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April 15, 2015

The Honorable Dean Heller
Co-Chair
Working Group on Community Development and Infrastructure
Senate Finance Committee
324 Hart Senate Office Building
Washington, DC 20510

The Honorable Michael Bennet
Co-Chair
Working Group on Community Development and Infrastructure
Senate Finance Committee
458 Russell Senate Office Building
Washington, DC 20510

RE: Inclusion of Bond Insurance Premium as an Interest Expense in Municipal Bond Subsidy Programs

Dear Co-Chairs of the Working Group on Community Development and Infrastructure,

Assured Guaranty (Assured) thanks you for the opportunity to provide your Working Group with comments regarding existing tax laws and necessary reforms related to municipal bond subsidy programs, as the Senate Finance Committee moves forward in its legislative efforts on bipartisan tax reform.

Assured is a provider of municipal bond insurance, which guarantees the timely payments due on specific insured securities. Assured's municipal bond insurance adds value in sectors serving a substantial public purpose, including not-for-profit issuers in the education, utility, housing, healthcare, and transportation sectors.

Assured strongly supports bipartisan tax reform that promotes infrastructure development to increase economic growth and competitiveness in the US. Assured believes that, to the extent that bipartisan tax reform includes any municipal bond subsidy programs to spur economic growth and infrastructure development, such programs should ensure that municipal bond insurance is included as an interest expense when calculating the yield on an issuance of such tax-exempt bonds. Moreover, as outlined in this letter, **we recommend that such municipal bond subsidy programs, if enacted, ensure that municipal bond insurance premiums are included as interest expenses when calculating the yield on an issuance of such municipal bonds**. To that end, this letter (1) provides a brief overview of the business of municipal bond insurance; (2) includes a background on Build America Bonds (BABs) and America Fast Forward Bonds (AFFBs), describes the historic treatment of municipal bond insurance premiums under municipal bond subsidy programs, and outlines our suggested treatment for municipal bond subsidy programs that may be enacted going forward; and (3) provides an economic analysis regarding the benefits of treating municipal bond insurance premiums as interest expenses when calculating the yield on an issuance of such municipal bonds.

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I. Brief Overview of the Business of Municipal Bond Insurance

Traditional municipal bond insurance is a monoline industry, consisting of insurance of scheduled payments due on specific securities – namely, municipal bonds. Generally, a municipal bond insurer undertakes to pay the amount of any defaulted scheduled payment on an insured obligation in exchange for the right to receive the defaulted payment (unlike with credit default swaps, a defaulted payment cannot trigger insurance payments by multiple counterparties). And, the insurer's payment obligation is not permitted to be accelerated under applicable law other than at the sole option of the insurer.

Of note, an uninsured security remains a ready substitute for an insured security, allowing market access for municipal issuers in the absence of municipal bond insurance. Nonetheless, municipal bond insurance increases market liquidity, market efficiency, underwriting, surveillance, remediation and other value to investors.

Municipal bond insurers, who are subject to extensive state insurance law and regulations, add value in sectors serving a substantial public purpose, including not-for-profit issuers in the education, utility, housing, healthcare, and transportation sectors.

Current and projected new business municipal bond insurance originations for current market participants and potential new entrants consist predominantly of US domestic tax-exempt municipal bonds sold to US domestic investors. As reported in our recently filed 10-K (at page 76), almost half of "single A" category municipal bond offerings employed bond insurance in 2014. S&P expects business volume for municipal bond insurers, such as Assured, to rise through 2015 and for the industry's risk-adjusted pricing ratios to improve. Recent upgrades by credit rating agencies are supported by Assured's (1) strong capital levels; (2) good operating performance; (3) reduction in legacy structured-finance portfolios; and; (4) punctual payment of claims for recent municipal bankruptcies.

II. Treatment of Municipal Bond Insurance Premiums and Suggestions for Municipal Bond Subsidy Programs Going Forward

Build America Bonds and America Fast Forward Bonds

BABs were created by the American Recovery and Reinvestment Act of 2009. They were taxable state and local bonds that could be used to finance capital projects. BABs were eligible for a federal subsidy that lowered the net interest costs compared to tax-exempt debt and thereby provided state and local governments with a competitive cost advantage for their capital. The subsidy was available either in the form of a direct payment to the state or local issuer from the federal government for a portion of the cost of the interest paid on the bonds, as a tax credit to the bondholder. The amount of credit is taxable as interest income to the bondholder. In the vast majority of cases, issuers chose the direct payment.

This program was created as another source of financing for state and local governments, augmenting traditional tax-exempt finance. The federal government has long provided an indirect subsidy to these issuers by providing that the interest paid on these bonds is exempt from Federal income taxation, lowering the interest rates demanded by investors in these bonds. The BABs program was intended to dramatically widen the potential market of municipal investors to include tax-exempt entities which have no appetite for tax exempt debt.

For the past few years, the President's budget has included a proposal to revive many aspects of the BABs program under a new program called "America Fast Forward Bonds." AFFBs would expand the eligible uses of BABs from capital projects to include current refundings and certain short-term working capital financings and would expand the program to many other types of tax-exempt bonds, including 501(c)(3) bonds and exempt facility bonds. AFFBs would include a subsidy – 28 percent of interest payments – that is less than the subsidy on BABs (35 percent). Moreover, interest subsidy payments on AFFBs would be exempt from sequestration, unlike the interest subsidy payments on BABs.

Historic Treatment of Bond Insurance Premiums

Under the tax code, the yield on the investment of proceeds of a tax-exempt bond issuance cannot exceed the yield to the bondholders on the bond issue. These rules prohibit state and local governments from inappropriately profiting on the difference in interest rates between taxable and tax-exempt bonds. In the tax-exempt bond provisions in the Tax Code, the issuer is allowed to include the cost of bond insurance in calculating the yield on the bond issue, where such insurance is shown to be cost effective by reducing the overall borrowing cost to the issuer. Bond insurance leads to a lower interest rate on the insured bonds because an investor in an insured bond issue has greater security that the issuers will timely pay off the bonds. This lower interest rate also reduces the cost to the Treasury through the exemption on state and local government bond interest.

In addition, to the extent bond insurance reduces the interest cost for issuers, the amount paid for the bond insurance premium effectively converts tax-free interest paid to an investor into taxable income paid to the financial guarantor in the form of the bond insurance premium. In essence, Congress and the Department of Treasury have recognized that bond insurance premiums replace the higher cost associated with bonds without bond insurance and therefore should be treated the same as interest for purposes of calculating the bond yield.

Suggested Treatment under Municipal Bond Subsidy Programs Going Forward

We believe that these same rules should be applied to AFFBs or any similar municipal bond subsidy programs going forward, if enacted. The rules should be clarified to make it expressly clear that

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premiums paid on bond insurance are included as an interest expense when calculating the yield on an issuance of AFFBs. In the alternative, the Department of Treasury and Congress should consider a rule that provides that the holder may only include the cost of the bond insurance in calculating the yield if the use insurance results in net interest rate savings for the issuer (based on some achievable market comparison).

III. Economic Analysis

The brief economic analysis described below shows the effect of the treatment of bond insurance premium under the BABs program, and how we suggest it should change for AFFBs or any similar municipal bond subsidy programs going forward. This economic analysis summarizes and reviews a simple numerical example as an illustration.

As the analysis demonstrates, where bond insurance reduces the cost of borrowing and saves money for state and local issuers, it will also reduce the cost of the direct subsidy to the federal government by reducing the interest rate on which the payment is based. However, if AFFBs or any similar municipal bond subsidy program enacted were treated similarly to the BABs program, by not including the cost of bond insurance as interest cost in the calculation, there would be a substantial disincentive and potentially a penalty for using bond insurance with AFFBs or an alternative municipal bond subsidy program.

To illustrate the point, the hypothetical example provided below lists a bond with and without bond insurance under the AFFB program (or any similar municipal bond subsidy program enacted going forward), first assuming that it would be treated similarly to the BAB program and then with the corrected treatment we suggest.

Key Assumptions

- A 5 year non-amortizing AFFB for a mid-investment grade issuer
- Bond insurance would generate a 0.50 percent reduction in bond coupon in the capital markets
- A bond insurer is prepared to provide insurance for approximately 1.2 percent upfront (converted to a per annum cost for comparison purposes), which is about two thirds of the economic value added

Three scenarios

- AFFB program: no bond insurance
- AFFB program: with bond insurance (assuming the same treatment as BABs)
- AFFB program with bond insurance, if bond insurance premium is included in the "yield" calculation on the bond issue

The following is a high level summary of the economics to the issuer and the federal government comparing the second and third scenario to the first:

	No Bond Insurance	With Bond Insurance – AFFB Program (assuming same treatment as BABs)	With Bond Insurance – Premiums Considered as Interest Expense
Bond Coupon	5.00%	4.50%	4.50%
Less AFFB Subsidy (28%)	(1.4%)	(1.26%)	(1.38%)
Plus Bond Insurance Premium (Converted from 1.2% upfront)	N/A	0.33%	0.33%
Net Cost to Issuer	3.6%	3.57%	3.45%
Net Savings to Issuer	N/A	0.03% Not Viable	0.15%
Reduction of AFFB Subsidy	N/A	N/A	0.08%

Of note, the net cost to the issuer for an insured bond would be only 0.03 percent lower (as highlighted in red) under the AFFB program (assuming same treatment as BABs). Thus, the issuer would be strongly disinclined to issue an insured security. Further, if the bond insurance premium is included in the yield calculation, as we suggest, both the subsidy and net issuer cost would decline relative to an un-insured AFFB.

This example also highlights a potential market distortion to the advantage of arbitrageurs at the implicit expense of issuers and the federal government. If a holder of the hypothetical 5 percent AFFB without insurance were to negotiate bond insurance in the secondary market at an up-front premium equivalent to 0.33 percent per annum and then sell the insured position at a 4.5 percent yield, the 0.17 percent net benefit would go to this holder alone, as opposed to being allocated between the issuer and the federal government.

The bond insurer would, of course, also be financially inclined toward this alternative as well, relative to reducing premium below viable levels or not participating at all. However, there are other factors that could limit insurers' appetite to participate in this secondary market format – principally the lack of any ability to participate in the design of the security's terms. This would have the effect of limiting secondary market participation to more "generic" transactions at the margin – a significant market segment to be sure, but not the most off-the-run segment of the market where insurance has the most value to issuers and the investing public alike.

From the bond insurers' perspective, if bond insurance premium could be included in the yield calculation for tax purposes, the financial incentive to favor execution in the secondary market relative to the primary market would disappear. Eliminating this market distortion would create a level playing field (as we believe Congress intended) between the AFFB program and other financing options available to state and local issuers. Indeed, the Department of Treasury's Green Book, describing the President's Fiscal Year 2016 Proposed Budget, makes this explicit. The Green Book notes that AFFBs are intended to be "approximately revenue neutral relative to . . . tax-exempt bonds."[1]

In summary, our economic analysis shows that including bond insurance premiums in the yield calculation for AFFBs or similar municipal bond subsidy programs would produce results consistent with the historic application of the yield restriction rules for state and local issuers. Indeed, the treatment of bond insurance under BABs not only discourages the use of this financing tool, but it also creates incentives for market participants to use it to arbitrage the program. Thus, in the Committee's upcoming efforts related to bipartisan tax reform – to the extent that Congress is considering AFFBs or similar municipal bond subsidy programs – we strongly encourage you to ensure a level playing field that would allow issuers to use insurance as they find appropriate, potentially lowering financing costs to both the issuer and the federal government.

* * * *

Assured appreciates the opportunity to engage you, your Senate Finance Committee colleagues, and your staff in this dialogue, and welcome the chance to continue our discussion. If you have any questions, please do not hesitate to contact the undersigned at [redacted] or [redacted]

Sincerely,

Bruce E. Stern
Executive Officer
Assured Guaranty

[1] *See* President's Fiscal Year 2016 Budget Proposal, Green Book, p. 73 (2015).

cc: Senator Orrin Hatch, Chairman of the Senate Finance Committee
Senator Ron Wyden, Ranking Member of the Senate Finance Committee
Senator Dan Coats (R-IN), Member of the Senate Finance Committee Working Group on Community Development and Infrastructure
Senator Tim Scott (R-SC), Member of the Senate Finance Committee Working Group on Community Development and Infrastructure
Senator Maria Cantwell (D-WA), Member of the Senate Finance Committee Working Group on Community Development and Infrastructure
Senator Bill Nelson (D-FL), Member of the Senate Finance Committee Working Group on Community Development and Infrastructure

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