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Do S&P's Upgrades of Bond Insurers Signal Renewed Value for Investors?

In late March, S&P upgraded its financial strength ratings of municipal bond insurance companies Assured Guaranty (to AA from AA-) and National Public Finance Guaranty Corp. (to AA- from A). In the case of Assured, the upgrade applied to both Assured Guaranty Municipal (AGM) and to its new muni-only insurer Municipal Assurance Corp. The upgrades raise the number of S&P double-A rated insurers to five (see table below), though only four of them are actively seeking to insure new issues of municipal bonds. Taken together, the upgrades, the emergence of new insurers over the past two years, and a slight uptick in insured issuance in 2013 suggest that the industry may be trending in a positive direction for the first time since 2007.

Municipal Bond Insurers' Current Ratings (As of April 1, 2014)

Insurer	Moody's Rating / Outlook	S&P Rating / Outlook	Writing New Business	2013 Market Share [1]	2013 Par Insured ($ bil)
Assured Guaranty Municipal (AGM) [2]	A2/Stable	AA/Stable	Yes	61.1%	$7.4
Build America Mutual Assurance (BAM) [3]	NR	AA/Stable	Yes	36.8%	4.4
Berkshire Hathaway Assurance (BHAC)	Aa1/Stable	AA+/Negative	No	n/a	N/A
Municipal Assurance Corp. (MAC) [4]	NR	AA/Stable	Yes	1.3%	0.15
National Public Finance Guaranty (NPFG) [4]	Baa1/Positive	AA-/Stable	Yes	0.0%	0.0

[1] Market share as the percentage of insured new issues in 2013.

[2] When FSA was acquired by Assured Guaranty in 2009, AGM became the municipal-only portion of Assured that continues to insure legacy FSA bond issues and write new municipal business.

[3] BAM is a new municipal bond insurer that was initially rated in 2012.

[4] MAC is a newly-capitalized, municipal-only subsidiary of Assured Guaranty that was initially rated and began writing new insurance in 2013.

[5] NPFG is the successor to MBIA that was formed in 2009 when MBIA rolled its existing municipal insurance into the new municipal-only subsidiary.

The recent rating changes mark a significant shift in S&P's perspective on the strength of the bond insurance industry, with its report highlighting the "***prospective*** strong business risk profile and strong financial risk profile" (emphasis ours). S&P's upgrade is based on the belief that these companies will be able to significantly grow their market acceptance and increase their financial performance as rates rise and credit spreads widen. In some analysts' minds, the dramatic difference in market penetration of municipal bond insurance between its heyday in the mid-2000s (over 50% of new issues were insured) and today (bond insurers wrapped 3.6% of new issuance in 2013) provides a promising growth market. As a result, many in the municipal market view these upgrades as a sign that the remaining municipal bond insurers, having weathered the storm of the financial crisis, have restructured and recapitalized sufficiently to once again provide a significant value for investors.

Is bond insurance back? Not in the way that it was 10 years ago. While the active bond insurers have reduced their risk exposure to structured financial products (the CMOs, CDOs and other securities that saw such significant losses during the financial crisis), they remain susceptible to market forces that can significantly alter their financial strength and ability to write business. While we do not avoid bonds that are wrapped with bond insurance, we generally continue to discount its value, and rely only on the underlying credit of the obligor. Our perspective is based on factors including:

- The rating agencies have very different views of the credit quality of the bond insurers. There is a reason that BAM and MAC only carry S&P ratings – they likely would not have gotten double-A category ratings from Moody's, and that would have damaged their value proposition to issuers and underwriters. Until there is a consensus that a bond insurer is a high-quality credit, liquidity will be limited.
- In a low-rate environment, bond insurers have a hard time generating meaningful margins. While profitability may increase when yields and spreads increase, the possibility of persistently low rates for an extended time period threatens the underlying profit model.
- The tiny penetration rate of bond insurance over the past two years (3.6% and 3.5% of total new issuance in 2013 and 2012, respectively) does not speak to a widespread acceptance of the value of these companies' guarantees.
- In secondary market trading, we generally do not see any significant trading value for bond insurance. There seems to be little in the way of value paid for bond insurance after the initial offering, hindering investors' secondary liquidity in these issues.
- The quality of the legacy insured portfolios of AGM and NPFG continues to face pressure from Puerto Rico, Jefferson County, Detroit and other distressed issuers. If default rates for insured issues exceed expectations it could stress the insurers' capital bases and weaken their credit quality.

Is there any value in bond insurance? In a word, we believe the answer is "yes".

1. We believe that BHAC bond insurance offers value for investors. Because the company has a very limited portfolio of insured issues, has substantial capital support, and is a very recognizable name, we view it as providing some meaningful credit support.
2. We do see some value in bond insurance over very short maturities. This runs somewhat counter to a common view of the value of bond insurance providing protection against unforeseen credit risks for longer maturity bonds over long holding periods. Over the long term, we believe the insurers are subject to greater credit and market risks than are most municipal issuers. However, over a one- to three-year timeframe, we view them as having sufficient capital to weather most reasonable scenarios and make timely payments of principal and interest on small to medium-sized insured issues.

Bond insurance faces somewhat of a Catch-22 in today's market, much the same as when it was first developing in the 1970s and 1980s. In order gain a meaningful market share, traders and investors have to see value in the credit wrap. However, there is little value in insurance until it represents a significant percentage of the market. It may be harder to reinvent the business in today's marketplace, however, due to the still-fresh memories of the collapse of the industry less than six years ago.

Like all municipal bonds, insured bonds must be evaluated on a case-by-case basis. Municipal bond insurance is only one component of the overall credit picture of a bond, and must be evaluated in context. Ultimately, however, we believe investors should be comfortable that the issuers which ultimately back their bonds offer high enough credit quality on a stand-alone basis, without depending on the insurance alone for credit strength.

Brian Tournier
Director of Research
Ascent Investment Partners

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