# Bond Case Briefs

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## Bond Insurers Charging Less to Take on Risk.

Bond insurers Assured Guaranty and Build America Mutual are getting less compensation for risk as compressed credit spreads and competition force the businesses to cut insurance prices.

Assured reported a U.S. public finance risk-adjusted pricing ratio, a risk-versus-return measure of an insurer's portfolio in which a higher score is considered stronger, of 3.55% in the first three quarters of 2013, down from 4.46% in 2012, Standard & Poor's said in a Nov. 20 report. Build America, which ramped up its business in the beginning of the year, reported RAP of 3.46% for the same period.

The implied premium rate for bond insurance is 20% lower in 2013 than in 2012, with an average of 40 basis points in the second quarter of 2013, compared with the 60 basis point average insurance obtained in previous years. Persistent low pricing ratios could lead to ratings cuts, analyst Marc Cohen said in the S&P report.

"In a perfect world with only two players you'd think they have the market power to exercise their abilities to extract the best premiums," Cohen said in an interview. "However, the current market dynamics are hindering the bond insurers' profitability. With those market dynamics there's a heightened level of competition among those two players."

Build America's launch in July 2012 ended Assured's post-financial crisis luxury of being the only active insurer. The financial guaranty market began to split, with Assured responsible for 59% of insured bonds as of September 30. The percentage of bonds with insurance fell to 3.53% in the third quarter, from 3.71% in the second quarter, according to data from Reuters.

Issuers are shying away from insurance as interest rates remain low and make guarantees less economically valuable, Cohen said. Instead, insurance has largely been present to provide liquidity and access to the market for smaller issuers.

"When spreads are wider, insurers are able to extract a significant portion of that interest savings, so when credit spreads and muni yields are as tight as they have been, there's less money on the table to extract from their premiums," Cohen said.

The difference in yield between single-A and triple-B 10-year municipal bonds, the section on the curve where insurers do most of their business, fell from 85 basis points in November 2012 to 61 points in September. The spread between AAA GO 30-year yields and BBB bonds feel from 131 basis points a year ago to 114 in September. Since September, those spreads have either fluctuated or risen.

Analysts expect theFederal Reserve to begin tapering its quantitative easing program in the near future, which would increase yields and spreads, and encourage issuers to look to insurers for savings on new debt, Cohen said. Assured expects rising interest rates to boost demand for guarantees.

"We've already seen the positive effects of rising rates during the summertime when rates were up," Bill Hogan, director of public finance at Assured, said in an interview. “Higher rates helped us then and we expect them to go a little bit higher next year, which will be beneficial to both penetration and pricing.”

As part of its rating methodology for financial guarantors, S&P places transactions into four risk categories, which determine the capital charge associated with backing a specific deal. Insurers are required to reserve a percent of the average annual debt service associated with the deal against the risk. In 2011, S&P increased that percentage, with deals in category four – charter schools, health care or private schools — requiring the largest capital charge.

Assured’s gross per period weighted capital charge is 16%, compared with BAM’s 11.4%. Insuring deals in the category four area has weakened Assured’s pricing ratio, Hogan said, even though those transactions make up just $200 million in par amount.

“It’s unfortunate that the high capital charges in Category 4 limit our ability to underwrite sound enterprise credits,” Hogan said. Not including category four transactions, Assured’s RAP in the first three months of the year satisfies S&P’s requirements, Hogan said.

Build America does not wrap debt in higher risk categories,

“Given the current spread environment, we are satisfied with our progress to date and look forward to continuing to serve our core market of essential public purpose municipal issuers,” Sean McCarthy, chief executive officer of BAM, said in an emailed statement.

S&P’s scrutiny into the insurers may reflect a more general concern for the industry, Mikhail Foux, a municipal strategist at Citigroup Global Markets. Foux believes insurers will likely see an uptick in market penetration but said rating agencies may be reconsidering how they look at insurers that have exposure to debt in distressed areas.

“They may be concerned about what could happen with stress in the sector and looking at how they separate high quality business from the rest,” Foux said.

The insurers’ pricing ratios are falling short of S&P’s expectations, the rating agency said in the report. S&P looks for insurers to remain in the 4% to 6% risk-adjusted pricing range, and remaining below 4% could lead to ratings downgrades.

Hogan expects the ratios to rise before year-end with large low-capital charge deals on the table.

BY OLIVER RENICK

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