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Economic Woes Continue For 'AAA' Bond Insurers' U.S. Public Finance Business

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The highly competitive conditions and tight credit spreads that have existed for bond insurers for the past few years in the U.S. public finance market were only intensified by a decline in insured penetration in the first half of 2007. Against this backdrop was a general decline in the 'AAA' rated companies' U.S. public finance risk-adjusted pricing indices, with the group average falling to 4.71%, the lowest level in the past six years.

New issue volume in the U.S. public finance market rose 27% for the first six months of 2007 compared with the same period in 2006. Insured penetration, however, dropped to 48% from 50% in 2006. This is quite surprising, as the sectors that experienced the strongest growth in issuance volume have traditionally had some of the highest insured penetration rates. This could be an indication of how tight credit spreads have become and the competitive pricing pressure the bond insurers are experiencing. In the future, the insurers may allocate less capital to the U.S. public finance market as they tap the U.S. structured finance and international markets in search of better growth and pricing opportunities.

The deterioration of the sub-prime residential mortgage-backed security market and the negative headlines that have plagued bond insurers do not appear to have had much of an effect on their ability to conduct business. Instead, as with past events of credit deterioration, strong pricing opportunities may present themselves due to widening credit spreads and the increased value of financial guarantee insurance.

Business Economic Trends For The First Half Of 2007

To evaluate the economic benefit of the bond insurers' various books of business, Standard & Poor's Ratings Services calculates a risk-adjusted pricing index. Formerly known as the profitability index, the risk-adjusted pricing index is calculated for business written in a given time period (usually one year). The risk-adjusted pricing index is a measure that shows how much premium the insurers have charged per unit of risk. The index divides the weighted average premium rate of a book of business by its weighted average capital charge. Standard & Poor's assigns capital charges to all insured transactions and uses the capital charges to determine theoretical losses in its capital adequacy model.

The industry appears to have adhered to tight underwriting standards; the per-period weighted average capital charge declined not only from the first six months of 2006, but also from the 2006 year-end level. While the weighted average capital charge was down 16% for the first six months of 2007 from the same period the previous year, the 24% decrease in the implied premium rate pushed the industry average risk-adjusted pricing index down 10% to 4.71%. In theory, movements in capital charges and premium rates should move in tandem in a world of rational pricing; however, competition and narrowing credit spreads greatly influence pricing, as they did in the first half of 2007.

It is important for insurers in this environment to exercise self-discipline when writing new business to avoid building up an overly large book of business that would generate only mediocre shareholder returns over 20 or more years. Such restraint would also benefit insurers from a capital adequacy perspective; too much lower-priced business could create a double whammy of inadequate capital generation without an appropriate lower level of theoretical losses. A disciplined approach to underwriting that would translate into a comparatively lower volume of new business and less damage to imbedded returns and capital generating capability could address long-term capital adequacy concerns.

Individual Company Results

Ambac Assurance Corp.

Ambac's management continues to push strongly into less-competitive public finance transactions where the company can add value because of its expertise in structuring and pricing at good risk/return levels. For the first six months of 2007, the company's share of gross principal and interest (P&I) written was 29% and its share of adjusted gross premiums written was 39% (both lead positions). Ambac's selective underwriting strategy, however, did not protect the company from competitive pricing trends in the industry. For the first six months of 2007, Ambac's risk-adjusted pricing index was down 3% from the same period in 2006. The weighted average capital charge declined 8% and the implied premium rate declined 11%, primarily driven by a trend toward more "plain vanilla" municipal credits during the first half of 2007 and several large transactions in the first half of 2006. The 2006 transactions had relatively high premium rates and capital charges; with similar transactions absent in 2007, the effect on the risk-adjusted pricing index was significant. Ambac was one of only two bond insurers to report a rise in its risk-adjusted pricing index from 2006 year-end levels. This was mainly due to an increased amount of utility business, which has proven to have some of the better risk/reward pricing dynamics for the industry in general.

Assured Guaranty Corp.

Except for some capacity-constrained names, Assured Guaranty Corp. (AGC) traditionally targets credits rated 'BBB' and 'BBB-' in public finance sectors including health care, private education, municipal utility districts, and municipal COPs. As AGC has developed its public finance franchise, the company has continued to see more and more opportunities in the lower risk sectors of the market. This is reflected in the business written in the first half of 2007, when the company reported its lowest gross per-period weighted average capital charge of 15.96%, down 25% from the same period in 2006 and down 12% from 2006 year-end levels. Production by the company in the first half of 2007 included a larger percentage of low capital charge GO and 'A' rated healthcare business. The shift to higher quality business also had an effect on the implied premium rate for the period, which was down by 22% from the first six months of 2006. The positive trends in the components of the risk-adjusted pricing index led to a 4% rise in the index, with AGC one of only two companies reporting a rise in the index for the period. AGC continues to make progress toward developing its franchise in the U.S. municipal market, one of its key goals. Improvement in AGC's market share of gross P&I written from its current 1.3% level is likely since the company has 'AAA' ratings from all the rating agencies.

The CIFG Group

As one of the less-established financial guarantors, CIFG faces compounded challenges in a competitive pricing environment. That being said, the company's 24% decline in gross P&I written had more to do with what CIFG insured in 2006 than with what it did not insure in 2007. In the first half of 2006, CIFG insured three large, well-priced transactions, but the company did not insure any similar transactions in 2007. For the first half of 2007, CIFG increased volume in the lower priced/lower risk sectors of the municipal market, and the components of the company's risk-adjusted pricing index reflect this fact. The implied premium rate was down 43% and the per-period weighted average capital charge was down 17%. The implied premium rate's large decline led to a 31% drop in the risk-adjusted pricing index to 2.99%, the lowest of the 'AAA' insurers. A slight trading differential on fixed-rate debt, the absence of opportunistic large transactions in 2007 so far, business declines in sectors with higher risk adjusted returns, and narrow credit spreads contributed to the decline in the index. The pipeline of transactions to close for the second half of 2007 is strong, particularly in healthcare, higher education, and the not-for-profit sectors.

Financial Guaranty Insurance Co.

Despite management's efforts to create a more diversified business plan over the past two years, Financial Guaranty Insurance Co.'s (FGIC) business mix in 2007 has so far been heavily weighted toward low-risk, low-premium GO and tax-backed transactions. The company's risk-adjusted pricing index shows this trend, which began in the second half of 2006. The per-period weighted average capital charge for the full year of 2006 was down from the first half of 2006, and the weighted average capital charge for the first half of 2007 was down from the 2006 year-end level. The implied premium rates for the same period followed the same downward trend, but at a greater rate, leading to a decline in the risk-adjusted pricing index. For the first six months of 2007, FGIC reported a 51% decline in the implied premium rate from the same period in 2006; the weighted average capital charge declined just 35%, however, leading to a 25% decline in the risk-adjusted pricing index to 4.17%. The company experienced aggressive competition in the healthcare and investor-owned utility financings which, combined with a disciplined approach to underwriting, hindered its participation in these sectors. Based on the competitive landscape, it is unlikely that much will change in these areas for the remainder of the year.

Financial Security Assurance Inc.

In the current competitive financial guarantee environment, Financial Security Assurance Inc. (FSA) continues to demonstrate a disciplined underwriting approach to new business. The company's risk-adjusted pricing index was the highest among the seasoned financial guarantors for the first six months of 2007, with the company ranking second in terms of adjusted gross premiums written among all 'AAA' financial guarantors. However, similar to most other financial guarantors, FSA reported a decline in its risk-adjusted pricing index. The reduction in the implied premium rate and the slight overall decline in adjusted gross premiums written between six-month periods was the result of decreases in health care and other high-premium types of transactions. The shift toward lower premium transactions is evident when comparing the 27% rise in gross P&I written with the 9% decline in adjusted gross premiums written. On the positive side, the company reported an 18% decline in its per-period weighted average capital charge and a risk-adjusted pricing index of 5.10%, 8% higher than the industry average.

MBIA Insurance Corp.

For the first six months of 2007, MBIA reported strong growth in gross debt service insured (24%) and adjusted gross premiums written (22%), primarily caused by a significant increase in insured volume in the GO and tax-backed sectors, which represented 57% of gross debt service insured. An increase in transportation and infrastructure transactions, however, drove the 10% increase in the per-period weighted average capital charge between six-month periods. Although the transportation and infrastructure sectors showed improvement for the company in terms of risk-adjusted pricing, the continuing competitive pricing environment in the GO and tax-backed sectors suppressed improvement in the index. The implied premium rate for the period was down a modest 2%; when combined with the 10% increase in the weighted average capital charge, however, the risk-adjusted pricing index was down 11%. It is worth noting that the 9% decline in the implied premium rate from the end of 2006 was much lower than the industry's average 16% decline and the second lowest rate of decline among its peers.

XL Capital Assurance Inc.

XL Capital Assurance Inc. 's (XLCA) U.S. public finance volume figures were down significantly for the first six months of 2007. Adjusted gross premiums written declined 52%, while gross P&I written fell 36%. Management attributes the declines to the company completing several large transactions in the first half of 2006 that it did not repeat in 2007. Lowered pricing and decreased spreads were also reasons for the reduction in volume during this period. In terms of risk-adjusted pricing, however, the story is not so negative. In the first half of 2007, XLCA's implied premium rate was down 25%, far less than the 38% decrease in the per-period weighted average capital charge, resulting in a 21% increase in its risk-adjusted pricing index to 6.56%. The contribution of the utility sector to overall business volume was the primary reason for the index's increase. In the first six months of 2007, approximately 30% of insured public finance business was in the utility sector, compared with 18% in the same period in 2006. The utility sector tends to be one of the more richly priced sectors in the U.S. public finance market.

Table 1

U.S. Public Finance Premium Rate and Economic Trends

	--Six months ending June 30, 2007--	--Six months ending June 30, 2006--	--Year ending Dec. 31--				
(Mil. $)			**2006**	**2005**	**2004**	**2003**	**2002**
Ambac Assurance Corp.							
Gross P&I written	59,702	43,900	85,427	100,521	82,473	81,287	87,243
Adjusted gross premium written	301	251	442	613	566	750	648
Implied premium rate (%)	0.51	0.57	0.52	0.61	0.69	0.92	0.74
Gross per-period capital charge (%)	10.50	11.41	11.17	10.55	10.94	11.83	11.51
Risk-adjusted pricing index (%)	4.86	5.02	4.64	5.78	6.28	7.80	6.45
Assured Guaranty Corp. (direct only)							
Gross P&I written	2,631	1,216	3,440	2,054	353	N.A.	N.A.
Adjusted gross premium written	24	14	36	24	6	N.A.	N.A.
Implied premium rate (%)	0.92	1.19	1.04	1.17	1.61	N.A.	N.A.
Gross per-period capital charge (%)	15.96	21.35	18.21	21.51	28.72	N.A.	N.A.
Risk-adjusted pricing index (%)	5.77	5.56	5.69	5.43	5.62	N.A.	N.A.
CIFG							
Gross P&I written	5,560	7,346	15,139	10,686	7,312	5,363	1,217
Adjusted gross premium written	16	37	70	61	36	62	12
Implied premium rate (%)	0.29	0.51	0.46	0.57	0.50	1.16	0.99
Gross per-period capital charge (%)	9.69	11.63	10.85	12.17	6.61	9.96	5.75
Risk-adjusted pricing index (%)	2.99	4.35	4.26	4.67	7.52	11.64	17.28
Financial Guaranty Insurance Co.							
Gross P&I written	38,398	27,555	59,771	74,226	58,755	58,291	68,807

Table 1

U.S. Public Finance Premium Rate and Economic Trends(cont.)							
Adjusted gross premium written	127	185	314	371	307	231	197
Implied premium rate (%)	0.33	0.67	0.53	0.50	0.52	0.40	0.29
Gross per-period capital charge (%)	7.92	12.13	10.64	8.82	8.00	6.20	6.06
Risk-adjusted pricing index (%)	4.17	5.53	4.94	5.67	6.52	6.39	4.72
Financial Security Assurance Inc.							
Gross P&I written	46,780	36,936	83,618	109,440	82,856	89,711	88,223
Adjusted gross premium written	151	167	310	485	434	483	421
Implied premium rate (%)	0.32	0.45	0.37	0.44	0.52	0.54	0.48
Gross per-period capital charge (%)	6.34	7.74	6.70	7.48	7.42	7.08	7.73
Risk-adjusted pricing index (%)	5.10	5.83	5.53	5.92	7.05	7.60	6.17
MBIA Insurance Corp.							
Gross P&I written	40,797	32,882	80,509	108,534	94,252	107,967	102,782
Adjusted gross premium written	147	121	319	486	457	626	452
Implied premium rate (%)	0.36	0.37	0.40	0.45	0.48	0.58	0.44
Gross per-period capital charge (%)	8.45	7.67	8.79	8.83	7.38	8.10	7.98
Risk-adjusted pricing index (%)	4.26	4.78	4.51	5.07	6.57	7.16	5.52
XL Capital Assurance Inc.							
Gross P&I written	11,235	17,447	32,970	26,938	19,581	20,344	8,271
Adjusted gross premium written	56	116	237	148	108	158	56
Implied premium rate (%)	0.50	0.67	0.72	0.55	0.55	0.78	0.67
Gross per-period capital charge (%)	7.65	12.30	13.94	9.54	9.05	7.77	13.89
Risk-adjusted pricing index (%)	6.56	5.42	5.16	5.77	6.09	10.00	4.84
'AAA' Primary Insurers' Average							
Gross P&I written	204,474	167,281	360,872	432,345	345,581	362,963	356,543
Adjusted gross premium written	823	891	1,728	2,187	1,913	2,310	1,786
Implied premium rate (%)	0.40	0.53	0.48	0.51	0.55	0.64	0.50
Gross per-period capital charge (%)	8.55	10.16	9.82	9.07	8.44	8.39	8.54
Risk-adjusted pricing index (%)	4.71	5.25	4.87	5.57	6.56	7.59	5.87

N.A.-not available.