

Bond Case Briefs

Municipal Finance Law Since 1971

S&P: U.S. Bond Insurers and the Financial Guarantee Sector Stand at a Crossroads.

In Standard & Poor's Ratings Services' view, there is still a need for municipal bond insurance in the U.S. public finance market. Meaningful value is assigned to the financial guarantees provided by the bond insurers. Yields on insured issues trading in the secondary market-as compared to yields on uninsured issues of the same issuer and similar maturities-indicate that pricing is strong for insured bonds.

We expect business volume for bond insurers to rise through 2015 and for the industry's risk-adjusted pricing ratios to improve. Municipal bond market participants in the public finance arena we have spoken to generally feel that bond insurance has proven its worth during the past several years. (Watch the related CreditMatters TV segment titled, "[Projected Higher Interest Rates And Spreads May Create Added Opportunities For U.S. Bond Insurers](#)," dated April 2, 2014.)

Overview

- Municipal bond insurance is still necessary in the U.S. public finance market.
- We expect business volume for bond insurers to rise through 2015 and for the industry's risk-adjusted pricing ratios to improve.
- If interest rates rise as expected and insured par volume does not increase or the increase in competition leads to poor pricing decisions, we could take rating actions on the bond insurers.

Business Prospects Are Likely To Increase

The prevailing lower yield environment and the spread compression it created hurt the financial guarantee market for much of 2013, making it difficult for bond insurers to attract insurable issuers and investor demand. Issuers already benefited from all-time low market yields. Investors searched for the highest-yielding fixed-income municipal assets available and were not willing to give up yield for the credit protection and liquidity provided by a financial guarantee.

If municipal yields widen by 50-75 bps through 2015 based on our analysis, there should be a corresponding increase in the insurable primary U.S. public finance market, as bond insurers should be able to create yield savings that would make it economical for issuers to pay for insurance. We have asked bond insurers their expectations for the U.S. public finance market and the insurable market in 2014. In a period of rising interest rates, they expect total U.S. public finance new issue par to be \$285 billion to \$300 billion, including refundings of approximately \$90 billion. The estimate for total new issue insured public finance par volume is \$20 billion to \$25 billion, equating to 7%-8% of total public finance issuance in 2014.

The bond insurers expect secondary market insured par to total \$2 billion to \$4 billion in 2014, depending on municipal market headline events, yield widening, and institutional investor capital market and hedging activities. In late 2013, insured secondary transaction picked up for the bond

insurers as a result of Detroit's bankruptcy filing, headline events about Puerto Rico, and general investor worries about the municipal debt market. There are still pockets of stress in the U.S. that might spur retail investors' demand for secondary market insurance.

We believe the market can support three bond insurers with the reemergence of National Public Finance Guarantee Corp. (National). In fact, U.S. public finance market participants have indicated a demand for a third insurer for diversity. In the near term, expansion of the insurable market with the expected rise in interest rates, combined with the disparate underwriting strategies of the bond insurers, should lead to sufficient underwriting opportunities to support each company's underwriting strategy. In the long term, as the bond insurers continue to prove the value of their product, the demand for financial guarantees should increase and the insured penetration of the U.S. public finance market should rise, but not to the same levels as prior to 2008.

To gauge demand for bond insurance, we spoke to various municipal bond-market participants who have different applications in the public finance arena. The findings of our discussions included the following:

- The overall sentiment was that bond insurance is a product that has proven its worth during the past two-to-three years.
- There is high demand for bond insurance in the middle-market space.
- There is investor and issuer demand for three players in the financial guaranty sector.
- Investors, especially the retail investors who are the primary end-users of bond insurance, do not see legacy bond insurers' structured finance portfolios as a detriment.

U.S. Public Finance Macroeconomic Trends

The 30-year Municipal Market Data (MMD) 'AAA' benchmark yield rose to 4.5% in September 2013 after the Federal Reserve announced quantitative easing tapering and headline risk associated with Puerto Rico increased. The current 30-year yield is 3.7%—65 basis points (bps) less than its recent peak, and 35 bps less than in January 2014.

We expect a gradual increase in long-term interest rates, with U.S. municipal rates rising through 2014 and 2015 by 50-75 bps. Standard & Poor's economists estimate a U.S. Treasury 10-year average yield of 3.0% for 2014 and 3.3% for 2015 (see [U.S. Forecast Update: A Recovery Postponed Not Canceled](#), published Feb. 10, 2014, on RatingsDirect). This is a 30-bp widening for 2014 and 70 bps for 2015.

The correlation of U.S. treasuries to the 'AAA' MMD general obligation yield curve has historically been close to the 0.9x-1.0x range, except during 2007-2009 both on 10-year. We therefore expect yields to widen by 25-50 bps by year-end 2014 and an additional 25-30 bps in 2015, increasing in total by 50-75 bps by the end of 2015.

Bond Insurers Economic Trends

With credit spreads forecast to widen in 2014 and 2015, we expect the bond insurers' risk-adjusted pricing (RAP) to improve from 2013 levels. We base this view on our assumption that the bond insurers will be able to capture a greater amount of the wider credit spread in the form of higher premium rates. We also assume that the rise in the premium rates will result in better pricing per dollar of risk as measured by our transaction capital charges and that the rise in premium rates will be greater than any rise in capital charges. In first-quarter 2013 when interest rates began to rise, this pricing dynamic was illustrated as the bond insurers experienced stronger pricing with relatively minimal change in underwriting risk. Interest rates in January 2014 began to decline

toward the end of the month, but bond insurers were able to execute on strong pricing, with RAPs on primary and secondary market transactions higher than those in 2013.

Ratings Hinge On Future Developments

Although we believe there is still a need for municipal bond insurance in the U.S. public finance market, the next two years will be crucial in determining the health of the financial guarantee sector. If interest rates rise as expected and insured par volume does not increase, we would likely reevaluate all our ratings in the sector.

The reemergence of National has introduced another layer of competition to the pricing dynamics of the financial guarantee market. In this competitive environment, insurers must exercise discipline when pricing insured transactions. If the increase in competition leads to poor pricing decisions or the current spread compression persists and insurers' RAPs are projected to fall and remain less than 4%, we could lower our ratings on the bond insurers.

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