G. Joseph McLiney is president of McLiney & Co., an investment banking firm in Kansas City.

Diamonds in the Rough?

For the last 10 years a few banks have been squirreling away a little-known investment that has consistently thrown off above-average returns. They were using a program that provided a CRA-eligible investment with excellent yields, a steady flow of funds and secure investments in school districts.

The federal program is known as Qualified Zone Academy Bonds and Qualified School Construction Bonds. Prior to 2009, there was $400 million for all the schools in the United States and U.S. possessions.

Then, along came the American Recovery and Reinvestment Act, which expanded this program from $400 million to $1.4 billion. Also included was a new program mimicking the QZABs, called Qualified School Construction Bonds, providing an additional $11 billion in 2009 and another $11 billion in 2010.

Both QZABs and QSCBs are taxable tax-credit bonds. They currently have a maximum maturity of 15 years, which is established monthly by the U.S. Treasury Department. The yields are also set daily by the Treasury Department, based on a composite of securities. The rates over the last few months have fluctuated between 6 and 7 percent.

The credit structure is two-fold: the school district and the federal government. The borrower (always a school district) pays principal to the bank over a 15-year period, and instead of an interest check from the school district, the bank receives a quarterly federal tax credit set by Treasury at the bond's closing.

As appealing as the structure is, a real concern for most bankers, especially in light of the current financial crisis, is the ability to use a quarterly tax credit. Taking on an investment, and not being able to immediately use the tax credit, never feels right when presented to your loan committee or investment board.

Two facts may help with this drawback: First, the taxable tax credit can be carried forward indefinitely. So, if your profits are not in need of sheltering this quarter or next, hopefully you'll turn the situation around in succeeding years and be able to use the credits.

The second, and perhaps more helpful remedy to the use of the tax credits, is that the Treasury has allowed for the stripping of the tax credit from the bond itself. If your bank finds itself in the uncomfortable situation of not being able to predict its next profitable quarter, the tax credit bonds can be separated into two saleable securities: a quarterly tax credit and, after the tax credit is removed, an ordinary, taxable, zero-coupon municipal school bond.

While we are still waiting on direction from the Treasury on how tax stripping will be structured, bankers are already imagining the new product they'll be able to offer high net-worth clients and businesses. The CRA-eligible, zero-coupon bond, which can be written as a loan if need be, can sit nicely on the shelf while the bank and its customers have access to the newly created quarterly tax credits.

A word of caution: Prior to October 2008, QZABs could not be stripped and the market was thinly traded. Treasury's new regulations were put in place to help with this investment's liquidity.

Regardless, in this market, 270+ basis points over the 10-year Treasury (currently around 6.10 percent) for a low-risk, CRA-eligible investment return, is pretty good.

There are structuring techniques allowing for even a greater internal rate of return. One option is to create an escrow or sinking fund-type account, into which the district is required to make deposits annually, and the payments accrue toward a final balloon payment in the 15th year.

Limited marketability and tax credits that are not immediately needed are the two flaws in these bonds. Treasury's massive expansion of the size of this market should make for much greater liquidity in the near future. In addition, allowing banks to carry forward the credits indefinitely and the ability to sell the tax credits will greatly increase the appeal of these bonds. The possibility of a competitive edge when pursuing new school district business is another plus.

Even with limitations, tax-credit bonds are worthy of careful consideration. Don't delay, for the ARRA has slated these opportunities to end Dec. 31, 2010. BN