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For All But the Lowest-Rated State and Local Governments, Buying Bond Insurance is a Bad Deal.

State and local governments paid over $17 billion in insurance premiums on their bonds between 1995 and 2008. Insuring a bond should add a layer of protection against default for investors in the bond and reduce interest costs for borrowing municipalities. But after many bond insurers collapsed during the financial crisis, the benefits of bond insurance to state and local taxpayers became much less clear.

In a paper presented at the 2019 Municipal Finance Conference at Brookings, Kimberly Cornaggia and Giang Nguyen of Pennsylvania State University and John Hund of the University of Georgia find that today, only a handful of state and local governments benefit from insuring their bonds. The authors studied a sample of over 700,000 municipal bonds issued over the last 30 years. They find that, before the financial crisis, bond insurers tended to have high credit ratings, so buying insurance on muni bonds was a good way for state and local governments of all credit ratings to reduce interest rate costs on their debt. In that period, local governments saved about 0.1 percentage point in borrowing costs by paying to insure the bonds.

When bond insurers' credit ratings were downgraded during the crisis, however, investors began to consider insurance to be less valuable. Post-crisis, insuring led to lower borrowing costs only for state and local governments with the lowest credit ratings. The authors show that insurance is effective at reducing interest costs only when the insurer has a higher credit rating than the borrowing government; after the financial crisis, very few insurers continued to have credit ratings as high or higher than the municipalities they insured.

Still, many municipalities continue to pay insurance premiums today. There is no clear explanation why well-rated governments do this, and the authors say that doing so subsidizes lower-rated municipalities that benefit from the insurance. The authors say their findings indicate that moving away from bond insurance could result in significant savings for state and local taxpayers.

In addition to lowering borrowing costs for municipalities, bond insurance should make purchasing and trading bonds cheaper for investors. Cornaggia and coauthors show, however, that transaction costs tend to be the same or even higher for insured municipal bonds relative to their uninsured counterparts. This finding points to another avenue by which bond insurance doesn't deliver benefits.

Read the paper here»

The Brookings Institute

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