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Bond Insurance Then & Now: The Revival of an Industry.

If you're new to the municipal market, you may not know what bond insurance is. And if you're a veteran in the market, you certainly don't recognize it. Bond insurance has undergone a makeover unlike any other segment of the municipal bond industry.

With the rapid dissolution of a then-$2.5 trillion business, the demise of the financial guarantors served as testament to the sprawling devastation of a financial crisis that left no asset class unscathed.

Exposure to toxic residential mortgage-backed securities that went bust with the pop of the housing bubble stuck the insurers with a fat tab to pay, with companies that had ventured into the collateralized debt end of the risk pool getting hit the hardest.

As industry leaders like Ambac, MBIA Corp. and Financial Guaranty Insurance Co. were stripped of their ostensible first-class triple-A ratings, the enormity of the mortgage crisis unfolded and restructurings permeated the bond insurance business. The number of municipal bonds issued with a guarantee plummeted, from as high as 57% before the recession to 19% in 2008, and to 3.5% in 2012.

The financial crisis incited a debate over the merits of insurance that sent market penetration by insurers into a free-fall that hasn't shown signs of abating — until now.

With freshly upgraded ratings on Assured Guaranty and MBIA-owned National Public Finance Guarantee, the bond insurers are hoping rising interest rates will push more state and local governments this year to consider the savings that come with piggybacking on an insurer's rating.

But where National, which plans to restart business, and Build America Mutual, the newcomer, see hope for rebirth from the ashes, many muni bond buyers see an antiquated model that's had its time in the sun.

And then there are the rating agencies — chastised by some on Wall Street for not getting the downgrade ball moving fast enough — which come down somewhere in the middle.

One thing they can all agree on: bond insurance will never be the same.

CRISIS FALLOUT

In 2007, around half of all new municipal bonds carried insurance. A product that originated as a competitive enhancement had become a commodity, and few buyers of bonds were looking at the underlying issuer rating. When it became clear that many of the loans behind those structured transactions would inevitably default, the insurers unraveled.

Standard & Poor's hit the industry with a slew of downgrades in early June 2008 and Moody's Investors Service followed suit weeks later. Within a year, the stock price of Ambac, which

introduced bond insurance to the muni market in the early 1970s, was barely worth more than a dollar. By 2010, Ambac and FGIC had filed for bankruptcy, other major players stopped writing new business and MBIA launched muni-only National.

Assured Guaranty, having acquired former league leader Financial Security Assurance, emerged as the only — and by default, biggest — bond insurer selling its product on the market. Assured continued business unchallenged, all the while fighting in courts against the banks that packaged the toxic policies in the first place.

In July 2012, former FSA veterans launched Build America Mutual, a mutual insurance company that promised it would only insure safer, essential public-purpose municipal bonds. In its first year, BAM took 39% of the total insured market by par amount.

Now, with National poised to write new business, competition is once more a word in the bond insurance vocabulary.

CRITICAL YEAR

National's timing couldn't be better. Bond insurers wrapped 3.6% of all new bond issues this past year, and while the rate remains less than a 10th of what it was before the financial crisis, it represents the first sign of growth in a decade.

"I believe it is the critical year for insurers," Mark Palmer, an equity analyst at BTIG, told *The Bond Buyer*. "What we have now are all the pieces in place for an increase in demand for bond insurance."

Those pieces were expectations for rising interest rates, S&P's March rating upgrades of Assured and National to AA and AA-minus, respectively, and a Detroit-driven awareness in the market that if your defaulted bond is insured, you'll still get paid.

"It's a pivotal year," John Dillon, chief muni bond strategist at Morgan Stanley Wealth Management, said in an interview. "Away from the upgrades, which I think are helpful, the bankruptcy of Detroit has proven the value of bond insurance."

While most of the fixed-income investing community shudders at the thought of rising interest rates, the insurers embrace it. Higher rates mean higher costs for municipalities looking to sell bonds, who would then, in theory, be more willing to pay for insurance.

"If, as some believe, the 10-year is going to go from 2.6% to something in the mid-3% range, that would create an environment that would be great for bond insurers," Palmer said.

Palmer is one of just a few remaining equity analysts actively following publicly traded Assured, MBIA and Ambac. One could say he represents the bullish side, with target prices on Assured and MBIA's stock at 54% and 80% higher than they're currently trading.

"The problem for the past couple of years has been it hasn't made sense for a municipality to pay up for bond insurance when their funding costs are already so low," Palmer said.

But the value proposition of bond insurance doesn't seem to be a self-evident idea in the municipal marketplace. After all, newcomers to the buy-side only see three insured bonds come by their screen for every 100 new ones. And those who remember insurance from its glory days now see a very different product.

VALUE PROPOSITION

With the introduction of BAM and the July 2013 launch of Assured's muni-only Municipal Assurance Corp., insurers now target the smaller traditional municipal issuers who don't carry the name recognition needed to make a sale in the marketplace. For them, insurance provides not just cost savings, but liquidity.

Assured and National may occasionally wrap the larger, riskier transactions, but single-A credits are now the insurers' bread and butter.

For an A-rated issuer selling bonds in the market as of April 1, wrapping with an AA-rated bond insurer would save the issuer 46 basis points on a 10-year bond, according to Municipal Market Data. On the 20-year bond, insurance would save the issuer 50 basis points. On the short end, insurers currently don't add much value: the yield for an A-rated five-year bond was 1.44%, compared with 1.75% on AA.

The value of insurance has undeniably withered. In 2009, the same issuer would save 160 basis points on 10-year bonds by issuing along an insurer's triple-A yield curve instead of their own single-A curve. No longer boasting the triple-A rating, insurers are waiting for an interest jump to buoy the business.

"Our business is countercyclical to rates. As rates go up our business grows," Billy O'Keefe, co-head of public finance at Assured, told The Bond Buyer. "In the second half of last year, when rates picked up and spreads were wider, we had the best fourth quarter we've had in a while."

The spread between single-A and double-A yields fell to a decade-low 41 basis points in April 2013. The gap has since grown closer to 50 basis points, but still remains well below 2009 levels, when the spread was 140 basis points.

The economy will continue to improve, quantitative easing will come to a close, and Federal Reserve Board chair Janet Yellen will eventually have to hike interest rates. Issuers will look to Assured, BAM and National to fill that gap, or so the story goes.

REBUILDING THE BRAND

But while credit spreads are tighter than in 2009, they're actually well above pre-financial crisis levels, when insurance was booming. The difference between single-A and double-A yields today is almost four times what it was from 2005 to 2007, MMD data shows.

"I don't buy the credit-spread argument," Dan Heckman, a municipal strategist at US Bank, said in an interview. "I just don't think buyers today put that much value in it. We're happy it's back but the reality is it's going to turn few buyers from a non-buy decision to a buy decision."

The challenge for bond insurers, buy-side analysts say, is in reclaiming the investor appeal that a guarantee once carried. While higher spreads may boost the value of the product for sellers, the benefit of insurance could be muted without receptive buyers.

"It's hard to look at it simply at a spread basis," Patrick Early, chief muni analyst at Wells Fargo Advisors, said in an interview. "The landscape is completely different now. There was reliance on insurers pre-crisis with buyers used to seeing those names — it was just the way things were done."

In the post-crisis world, many investors now make decisions based on an underlying rating, regardless of credit enhancement. Insurers need to be proactive in approaching the institutional investor community as well as the issuers, analysts said.

“With the recent upgrades, this will certainly be a good year to see how well the insurers will execute marketing plans and expand penetration,” Patrick Early, chief muni analyst at Wells Fargo Advisors, said in an interview.

Insurers as a whole must rebuild the brand, and the reformed National will need to sell a new image that will put negative stigma attached to its parent company, MBIA, at rest.

NATIONAL’S RETURN

“They’re going to have to convince people that they were just rehabilitating the company during their hibernation,” John Mousseau, vice president and portfolio manager at Cumberland Advisors, said in an interview. “They’re not starting from scratch, but there will be a little pricing pressure on premiums.”

With the company eager to begin rebuilding its books, National is likely to be faced with issuers looking to get a cheap price on insurance. Issuers looking to take advantage of the resurrected company will be a challenge in the earlier phases, BTIG’s Palmer said.

National CEO Bill Fallon is well aware of the tactic.

“We’re not trying to cut price to win market share or anything along those lines,” he said in an interview, adding that serious inquiries are already coming. “We’ve had several calls for our insurance both on the secondary and primary side, and that’s without really doing a whole lot apart from people knowing about the S&P upgrade.”

For National, which hasn’t written new policies since the financial crisis, a string of settlements with Bank of America and Societe Generale in May 2013 for more than $2 billion was a turning point. The company found liquidity after being repaid on a $1.7 billion loan it made to parent MBIA; it was then just a waiting game for the rating agencies.

In March, the AA-minus rating came from Standard & Poor’s.

“Whereas in the old days it was a triple-A rating from two rating agencies, it appears nowadays that it’s a double-A rating by S&P that’s the requirement to do business,” Fallon said.

The waiting game continues for Moody’s, which rates National at Baa1 with a positive outlook. The rating agency has Assured at A2, the equivalent of an S&P single-A rating, which the company has openly contested.

“A lot of this depends on Moody’s,” said Howard Cure, director of municipal research at Evercore Wealth Management. “If they upgrade insurers it would help the business. The future of the industry depends on rating agencies.”

Moody’s plans to revisit its industry commentary, the rating agency told The Bond Buyer. And while National has a positive outlook, Assured’s rating remains stable.

“The sector has not recovered from the financial crisis but has stabilized, and it’s still a very small fraction of what we saw pre-crisis,” Stanislas Rouyer, associate managing director at Mooody’s, said in an interview. “It seems to show some increased penetration, but it’s too early to tell if it’s the start of a trend or not.”

$20 BILLION FOR EVERYONE

The addition of a third competitor could have mixed results on the market. Insurers are hoping National's added business will invigorate the market, but increased competition could mean lower premiums for insurance. S&P reported in November that Assured and BAM were getting less compensation for taking on risk, with Assured's risk-adjusting pricing ratio, a risk-versus-return measure of the company's portfolio, falling to 3.55% from 4.46% in 2012. BAM's was 3.46%.

"The new competition from BAM has not breathed too much life into the market," Rouyer said. "It's mostly just redistributed market share and not enlarged the pie."

As National builds out its marketing strategy and takes hold in the market, so will BAM continue its effort to gain name recognition among investors.

BAM, which opened for business in July 2012, received its initial startup capital from White Mountains Insurance Group, a financial services holding company. White Mountains owns $503 million in BAM surplus notes, which accrue interest annually.

That interest was at $59 million as of Dec. 31, 2013, putting BAM at a GAAP operating loss of $79 million in 2013. But the interest isn't compounded, and the insurer isn't under pressure to begin payment on the debt until 2042.

BAM's key insurance metrics — statutory capital and claims paying resources — were relatively stable through its first full year of operations, with statutory capital down $13.6 million to $470 million by year-end. Claims paying resources were unchanged as of March 31, at $583 million.

"There's a very good playing field for BAM to come and extoll its values in this market," Rick Holzinger, head of investor relations at BAM, said in an interview. "We have no legacy portfolio and none of the noise associated with one."

With full registration in all 50 states, 2014 will be an important year for the startup insurer, which nabbed 39% of the market from Assured in 2013. With a rating now equal to BAM's, Assured is looking to take some of that back.

Competition among three insurers, if premiums are kept at healthy levels, may indeed be the piece of the puzzle needed to get the market to animate investors once more. In the first quarter of 2014, market penetration continued its slow climb from last year, moving toward 5%.

"People are so focused on the old days when it used to be 50% penetration," National's Fallon said. "You don't need $60 billion to make this business model work. You could do it at $20 billion. Now there are three competitors – if they each do $20 billion in par, the economics should work fine for everyone."

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