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Paying for Protection: The Return of Bond Insurers.

Some municipal bond investors have had it pretty hard of late. For the holders of the debt of Puerto Rico, Detroit, Stockton, CA, Ferguson, MO, and Jefferson County, AL it's been a parade of deteriorating financial performance, defaults and bankruptcies. In Detroit's final bankruptcy agreement, for example, bondholders of the unlimited tax general obligation debt received a haircut down to 74% of their principal.

Yet some other Detroit bondholders got 100% of their principal, never missed an interest payment and generally saw better valuation on their bonds throughout the bankruptcy proceedings. So how did those bondholders walk away with full wallets while others lost $260 on every $1,000 invested? They had bought bonds wrapped with a bond insurance policy–a policy that unconditionally guarantees payment of principal and interest on the debt.

The days of bond insurance were assumed long gone after the collapse of nearly all of those businesses during the financial crisis of 2008. As of August 2015, there were $18.1 billion of insured bonds, up from a low of $11.4 billion in 2013, but still a far cry from the $191.3 billion of bonds insured in 2006. In fact, just two public companies survived that tumultuous period—Assured Guaranty (NR/AA) and National Public Finance (the restructured company of the insurer formerly known as MBIA) (A3/AA-).

But in a sign of renewed life, a new mutual insurance company was recently formed, Build America Mutual (NR/AA), which is owned by the municipalities it insures. Under revised rating agency guidelines, no financial guarantor can receive the formerly vaunted "AAA" rating. However, each bond insurer enjoys a "AA" level rating by Standard & Poor's and each is focused on municipal bond insurance as a core business. In fact, Assured Guaranty established a separate insurance subsidiary, MAC, which will only insure municipal bonds.

Benefits of Insurance

Given that municipal bond defaults are still rare (less than 0.05% according to a Moody's study of ten-year cumulative default rates), investors might reasonably ask why they should bother purchasing insured bonds. After all, like any insurance, bond insurance costs money. For investors that extra cost is in the form of lower yields for insurance bonds than for similar uninsured bonds.

It's a fair question, but there are several reasons to consider insured bonds. First, keep in mind that the municipal bond market is extremely diverse. There are more than 50,000 borrowers across more than 15 sectors, from local governments to industrial development bonds. Even the most diligent individual investor probably doesn't have the technical expertise to analyze the creditworthiness of a borrower and value its bonds appropriately.

Another consideration is that when municipal bonds do default—however infrequently—it's a real mess. Not only are numerous stakeholders and creditors fighting vociferously for a very small pie, any resolution is tempered by the fact that the municipal entity must emerge from the negotiations strong enough to continue serving the public. In almost any scenario, an investor will get a haircut

on principal and, as the resolution process drags on, face the added uncertainty of when you are going to get paid either principal or interest again.

Bond insurance eliminates all of this. In the event of a default, the bondholder never misses a payment of either principal or interest. But insurance is not only useful in the event of default, it also cushions against a ratings downgrade—which have become more frequent.

Consider the City of Chicago. When the general obligation debt of the city was downgraded in May 2015 to Ba1 by Moody's (its highest junk bond rating), the value of the uninsured ten-year maturity bonds dropped nearly $80 per $1,000 bond, or 8%, by the end of the week. However, investors holding these insured Chicago bonds remained valued slightly above $1,000 during that period.

Another benefit of insurance is liquidity. Tens of millions of dollars of bonds backed by bond insurers are traded daily. Meanwhile, buyers of distressed bonds often demand substantial discounts—when they can be found.

Strength of Insurers

In light of recent history, some investors have voiced concern about whether insurers could maintain their ratings and fulfill their obligations in the event of a big municipal default. For example, both Assured Guaranty and National Public Finance insure the bonds of one or more of Puerto Rico's troubled municipal borrowers.

But even with Puerto Rico's default on some of its bonds, it's critical to remember that a default on an insured bond does not mean the entire outstanding par amount of those bonds become immediately due and payable. The bond insurer simply continues to pay principal and interest on the originally mandated dates.

In the event of a default and subsequent claim, the bond insurers have strong covenants and legal provisions protecting them. These will be vigorously enforced and litigated, if history is any guide. The insurer will have to pay something, but the recovery on the bonds is often far greater than zero.

Moreover, bonds coming out of default are often restructured and refunded. This is an important consideration. As soon as any refunding occurs, the existing holders of the insured debt are made whole, the bond insurer's commitment ceases, any reserved capital is freed up and any unearned premiums become earned immediately. There are tremendous incentives to resolve a bankruptcy expeditiously by refunding the outstanding defaulted debt.

Lastly, these companies are very well capitalized, with capital positions that are arguably better, and books of business that are certainly stronger, than prior to the credit crisis. In the event of a claim, the bond insurer continues on with business as usual. New policies are written, older policies roll off as bonds mature and the portfolio capital continues to earn money which can (and is) applied to paying on outstanding claims.

For all of that, bond insurance is not an investment panacea. It does not guarantee a risk-free investment; instead, investors take on the risk—however slight—of the bond insurer itself. In other words, bond insurance is transferred and diminished risk, not the elimination of risk. You still have to do your homework.

FORBES

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