Bond Insurance: Stronger Than the "Old" Triple-A

The bond insurance industry, like much of the financial services sector, has emerged from the Great Recession looking considerably different than it did less than a decade ago.

From as many as nine firms actively pursuing public and structured finance business around the globe in 2007, the industry is now much smaller and primarily focused on the U.S. public finance market. Insured penetration declined from over 50% of the municipal market at its peak to the mid-single digits today, and has only recently begun to grow again.

That much is well known. But there's a less appreciated story that's been largely overshadowed by changes in the rating agencies' criteria which turned the once Triple-A bond insurance industry into one where the highest current ratings now are in the Double-A range. Relative to 2007, the currently active bond insurers have significantly greater ratios of financial resources to their insured portfolios ("leverage ratio"). Put another way, at their current ratings, we believe the active insurers are now stronger on a capitalization and leverage ratio basis than when they were rated Triple-A.

national
public finance
guarantee

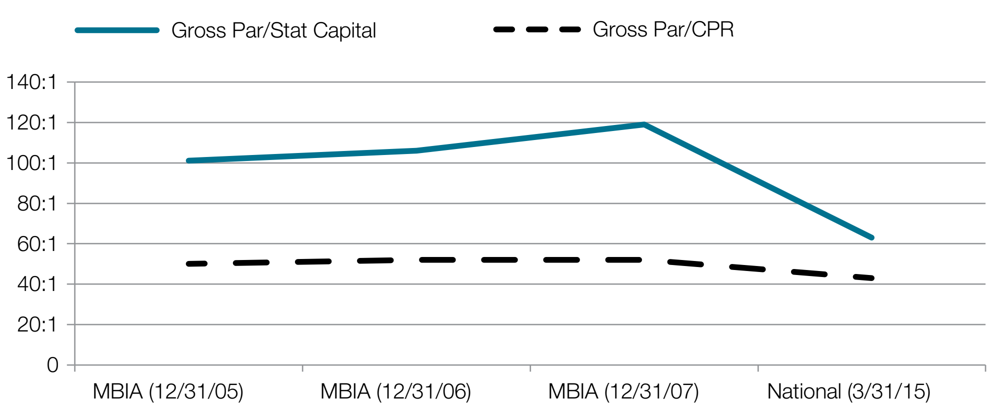
Back to the Future

Today, the bond insurance industry looks a lot like it did at its inception in the 1970s when the first bond insurers were formed and provided financial guarantee insurance solely to the U.S. public finance market. In the wake of the financial crisis, most insurers have narrowed their business focus to the U.S. public finance market in recognition of a preference among municipal bond issuers and investors for financial guarantee platforms that are dedicated to their market and free of structured finance exposures. In fact, National Public Finance Guarantee was created specifically to satisfy that preference, as it is focused exclusively on the U.S. public finance sector and has no non-U.S. or structured finance exposures in its insured portfolio. Within the U.S. municipal market, bond insurers are providing insurance primarily for the smaller, less frequent issuers, as this group benefits most from the enhanced liquidity and market access that bond insurance provides. Transaction sizes reflect this, as during 2014 the average size of all municipal bond issues was $31 million while the average size of an insured issue was approximately $13 million.

Lower Leverage Ratios

Bond insurer leverage ratios have improved significantly as more rigorous rating agency capital requirements, insured portfolio amortization and explicit strategic objectives to operate with lower leverage have combined to reduce the ratios of insured exposure to statutory capital and claims-paying resources. As seen in the chart below, leverage, as measured by gross par insured to statutory capital and claims-paying resources, has declined significantly from the pre-crisis days for MBIA/National:

	National (3/31/15)	MBIA (12/31/07)
Gross Par Outstanding ($ in billions)	$210	$762
U.S. Public Finance	100%	60%
Statutory Capital ($ in millions)	$3,329	$6,382
Claims-Paying Resources ($ in millions)	$4,919	$14,562
Gross Par/Statutory Capital (lower is better)	63:1	119:1
Gross Par/Claims-Paying Resources (lower is better)	43:1	52:1



Shifting Rating Agency Methodologies

Perhaps counterintuitively, ratings alone do not provide a clear picture of the bond insurers' financial strength as the rating agencies' approaches to rating the industry have evolved in recent years to include non-financial factors. While capital adequacy and the ability to make timely payments of interest and principal when due under a variety of stressful scenarios remain components of their analysis, the application of qualitative adjustments to the ratings metrics results in less emphasis on financial strength than in 2007.

Moody's Investors Service, for example, places a 45% weighting simply on the market share of the bond insurer and how profitable it is for shareholders, which arguably is unrelated to its ability to pay claims at any particular point in time. By contrast, the quality of the insured portfolio and the bond insurer's capital adequacy, the key concerns for holders of insured bonds looking for timely payment of principal and interest, have only a 40% weighting. Moody's has also stated that regardless of the specific bond insurer metrics, it does not believe that the industry can readily achieve ratings in the Double-A category, which by itself is a limiting factor in the public's understanding of the fundamental financial strength of a bond insurer. Standard & Poor's includes qualitative emphasis on factors that include competitive position and business strategy to make adjustments to the rating separate from its financial strength assessment. The Kroll Bond Rating Agency began rating bond insurers in 2013 and its methodology is probably the closest to a pure capitalization analysis given its emphasis on an insurer's portfolio, claims-paying resources and financial profile.

There is room for a thoughtful debate regarding the relative merits of each approach, but the key points for users of bond insurance to bear in mind are that each rating agency has developed its own standards and approaches to rating bond insurers, which differ from the other rating agencies and the current rating standards require more capital for Double-A ratings than the ratings standards of 2007 required for Triple-A ratings.

Conclusion

While the bond insurance industry is no longer Triple-A, its leverage ratios have improved since the financial crisis. At the same time, the industry's narrowed focus on the U.S. public finance market has removed much of the volatility that came from other market sectors. Market participants need to bear in mind that the ratings applied to bond insurers today are not comparable to those in use when most insurers were rated Triple-A. But despite lower average ratings, we believe investors and issuers should have a high degree of confidence that National and the other active bond insurers will meet their obligations to pay principal and interest when due even in highly stressful scenarios.

Key Takeaways

- Investors and issuers have expressed a clear preference for bond insurance platforms dedicated exclusively to U.S. public finance business
- Leverage ratios in the bond insurance sector have improved considerably from the pre-financial crisis era
- Double-A ratings are based on higher capitalization and lower leverage ratios than the Triple-A ratings assigned to bond insurers in 2007

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