

THE BOND BUYER

THE DAILY NEWSPAPER OF PUBLIC FINANCE

Build America Bonds: Seeking the Missing Option

Bond Buyer | Monday, May 11, 2009

By Andrew Kalotay

The emergence of optionless Build America Bonds paradoxically highlights the importance of the proper valuation of the call option embedded in conventional long-term tax-exempt munis. The coupons on BABs are higher, but the federal government pays the issuers a subsidy of 35% of the interest payments. So which is the better deal?

Some commentators are comparing the after-subsidy yield on BABs to the yield of a 30-year tax-exempt bond, but this is not apples-to-apples. A long tax-exempt bond is callable at par any time after 10 years. If rates decline, the issuer can refund the bonds to capture interest rate savings. By contrast, long BAB issues to date have been bullets. Their "make-whole" call provision has no financial value; it merely allows the issuer to retire the bonds at an excessive premium to the fair price - a right invoked only under extraordinary circumstances.

The industry-standard Municipal Market Advisors and Municipal Market Data rates refer to NC-10 bonds, and this makes the estimation of long-term optionless municipal yields problematic. However, it is a widely held opinion among professionals that the muni call option is cheap - 7 to 10 basis points, according to current estimates.

In contrast to munis, the norm in the taxable market is an optionless bullet. Taxable issuers, therefore, think in terms of their bullet rates - quoted as spreads to a benchmark such as Treasuries or Libor swaps. The method for determining the coupon premium associated with a particular call feature is well-established and widely used. For example, in the case of government sponsored enterprise bonds, professionals use observable live swaption volatilities. The coupon premium for the call is much higher than in the tax-exempt world; for example, in the current market, for a 30-year NC-10 bond, it would be roughly 50 basis points.

The taxable market provides critical insight into appreciating the true value of the call option in municipal bonds. While the call option on a 30-year muni may cost only 7 to 10 basis points, it is worth considerably more. Any decision should be based not only on how much the call option costs, but what it is worth.

So how should an issuer choose between optionless BABs and conventional callable munis? The correct yardstick is the option-adjusted yield, or OAY, which is simply the standard yield to maturity calculation but based on the sum of the proceeds and the option value. The challenge is to determine the value of the option. This can be accomplished with standard option-based analysis. The key is to estimate the appropriate volatility, which understandably is held close to the vest by professionals.

Here is an example. Assume that a new 30 NC-10 muni pays 5.25%. Based on current swaption volatilities, the value of the call option is 3.22% of face amount. The option-adjusted proceeds to the municipality, taking into consideration a 5/8% issuance fee, would be 99.38 plus 3.22 equals 102.60%,

resulting in a 5.08% OAY. The break-even borrowing cost for BABs, taking into account the 35% interest subsidy and the typical 7/8% underwriting fee, would be 7.68%.

The OAY measure allows the issuer to compare alternatives on an apples-to-apples basis and avoid unfavorable deals. Under current market conditions long BABs, sweetened by the 35% federal subsidy, are clearly superior to long munis. But does it follow that the right choice is a long-term BAB issue? Not necessarily.

The long-term taxable market is currently in turmoil - just observe the price volatility of the BABs in the secondary market. Tellingly, no U.S. corporation has issued 30-year bullets lately. In particular, the GSEs have abstained from issuing long bonds in favor of intermediates, sometimes with a call option. The only action on the long end has been the issuance of BABs. It makes one wonder what the municipal advisers know that the pros in the taxable market don't.

Andrew Kalotay is president of Andrew Kalotay Associates.

© 2009 The Bond Buyer and SourceMedia Inc., All rights reserved. Use, duplication, or sale of this service, or data contained herein, except as described in the subscription agreement, is strictly prohibited. Trademarks page.

Client Services  1-800-221-1809 , 8:30am - 5:30pm, ET

For information regarding Reprint Services please visit: http://license.icopyright.net/3.7745?icx_id=20090508A17UVZY5