Center for American Progress

A House America Bond for State Housing Finance Agencies

More Affordable Housing for Low- and Moderate-Income Households

By Jordan Eizenga March 1, 2012

Introduction

State housing finance agencies play an important role in the provision of affordable housing. As state-chartered institutions, these agencies emerged in the 1960s in response to the failure of private lenders and developers to finance affordable low- and moderate-income housing.[1] With a detailed understanding of the needs of local housing markets, housing finance agencies are uniquely positioned to responsibly underwrite mortgages—often with down payment assistance—for low-income, first-time homebuyers and to finance the development of multifamily affordable rental housing.

Since their creation housing finance agencies have financed the construction of nearly 1 million affordable rental units and approximately 4 million affordable mortgages for low- and moderate-income households.[2] Yet over the past several years, many of them have struggled to raise funds from their traditional source of capital—the tax-exempt bond market—at affordable rates and long maturities to finance their mortgage programs. This has made it more difficult for them to provide affordable mortgages for low- and moderate-income households where the lack of mortgage credit is greatest.

As this issue brief demonstrates, these funding challenges must be resolved if housing finance agencies are to continue to play an effective and central role in supporting their state and local housing markets. In particular, this brief argues for a promising new source of financing for housing finance agencies—what the Center for American Progress would like to call the "House America bond," modeled after the successful Build America Bond program that was part of the American Recovery and Reinvestment Act of 2009.

A House America bond—a direct-subsidy bond where a portion of the housing finance agencies' interest costs are subsidized by the federal government—would expand the market for these bonds and lower borrowing costs for state housing finance agency issuers that can be passed on in the form of lower rate mortgages. Most importantly, it would also expand access to affordable rental housing and homeownership for many of those hardest hit by the housing crisis.

This issue brief will outline why state housing finance agencies are important to affordable housing. We focus on state housing finance agencies, but that does not mean that local housing finance agencies play an umimportant role in the provision of affordable housing or are undeserving of additional assistance going forward. Here, though, we look at the funding challenges they face today, and the impact of these challenges, and then describes the merits of a House America bond.

Why housing finance agencies matter to affordable housing

State housing finance agencies are an effective and central player in the provision of affordable housing for two reasons. First, they have a good understanding of local real estate markets and are uniquely positioned to serve segments overlooked by mainstream private lenders. This is particularly important today, as mortgage credit has contracted 13 percent in real terms (after accounting for inflation) since 2007 and underwriting standards have tightened to such an extent that many creditworthy borrowers are unable to access mortgage loans.[3]

Most state housing finance agencies also offer mortgage loans statewide and reach more communities than conventional lenders. This is critical in rural communities where access to affordable mortgage loans is much harder to come by.[4] As a result, state housing finance agencies are able to underwrite affordable and safe mortgages, often coupled with down payment assistance, for borrowers and communities that would not usually be served by conventional lenders. Down payment assistance is a critical factor in making it possible for first-time homebuyers to buy homes with affordable mortgages, particularly since the onset of the foreclosure crisis. State housing finance agencies also connect homeowners to counseling services for low- and moderate-income first-time homebuyers as part of their eligibility requirements.

Second, the federal government has gradually withdrawn from affordable housing policy over the past several decades, which has led state housing finance agencies to take on a bigger role. While federal spending on low-income housing has increased since the 1970s, most of this money has gone to renewing subsidies for existing units rather than toward the production of new affordable housing units.[5] Throughout this time the demand for affordable housing has grown. Indeed, the percentage of renters who are rent-burdened has doubled over the past 50 years.[6]

The end result is that states have had to take on a greater share of responsibility in affordable housing policy. This helps explain why total spending on housing by all 50 states has been trending upward.[7] The lion's share of this increased role in affordable housing has fallen to state housing finance agencies.[8]

These agencies are relied upon not only as an affordable-housing capital provider but also as an administrator of federal subsidy programs such as the low-income housing tax credit.[9] Through 2004 state housing finance agencies funded 2.4 million affordable mortgages for low- and moderate-income first-time homebuyers and 687,000 affordable rental units using tax-exempt bonds, as well as 1.7 million affordable rental units using low-income housing tax credits, or LIHTCs.[10] Meanwhile, at their peak public housing units subsidized by the federal government clocked in at 1.4 million units, while 1.8 million very-low-income households were able to access rental housing using housing choice vouchers.[11]

In the wake of the foreclosure crisis, these agencies have played an important role in foreclosure prevention and neighborhood stabilization as well.

How state housing finance agencies fund their activities

To fund their activities, state housing finance agencies have historically borrowed money in the tax-exempt bond market by issuing mortgage revenue bonds and multifamily housing bonds. Mortgage revenue bonds are a unique type of private activity bond issued by state housing finance agencies to fund affordable mortgages for low- and moderate-income first-time homebuyers.[12]

Multifamily housing bonds are also state housing finance agency-issued bonds and are used to finance the development of apartments that will be offered for rent at affordable rates to lower-income households.[13] Neither mortgage revenue bonds nor multifamily housing bonds are government guaranteed. Congress sets a volume cap on the number of these bonds that can be issued annually.[14]

Because the interest income from the bonds is exempt from federal income taxes, individual investors are willing to purchase the bonds at lower interest rates. These lower borrowing costs allow state housing finance agencies to use bond proceeds to make loans for affordable housing at below-market rates. Since their inception multifamily housing bonds have helped finance the creation of nearly 1 million affordable rental units, and mortgage revenue bonds have funded low-cost mortgages for approximately 4 million low-income families.[15]

A small number of state housing finance agencies have adopted a model whereby they securitize loans into Fannie Mae, Freddie Mac, and Ginnie Mae mortgage-backed securities. Ginnie Mae is the federal national mortgage association, and Fannie Mae and Freddie Mac are the two mortgage finance giants now in federal conservatorship. The state housing finance agencies sell the mortgage-backed securities to investors and use proceeds from the sale to fund their mortgage programs.[16]

Case in point: The state housing finance agencies of Massachusetts and Idaho have sought to reduce their reliance on tax-exempt bonds to fund their mortgage programs by shifting to this mortgage-backed securities funding model.[17] The central benefit of the mortgage-backed securities market is its liquidity. The ability to easily buy and sell mortgage-backed securities "raises prices [of the securities] and improves market functioning."[18]

While securitizing loans has helped lower borrowing costs for a small number of state housing finance agencies, many others remain reliant on the tax-exempt bond market to fund their mortgage programs.

The problem: High borrowing costs crimp affordable housing programs

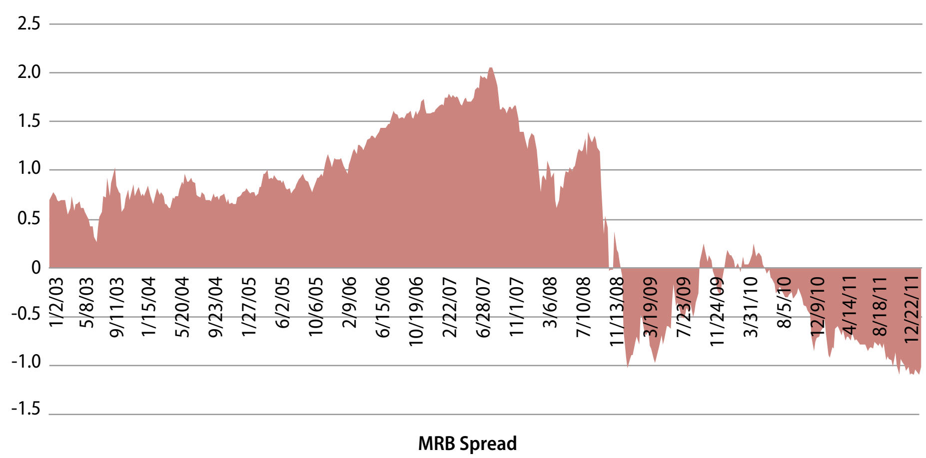
When the housing market dropped off a cliff during the financial and housing crises in 2008 so too did investor demand for housing bonds. Investors did not want to purchase assets closely linked to the housing market. Additionally, the firms that provided credit enhancement products—such as letters of credit and bond and private mortgage insurance—saw their credit ratings downgraded. This had the effect of weakening the value of the credit enhancements that supported these housing bonds.[19]

The funding problem facing state housing finance agencies is best illustrated by the "mortgage revenue bond spread," or MRB spread as it's called in housing finance markets.[20] The MRB spread is the difference between mortgage rates and tax-exempt revenue bond rates. Historically the MRB spread has been positive, reflecting the fact that mortgage rates tend to be higher than tax-exempt bond rates. This was important because it allowed state housing finance agencies to issue bonds at low rates and then use the proceeds to offer safe mortgage products at affordable rates.

FIGURE 1

Why state housing finance agencies face funding problems

Beginning in October 2008, the rates at which state HFAs borrowed exceeded the rates at which they could competitively make loans



Sources: Bond Buyer 25 Revenue Bond Index and the Freddie Mac Primary Mortgage Market Survey.

However, beginning in October 2008 the MRB spread turned negative, as tax-exempt rates exceeded mortgage rates, making it very difficult for state housing finance agencies to offer affordable mortgages because the rate at which they borrowed was higher than the rate at which they could competitively originate loans. By October 2009 housing finance agencies were struggling to maintain affordable access to the tax-exempt bond market, with bond issuance dropping to one-fourth of what it had been in prior years.[21] (see Figure 1)

To complicate matters, the housing crisis also laid bare a more structural and longstanding problem in the way state housing finance agencies had traditionally financed their activities: declining investor demand for long maturity tax-exempt bonds from the natural buyers of these bonds—tax-driven retail investors. In the past several years, retail investors (typically high-income households) became increasingly reluctant to buy long-term tax-exempt bonds, as they tended not to like tying up their money in longer maturity debt because of inflation concerns. As a result, officials reported that it was difficult for many tax-exempt issuers, state housing finance agencies included, to borrow long-term at low rates in the tax-exempt bond market.[22]

Tax-exempt bond issuers recognized this problem and employed a variety of strategies to attract investors for longer maturity debt. They issued adjustable-rate securities with interest rates that regularly reset at auction—known as auction rate securities in housing finance markets—alongside bond insurance. This strategy proved problematic, however, as many bond insurers saw their credit rating downgraded during the financial crisis.

Issuers also offered so-called variable rate debt obligations, or VRDOs, with a letter of credit. Similar to auction rate securities, VRDOs are longer maturity bonds with interest rates that reset regularly. The central difference with VRDOs is that the issuer must buy back the bonds from the bondholder if no one else wants to buy these bonds. Banks are often the party required to purchase the bonds, as most municipalities purchase a letter of credit from banks. A letter of credit is simply a guarantee from a bank to purchase an outstanding bond should a bondholder wish to sell the bond and not be able to find a buyer.

But this funding model was not without its risks. At the beginning of 2011, many of these letters of credit were set to expire and the concern was that, if they did, some state housing finance agencies would have to spend a lot of money to buy back bonds. Those most susceptible to this problem were lower-rated issuers whose investors were more likely to exercise the option to sell back the bonds.[23] Others susceptible were those who had a high percentage of their outstanding debt in the form of variable-rate debt. This is one reason why certain state housing finance agencies such as the one in Colorado have seen their credit rating downgraded.[24]

As a result of these funding challenges, some of these agencies responded by shifting their focus away from low-income, first-time homebuyers to "move-up" buyers and middle-income homebuyers. One official stated that "the focus on low-income families is being diluted" by the inability to affordably access long-term funding, with some agencies reducing their financing activity altogether.

Due to difficulty raising capital for their programs, "All state housing finance agencies have severely curtailed and several have suspended their lending programs," said Barbara Thompson, executive director of the National Council of State Housing Finance Agencies in 2009, when the problems facing HFAs were still growing.[25]

This could not have happened at a worse time. With mortgage credit conditions exceptionally tight, the difficulties facing state housing finance agencies threatened to further hold back local real estate markets, particularly in communities that are traditionally served by these agencies.

Crucial federal support

In response to the problems facing housing finance agencies, the Treasury Department in October 2009 launched the New Issue Bond Program to help state housing finance agencies maintain affordable access to the long-term tax-exempt bond market through the difficult market conditions.[26] The program authorizes Fannie Mae and Freddie Mac to purchase and securitize tax-exempt housing finance agency bonds and sell them to the Treasury Department at below-market rates while maintaining private-market discipline by requiring simultaneous issuance of a portion of the housing bonds in the private tax-exempt market.[27]

In maintaining access to the longer maturity tax-exempt market at low rates, the New Issue Bond Program allowed state housing finance agencies to continue providing access to their affordable mortgage programs. All told, $15.3 billion in housing finance bonds were authorized to be issued through the program, some of which have already been used to finance low-cost mortgages on approximately 100,000 single-family units and affordable financing for the development of 24,000 multifamily units as of the third quarter of 2011.[28]

Treasury also created the Temporary Credit Liquidity Program to respond to the problem of expiring letters of credit. This program authorized Fannie Mae and Freddie Mac to provide a three-year, temporary letter of credit to state housing finance agencies for their outstanding variable rate demand obligations. The program has since been extended through to the end of 2015.

Looking ahead: A House America bond

While the Treasury Department has provided important temporary support for state housing finance agencies through the difficult market conditions, it is important that the state agencies themselves be equipped with additional, more permanent tools to better fund their mortgage programs going forward.

One potential policy to strengthen the ability of state housing finance agencies to fund their mortgage programs and focus their work on low- and moderate-income households is a taxable direct-subsidy bond—what the Center for American Progress would suggest calling a House America bond. A taxable direct-subsidy bond is a bond for which the federal government makes direct payments to the issuer equal to a percentage of the issuer's interest costs. The most recent incarnation of a taxable direct-subsidy bond was the Build America Bond program created in the American Recovery and Reinvestment Act of 2009.[29] Under this program state and local governments could issue taxable bonds to finance infrastructure investment but have the federal government pay part of the interest cost. The program, however, prohibited private activity bond issuers such as housing finance agencies to issue the bonds.[30]

The subsidy for Build America Bonds was set at 35 percent of the interest costs.[31] President Barack Obama has proposed bringing back the bonds at an initial subsidy rate of 30 percent to be lowered to 28 percent in future years. A House America bond would follow a similar subsidy rate schedule.[32]

There are several benefits of a proposed taxable direct-subsidy House America bond.

First, it expands demand for state housing finance agencies' debt by appealing to tax indifferent buyers who aren't helped by the municipal bond tax exemption such as pension funds, foreign investors, and life insurance companies. By appealing to a broader array of investors, a House America bond accesses untapped demand in the market.[33] This is particularly important for state housing finance agencies, which use bond proceeds to fund mortgages with longer maturities.

Second, a House America bond is a more efficient way to provide increased funding for state housing finance agency programs. As the tax exemption in the municipal bond market has demonstrated, delivering a subsidy through the tax-code has some inefficiencies. With the tax exemption, a portion of the subsidy intended for issuers is instead captured by bond investors in the top income tax brackets. In fact, the Treasury Department estimates that 10 percent to 20 percent of the subsidy intended for issuers is accidentally captured by investors in higher income tax brackets.[34] Under a House America bond, the direct payment to the issuer by the federal government channels 100 percent of the federal subsidy to the benefit of state and local governments and, in turn, to households they serve.

Third, as the Build America Bond program demonstrated, direct-subsidy bonds can be issued at longer maturities because they cater also to long-term institutional investors. The first independent study of the Build America Bond program by Andrew Ang of Columbia University, Vineer Bhansali of PIMCO, and Yuhang Xing of Rice University noted that 54 percent of Build America Bonds had maturities longer than 10 years, compared to just 34 percent for tax-exempt bonds.[35] This is a particularly important finding, as HFAs use bond proceeds to fund mortgages with long-maturities.

As the Build America Bond program indicates, the end result from issuing taxable, direct-subsidy bonds is lower borrowing costs and improved access to longer maturity debt. The Treasury Department estimates that state and local governments saved more than $20 billion in present value by issuing Build America Bonds.[36]

This suggests that state housing finance agencies' funding challenges could be alleviated if a similar taxable direct-subsidy House America bond were made available to them. With lower borrowing costs these agencies would be better positioned to focus their programs on low- and moderate-income households. Put simply, a House America bond could expand the capacity of these state agencies to provide affordable rental and homeownership opportunities to low- and moderate-income households.

Furthermore, a House America bond need not cost the federal government any additional money if the overall volume cap for state housing finance agencies bond issuances—tax-exempt and House America bonds—remains in place. And each of these agencies would be able to choose the amount of tax-exempt bonds relative to House America bonds it issues so long as its total issuance remains below the volume cap.

To be sure, given that a taxable direct-subsidy bond provides federal payments to issuers to offset borrowing costs, these costs will appear as an outlay in the federal budget. Tax-exempt bonds, by contrast, involve no federal outlay because the equivalent government subsidy is delivered as a tax expenditure or forfeited revenue. Tax expenditures are special tax breaks such as exemptions, credits, and deductions that result in forgone revenue to the federal government.

Because a taxable direct-subsidy bond generates a cost on the spending side of the ledger, it is susceptible to attack from those who are ideologically averse to direct spending. Indeed, Sen. Charles Grassley (R-IA) says the Build America Bond program "increases the size of the already bloated federal government because it takes what used to be a tax-cutting program, namely, [tax-exempt] municipal bonds, and converts that into Build America Bonds."[37]

In reality, there is no difference between direct spending and spending that delivers money to people by permitting them to avoid paying taxes on a certain type of income. At the end of the day the net effect on the budget is the same.[38]

Conclusion

Given the important role that state housing financing agencies play in affordable housing, it is crucial we preserve these institutions, equip them with the right tools to continue to fulfill this role, and make better use of them in expanding affordable housing. This brief has outlined a House America bond that should strengthen the ability of housing finance agencies to fund their mortgage programs to serve low- and moderate-income households and to help more first-time homebuyers achieve sustainable and affordable homeownership.

In his fiscal year 2013 budget proposal, President Obama called on Congress to reinstate the Build America Bond program for state and local governments. Housing finance agencies need help too, and Congress should pass legislation authorizing the issuance of House America bonds.

Jordan Eizenga is a Policy Analyst with the Housing team at the Center for American Progress.

Endnotes

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7 Scally, "State Housing Finance Agencies 40 Years Later: Major or Minor Players in Affordable Housing?"

8 Ibid.

9 Ibid.

10 Ibid. The U.S. Department of Housing and Urban Development describes the Low Income Housing Tax Credit as "an indirect Federal subsidy used to finance the development of affordable rental housing for low-income households." It is designed to incentivize private market interest in affordable rental housing by awarding federal housing tax credits to developers to sell to investors to raise equity capital for affordable housing projects. This, in turn, reduces the amount of debt that the developer needs to raise to fund the project. With lower debt on the property, the project can offer rent at lower and more affordable rates. For more, see: "How Do Housing Tax Credits Work?," available at http://www.hud.gov/offices/cpd/affordablehousing/training/web/lihtc/basics/work.cfm (last accessed February 24, 2012); "LIHTC Basics," available at http://www.hud.gov/offices/cpd/affordablehousing/training/web/lihtc/basics/ (last accessed February 24, 2012).

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28 Data provided to the author by the Treasury Department.

29 Securities Industry and Financial Markets Association, "US Municipal BABs Fact Sheet, 2010 Q3" (2010), available at http://www.sifma.org/research/item.aspx?id=19650.

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31 The direct subsidy on a Build America bond was equal to the implicit federal subsidy on a tax-exempt bond purchased by an investor in the 35 percent tax bracket.

32 U.S. Department of the Treasury, General Explanations of the Administration's Fiscal Year 2013 Revenue Proposals (2012), available at http://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2013.pdf.

33 Andrew Ang, Vineer Bhansali, and Yuhang Xing, "Build America Bonds" (Columbus, OH: Council of Development Finance Agencies, 2010), available at http://www.cdfa.net/cdfa/cdfaweb.nsf/ord/700a52f4588a76df88257936006861c6/$file/bab%20report.pdf.

34 Alan B. Krueger and John Bellows, "Build America Bonds: A New Approach to Municipal Finance," American Economic Association Meetings, January 7, 2011.

Any tax exemption is most valuable for buyers in the top income tax brackets. A municipal bond investor in the 35 percent bracket pays $35 less in taxes for every $100 in interest income he receives, while a buyer in the 10 percent bracket saves just $10. That explains why people in the top income tax bracket, the wealthiest Americans, are the most willing buyers of tax-exempt bonds. If issuers sold bonds exclusively to these top-bracket investors, they could in theory offer bonds paying a 35 percent lower yield than comparable taxable Treasury bonds. At that yield top-bracket investors would find the tax-exempt and taxable bonds equally attractive. Unfortunately, the appetite for tax-exempt municipal bonds among people in the top tax bracket is typically insufficient to meet an issuer's need for financing. The issuers, therefore, must also sell bonds to people who are taxed at lower rates. And that means the issuers have to offer higher rates to all investors, giving the bond buyers in the highest income tax brackets a windfall. As a result, issuers offering tax-exempt bonds pay higher interest-rate payments to attract top-bracket investors. For more, see: Congressional Budget Office, "Subsidizing Infrastructure Investment with Tax-Preferred Bonds" (2009), available at http://www.cbo.gov/doc.cfm?index=10667; T. Atwood, "Implicit Taxes: Evidence from Taxable, AMT, and Tax-Exempt State and Local Government Bond Yields," Journal of the American Taxation Association 25 (1) (2003).

35 Ang, Bhansali, and Xing, "Build America Bonds."

36 Alan B. Krueger and John Bellows, "Build America Bonds: A New Approach to Municipal Finance."

37 United States Senate Committee on Finance, "Grassley Asks GAO to Review Accountability of Tax Dollars in Build America Bonds Program," Press release, November 16, 2010, available at http://finance.senate.gov/newsroom/ranking/release/?id=78ff744e-2e82-4ba0-9e50-77b56d85d09e.

38 Build America Bond critics also noted that underwriting fees were typically higher for direct-subsidy issuances than for comparable tax-exempt bond issuances. To be sure, fees were higher at the outset, as underwriters took on the additional risk and effort involved in offering a new product. By the end of the program, the fees had declined to be in-line with underwriting fees for tax-exempt bonds. Had the program been extended, underwriting fees would have likely been pushed down by more competition among underwriters and an expanding market for the bonds. One official with whom I spoke also expressed concern that a direct-subsidy bond would allow the Internal Revenue Service, or IRS, to withhold subsidy payments if it so decided. The IRS, which was the agency responsible for delivering subsidy payments to state and local governments, previously withheld subsidy payments to issuers because they owed money to the federal government. While this may have been the correct course of action, the worry is that withholding subsidy payment could have an adverse material impact on the financial operations of state HFAs. For more, see: Julie Creswell, "Stimulus Bond Program Has Unforseem Costs," The New York Times, June 15, 2010, available at http://www.nytimes.com/2010/06/16/business/economy/16bonds.html?scp=1&sq=stimulus%20bond&st=cse.