



Build America Bonds – Market Overview and BondEdge Approach

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In February 2009, with the purpose to stimulate the U.S. economy, President Barack Obama signed into law the American Recovery and Reinvestment Act of 2009 (ARRA). This Act includes \$787 billion of federal tax benefits, contracts, grants, loans and entitlements.

The tax benefit component of ARRA provides the ability for state and local governments to issue taxable municipal bonds that can give them access to the conventional corporate debt market. These securities are known as Build America Bonds (BABs) and were first issued in April 2009.

There are two general types of BABs:

- Tax Credit Option: Bondholders receive a subsidy through federal tax credits equal to 35% of the total coupon interest (net of tax credit) from the federal government for the life of the bond.
- Direct Pay Option: Issuers receive a subsidy equal to 35% of the interest paid on the bond for the life of the bond.¹

Local and state governments may issue BABs as long as the bonds issued are not private activity bonds.

BABs have quickly become popular with both issuers and investors, with issuance during 2009 amounting to over \$64 billion.² This accounted for approximately 16% of overall municipal bond issuance in 2009 and is widely expected to account for an even higher percentage of municipal issuance in 2010. In fact, market estimates for 2010 issuance are as high as \$150 billion.³ Driving the high expected issuance in 2010 is the popularity of BABs with issuers and investors, and also as part of the white house's proposed fiscal year 2011 budget, the Obama administration has proposed a permanent extension of the BABs program, with a reduction in the tax subsidy from 35% to 28% after December 31, 2010.

The BondEdge[®] Approach

Interactive Data's BondEdge fixed income platform provides robust fixed income analytics that are bundled together with security master data that provides comprehensive security coverage for more than 2.7 million bonds, including a structured finance library of more than 15,000 U.S. structured deals.

There are three benchmark yield curves employed within BondEdge for the computation of analytic risk measures for \$US denominated securities. Tax-exempt municipal securities utilize a AAA-rated General Obligation (GO) benchmark curve, while analytics for taxable securities are derived by using either an On-The-Run U.S. Treasury Curve or an All Treasury Curve. In addition, option-adjusted spreads, total return simulations and cash flow projections for taxable securities can be also computed by utilizing the U.S. Swap Curve. BABs employ the U.S. Treasury Curve for analytic measures since they are issued as taxable instruments.

BondEdge provides data coverage on BABs via its affiliate Interactive Data Pricing and Reference Data, Inc.'s municipal database. During 2009, Interactive Data added over 6,000 BAB securities to its municipal database. Terms and conditions provided include coupon, maturity, full call schedules, sinking funds, underlying and actual credit ratings, credit enhancement, sector classifications and tax status. It is the tax status field that provides BondEdge the guidance on whether to utilize a tax-exempt or taxable curve for analytic measures. If the Federal Tax Exempt status flag is turned off, BondEdge will consider the bond a taxable issue. State Tax Exempt status flags do not affect the yield curve selection.

¹ For Recovery Zone Economic Development Bonds (RZEDBs), issuers receive a subsidy equal to 45% of the interest paid on the bond for the life of the bond.

² The Bond Buyer

³ Build America Subsidy Cut May Spur \$150 Billion Taxable Munis, Bloomberg Business Week, February 2, 2010

To date, Barclays Capital and Bank of America Merrill Lynch have added BABs to their taxable U.S. fixed income investment grade credit indices. The standard amount outstanding thresholds and composite ratings rules for corporate bonds have been applied to BABs when determining index inclusion status.

Based on published Barclays index data, within the Barclays Capital Credit Index, BABs are included in the non-corporate portion of the Credit Index and are classified within the Local Authority sub-sector. Barclays Capital's predecessor, Lehman Brothers, added taxable municipals to their credit benchmarks in 2003. Prior to the BABs program, taxable municipal securities were typically associated with private activity bonds. The addition of BABs to the taxable municipal bonds within credit indices have significantly increased this security type on a relative basis, but taxable municipals still represent a modest allocation (about 2%) in investment grade credit benchmarks.

BAB Issuance Characteristics

Following below is a description of the overall BABs universe. For this analysis, we have used Interactive Data's coverage of the market (over 6,000 securities through year-end 2009). All percentages cited below are computed by using a market-weighted contribution for each issue (i.e. amount outstanding multiplied by year-end 2009 evaluation).

Maturity/Effective Duration

Through year-end 2009, BABs issuance has been highly focused on the long maturity segment of the yield curve. Less than 15% of BABs have stated maturities less than 10 years. Over 60% of the issuance has been in bonds with stated maturities over 20 years.

The overall effective duration for the BAB universe is 10.30, more comparable to long (e.g. 10+ maturity benchmarks).

Credit Ratings

The BAB security universe is, in overall relative terms, a highly rated one from a credit perspective. Over 70% of BAB securities have been rated AA or higher, with only 13% rated at Baa/BBB. In contrast, approximately 25% of the BondEdge representation of the Barclays Capital All Credit Index is rated at AA or above.

Call Options

Approximately 31% of the BAB security universe has embedded call features, while only about 2% of bonds within the Barclays All Credit Index are callable. As of year-end 2009, approximately 33% of the callable bonds are priced to call (i.e. the yield to any of the call dates is lower than the yield to maturity). This relative high exposure to callable bonds produces a lower convexity for the BABs universe (0.75) compared to other long term indices (e.g. the convexity of the BondEdge representation of the Barclays Capital Long Credit Index is 1.09 as of year-end 2009).

Underlying Issuers

States in the U.S.

California has represented nearly 25% of BABs issuance through year-end 2009, followed by Texas (11%) and New York (9%). 90% of the states in the U.S. have participated so far in this program.

Sector

Approximately 45% of BABs amount outstanding is accounted for from General Obligation (GO) issuers – with the breakdown between local and state issuers at about 2:1. For the remaining 55% of issuance, transportation and utility issuers have dominated, representing approximately 30% of overall BABs issuance.

Credit Spreads

The Treasury option adjusted spread (OAS) for the BABs universe, as computed by BondEdge, finished 2009 at a level of 195 basis points. While this is close to the OAS for long corporate benchmarks (the OAS for the BondEdge representation of the Bank of America Merrill Lynch 10+ Corporate Index was 187 bps), BAB spreads are significantly higher than similarly rated corporate bonds (see Exhibit 1).

Exhibit 1

Rating	BABs Universe		Long Corporate Index ⁴	
	Tsy OAS	%MV	Tsy OAS	%MV
AAA	113	9.5%	88	0.8%
AA	169	61.1%	145	12.9%
A	217	16.1%	170	44.3%
Baa	343	13.2%	221	42.0%
Total	195		187	

December 31, 2009

Conclusion

The Build America Bonds program has been popular with both taxable bond investors and municipal issuers and is expected to bolster taxable bond issuance in 2010 and potentially beyond. The BondEdge platform is well positioned to accommodate these securities within portfolios and fixed income benchmarks from both a reference data and analytical perspective.

⁴ Bank of America Merrill Lynch U.S. Corporates 10+ Years

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