Bonds Fail to Deliver Economic Punch

By Michael Kiely and Claudia Gutierrez

On Feb. 17, 2009, President Barack Obama signed into law the $787 billion stimulus bill, The American Recovery and Reinvestment Act of 2009 (ARRA). As part of ARRA, Recovery Zone Facility Bonds were introduced as a groundbreaking type of tax-exempt private activity bond that would tremendously increase financing opportunities for private development projects that have historically not qualified for tax-exempt financing. The list of qualified businesses under the Recovery Zone Facility Bonds program is extensive — any trade or business within a designated recovery zone, excluding only a few types of businesses such as residential property, golf courses, country clubs, massage parlors, facilities dedicated to sale of alcohol or gambling, etc.

With the frozen capital markets, many developers have been presenting Recovery Zone Facility Bonds as the only source of financing for their stalled development projects. However, before developers devote substantial time and resources in the pursuit of Recovery Zone Facility Bond financing, they need to take a hard look at this program and their own situations to determine if this financing will truly be available and workable in their local jurisdictions.

Out of the 78 cities and counties in the state of California that received an allocation for Recovery Zone Facility Bonds, only 33 of them timely completed the plan of issuance due to the California Debt Limit Allocation Committee (CDLAC) on Jan. 31, 2010. As of Feb. 24, 2010, CDLAC anticipates having $132,254,000 available for reallocation for the March 24, 2010 reallocation award round.

So why are Recovery Zone Facility Bonds going unused by so many municipalities and counties that received allocations? Four major challenges appear to be leading to their underutilization.

First, there was initially a great amount of confusion regarding what Recovery Zone Facility Bonds can really do. The only benefit these bonds offer is their tax-exempt status on the debt interest — this is the sole subsidy provided. The debt service must be funded by the private business. There is no cash subsidy. Initially, many business owners within designated recovery zones, and even city/county staff, wrongly assumed that Recovery Zone Facility Bonds were more in the nature of a grant. They are not. Accordingly, real debt, obtained with real credit, is still required for the issuance of these bonds. The required debt can come through private placement (i.e., a bank-issued loan for which tax would be exempt, thereby resulting in a substantially lower interest rate) or in the form of salable municipal bonds, which would be made tax exempt through this program.

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Second, few private businesses are in a position to take advantage of Recovery Zone Facility Bonds today. The lack of debt, combined with the lack of confidence in the markets, continues to mean that businesses are holding off on further investment for the time being. In Los Angeles, for example, projects that received priority consideration include those that will create a substantial number of permanent new jobs, projects that will pay prevailing and living wages, green projects and those that demonstrate a *high degree of readiness* — these are the types of projects that generally meet the intent of the Recovery Zone Facility Bond program. Not many projects meet such criteria today. Even some of the projects in the city of Los Angeles' plan of issuance (which was timely completed and submitted to CDLAC) that met the basic eligibility requirements established by ARRA will not ultimately be able to secure a credit commitment and close on the bonds by the Dec. 31, 2010 deadline. In many other jurisdictions, there simply may not have been enough projects meeting the very basic requirements for eligibility.

Third, in a time when credit is extremely difficult to obtain, and when attainable, is subject to historically low interest rates, Recovery Zone Facility Bonds are not very attractive. Projects that could theoretically attain a "high degree of readiness" in a short period of time are not necessarily incentivized by these bonds. On top of having to secure their own credit and pay their own debt service, ARRA limits the cost of issuance amount that can be financed through bond proceeds to 2 percent of the par amount of the bonds. In large municipalities, the average cost of issuance is approximately $200,000. By way of example, for a $5 million Recovery Zone Facility Bond allocation, the maximum cost of issuance that can be wrapped into the bond financing is $100,000, thereby requiring that the applicant be able to fund the outstanding $100,000 from other sources. Many applicants are not in a position to do so without substantial effort and cost.

Fourth, many cities and counties appear to not be focused on Recovery Zone Facility Bonds. According to CDLAC's latest figures, seven cities and counties have voluntarily waived their allocations, 25 were non-responsive to CDLAC's Jan. 31, 2010 deadline for plan of issuance submission and 13 cities and counties delivered incomplete plans for which review by CDLAC is currently pending. The reasons for such lukewarm response to the Recovery Zone Facility Bond program may be many, but one of those reasons appears to be the challenging times cities and counties are currently facing. With cities and counties suffering tremendous budget deficits and having to implement innumerable layoffs, the result has been lack of necessary staff to monitor the program and accomplish required milestones in a timely manner. By way of illustration, Los Angeles County, the largest allocatee in California, with a Recovery Zone Facility Bond allocation of $271,484,000, was among the counties to deliver an incomplete plan of issuance to CDLAC by the mandated deadline. While CDLAC review is still pending on Los Angeles County's plan of issuance, one may wonder as to the county's ability to meet upcoming deadlines. The upcoming critical deadline is Aug. 15, 2010, by which cities and counties in California must provide all supporting documentation for those projects included in their Jan. 31, 2010 plan of issuance.

With these issues in mind, Recovery Zone Facility Bonds may be the right option where the following factors, in addition to the criteria described above, are in place:

The project is already on the allocation list for the jurisdiction in which it is located; the jurisdiction has the staff and commitment to follow through; there is either a lending source, e.g., a bank that has committed to provide the debt or an underwriter that has expressed confidence on the marketability of a municipal bond issuance; there is enough other money in the deal to cover the substantial legal and other transaction costs associated with the bond issuance; and the project and developer otherwise qualify for conventional project financing, even under the current stringent underwriting criteria employed by many lenders. Characteristics of such a situation include committed, and very strong tenants, affordable credit enhancements, and/or strong financial guarantors.

Since so few projects meet these additional criteria, it appears likely that a substantial amount of the Recovery Zone Facility Bond allocations in California will not materialize by year end. With their very limited subsidy and high cost of issuance, Recovery Zone Facility Bonds are not creating a sufficient incentive for private businesses to get into a position to be eligible for the program. Even if the incentive were greater, the reality of today's market will prevent otherwise highly ready projects from obtaining credit commitments in the near future. In addition, the short lifespan on the Recovery Zone Facility Bonds is a significant obstacle for both the credit-strapped applicants and the overwhelmed, understaffed cities and counties responsible for administrating the program. As such, the Recovery Zone Facility Bond may not, without a meaningful extension and some added incentives, provide the economic stimulus that local governments and developers had hoped for.

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