In recent years the top municipal bond insurers have minimized the risk associated with distressed municipal bonds. Informed investors who purchased distressed muni bonds insured by these insurers have earned above market yields.

**Insured Municipal Bonds are a $900 Billion Market:** Assured Guaranty, National Public Finance Guarantee, AMBAC and Radian insure 93% of all outstanding insured municipal bonds.

**Bond Insurers Return to Their Roots…**
Bond insurers were born in 1971 to provide credit protection to investment grade municipals only. Lessons learned along the way have taken bond insurers back to their roots: Investment Grade Municipal Bonds, “only”.

For a quarter of a century bond insurers built capital by insuring only low risk essential service and general obligation municipal bonds where defaults and losses were close to zero.

With insurance wrapping more than 50% of new muni issues by the mid-90s, the “AAA” rated premier bond insurance sector sought new avenues for further growth. In 1995, bond insurers started writing insurance on structured asset (mortgage) backed and international securities to diversify.

By the early 2000s bond insurers were tipped more towards insuring lucrative complex structured residential mortgage backed securities than safe and steady municipal bonds. At that time, insurers incurred lower capital charges for short term structured products which rolled over more frequently than similarly rated longer term municipals.

**The Origin of the Problem…**

**Risky Structured Finance**
The house of cards imploded in 2008 when the housing market collapsed. Major banks reported losses on subprime mortgages and other nonperforming loans.

Bond insurers exposure to revenues from loan repayments underwritten by large banks took a hit. Bond insurers suffered ratings downgrades. As a result, there was no longer a market for the limited, if any, credit protection they offered.

**Bond insurers had ventured too far…** straying away from their steady core business of insuring U.S. municipal debt. Exposures to poorly performing Mortgage Backed Securities, Collateralized Debt Obligations, and credit derivatives issued by large banks triggered the decline. In hindsight, these newer products simply did not meet bond insurer’s “zero loss” underwriting standard, which was a prerequisite to their highly leveraged insurance business model, even though many of the structured finance transactions underlying ratings were supposedly “AAA” credits.

**Many bond insurers exited the market as the remaining bond insurers took a step back.** To write new insurance again, bond insurers would need to lower significant uncertainties. By legally challenging the large banks on the issue of underwriting standards, many exposures were put back to banks or commuted. Segregating insured exposure to mortgages in a separate account isolated the problem.

**Municipal Bonds are the Future…**
Six years on, bond insurers have solved many problems. Today major uncertainties are out of the way. The top bond insurers preserved capital and lowered risky exposures.

Bond insurers municipal bond exposure caused no strain. Throughout the Great Recession, state and local governments honored their commitments to debt service. Recently bond insurers have paid claims on troubled credits, which have been a miniscule portion of insured exposure.

**Bond insurers realized that steady stable income from municipal bonds that experience close to zero defaults or losses is a powerful business model.** Today bond insurance is a niche “municipal bonds only” business, like it was meant to be.
Assured Guaranty insures 10% of the $3.6 trillion muni market. With three bond insurance platforms: Assured Guaranty Municipal, Assured Guaranty Corporate and MAC, Assured Guaranty (‘Assured’) is the top bond insurer.

High Quality Insured Exposure
Assured’s insured exposure ($450 billion) has an average rating of “A”: U.S. public finance $346 billion (77%, average rating “A”), U.S. structured finance $55 billion (12%, average rating “AA-”) and international $48 billion (11%, average range “AA+” to “BBB+”).

Paid All Claims
Of approx. 10,000 U.S. public finance exposures, losses net of recoveries are expected to be less than a dozen. Assured has paid claims on: Stockton, Jefferson County Sewer Authority, Harrisburg Incinerator Authority & Detroit where it is actively pursuing recoveries. Many informed GMS investors purchased these AGM insured bonds at considerable discounts. Assured is positioned to make substantial recoveries related to its Stockton and Harrisburg exposure over the long term. Claims related to Jefferson County were well within Assured Guaranty’s Jefferson County reserves.

Adequate Capital
Assured’s Detroit exposure consists of $784 million water revenue bonds reflecting debt service coverage ratio of 1.18x, $1 billion sewer bonds with debt service coverage also over 1x neither should be exposed to insurance claims, unresolved are $321 million general obligation and certificates of participation with debt service aggregating to $27 million over the next ten years well within Assured’s claims paying resources.

Assured’s exposure to Puerto Rico is $5.3 billion. Puerto Rico administration is committed to debt service and all debt obligations have been paid to-date. Assured has sufficient capital adequacy rated Moody’s “Aa” reflecting its emphasis on high quality municipals, active run-off and recoveries from structured finance exposures.

Claims Paying Resources Relative to Guaranteed Debt Service Highest Since 2009.
Rapidly declining insured exposures due to refunding, terminations and scheduled amortizations has accelerated capital growth.

Winning major legal battles got National a new life. A protracted legal battle around its 2009 split from weaker MBIA Corporation ended with favorable settlements for National. National became separate from MBIA Corp after the latter repaid a $1.7 billion loan to National from improved liquidity. Newly capitalized in 2009 National is a muni only bond insurer. When parent MBIA, Inc. split, National got the “good” municipal exposures, while risky structured finance problems were left to affiliate MBIA Corporation.

National scores high on its insured portfolio: minimal claims payments, only $707 mm or a scant 0.04% of $1.8 trillion debt service insured since inception. Compare this minimal claim track record to National’s revenues, $1.6 billion premium reserve, $4.9 billion of investments generating steady earnings and additional investment income, it becomes obvious why both Moody’s and S&P have recently raised National’s respective ratings to“A3/AA-“.

National is well capitalized: Solid claims paying resources $5.2 billion for its $268 billion insured portfolio (dominantly “A/AA” rated with 98% investment grade). Without writing new policies since 2008, National is earning substantial revenues from its existing insured portfolio through premium accretion, municipal refunding and investment income. 95% of National’s $2.4 billion Detroit exposure is secured by pledged revenues. Taking into account National’s Puerto Rico exposure $4.8 billion, National maintains adequate capital and liquidity to cover theoretical losses under the S&P extreme stress model.

National is now at a turning point: Given its capital base (stable strong earnings and high quality insured portfolio) and proven bond insurance infrastructure (management underwriting, distribution channels and customer relationships), National Public Finance Guarantee ratings upgrades will enable the insurer to write new insurance.
AMBAC: Represents Significant Value

Rating: “Non-Rated” Claims paying resources $7.2 billion
Investment Portfolio $6.7 billion, insured par value outstanding $173 billion

Isolating risky exposures away from the General Account added considerable value to AMBAC insured municipal bond exposures held in the General Account.

Newly capitalized AMBAC emerged from bankruptcy in May 2013. Risky exposures (12% of AMBAC insured exposures), primarily residential mortgage backed securities, were taken out of the General Account and placed in a separate significantly less protected Segregated Account.

The General Account is highly protected with a senior claim on AMBAC claims paying resources. 99% of AMBAC insured muni’s are in the secure General Account which is current on claims. AMBAC’s General Account (88% of AMBAC insured exposure) has a high credit quality: 95% of AMBAC insured bonds held in the General Account are investment grade rated “Baa” or higher unlikely to ever need insurance coverage. AMBAC’s claims paying resources are over $7 billion.

AMBAC’s insured exposure $173 billion is roughly 40% of 2008 levels. Surging bond calls, debt refinancing and releases reduced insured exposure by $50 million annually for the last six years. AMBAC’s Puerto Rico exposure is $2.5 billion: 90% is secured by revenue pledges providing adequate debt service coverage ranging from 1.4x to 3.0x; only 10% is general obligation debt. Puerto Rico general obligation debt carries strong constitutional protections and has always paid.

AMBAC’s Detroit exposure is $170 million general obligation bonds, on which AMBAC is currently paying claims as the bankruptcy is being resolved. Contributing stable steady income are AMBAC’s $8.7 billion investment portfolio and $2 billion unearned premium reserve. AMBAC’s investment portfolio is 71% investment grade. The no longer rated, AMBAC is a strong insurer.

With foreseeable risk gone from the General Account, lower load on claims paying resources should make AMBAC very capable of paying any General Account claims—a valuable cushion for AMBAC insured municipal bonds.

The General Account’s preferred claims payment status and the high credit quality of its insured exposure make AMBAC a good place for municipal bond investors to realize added value.

Radian: Adequate Capital

Rating: “Ba1” / “B+” Claims paying resources $1.5 billion
Investment Portfolio $1.5 billion, insured par value outstanding $23 billion

Radian is actively running-off its municipal bond exposure. Radian has exited 80% of its financial guaranty exposure since 2008 through commutations, refunding and amortization.

The vast majority of its remaining riskier exposure should terminate by 2017. To reduce uncertainty, Radian terminated re-insurance exposures with Assured Guaranty and FGIC and capped exposure to non performing Freddie Mac loans. Radian’s current exposure $23 billion includes $450 million Puerto Rico general obligations, $2.3 billion healthcare and tax backed special district bonds. $100 million troubled Eurozone countries. Radian’s capital adequacy is very strong.

Radian, an insulated subsidiary of Radian Group supports parent Radian Group with its excess capital through dividends and release of redundant contingency reserves all subject to insurance regulatory approval.

Radian insured municipal bond claims paying ability is deemed adequate. Representing value for Radian insured municipal bonds.
Despite a lot of rhetoric and unflattering media headlines on insurers, in general quality bond insurers can be expected to continue to pay all claims on distressed bonds they insure.

Informed investors realize that top bond insurers provide several layers of protection throughout the life of the bond. This SAFETY NET includes: financial guaranty of timely debt service payments and expert intermediation with issuers.

The value of insurance is most visible with speculative grade credits. Quality bond insurance has always provided added value to speculative grade bonds. Significant claims paying resources of quality bond insurers minimize debt service risks that speculative bonds may carry. Liquidity for claim payments paid when due over the life of the bond comes from earnings based on strong, stable premium reserves, investment portfolio income and statutory capital.

Insurers bring to the table distinct workout teams including legal counsel to lead creditor committees.

Detroit and Puerto Rico bonds insured by Assured Guaranty, National, AMBAC and Radian are in high demand. The security of claims paying ability (Assured $12 billion; National $5 billion; AMBAC $7 billion, Radian $1.5 billion) adds significant value and protection to insured distressed bonds.

The high yield associated with insured speculative grade bonds is sought by investors. Quality bond insurance minimizes the risks associated with speculative grade bonds.

Even for high quality credits, sophisticated investors see the value of insurance: expert intermediaries between retail investors and issuers. Insured deals typically carry tougher bondholder security covenants enforced actively by experienced insurance analysts. Insurers surveillance of pending problems can be addressed before they surface which benefits all bondholders and the issuer.

Insurers interests are aligned with bondholders along with the backing of a good balance sheet.

At present low interest rates, new insurance is written on less than 5% of new municipal bonds issued. Amid a supply drought in the municipal bond market, low volumes of insured new issues and amortizations, brings up prices of outstanding insured municipal bonds.

The Need For Bond Insurance

With over 50,000 local governments issuing bonds for a wide range of infrastructure: roads, airports, industrial facilities, jails, hospitals, schools, etc. Bond insurance enhances market visibility and marketability which is good for investors and issuers.

Bond insurance is most valuable to “A” or “BBB” type issuers who issue roughly $135 billion or 40% of municipals issued annually. Insurance, well understood by the market, gets a wider audience yielding higher liquidity and interest savings. Getting a rating and maintaining it for the life of the bonds is costly and time consuming for issuers. Small and mid-sized issuers who do not frequently come to market seem to favor bond insurance and the accompanying rating.

Today there is a demand for bond insurance as it was in 1971: Insurance volume is expected to rise gradually. Assured Guaranty is expected to keep its lead due to consolidated market share. Well capitalized National could eventually bring price competition, build market share and grow. New bond insurer Build America Mutual, (BAM) established in 2013, rated S&P “AA, is a quality insurer widely accepted by issuers and investors.

Holders of bonds insured by the mentioned insurers should note that the insured municipal bonds are secured by significant claims paying resources that guarantee principal and interest when due.

Since 2008, bond insurers have recapitalized and returned to the safe old time-tested approach: value for bondholders of insured municipals.

*May not be suitable for all investors. Insured distressed bonds can experience extreme market volatility based on changing underlying credit metrics of the issuer. Municipal bond insurers have in the past changed their Business Model, there is no guarantee they will not do so again. Buy recommendation is based on current information. Information obtained from sources deemed reliable; report does not purport to contain all available information.