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U.S. Municipal Bond Insurers Set to Withstand Puerto Rico Default.

U.S. municipal bond insurers will likely weather any potential losses as a result of Puerto Rico's debt crisis but a downgrade to their ratings or a loss of investor confidence longer-term could pose a serious challenge to their post-crisis recovery.

Bond insurers insure about \$13 billion of Puerto Rico's \$72 billion debt load, substantially more than they did in Detroit which centered on a few hundred million dollars of city debt, meaning that losses for the insurers could be much higher.

"We're monitoring it closely because we don't know what any type of settlement or restructuring will be," said David Veno, who analyzes bond insurers for Standard & Poor's.

Bond insurers such as MBIA and Assured Guaranty were hit during the financial crisis after they ventured into mortgage-backed securities in the years before 2007. Ratings agencies slashed their AAA ratings to junk or withdrew them altogether. That meant bond issuers no longer benefited from their coverage.

Bond insurers essentially lend their rating to municipalities who use insurance to lower their borrowing costs.

For example, Puerto Rico's insured bonds are trading at hefty premiums compared to uninsured bonds. Insured debt of the Puerto Rico power authority, which is currently in restructuring talks with creditors, recently sold for around 96 cents on the dollar, while uninsured debt is selling for around 54 cents.

Before the crisis, around half of all new municipal bonds had insurance from nine insurers, with nearly 60 percent covered in 2005. By 2012, that had fallen to just 3.6 percent, although it has climbed steadily to 6.6 percent in the first quarter of this year, Thomson Reuters data shows.

Although insurers have slowly recovered since then, Puerto Rico could be their first major test in terms of losses.

Puerto Rico's Governor Alejandro Garcia Padilla said in June that the U.S. Territory could not afford to pay its debts, adding that all Puerto Rico's bonds were now negotiable. That shocked many investors who believed the problem was contained in Puerto Rico's public corporations.

Puerto Rico actually defaulted on Aug. 1 by paying only a fraction of what was due on its Public Finance Corp (PFC) bonds. None of those bonds were insured,

Crucially, S&P's Veno reaffirmed the ratings on Puerto Rico's two biggest insurers, MBIA - through its National Public Finance Guarantee subsidiary - and Assured Guaranty, after the governor's comments. But a downgrade in response to bigger-than-expected losses could limit their ability to get new business from municipalities that borrow based on their credit ratings.

Key to the health of the insurers will be whether they can maintain the momentum in writing new business or whether bond investors can go without insurance or diversify into firms with little or no Puerto Rico exposure such as Build America Mutual (BAM).

Many stock investors have not stuck around to find out. Shares in both MBIA and Assured plummeted after the governor's statement. MBIA's shares fell to their lowest level since 2010 although they have since recovered some of their losses.

Both companies said in statements they can handle pessimistic scenarios in Puerto Rico. MBIA pointed to the "extremely strong" capital position of its National Public Finance Guarantee subsidiary. Assured said it had the "resources and loss mitigation expertise" to handle its exposure to Puerto Rico.

Assured has \$4.9 billion of net exposure to Puerto Rico and \$12 billion in claims paying resources. It also generates \$400 million from its investments portfolio. Given that municipal claims are paid out over the life of the bond and not all at once means that it is more than adequately capitalized to honor any claims made by investors on Puerto Rico debt.

Assured says a 20 percent loss to the \$773 million of power authority bonds it insures would result in annual claims of just \$13 million. But losses could be substantially higher in the event of a wider and deeper default.

Assured is also rated 'AA' compared to MBIA's 'AA-', giving it an extra buffer in the event of a downgrade.

MBIA's gross exposure of \$4.3 billion to Puerto Rico is lower than Assured's but is closer to claims paying resources of \$4.9 billion at its National Public Finance Guarantee Corp unit. However, MBIA said it has seen business volumes growing since Padilla's speech.

Its lower AA- rating also means a potential downgrade could have a more profound impact.

Still, muni bond investors continue to buy the insurers' products, seeing value in insurance even if they may be distinguishing between the firms.

"Bond insurance will surprise to the upside," said John Loffredo, a fund manager with MacKay Municipal Managers, who says the firm's retail clients have been asking for it more frequently since Puerto Rico hit the headlines in 2013.

Loffredo says 26 percent of the firms \$13 billion in municipal bonds is insured. That number is as high as 35 percent in the firms \$1.4 billion MainStay tax free fund, which Loffredo co-manages.

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