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Puerto Rico Balloon Payments Seen as Risk for Some Bond Insurers.

For bond insurers, Puerto Rico's balloon payments on debt that puts off interest bills for decades is a billion-dollar asterisk.

With Governor Alejandro Garcia Padilla set to receive a plan as soon as next week to restructure $72 billion of debt, the commonwealth's capital appreciation bonds, which were first sold for pennies on the dollar because they don't pay interest until maturity, threaten to saddle Ambac Financial Group Inc. and MBIA Inc. with swelling liabilities.

The companies typically use the price at which the bonds were issued when disclosing the potential payouts they face. Once interest is included, Ambac says its Puerto Rico exposure jumps to much as $10.5 billion from $2.4 billion. For MBIA's National Public Finance Guarantee Corp., it more than doubles to about $10.5 billion.

"The difference between principal at issuance and the amount due at maturity is enormous" on capital-appreciation bonds, said Tamara Lowin, director of research at Rye Brook, New York-based Belle Haven Investments, which oversees $3 billion in munis. "Ignoring the accreted value is irresponsible."

Bond insurers, which agree to make interest and principal payments if an issuer defaults, are among those with the most at stake as Puerto Rico is pushed to the financial brink. Years of borrowing caught up to the island as the economy languished and residents moved out. The territory defaulted last month for the first time, when it made just a fraction of a payment due on uninsured securities sold by one of its agencies, and Garcia Padilla's advisers are scheduled to present a debt-adjustment plan on Sept. 8.

Shares of Ambac, MBIA and rival Assured Guaranty Ltd., which tumbled as the commonwealth veered toward default, rose this week after Puerto Rico's electric company struck an agreement that left investors facing smaller losses than some analysts had predicted. Puerto Rico's bonds also climbed amid speculation that the government will be able to reach other such deals.

Island officials have yet to say how much of their debt they'll seek to cut, or which securities may be affected. Some investors have snapped up insured Puerto Rico securities, confident that insurers have enough to cover any defaults.

Assured, which insures $9.1 billion of commonwealth debt as measured by principal and interest, has $12.6 billion in claims-paying resources, according to company filings. Ambac has $8.8 billion to meet obligations and National has $4.9 billion, company disclosures show.

National and Ambac say they're confident in their ability to weather a Puerto Rico restructuring, and the biggest balloon payments faced by the commonwealth won't come due for decades. Assured says its $72 million exposure to capital-appreciation bonds is minimal.

MBIA is rated AA-, the fourth-highest grade, from Standard & Poor's, which ranks Assured AA, one step higher. Ambac isn't rated by S&P.

Those rankings are based on their ability to pay debt service on the island securities they insure for the next four years, said David Veno, an analyst at S&P in New York. The largest portions of Puerto Rico's capital appreciation bonds, or CABs, don't factor into that calculation because they don't mature in that time.

Ambac guarantees at least $7.3 billion of Puerto Rico's payments on CABs, most of which are backed by sales taxes and aren't due until 2047. National has more than $4 billion.

MBIA began including the full debt-service total along with the par amount in its last two quarterly reports, which reflect its exposure to CABs. Adam Bergonzi, National's chief risk officer, said the bonds, known by the Spanish acronym Cofina, are backed by a top claim on sales taxes that are sufficient to cover the debt payments.

"We are comfortable with our Cofina exposure," he said in a statement. Though CAB payments may seem large, "collection levels exceed amounts necessary to service all senior debt in future years."

Ambac discloses its exposure to Puerto Rico interest payments on its web site, though its most recent quarterly filing includes only a tally based on the amount of bonds outstanding.

"You need some sort of consistent basis to disclose your par exposure in your portfolio, and that's a metric over time that investors have found valuable in assessing the guarantors and their risk," David Trick, chief financial officer of Ambac, said in an interview. "It's hard to make everything perfectly apples-to-apples without making disclosures extremely complex and potentially confusing."

CABs have drawn scrutiny in states including California, Michigan and Texas because of the financial squeeze the securities put on local governments when they come due. All three have banned or limited the ability of officials to sell them.

Texas's bill, which took effect Sept. 1 and restricts CAB maturities to 20 years, is a credit positive for the state's school districts because they will have more stable debt burdens, Moody's Investors Service said Thursday in a report.

In 2007, Puerto Rico issued Cofina bonds backed by Ambac due in August 2054 that netted the commonwealth $701 million up front, data compiled by Bloomberg show. As the debt matures, investors are supposed to receive about 10 times that amount.

The securities have traded at about 6.8 cents on the dollar over the past month, compared with 9.2 cents when they were issued. Usually zero-coupon bonds increase in price as they get closer to maturity.

"The biggest risk for National and Ambac is Cofina," said Bill Bonawitz, director of municipal research in Philadelphia at PNC Capital Advisors. Because of the CABs, "they would ultimately owe enormous numbers."

Bloomberg News

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September 3, 2015 — 9:01 PM PDT Updated on September 4, 2015 — 6:02 AM PDT