Higher Yields May Boost Bond Insurers.

The bond insurance industry is one segment of the municipal market that stands to benefit as interest rates continue to rise.

Assured Guaranty Ltd., one of the two active bond insurers in the municipal market, has already noticed increasing interest in its product in the relatively short period since rates have gone up, according to Robert Tucker, head of investor relations and communications.

"As interest rates rise and credit spreads widen, we would expect an increase in demand for bond insurance as investors become less focused on yield alone and increasingly incorporate the benefits of insurance in their investment decisions," he said.

The bond insurance industry was all but wiped out during the financial crisis, which left Assured Guaranty as the only active bond insurer for years to follow. At its peak, the industry was responsible for insuring more than half of muni bond issuance in a year. Last year, only 3.5% of new issues carried insurance. Low interest rates, among other limiting factors, have prevailed for the past four years, reducing both investment income for insurers and the amount of absolute spread available for issuers to fund insurance.

Interest rates have finally reversed direction in recent months, taking off Thursday in response to Federal Reserve chairman Ben Barnanke's comments that hinted the Fed may start tapering its bond purchasing program by the end of the year. Following Thursday's close, yields on the Municipal Market Data triple-A scale were up 90 basis points in 10-year maturities, and 104 basis points in 30-year maturities since May 1, with much of the increase taking place since June 3.

"Higher rates probably increase our opportunity to save issuers money as a logical consequence of wider spreads between credits," said Sean McCarthy, managing director and chief executive officer of the newest bond insurance company, Build America Mutual, which launched in July.

"That said, today in any interest rate environment, BAM's success is primarily driven by providing greater access for small- to medium-sized issuers, who benefit from the name recognition and liquidity the AA/stable guaranty provides."

National Public Finance Guarantee Corp., MBIA Inc.'s municipal-only insurer, also said rising interest rates would be a positive for bond insurers.

"As rates rise and spreads widen, insurers will be better positioned to create value for more issuers while charging premiums sufficient to achieve an acceptable return on the capital deployed," said Adam Bergonzi, a managing director at National.

The currently inactive bond insurer is a subsidiary of MBIA Inc. and was formed in 2009 when MBIA separated its municipal bond insurance business from its other, mostly asset-backed business. National has been preparing to re-enter the market, and the company has said it expects to do so sometime in the near future.

“Over a longer period of rising rates, debt buyers can be expected to become increasingly selective, as they will have more options to satisfy their investment goals,” Bergonzi said. “And as the market becomes more discerning over credit, insurance becomes compelling in a greater number of circumstances.”

Until recently, yields had been declining to historic lows, creating a challenging environment for the declining bond insurance industry. With borrowing costs already very low, municipal bond issuers find the bond insurance product — which provides credit enhancement to help issuers save on borrowing costs — less valuable.

In November of 2012, the Bond Buyer 20-bond index — a selection of mostly double-A general obligation bonds maturing in 20 years — dropped to 3.29%. That was its lowest level since Sept. 2, 1965, when it was also 3.29%.

Interest rates ended 2012 lower than they began at 1.72% in the 10-year, and 2.83% in the 30-year. The 20-bond index was at 3.58% as of Dec. 27, slightly down from the beginning of the year, when it was at 3.83%.

“It’s a positive development,” said Alan Schankel, managing director at Janney Capital Markets. “I don’t think there will be an overnight change, or a rush to embrace insurance because rates are a little higher, but in general, it’s a positive point for insurers and one of the things they need going forward to grow their business and grow their market share.”

In assigning ratings to bond insurers, credit rating agencies have cited the low interest rates as a limiting factor in bond insurers’ ability to generate new business.

Standard & Poor’s, for example, has assigned Assured Guaranty a financial strength rating of AA-, saying the company has a strong competitive position and strong capital, but limited business growth prospects due to the low interest rates.

Moody’s Investors Service rates the company lower at A2, also citing the low interest rates, among other factors.

Analysts at Moody’s say the rise in interest rates is a positive sign for the industry, but it also has to overcome other problems.

“There are two primary reasons why new business volume has been so low,” said James Eck, vice president and senior credit officer at Moody’s. “One is the low absolute interest rate environment, which has led some issuers to feel that since they’re able to issue at such low rates, the additional savings from bond insurance either aren’t there, or do not produce meaningful savings. The other potential reason is general investor skepticism of the value proposition.”

Stanislas Rouyer, associate managing director in the financial institutions group at Moody’s, said that the investor skepticism is based on the fact that the industry almost disappeared during the financial crisis and that, until recently, there has only been one active bond insurer.

“Now, with BAM being active, and National possibly re-entering the market, there is more of an industry,” he said. “More players appears to be a good thing for the industry overall. It gives more of a sense of the durability of the product.”

The other issue that causes investor skepticism is the legacy exposures of guarantors. Situations like Detroit remind people of the risks in the industry, Rouyer said. But at the same time, they can also highlight why the product is useful.

Schankel also believes events in Detroit, as well as Jefferson County and other troubled municipalities, will help illustrate the value of bond insurance. He says that time is also a factor that will help the industry to grow.

“The further away we get from 2008 and those bad memories of insurance, I think the better opportunity insurers will have to penetrate the market, at least on the retail level,” he said, adding that he doesn’t think the industry will ever return to the 57% market share it saw in 2005.

Standard & Poor’s analysts said in a July 12 report that the bond insurance industry could see its market share of insured new issues return to 20% to 30% in a “normalized interest-rate environment.”

However, in the current environment, yields aren’t quite there yet.

Matt Fabian, a managing director at Municipal Market Advisors, noted that while yields have increased, they have only risen 1% in the last few months.

“This isn’t nearly what we’re talking about when we say that higher yields would help the insurers,” he said. “Getting back to more ‘normal’ yields, at least for when the insurers had their heyday, might take another 1% or more.”

In addition to a waning investor acceptance, the industry has a few structural factors working against it as well. These include the movement away from direct retail ownership to funds and separately managed accounts, rating recalibration, and the reduction in the use of variable-rate and other products that depended on insurance, Fabian said.

“Lack of issuance, in particular longer fixed rate bond issuance, and the severe downward pressure on underwriting fees” are other limiting factors, he added. “These don’t leave a lot of room to pay an insurer for their services.”

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