
How Rising Interest Rates and Widening Credit Spreads Will Drive Greater Use of Bond Insurance.

The use of municipal bond insurance has diminished substantially since the financial crisis. Low interest rates and tighter credit spreads have reduced the benefits of bond insurance for municipalities.

In this article, we examine why the use of bond insurance should grow as rising interest rates drive higher borrowing costs and concerns over rising credit risk make it difficult to make a sound investment decision.

The Case for Municipal Bond Insurance

Bond insurance is used to guarantee the timely principal and interest payments of a bond issuer or obligor. The bond insurer charges a premium to the bond obligor to insure or “wrap” the bonds. Bond insurance is structured so that it benefits the bond investor, the bond obligor and the bond insurer. The bond investor benefits from the protection provided by bond insurance in the event of a default. If the bond obligor defaults, the bond insurer makes the interest or principal payment and the bond investor avoids taking losses. Assuming the bond insurer has a higher creditworthiness than the obligor, the obligor benefits from lower borrowing costs. Lastly, the bond insurer benefits when they profit from the premium charged to bond obligors who do not default.

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