

Corporate Trust Connection

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How Will Bush's Tax Proposals Affect the Bond Market?

Early this year, President Bush proposed a \$674 billion tax initiative intended to boost the economy. Congress has pledged to slash the tax cut in half, but it remains to be seen how much of the plan is finally approved. More than half of its cost (\$364 billion) comes from a plan to eliminate tax on dividends paid to investors. Other provisions would:

- Accelerate the tax cuts of EGTRRA (The Economic Growth and Tax Relief Reconciliation Act of 2001)
- Create new, streamlined savings accounts for

retirement, education and other major expenses

- Increase tax write-offs of equipment for small businesses, revise unemployment benefits and provide a variety of other miscellaneous tax cuts.

Some of the proposed measures would affect the bond market. Here's one analysis of the likely impact on various segments of the bond market, should the president's plan become law.



Munis Face New Competition

The centerpiece of the president's plan allows taxpayers to exclude stock dividends from their taxable income. This could put dividend-paying stocks into competition with municipal bonds for the dollars of investors who want tax-free income. The result could be that bond issuers would have to pay higher interest rates to keep their debt attractive to investors.

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Did You Know...

U.S. Bank Corporate Trust Services participates in industry conferences across the country. A few of the conferences where you can stop and visit with a U.S. Bank representative are:

<i>Government Finance Officers Association Annual Conference</i> New York, NY	May 18-21
<i>Minnesota National Association of Housing & Redevelopment Officials Spring Conference</i> Brainerd, MN	May 21-23
<i>Florida Association of Local Housing Finance Authorities Conference</i> Key West, FL	July 9-12
<i>13th Annual California Public Finance Conference</i> San Diego, CA	Sept. 22-24
<i>ABS East Securitization Conference</i> Boca Raton, FL	October 8-11

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Have You Considered a CDO?



Since collateralized debt obligations (CDOs) were first created in the late 1980s, the number of CDOs issued has grown rapidly. “CDOs offer distinct advantages to a specific investor community,” explains Ralph Creasia, vice president, CDO Group, U.S. Bank Corporate Trust Services. “Organizations seeking to increase liquidity and manage their balance sheets, including commercial banks and investment banks, often employ CDO technology.”

CDOs change the risk/reward profile of an asset class to appeal to a more diverse array of investors. The transactions are placed privately, with CDO underwriters ensuring that all purchasers are qualified buyers. This avoids an investment company classification and subsequent filing with the Securities and Exchange Commission.

Different CDOs for Particular Needs

CDOs come in a variety of structures but the motivation for issuing them has been driven by two primary factors: maximizing spread arbitrage opportunities and balance sheet management.

Balance sheet CDOs are typically issued by domestic and international banks that want to reduce their balance sheets to improve capital ratios. Their collateral is generally high-grade, bank-originated commercial and industrial loans. In recent years, CDO structuring has increased the use of a broader array of collateral, including asset-backed securities, mortgage-backed securities, commercial mortgage securities and REIT securities. “Balance sheet CDO transactions can reduce regulatory capital requirements while enhancing lending capacity and return on equity by using the proceeds of the CDO securities to take these assets off balance sheet, out of the corporate portfolio,” Creasia says.

Arbitrage CDOs, on the other hand, are typically issued by mutual fund companies, investment management boutiques and private equity funds seeking an arbitrage opportunity. They issue CDOs to take advantage of the difference between investment grade funding and high-yield investing. Their collateral is usually high-yield corporate loans or bonds.

Purchase of State Street CDO Business Expands Existing Portfolio

At the end of 2002, U.S. Bank purchased the collateralized debt obligation (CDO) book of business from State Street Bank and Trust Company. State Street was one of the pioneers in the CDO marketplace, entering the business in the early 1990s. It earned the reputation as the premier collateralized loan obligation (CLO) trustee.

Now U.S. Bank, through its acquisition of State Street's corporate trust business, continues to gain the respect of all the dominant CDO players. Our client base includes the major investment houses on Wall Street. We provide a client-focused approach to serving the CDO marketplace, offering unmatched expertise and service levels.



CDOs change the risk/reward profile of an asset class to appeal to a more diverse array of investors.

“Arbitrage CDO transactions aim to capture the positive spread between a portfolio of high return, greater risk assets and the lower-cost, highly rated CDO securities issued to purchase the CDO portfolio,” explains Dawn Zanotti, vice president, CDO Group, U.S. Bank Corporate Trust Services.

We Can Help Create a Smooth Transaction

As trustee of a CDO transaction, the role of U.S. Bank Corporate Trust Services is to ensure that all aspects of the CDO transaction are in compliance with the governing documents. “We make an ongoing effort to maintain the investment of the noteholders,” Zanotti says. “Additionally, we perform various agency roles, including paying agent, note registrar, transfer agent, calculation agent and custodian.”

In most CDO transactions, Corporate Trust Services is also appointed collateral administrator. This role involves maintaining the collateral pool or assets of the trust selected by the collateral manager. “We create and maintain a collateral database, record and monitor all inflows and outflows of cash, create all indenture reporting – both on a monthly basis and in conjunction with distribution dates – and verify that the collateral pool is in compliance with the specifications of the transaction,” explains Creasia.

Can We Help You?

To learn more about CDOs, and whether issuing a CDO may be beneficial to you, contact your U.S. Bank Corporate Trust Services Account Manager.

Tax Proposals continued from page 1

A Weaker Corporate Market

Under the proposal, corporations must have paid tax on income they use to pay dividends to shareholders, or the dividends will not be tax-free. This rule leads to a deterrent for corporations – who account for 98% of all housing credit equity* – to invest in the multifamily housing bond market.

The Bond Market Association has called on the Bush administration to modify its proposal so that corporations would be allowed to distribute to shareholders tax-free the interest income earned from tax-exempt bond holdings.**

Reduced Value for Tax Credits

This market also often makes use of tax credits. However, under the plan, all tax credits except foreign tax credits would be considered to reduce a corporation’s taxable income and would therefore convert dividends from tax-free to taxable. Each dollar of tax credit would be treated as if it were three dollars of tax deductions, nullifying the proposed tax exemption on three dollars worth of dividends.

As a result, dividend-paying corporations may no longer invest in tax credits and would likely sell the tax credits they already own. The negative effect would likely extend beyond the multifamily housing bond market to the qualified zone academy bond market, as well. (Bush’s proposal extends the use of qualified zone academy bonds through the end of 2005.)

Eased Restrictions on 501(c)3 Bonds

On a brighter note, the plan contains two measures to simplify and ease the use of 501(c)3 bonds. One would remove the remaining \$150 million limitation on bonds that weren’t exempted by the partial repeal enacted in 1997. The other would repeal the income targets that apply to residential rental properties financed with tax-exempt bonds by 501(c)3 organizations.***

Where It Stands

The federal budget for fiscal year 2004, which begins Oct. 1, 2003, was passed by Congress in April, but debate continues on the size and extent of the tax cuts. This article was current as of the date of publication. We encourage you to stay informed of the proposal’s status and how it may affect your business.

* Source: Press release, March 5, 2003, The Bond Market Association, www.bondmarkets.com.

** Source: Study by Ernst & Young, “The Impact of the Dividend Exclusion Proposal on the Production of Affordable Housing,” commissioned by the National Council of State Housing Agencies, February 2003.

*** Source: *The Bond Buyer*, Feb. 4, 2003.

Spotlight on Los Angeles

Los Angeles may bring to mind movie stars, palm trees and shopping on Rodeo Drive, but the city is also home to the Los Angeles office of U.S. Bank Corporate Trust Services. It is the largest corporate trust office in California and is a perennial leader in market share.

The Los Angeles office is part of the Western region of U.S. Bank Corporate Trust Services, which also includes the San Francisco, Seattle, Portland, Denver, Arizona, Idaho, Utah and Montana offices.

Sunny Service

“The Los Angeles office provides a full range of corporate trust services,” says Teresa Caspary, senior vice president, Western Regional Manager. “We administer all

types of municipal and corporate bond issues from simple to complex, including issues of the largest housing authorities in the state. We pride ourselves in being able to service even the most complex type of financings on behalf of our clients.

“A dedicated group of experts also administers corporate escrow transactions, which, as a result of our excellent reputation in this area, have been a rapidly growing part of our business. This includes indemnification, subscription, and merger and acquisition escrows.

A Seasoned Staff

The 58 people in the Los Angeles office make up a highly experienced, seasoned staff. “With an average of 15 to 20 years of experience, we



Some of the U.S. Bank Corporate Trust Services L.A. staff.

feel that our staff significantly sets U.S. Bank apart from our competitors,” Caspary says. “This depth of experience and a spirit of teamwork help us provide the highest level of service and expertise to our customers.”

The Los Angeles office recently expanded, adding about 1,000 accounts and 18 people as a result of the State Street acquisition. “Due to our extensive experience with acquisitions, the integration has gone very smoothly.” Caspary says. “We welcome

our new staff and are very pleased to be able to extend our services to former State Street customers. In addition to our existing large market share, this acquisition further positions us as the market leader in terms of California debt financings.”

From East coast to West, U.S. Bank Corporate Trust Services can provide the financial services you need. If you'd like more information, please contact your Account Manager.

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