



Do We Really Need Bond Insurance?

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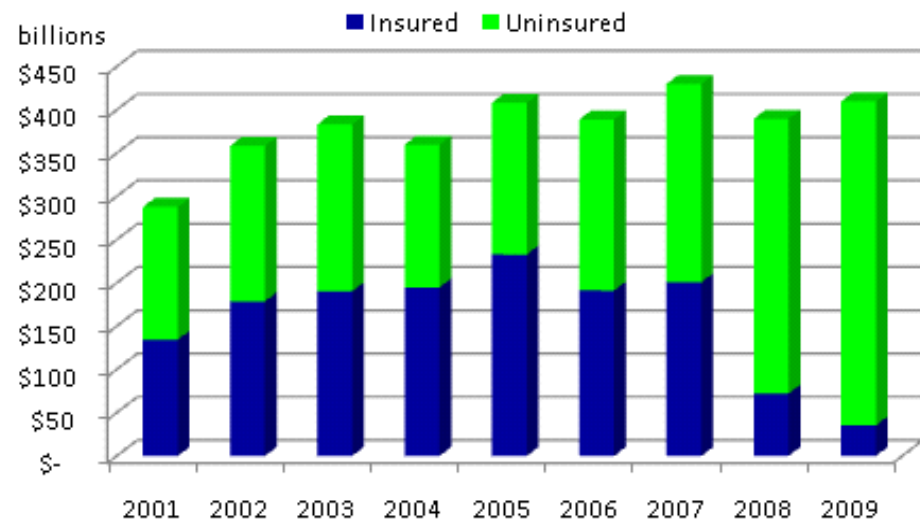
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Market Coverage

- ❑ 1980 – 2.5% of bonds were insured
- ❑ 1983 – WPPSS \$2B default
- ❑ 2001 to 2007 – 50% of bonds were insured
- ❑ Dec '07 – Major insurers put on credit watch
- ❑ 2008 – 19% insured
- ❑ 2009 – 9% insured
- ❑ 2010* – 6% insured

**first quarter*





Bond Insurers

The Big Four – rated Aaa/AAA/AAA until Dec '07:

- ❑ American Municipal Bond Assurance Corporation (AMBAC) formed 1971
- ❑ Municipal Bond Insurance Association (MBIA) formed in 1973
- ❑ Financial Guaranty Insurance Corporation (FGIC) formed in 1983
- ❑ Financial Security Assurance (FSA) formed in 1985 – acquired by Assured Guaranty Corp. (AGC) in 2009

(other formerly triple-A rated insurers: CIFG and XL Capital)



Bond Insurers

In July 2007, the industry had **seven** Aaa/AAA/AAA-rated municipal bond insurers.

In December 2007, the rating agencies put **five** insurers on negative watch (all but Financial Security Assurance & Assured Guaranty Corporation).

By December 2009, **no** municipal bond insurers were rated Aaa/AAA/AAA.

Currently, FSA/AGC is rated AAA (negative outlook) by S&P.



Why Bond Insurance?

Advantages to small or infrequent issuers & lower-rated issuers:

- ❑ Market Access – Increased marketability of bonds, lower marketing costs
- ❑ Pricing – Lower interest cost

Analysis:

Insurance premium vs. PV debt service savings



What Happened?

STRUCTURED FINANCE – issues resembled traditional “munis” but significantly were more complex with much lower credit quality, including...

- ❑ Asset-backed securities
- ❑ Collateralized debt obligations
- ❑ Collateralized mortgage obligations
- ❑ Non-prime & sub-prime mortgage exposure

WHY – fees significantly higher than traditional munis.



The Downward Spiral...

As the risk of these securities became apparent, the capital reserves required to maintain triple-A ratings increased.

Insurers needed to raise capital (and reinsure) or face downgrade.

Raising capital and reinsurance was difficult because fees and profitability was declining (no more structured finance fees).

Potential downgrades introduced instability into the fundamental business model.



Now...

	Moody's	S&P	Fitch
AGC/FSA	Aa3 Negative	AAA Negative	WD
MBIA	B3 Negative	BB+ Negative	WD
AMBAC	Caa2 Positive	Regulatory Supervision	WD
FGIC	WD	WD	WD
Berkshire Hathaway	Aa1 Stable	AA+ Stable	NR
<i>WD = rating withdrawn</i>			
<i>NR = not rated</i>			

- ❑ Insurance is no longer cost effective for Aa/AA issues (except small or infrequent issuers).
- ❑ AGC/FSA has over 98% of the market.
- ❑ Premiums are higher but savings are greater due to larger credit spreads.



Other factors...

- ❑ Ratings have been recalibrated by Moody's & Fitch (resulting in higher ratings for many issues).
- ❑ Investors are no longer simply relying on ratings and bond insurance.
- ❑ One insurer naturally limits diversification within investment portfolios.



The Future...

- ❑ The government sector's ability to effectively manage the financial effects of the current economic downturn will impact the market value of bond insurance (trends in municipal defaults & bankruptcies).
- ❑ New and restructured bond insurers are likely to enter the market.



Alternatives?

State supported alternatives (such as Texas Permanent School Fund)

Future bond insurers

Pooled insurance funds

Letters of credit (variable rate debt) – LOCs up 240% in 2008; down 68% in 2009; down 73% in 2010