

For The U.S. Bond Insurance Market, There May Be No Turning Back

Primary Credit Analyst:

Rodney A Clark, FSA, New York (1) 212-438-7245; rodney_clark@standardandpoors.com

Secondary Credit Analysts:

Dick P Smith, New York (1) 212-438-2095; dick_smith@standardandpoors.com

David Veno, New York (1) 212-438-2108; david_veno@standardandpoors.com

Table Of Contents

The Beginnings Of The Crisis

New Entrants Are Emerging, But No Successes Yet

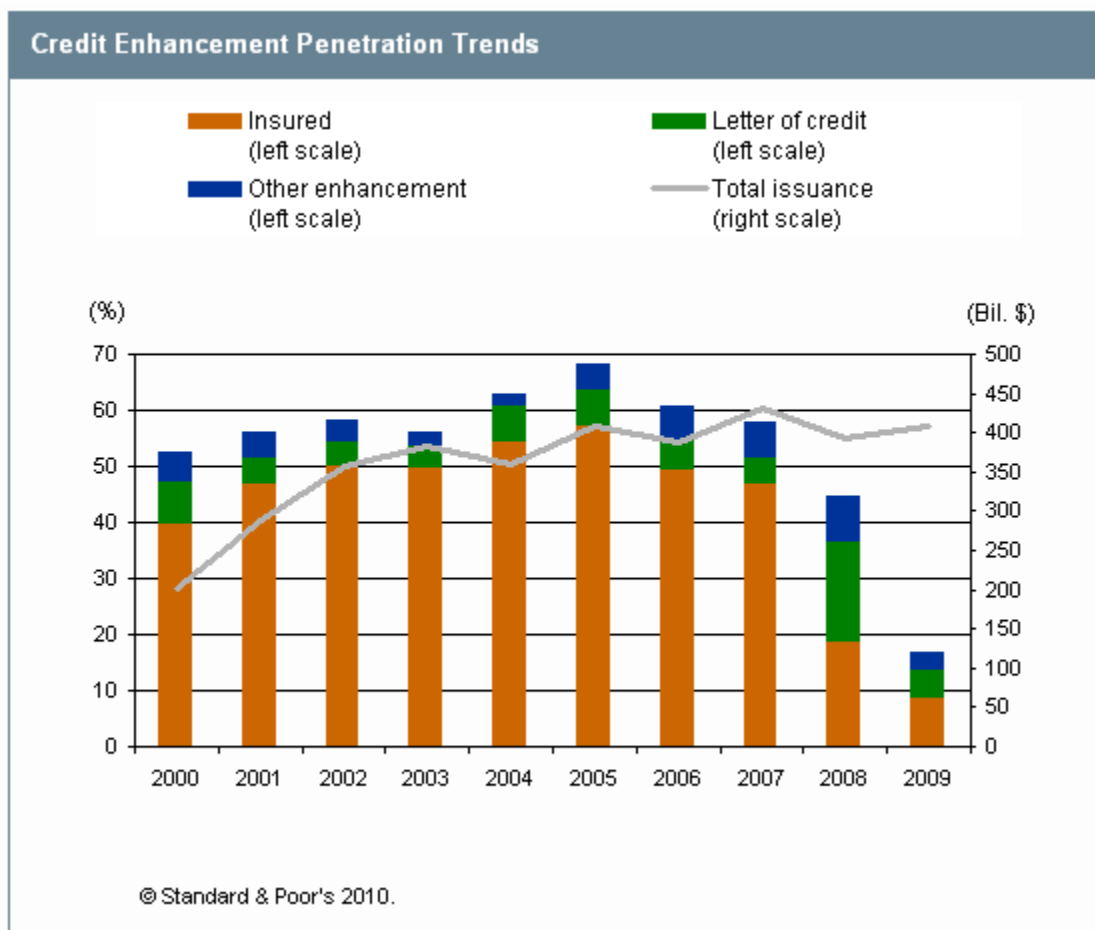
Three Scenarios For The U.S. Bond Insurance Sector

The Sector Has The Potential To Thrive, But It Will Look Different Than It Has In The Past

For The U.S. Bond Insurance Market, There May Be No Turning Back

What began in the 1970s as a relatively stable business--insuring U.S. municipal bonds against default--grew significantly in the early 2000s as U.S. bond insurers increased their coverage of structured finance instruments. The exposures in that sector led Standard & Poor's Ratings Services to downgrade many bond insurers. Now, only one active bond insurer remains--Assured Guaranty Corp. (AAA/Negative/--)--and the future of the bond insurance industry is uncertain. Taking into account the recent market stress, the decline of the large well-established insurers, the potential for new entrants, and possible alternatives to bond insurance in the municipal market, we believe the prospects for a revival of this industry are modest.

At their peak in 2005, bond insurers covered about 57% of new municipal bond issuance (see the chart). That fell to about 9% in 2009, leaving Assured Guaranty as essentially the only provider. In 2007 and 2008, banks offered letters of credit as an alternate form of credit enhancement. But that form largely dried up by 2009 as credit markets seized and bank lending diminished greatly. There is still demand for municipal bond insurance, though less than in the past. So, in our view, there are several possible scenarios, which might include: Bond insurance could remain a small niche market, or recover to more moderate levels, or emerge in a new form, offering new types of credit enhancement.



The Beginnings Of The Crisis

Bond insurers began to diversify out of U.S. public finance in the 1990s. This trend accelerated during the 2000s in part because the structured finance business generated higher returns, even as tight credit spreads and highly competitive conditions led to lower risk-adjusted pricing for traditional bond insurance. For example, MBIA Insurance Corp. (BB+/Negative/--), which had long been one of the largest bond insurers, had 87% of its insured par in U.S. public finance and only 8% in structured finance products as of Dec. 31, 1995. By 2000, structured finance had grown to 34% of MBIA's insured portfolio, and by 2006, insured structured finance accounted for more than half of the company's total gross par written. Across the industry, the insured exposures in structured finance varied. But the structured finance exposures typically included residential mortgage-backed securities (RMBS) and collateralized debt obligations, which often contained RMBS.

In 2007, as the U.S. housing crisis began to take hold, many banks turned to bond insurers for protection and many bond insurers continued to insure these exposures. As housing markets declined and losses on structured securities mounted from late 2007 through 2008 and 2009, and the bond insurers' capital eroded, Standard & Poor's lowered its ratings on most bond insurers to below investment grade (lower than 'BBB-'). The market's loss of confidence in complex, highly leveraged institutions was such that even 'AAA' rated Assured Guaranty's credit default swap spreads traded far higher than historical investment-grade levels.

New Entrants Are Emerging, But No Successes Yet

In our view, there's still a need for municipal bond issuance, historically the sector's bread and butter. In particular, smaller and less-creditworthy governments and institutions have relied on the credit enhancement provided by bond insurers to gain access to the market and to lower their cost of issuance. But by 2008, these institutions had few options for credit enhancement.

Warren Buffett's Berkshire Hathaway entered the municipal bond insurance market with great fanfare in late 2008, and Standard & Poor's rated the company 'AAA' based in part on a guaranty from an affiliate. However, Berkshire Hathaway Assurance Corp. (AAA/Watch Neg/--), the new municipal bond insurer, never staffed up to insure significant volumes, based on our analysis, and it focused on the limited market of secondary or tertiary bond insurance on top of other bond insurers. As a result, after a surge in late 2008, it quickly decreased its writings. Today, it writes a minimal amount of new coverage.

Other new ventures have received attention in the media. One of these, a mutual insurer that the National League of Cities (NLC) sponsors, has yet to ramp up because of a lack of government-sponsored seed capital. However, we believe the NLC's interest implies that issuers strongly value a viable municipal bond insurance market.

Another new entrant, Municipal Infrastructure Assurance Corp. (MIAC), sponsored by Macquarie and Citadel, has gotten media attention, but it has yet to launch. This is likely a reflection of the difficulties these start-ups are facing in obtaining capital and establishing a structure and business plan consistent with the financial strength necessary in this credit-sensitive market.

Fallen legacy bond insurers--notably MBIA and Ambac Assurance Corp. (CC/Developing/--)--also have proposed setting up new entities to serve the municipal market--separate from their structured finance exposures. But so far, these strategies are on hold. MBIA faces legal obstacles to its restructuring, and both companies have been unable to

raise capital and create corporate structures that will regain market confidence. So we believe that both companies face uphill battles in getting off the ground and regaining the confidence of issuers and investors.

Three Scenarios For The U.S. Bond Insurance Sector

Formation of a small niche market

Many issuers and investors learned to go without bond insurance over the past year, so it is possible that the market might never recover to more than low-double-digit penetration. This likely would leave little room for new entrants. In our view, Assured Guaranty and perhaps another small competitor might end up being the only insurers serving the market. If more new entrants emerge and the market doesn't expand, profitability likely will suffer. In such a scenario, we believe that the negative impact on profit margins could reduce the creditworthiness of the insurers--which might make bond insurance less attractive in the municipal bond market.

Recovery to more moderate levels of penetration

Another possibility we can imagine is that as market conditions improve and new bond insurers emerge, the industry could end up insuring 20%-30% of the new issuance in the municipal market. In the past year, although many larger municipal issuers successfully went to market without insurance, smaller and less-creditworthy issuers still had difficulty issuing at reasonable spreads. Because of these factors, this scenario of a moderate-size market could develop, but only, in our view, if investors (a large portion being retail investors) place a value on insurance and if strong new bond insurers enter the market. Under this scenario, three or perhaps four bond insurers could function successfully in the market. We think that more new entrants than that would, again, increase competition and reduce profit margins.

Emergence of new forms of credit enhancement

As bond insurer ratings declined and market confidence eroded in 2008, banks significantly stepped up their offerings of liquidity and credit enhancement through letters of credit. However, the credit crunch at U.S. banks caused the U.S. municipal bond market to decline significantly during 2009. As banks grow stronger in the future, they might see this market as a profitable and low-risk way to extend credit to the market. Furthermore, structured finance approaches to credit enhancement through limited purpose vehicles could emerge. In our view, this could limit the opportunities for bond insurance. We believe that bond insurance still offers a more complete solution to municipal credit enhancement (letters of credit generally provide coverage that is much shorter than the term of the bonds they enhance). But the market preference for the various options likely will depend on investor confidence in bond insurers and issuers' perceived value of the different options.

It could be two or more years before it is clear which of these scenarios will shape municipal credit enhancement in the future. The current market, with only one active insurer, means that investors and issuers are learning to live without insurance. The longer this is true, the more limited the potential for the reemergence of a strong and vital bond insurance sector, in our view.

The Sector Has The Potential To Thrive, But It Will Look Different Than It Has In The Past

In other words, this year will be telling for the future of bond insurance. If one or two strong and highly rated new insurers launch in 2010, and if they successfully penetrate the market, then it is likely that the sector will thrive in

the next few years. But we believe the window of opportunity is small. Declining tax revenues and growing pension and other benefit obligations are weighing heavily on state and municipal credit. These developments increase the value of insurance. At the same time, however, they increase the risk to insurers.

We believe that demand for bond insurance could increase, but that will depend on insurers attracting strong capitalization and achieving stable credit portfolios. Our view of any start-up company will depend in large part on whether we believe management can create a sustainable business model and generate a profitable stream of revenue that is sufficient to support the capital employed in the business. Furthermore, we believe it is critical for insurers to demonstrate strong enterprise risk-management capabilities to achieve high credit ratings.

So the "new normal" for bond insurance remains unclear. But what is clear is that the future of the sector will be in striking contrast to the past--with new names, new business models, and a redefined scope--as bond insurers attempt to rebuild based on lessons learned from the recent crisis.

Copyright (c) 2010 by Standard & Poor's Financial Services LLC (S&P), a subsidiary of The McGraw-Hill Companies, Inc. All rights reserved.

No content (including ratings, credit-related analyses and data, model, software or other application or output therefrom) or any part thereof (Content) may be modified, reverse engineered, reproduced or distributed in any form by any means, or stored in a database or retrieval system, without the prior written permission of S&P. The Content shall not be used for any unlawful or unauthorized purposes. S&P, its affiliates, and any third-party providers, as well as their directors, officers, shareholders, employees or agents (collectively S&P Parties) do not guarantee the accuracy, completeness, timeliness or availability of the Content. S&P Parties are not responsible for any errors or omissions, regardless of the cause, for the results obtained from the use of the Content, or for the security or maintenance of any data input by the user. The Content is provided on an "as is" basis. S&P PARTIES DISCLAIM ANY AND ALL EXPRESS OR IMPLIED WARRANTIES, INCLUDING, BUT NOT LIMITED TO, ANY WARRANTIES OF MERCHANTABILITY OR FITNESS FOR A PARTICULAR PURPOSE OR USE, FREEDOM FROM BUGS, SOFTWARE ERRORS OR DEFECTS, THAT THE CONTENT'S FUNCTIONING WILL BE UNINTERRUPTED OR THAT THE CONTENT WILL OPERATE WITH ANY SOFTWARE OR HARDWARE CONFIGURATION. In no event shall S&P Parties be liable to any party for any direct, indirect, incidental, exemplary, compensatory, punitive, special or consequential damages, costs, expenses, legal fees, or losses (including, without limitation, lost income or lost profits and opportunity costs) in connection with any use of the Content even if advised of the possibility of such damages.

Credit-related analyses, including ratings, and statements in the Content are statements of opinion as of the date they are expressed and not statements of fact or recommendations to purchase, hold, or sell any securities or to make any investment decisions. S&P assumes no obligation to update the Content following publication in any form or format. The Content should not be relied on and is not a substitute for the skill, judgment and experience of the user, its management, employees, advisors and/or clients when making investment and other business decisions. S&P's opinions and analyses do not address the suitability of any security. S&P does not act as a fiduciary or an investment advisor. While S&P has obtained information from sources it believes to be reliable, S&P does not perform an audit and undertakes no duty of due diligence or independent verification of any information it receives.

S&P keeps certain activities of its business units separate from each other in order to preserve the independence and objectivity of their respective activities. As a result, certain business units of S&P may have information that is not available to other S&P business units. S&P has established policies and procedures to maintain the confidentiality of certain non-public information received in connection with each analytical process.

S&P may receive compensation for its ratings and certain credit-related analyses, normally from issuers or underwriters of securities or from obligors. S&P reserves the right to disseminate its opinions and analyses. S&P's public ratings and analyses are made available on its Web sites, www.standardandpoors.com (free of charge), and www.ratingsdirect.com and www.globalcreditportal.com (subscription), and may be distributed through other means, including via S&P publications and third-party redistributors. Additional information about our ratings fees is available at www.standardandpoors.com/usratingsfees.