and evaluation will help make the most of this opportunity. Here are some factors to consider in planning for the issuance of advance refunding bonds.

**Market Risk.** Every refunding decision is a balancing act between locking in savings and future market conditions that may produce more savings. This evaluation is influenced by the amount of time to the first Call Date. The further away the Call Date, the more chances for market conditions that produce acceptable savings.

**Negative Arbitrage.** Low investment rates reduce the efficiency of the Refunding Escrow. Low investment income requires issuing more refunding bonds to properly fund the Refunding Escrow. Adding refunding bonds reduces the amount of savings. Improved investment rates and a shorter period to the Call Date help to reduce Negative Arbitrage.

**Use of Cash.** Some types of debt build up balances in the debt service fund that can (or must) be used to call bonds and reduce the overall debt. Bonds for public improvements, for example, often receive prepaid assessments.

**Restructuring.** Refundings creates the opportunity to review and evaluate changes in the debt structure. Some restructuring considerations include:

- Altering principal payments to better match dedicated revenues.
- Adjusting savings to free up revenues for other capital projects.
- Extending debt to reduce annual impacts.

### Using a "Trigger"

Refunding opportunities come and go quickly with constantly changing bond and investment rates. In this environment, a competitive sale may not be the best means to achieve your primary objective - maximize savings. A competitive sale sets a fixed sale date, often 4-6 weeks after you first become aware of the refunding opportunity. The competitive sale may produce the lowest rates at a given time, but the window of low rates that started the process may have passed. Look at the chart on Page 1. Few of the low rate periods last for the 4-6 weeks required for the typical competitive sale process.

A more flexible option for refundings is the use of a trigger resolution and the negotiated sale of bonds. The trigger approach uses a

minimum savings threshold, not a fixed sale date, as the criteria for a refunding.

The governing body adopts a trigger resolution that authorizes specific officials to accept a bond purchase agreement when stated savings (and other potential criteria) can be achieved. The agreement is subsequently ratified by the governing body at its next meeting.

The resolution creates the flexibility to sell refunding bonds when conditions merit rather than waiting for a scheduled meeting.

Draft sale documents and rating materials are prepared in advance. This preparation greatly reduces the time needed from concept to sale.

A negotiated sale enhances the ability of the trigger approach to maximize savings.

Bond traders often see the signs of improving market conditions before bonds sales attract lower rates. Getting to the market early may avoid the rate rebound that often comes with increased supply.

The ability to adjust the structure of the refunding bonds and the escrow to respond to changing market conditions is paramount with an advance refunding. The opportunity to realize savings is determined by the interest rate on the new refunding bonds and the investment rate for the Refunding Escrow. Market flexibility allows the issuer to maximize both sides of the equation.

In a negotiated sale, the underwriter engages in pre-sale marketing activities to assess investor interest in an issue, as well as demand for certain structures or maturities. Pre-selling of the bonds creates competition among the investors, enhancing the issuer's position resulting in aggressive or low interest rates. The issuer also has the ability to react to this market response and alter terms of the issue that increase savings without damaging basic financial objectives.

The negotiated sale allows the issuer to shift timing to achieve the best results. A competitive sale is all or nothing at the fixed time to bid. The negotiated sale can extend pricing for days or simply restart weeks later until the savings target is met.

### Conclusion

Refunding existing debt is an important part of the financial management tool kit. With one chance to perform an advance refunding it is essential that issuers clearly understand the issues associated with refunding. Define your objectives for refunding and create a process for issuing the bonds that achieves the best results.