A

Practitioner's

Guide

Purchasing Credit Enhancement

How to Decide if Bond Insurance Makes Sense

To

Effective

Debt

Management

Government Finance Officers Association

Additional copies of this publication may be ordered from:

Government Finance Officers Association
180 N. Michigan Avenue, Suite 800
Chicago, Illinois 60601
(312) 977-9700

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ISBN no. 0-89125-189-8

This report was prepared by Patricia Tigue of the Government Finance Officers Association (GFOA). The author extends her thanks to James B. Kurish (GFOA), Thomas McLoughlin, Vice President, Tax-Backed Department, Municipal Bond Investors Assurance Corporation (MBIA), Kenneth L. Rust, Debt Manager, City of Portland, Oregon, and the staff of the Debt Management Group, City of Portland, Oregon, for reviewing this document. Any opinions expressed in this report are those of the author, and not the GFOA.

PURCHASING CREDIT ENHANCEMENT

How to Decide if Bond Insurance Makes Sense

WHAT IS CREDIT ENHANCEMENT AND WHY IS IT USED?

As the date for the sale of bonds approaches, issuers of tax-exempt securities must decide whether or not to purchase credit enhancement for the bonds. Credit enhancement provides assurance to investors that debt service payments will be made in full and on time, even if the issuer is delinquent in making payments or defaults on the bonds. In exchange for this guarantee, issuers pay a premium to the credit enhancement provider.

The primary reason issuers purchase credit enhancement is to save money on debt service costs. The coupon interest rates for bonds with a third-party guarantee will be lower than for bonds without such a guarantee for certain credit qualities. This is because, all things being equal, investors prefer securities with less rather than greater risk. Growing demand for tax-exempt bonds on the part of retail investors, who tend to be more risk averse, has increased the demand for credit-enhanced bonds.

One form of risk facing investors is known as "credit risk." This is the risk that an issuer will default on its debt, failing to repay principal and interest to investors. Some securities are perceived to have a particularly high degree of credit risk, and purchasing credit enhancement may be the only way in which the issuer will be able to attract investor interest in the bonds.

Bonds featuring complex security provisions or an innovative financing product may have difficulty in the market without credit enhancement. Investor uncertainty regarding new financing structures, such as derivatives, has increased the demand for credit enhancement on these types of transactions. Credit enhancement provides a commonly understood means to evaluate the credit quality of complex financings, and hence, may increase the marketability of the bonds.

Credit enhancement may also alleviate "liquidity risk." This is the risk that an investor may not be able to sell a security in the secondary market quickly and at competitive prices due to financial or other problems facing the issuer. For example, prices

for uninsured bonds where the underlying credit quality has suddenly deteriorated have been observed to be more negatively affected than prices for insured bonds of the same issuer in the secondary market. Investors interested in secondary market liquidity are likely to seek out securities that are credit-enhanced.

CREDIT ENHANCEMENT PROVIDERS

Credit enhancement for long-term bonds is provided in one of two forms. The most common type is referred to as bond insurance. Approximately 91 percent of the total number of credit-enhanced issues in 1993 used bond insurance. Bond insurance provides coverage for payment of principal and interest over the life of the insured bonds. It may be purchased either for the entire issue or for selected maturities. Three insurance providers dominate the market: AMBAC Indemnity Corporation (AMBAC), Financial Guaranty Insurance Company (FGIC), and Municipal Bond Investors Assurance Corporation (MBIA). The claims-paying ability of these companies has been rated "Aaa" and "AAA" by Moody's Investors Service, Inc. and Standard & Poor's Rating Group, respectively. Together, they account for over 90 percent of the insured issues in the municipal market. Other insurance providers include Asset Guaranty Insurance Company, Capital Guaranty Insurance Corporation, Capital Markets Assurance Corporation (CapMAC), Connie Lee Insurance Co. (created to insure education bonds of lower credit quality), and Financial Security Assurance Inc. (FSA). As of May 1994, each of these insurance providers carried a "Aaa" rating from Moody's Investors Service except for Asset Guaranty and Connie Lee, which are not rated by Moody's. Standard & Poor's has assigned each insurer a "AAA" rating except for Asset Guaranty Insurance Company, which has a "AA" rating. Only AMBAC and FGIC have been rated by Fitch Investors Service; each has a "AAA" rating.

The other type of credit enhancement is a letter of credit (LOC). Letters of credit constitute a declining share of the credit enhancement market. Unlike bond insurance, LOCs for fixed rate bonds are provided for limited term that is often shorter than the life of the bond, typically between 5 and 10 years; hence, they must be renewed to cover longer maturities. Letters of credit are issued by commercial banks. Foreign-owned banks have been the primary source of this type of credit enhancement. The dominance of foreign-owned banks in the LOC market has been attributable to a number of factors, including U.S. banking

regulations concerning the amount of required capital that must be reserved when extending credit. Recently, the number of banks with a "Aaa/AAA" rating has declined, thereby making LOCs for fixed-rate issues less advantageous. LOCs are more common for variable rate debt issues, where the right of the investors to "put" the bonds back to the issuer on specified dates could otherwise create liquidity problems for the issuer.

In addition to differences in the term of coverage, letters of credit and bond insurance differ in how the premiums are paid. Premiums for letters of credit are usually paid annually, much like a typical homeowner's insurance policy. This cost must be budgeted each year by the issuer over the life of the policy. Bond insurance premiums are normally paid once, at the time of closing, although a few issuers make payments on an installment basis. Issuers often choose to pay the premium with the proceeds of the bond issue.

Because they represent such a small percentage of the insured market, letters of credit for long-term bonds will not be discussed in great detail in this publication. Issuers may want to discuss this credit enhancement option with their financial advisor and bond counsel. Letters of credit for variable rate issues will be discussed more fully in a separate publication in this GFOA series.

HOW INSURED BONDS ARE PRICED IN THE MUNICIPAL MARKET

If an issue is insured, it carries the rating of the insurer -- usually a "Aaa/AAA" rating. In recent months, the interest rate differential (or "spread") between a "Aaa/AAA"-insured bond and an "A"-rated bond has been in the range of 10-15 basis points. Thus, an "A"-rated bond with a 30-year maturity might have a coupon of 5.60 percent without insurance; with insurance, the coupon would be reduced to 5.50 percent. Of course, the insurance premium paid by the issuer must be factored into the overall borrowing cost for the bonds. This will be discussed more fully in a later section.

Securities that are "AAA-insured" bear higher coupon interest rates than those with a "AAA" rating of their own. In recent months, the spread between an insured bond and a natural "AAA" bond has been in the range of 10-20 basis points, depending on the maturity. This differential reflects the market's perception of

greater credit risk associated with bond insurers relative to highly rated state and local governments.

Not all insured bonds trade alike in the marketplace. This is due to two factors. First, despite being insured, investors continue to look to the underlying credit quality of the issuer. Even with insurance, the issuer remains liable for principal and interest payments. In addition, there may be some variation in the market's perception of different insurers. Among the factors that are considered in evaluating the strength of bond insurers are their ownership, corporate strategy, capital adequacy, financial performance, risk exposure, and liquidity. Investors may come to different conclusions about the strength of each insurer with respect to each of these qualities. There is little apparent market differentiation between insured bonds of the three major insurance providers, however. Bonds insured by AMBAC, FGIC, and MBIA all trade at the lowest yields available in the insured market.[1]

COST OF INSURANCE

The cost of bond insurance has remained relatively constant over the past few years. Between 1988 and 1992, average insurance premiums for general obligation bonds have been in the range of 43-50 basis points on total principal and interest payments. For revenue bonds, the average cost has been in the range of 56-60 basis points. These averages represent a significant decline from the mid-1980s.

The stability in bond insurance premiums in recent years is attributed to two major factors. First, as interest rates have fallen and spreads between insured and uninsured issues have narrowed, credit enhancement providers have been required to offer lower premiums in order to make insurance cost-effective for issuers. Exerting pressure in the opposite direction has been the large volume of municipal bonds competing for bond insurance.[2] Higher volumes tend to increase premium prices, all other factors being equal.

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[1] "Investor Update: Bond Insurance," Priscilla Hancock, in *Lehman Brothers Municipal Market Review*, March, 1994.

[2] "Bond Insurers' New Horizons," A Special Report issued by Fitch Investors Service, May 3, 1993.

Premiums charged for individual issuers' bonds may vary from these averages. Insurers must maintain their capital at adequate levels in order to cover potential losses. Premiums will reflect general market conditions for bonds of different credit quality and the degree of risk perceived by the insurer in adding a particular issuer's bonds to its portfolio. In addition to the premium charged by the insurer, the issuer will also be required to pay a fee to the rating agencies for obtaining the triple "A" rating.

CALCULATING THE BOND INSURANCE PREMIUM

Bond insurance premiums often are quoted in terms of a percentage of the total principal and interest payments for which coverage is provided. This percentage is usually stated in basis points -- that is, 1/100th of one percent. Accrued interest or capitalized interest is often subtracted from the total debt service amount. Exhibit 1 illustrates how bond insurance premiums are calculated.

In this example, the bond insurance premium is 35 basis points of principal and interest payments. A total of $5,000,000 of principal is being repaid over a ten-year period. Interest costs are $1,120,750, of which a total of $7,398.61 represents "accrued interest." Accrued interest is attributable to the period between the dated date and the delivery date of the bonds. During this period, the issuer has not yet received proceeds from the issue, but is nevertheless required to pay interest from the dated date. The underwriter, when purchasing the bonds, pays the issuer any accrued interest earned on the outstanding debt. Because this amount has already been provided at the closing of the transaction, it is subtracted from the total interest payment in the calculation of bond insurance. Therefore, bond insurance would cost the issuer $21,396.73.

QUALIFYING FOR CREDIT ENHANCEMENT

There are several ways in which a bond issue can qualify for credit enhancement. First, the issuer can apply directly to the insurance provider. Typically, this application is made just prior to the sale of the bonds. The issuer submits a request for proposal in writing to several insurance providers asking for bids.

Another option is to permit the underwriter to purchase credit enhancement. There are several options in this regard. Underwriters may be permitted to purchase insurance at their option, and submit a bid using an insured scale. In this case, the

Exhibit 1

CALCULATION OF INSURANCE PREMIUM AND INSURED TRUE INTEREST COST

Bid Type:	Insured
Type:	General Obligation
Issue Date:	1/1/1994
Delivery Date:	1/15/1994
Ratings:	Aaa/AAA Insured
NIC:	4.2747642%
TIC:	4.2885818%

Calendar Date	Coupon Rate Insured	Interest Payment Insured	Total Debt Service Insured	Discounted Total Debt Service Insured
1/1/94		$ -	$ -	$ -
7/1/94		95,125.00	95,125.00	93,281.87
1/1/95	2.65%	95,125.00	595,125.00	571,342.66
7/1/95		88,500.00	88,500.00	83,179.75
1/1/96	3.20%	88,500.00	588,500.00	541,510.31
7/1/96		80,500.00	80,500.00	72,517.37
1/1/97	3.45%	80,500.00	580,500.00	511,957.95
7/1/97		71,875.00	71,875.00	62,057.72
1/1/98	3.70%	71,875.00	571,875.00	483,398.15
7/1/98		62,625.00	62,625.00	51,824.79
1/1/99	3.85%	62,625.00	562,625.00	455,821.39
7/1/99		53,000.00	53,000.00	42,037.55
1/1/00	4.00%	53,000.00	553,000.00	429,410.45
7/1/00		43,000.00	43,000.00	32,689.01
1/7/01	4.15%	43,000.00	543,000.00	404,128.16
7/1/01		32,625.00	32,625.00	23,771.45
1/1/02	4.25%	32,625.00	532,625.00	379,937.91
7/1/02		22,000.00	22,000.00	15,363.84
1/7/03	4.35%	22,000.00	522,000.00	356,889.19
7/1/03		11,125.00	11,125.00	7,446.44
1/1/04	4.45%	11,125.00	511,125.00	334,935.99
		$ 1,120,750.00	$ 6,120,750.00	$ 4,953,501.95

	Face Value of Bond Issue:	$ 5,000,000.00
+	Accrued Interest	7,398.61
+	Total Premium/Discount	-32,500.00
-	Cost of Credit Enhancement	21,396.73
=	T.I.C. Target	$ 4,953,501.88

COST OF INSURANCE = 35 Basis Points

	Principal	$ 5,000,000.00
+	Interest	1,120,750.00
-	Accrued Interest	(7,398.61)
=	Total Debt Service	$ 6,113,351.39
x	Insurance Premium	0.0035
=	Cost of Insurance	$ 21,396.73

Notice of Sale would include a provision giving underwriters this option. An example of language that might be included is shown in Exhibit 2. While the issuer would not pay directly for the bond insurance premium in this case, the cost of the insurance premium may be reflected in the underwriter's bid. Issuers may also decide to require underwriters to submit both insured and uninsured bids. If the insured bid plus the premium costs was lower than the uninsured bid, the issuer would opt to insure the offering. When giving the underwriter the option to purchase insurance, issuers must make sure that the amount of the discount permitted in the Notice of Sale is sufficient to cover the cost of insurance in order to avoid issuing some bonds at a premium. Under certain market conditions, bonds issued at a premium can result in higher borrowing costs to the issuer. Issuers might opt to allow underwriters a higher discount if they decide to offer the bonds with insurance.

Exhibit 2

SAMPLE LANGUAGE
GIVING UNDERWRITER
THE ABILITY TO INSURE A BOND ISSUE

Bond Insurance at Purchaser's Option. If the Bonds qualify for issuance of any policy of municipal bond insurance commitment therefor at the option of the bidder, the purchase of any such insurance policy or the issuance of any such commitment shall be at the sole option and expense of the purchaser of the Bonds. Any increased costs of issuance of the Bonds resulting from such purchase of insurance shall be paid by the purchaser, except that, if the City has requested and received a rating on the Bonds from a rating agency, the City will pay that rating fee. Any other rating agency fees shall be the responsibility of the purchaser.

Failure of the municipal bond insurer to issue the policy after bonds have been awarded to the purchaser shall not constitute cause for failure or refusal by the purchaser to accept delivery of the Bonds.

Credit enhancement may also be purchased once the bonds are sold to investors. Bond insurance companies have begun to tailor their products to meet the particular needs of investors. For

example, they are now offering policies that cover the bonds only as long as a particular investor holds them, or policies that provide coverage until the first call date.

Bond insurers generally prefer to insure issues of investment grade quality, that is, bonds rated "Baa/BBB/BBB" or higher. In deciding whether or not to insure a general obligation issue, bond insurers will be interested in historical trends relating to financial performance, tax collections, economic diversity, and socioeconomic and demographic characteristics. Bond insurance companies also may impose stringent requirements for certain types of revenue bonds. A rate covenant specifying a minimum level of debt service coverage (e.g., 1.25 times coverage) may be required. Debt service coverage is the ratio of pledged revenues available to pay debt service compared to actual debt service payments. Other stipulations may include an additional bonds test, which identifies the conditions under which additional bonds may be issued, and the maintenance of a debt service reserve fund. In some cases, the insurer may require a feasibility study to demonstrate the economic viability of an enterprise.

HOW TO EVALUATE THE COST-EFFECTIVENESS OF BOND INSURANCE

Once bids for insurance have been received, the issuer must determine whether insurance will lower its overall borrowing costs. This analysis entails a comparison of the present value of the stream of principal and interest payments if the issue is not insured with the present value of principal, interest, and insurance costs if the issue is insured.

A critical component of this analysis is the interest rate scales for an insured and uninsured issue. The issuer's financial advisor or underwriter can obtain these rates for the issuer. Another source for this information is *The Bond Buyer*, the public finance industry's trade journal. *The Bond Buyer* publishes interest rate scales each day by maturity for issues of various credit qualities, including "AAA-insured" bonds. These scales will generally not be as precise as those provided by a financial advisor or underwriter, who will have better market data for a specific issuer. However, they can provide a reasonable estimate of interest rates if no other data are available.

Assuming the credit rating is known, the issuer can select the appropriate set of interest rates and calculate an estimated debt service schedule without insurance. Similarly, a debt service

schedule can be calculated assuming the bonds are insured. In the case of the insured bonds, the cost of the insurance premium must also be factored in when calculating the present value of the two debt service streams.

It is common for the present value comparison to be expressed in terms of a True Interest Cost (TIC) rate. This is the rate that, when used to discount a stream of debt service payments, produces the amount of net bond proceeds received from the sale. The amount of net bond proceeds to the issuer is derived by subtracting certain expenses related to the sale of the bonds from the amount of total gross proceeds. Gross proceeds is defined as the par amount of the bonds, less any original issue discount (or plus any premium). The original issue discount or premium often is used to meet particular financing objectives, such as lower interest costs or enhanced marketability of the bonds. To obtain net proceeds for the TIC calculation, the underwriter's discount or "spread" -- the amount paid to the underwriter for selling the bonds -- is subtracted from gross bond proceeds. When bond insurance is used, the insurance premium also is subtracted from gross bond proceeds. The TIC with insurance can then be compared to the TIC without insurance. The more cost-effective option is the one that produces the lowest TIC.

Exhibit 3 provides an illustration of these calculations, continuing the example described earlier. Once again, the issuer is assumed to have an "A" rating. The total insurance premium, as calculated earlier, is $21,397. Debt service schedules for an insured and an uninsured issue have been calculated. The total amount of debt service if the bonds are uninsured is estimated to be $6,148,500. With insurance, debt service payments are $6,120,750. The total difference between the two scenarios is $27,750. On a present value basis, the insured bond issue's aggregate debt service is $21,601 lower than the uninsured issue. After deducting the up-front cost of the insurance from the present value difference between the two debt service schedules, a net savings of $204 is obtained by the issuer through the use of insurance. This savings is also reflected in the TIC of the insured issue relative to the uninsured issue, which is 4.2886 percent compared to 4.2982 percent, respectively. For this issuer, the use of bond insurance would be more cost-effective than issuing the bonds without insurance.

Exhibit 3

COMPARISON OF TRUE INTEREST COST WITH AND WITHOUT INSURANCE

	Uninsured		Insured
Bid Type:	Uninsured Scale	Bid Type:	Insured
Type:	General Obligation	Type:	General Obligation
Issue Date:	1/1/1994	Issue Date:	1/1/1994
Delivery Date:	1/15/1994	Delivery Date:	1/15/1994
Ratings:	A/A/A	Ratings:	Aaa/AAA Insured
NIC:	4.2972838%	NIC:	4.2747642%
TIC:	4.2982368%	TIC:	4.2885818%

Calendar Date	Coupon Rate Uninsured	Total Debt Service Uninsured	Discounted Total Debt Service Uninsured	Coupon Rate Insured	Total Debt Service Insured	Discounted Total Debt Service Insured
1/1/94		$ -	$ -		$ -	$ -
7/1/94		97,750.00	95,851.83		95,125.00	93,281.87
1/1/95	2.80%	597,750.00	573,810.63	2.65%	595,125.00	571,342.66
7/1/95		90,750.00	85,282.71		88,500.00	83,179.75
1/1/96	3.30%	590,750.00	543,479.90	3.20%	588,500.00	541,510.31
7/1/96		82,500.00	74,301.76		80,500.00	72,517.37
1/1/97	3.55%	582,500.00	513,578.03	3.45%	580,500.00	511,957.95
7/1/97		73,625.00	63,547.90		71,875.00	62,057.72
1/1/98	3.80%	573,625.00	484,695.89	3.70%	571,875.00	483,398.15
7/1/98		64,125.00	53,043.73		62,625.00	51,824.79
1/1/99	3.95%	564,125.00	456,822.37	3.85%	562,625.00	455,821.39
7/1/99		54,250.00	43,006.80		53,000.00	42,037.55
1/1/00	4.10%	554,250.00	430,138.66	4.00%	553,000.00	429,410.45
7/1/00		44,000.00	33,428.80		43,000.00	32,689.01
1/7/01	4.25%	544,000.00	404,606.10	4.15%	543,000.00	404,128.16
7/1/01		33,375.00	24,300.78		32,625.00	23,771.45
1/1/02	4.35%	533,375.00	380,186.72	4.25%	532,625.00	379,937.91
7/1/02		22,500.00	15,700.45		22,000.00	15,363.84
1/7/03	4.45%	522,500.00	356,928.59	4.35%	522,000.00	356,889.19
7/1/03		11,375.00	7,606.97		11,125.00	7,446.44
1/1/04	4.55%	511,375.00	334,784.45	4.45%	511,125.00	334,935.99
		$ 6,148,500.00	$ 4,975,103.07		$ 6,120,750.00	$ 4,953,501.95

Uninsured		Insured	
Face Value of Bond Issue:	$ 5,000,000.00	Face Value of Bond Issue	$ 5,000,000.00
+ Accrued Interest	7,602.78	+ Accrued Interest	7,398.61
+ Total Premium/Discount	-32,500.00	+ Total Premium/Discount	-32,500.00
- Lump Sum Credit Enhancement	0.00	- Cost of Bond Insurance	21,396.73
= T.I.C. Target	$ 4,975,102.78	= T.I.C. Target	$ 4,953,501.88

The TIC can be calculated using a personal computer and spreadsheet software package; however, a bond calculation package will generally perform this calculation with greater ease. An issuer's financial advisor should have access to such a package if the issuer does not already have one.

FACTORS TO CONSIDER

Issuers evaluating the use of bond insurance should consider a number of factors. Among the most important are the following.

Cost Savings

Cost savings is the primary consideration for most tax-exempt bond issuers contemplating the use of bond insurance. Bond insurance has, in recent years, been particularly cost effective for bonds in the "Baa/BBB/BBB" and single "A" categories. Issuers with a "AAA" or a high "AA" credit rating will probably not save money by purchasing bond insurance.

In evaluating the cost effectiveness of bond insurance, issuers also will want to consider the likelihood of bonds being redeemed prior to maturity. Insurers will not return any portion of a premium paid for insured bonds that have been called early (although, in the case of a refunding, they may offer to apply some of the premium associated with the insured, refunded issue toward insurance on the refunding issue). Issuers should compare the level of savings assuming bonds are called on the call date. This type of analysis is particularly important when interest rates are relatively high compared with historical averages.

Insurer Requirements

Bond insurers have many requirements that must be met both prior to insurance being offered and, once purchased, over the life of the bonds. In some cases, the bond insurer may request changes to the underlying bond ordinance before qualifying the issue for insurance. This creates an added burden on the issuer both in making the changes and in complying with the new provisions. For competitive sales in particular, insurers should be told up-front that any required changes to the legal documents cannot be guaranteed; hence, insurance must be based on the documents in their current form.

In order to obtain bond insurance, issuers must sign a contract with the insurer that obligates them to take certain actions at the time of the bond sale and over the life of the policy. Issuers have

an ongoing responsibility to provide information to the insurer once the bonds are sold. For example, copies of audited financial statements or annual reports must be provided when they become available. The insurer may request other information as is necessary in order to monitor the credit quality of the bond issue through final maturity. As discussed earlier, the insurer may place certain restrictions upon the issuer. For example, issuers may need to adhere to net coverage or additional bonds tests, or limit investments to specified types. They may also be required to obtain approval of the insurer to change certain provisions in the trust indenture, such as the firm serving as trustee or how the debt service reserve fund requirement is met.

Because the insurer will require certain actions to be taken over the life of the bonds, the issuer must understand exactly what its obligations will be to the insurer. If the insurer must be notified and give consent with regard to changes in the trust indenture, for example, the issuer's flexibility to make such changes may be limited. Jurisdictions that have several bond issues outstanding may be subject to the terms and conditions of more than one bond insurer, which adds further complexity to the debt management process. Because each insurer has its own requirements, issuers will need to reconcile the provisions of the various insurers. The issuer must determine whether the benefit of a lower interest cost on the bonds outweighs this loss of flexibility.

Municipal Market Reception

A new issuer may be interested in seeing how its credit is perceived in the municipal market. Issuers sometimes find that their bonds are well-received in the municipal market, such that the coupon rates for the bonds arc actually lower than would otherwise be expected for an issuer of a certain credit quality. If the savings using bond insurance appear to be marginal, an issuer may want to forego insurance to see how the bonds sell on their own. Some issuers have found that it is a good practice to keep some of their bonds uninsured. In this way, the market can establish a price for the bonds based on the underlying credit quality, which may improve marketability.

Credit Capacity

Several states, including New York State, California, Florida, and Illinois, have statutory requirements limiting the amount of any one issuer's bonds a credit enhancer is permitted to insure. Moreover, insurers have their own risk management strategies

that determine the amount of any one jurisdiction's bonds that they are willing to guarantee at all, or guarantee at a premium that is cost effective from the issuer's perspective. Issuers that are concerned about their ability to get credit enhancement in the future (e.g., those planning to sell a large amount of debt) may opt to forego insurance for certain issues in order to preserve their ability to obtain insurance in later years.

Policy Considerations

A decision to insure a bond issue may also be determined by the policy goals of the issuer. For example, some jurisdictions have a policy of not taking a rating if it is lower than some minimum threshold (e.g., an "A" rating). Such a policy could be adopted in order to mitigate the risk facing governmental issuers of conduit bonds. For these issuers, insurance may be purchased even if it is not cost-effective in order to maintain standards on the credit rating of outstanding bonds.

SURETY BONDS FOR THE DEBT SERVICE RESERVE FUND

For revenue bond issuers who may be required to maintain a debt service reserve fund, another question must be answered. Should the issuer use bond proceeds to maintain this fund or purchase a surety bond in lieu of using cash? A surety bond is a financial instrument in which a third party guarantees that it will make the required debt service payments up to the amount covered by the surety bond if moneys must be drawn from the debt service reserve fund to make those payments. Ordinarily, a debt service reserve fund requirement is an amount equal to at least ten percent of the par amount of the bonds or maximum annual debt service. The trust indenture must specifically permit the substitution of a surety bond, so issuers should consult bond counsel to determine whether this option is available to them.

An issuer purchasing a surety bond for its debt service reserve fund is able to preserve its debt capacity for capital projects; hence, these instruments are particularly advantageous for issuers who are subject to statutory or constitutional limitations on the amount of debt they can issue. If the issuer were to fund the debt service reserve with cash, it would either have to issue more bonds than necessary for capital projects or use available cash. A surety bond also may reduce the risk of negative arbitrage on the debt service reserve fund. This would occur if interest earnings in the debt service reserve were at a rate below the TIC of the bonds used to fund it.

A surety bond for the debt service reserve fund may be purchased from the same firms supplying credit enhancement. Issuers qualifying for bond insurance may apply for a surety bond. Some insurers will not offer to provide a surety bond for the debt service reserve fund unless they also insure the debt service payments. The cost of a surety bond is based on the size of the debt service reserve fund requirement, and is generally in the range of 3-5 percent of the debt service reserve requirement. Premiums can be paid at the time the bonds are issued, or annually over the life of the bonds.

DECIDING TO PURCHASE INSURANCE

An issuer considering the purchase of bond insurance or a surety bond for the debt service reserve fund should begin to solicit bids at a minimum of a few weeks prior to the scheduled sale date. Bids should be requested in writing from two or more insurers. In requesting bids for insurance, the issuer is not required to insure the entire issue. If it appears that insurance may be more cost effective for certain maturities than for others, the issuer may request a bid to have only certain maturities of the issue insured. The issuer will also be required to make available its preliminary official statement, bond resolution/ordinance, and audited financial statements. Other information may also be requested by the insurer in order to determine the issuer's credit quality. Once the bond insurers have undertaken their analyses, they will decide whether or not to insure the bonds and quote a premium at which insurance will be offered. Proposals are usually good for 60-120 days, but may be extended beyond this period by the insurer under certain conditions. A new application would be necessary if the issuer failed to respond within the specified timeframe.

Having received the bids, the issuer will need to conduct an evaluation to determine whether or not insurance is cost-effective. In order to make the appropriate comparison, the issuer will need to obtain an insured and uninsured interest rate scale from its financial advisor or investment banker. This scale should be obtained as close to the sale date as possible. Bond insurance is cost-effective if the true interest cost of the insured issue is less than the true interest cost of the uninsured issue, as described earlier and illustrated in Exhibit 3.

Factors other than costs should also be evaluated in deciding whether or not to purchase insurance. Having weighed the advantages and disadvantages of using bond insurance, the issuer

is in a position to make a decision. If a decision is made to purchase insurance, the issuer will receive a commitment letter from the insurer reviewing the terms and conditions under which insurance is offered. This letter must be signed by the issuer. Prior to the closing, the insurer will generally require final copies of the official statement, bond ordinance or trust indenture, legal opinions, a debt service schedule, and other information described in the commitment letter prepared by the insurer. The insurer will also provide a copy of the language that must be included in the issuer's official statement describing the insurer and its obligation to bondholders under terms of the insurance policy.

It is important to note that, in the event that the insurance policy is called upon to make a debt service payment, the issuer remains liable for all debt service payments, including payments made by the insurer. If an issuer defaults on a payment, the insurer will step in to pay debt service on insured bonds; however, once the issuer has recovered from its financial difficulties and is able to resume debt service payments, it will also be required to reimburse the insurer. The contract between the insurer and the issuer will specify the terms and conditions under which insurance is provided, including the consequences of an issuer's failure to make a payment.

A second point to remember is that purchasing bond insurance does not relieve an issuer of its disclosure responsibilities under the antifraud provisions of federal securities law. In general, issuers of tax-exempt bonds -- including insured bonds -- will be required to make available an official statement that adequately discloses material information about the offering.

SUMMARY

Bond insurance can provide important benefits to issuers of tax-exempt bonds. For many issuers, the most important reason to purchase bond insurance is to obtain lower borrowing costs. This publication has described the calculations involved in determining the cost effectiveness of insuring a bond issue. Factors other than cost savings, including insurer requirements, municipal market reception, ability to purchase insurance in the future, and policy issues, may also influence the decision on whether to purchase insurance. Issuers need to carefully evaluate savings on debt service costs in relation to all of these factors, as their decision will have long-term ramifications over the life of the bonds.