

BAB – Build America Bonds

Out of the Financial Crisis of 2008-2009 spawned a whole new asset class: Build America Bonds (BABs).

The American Recovery and Reinvestment Act of 2009 included a provision that authorized the issuance of BABs. Although issued as a temporary solution, BABs may become a permanent part of the bond marketplace due to municipal issuer infrastructure and capital needs, as well as investor demand for alternatives to corporate bonds.

What makes BABs unique is that, under current legislation, issuers can choose to offer investors a tax credit or receive a periodic payment from the U.S. Treasury to subsidize a portion of the interest expense on the bonds. The most widely used arrangement is when the issuer elects to receive 35% to 45% of the bonds' interest expense from the federal government in the form of a cash subsidy. Additionally, BABs are a federally taxable municipal security.

This allows municipalities to sell bonds with yields that are higher than tax-exempt bonds and at spreads above U.S. Treasuries or highly rated corporate bonds.

Benefits to Investors

Since the first BABs came to market in April 2009, they have been well received by investors likely because they offer higher yields typically associated with taxable bonds. The federal subsidy feature provides a consistent stream of revenue from the government to the municipal issuer. Many BABs are exempt from state income tax.

BABs carry general risk characteristics that are similar to tax exempt municipal bonds, which have low historical default rates. However, unlike U.S. Treasury Bonds—BABs are not backed by the full faith and credit of the U.S. Treasury and Congress could decide to terminate the federal subsidy at some point in the future.

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