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Is Municipal Bond Insurance Still Worth the Money in an 'Over-Insurance' Phenomenon?

In theory, the municipal bond insurance should reduce the cost of municipal borrowing by reducing expected default costs, providing due diligence, and improving price stability and market liquidity. However, prior empirical studies document a yield inversion in the secondary market, where insured bonds have higher yields than comparably-rated uninsured bonds during the 2008 financial crisis, suggesting that insurance has no value precisely when needed most.

Whether bond insurance provides value to issuers of municipal bonds (munis) is an important question because the cost of insurance is borne by taxpayers. But this question remains unanswered by a literature providing mixed evidence based on relatively small samples of munis issued in particular states (e.g., Texas, California, New York) or in limited time periods. To fill this gap, Kimberly Cornaggia (Penn State University), John Hund (University of Georgia) and Giang Nguyen (Penn State University) examine the benefits of bond insurance to taxpayers in this paper, using comprehensive data and selection models to control for fundamentals and the endogenous choice to insure.

The authors bring a more comprehensive dataset to the question of insurance value than prior studies and tackle the selection effects associated with the endogenous choice to insure. They first find that the previously documented yield inversion in the secondary market during the 2008–2009 financial crisis, is driven primarily by insured munis with credit ratings at or above the ratings of their insurers, many of whom experienced serious financial distress and downgrades during the crisis. They then focus on the primary market and measure the benefit of insurance to issuers as a reduction in offering yields at issuance. Consistent with the secondary market results, the authors' primary market analysis indicates this lack of insurance value stems from the relative quality of insurers vis-a-vis insured issuers and that highly-rated issuers subsidize lower-rated issuers and any insurance premium represents negative value for the highly-rated issuers. The authors employ two state-of-the-art selection adjusted models to account for the selection into insurance. Although it is puzzling that highly-rated issuers pay for relatively low-rated insurance without commensurate economic benefits, the evidence is consistent with prior literature documenting an "over-insurance" phenomenon.

The authors conclude that the "over-insurance" phenomenon is influenced by:

- **Agency problems between public officials and the taxpayers they represent:** Jurisdictions with higher corruption (relatively higher conviction rates among public officials) despite lower deterrence (relatively lower prosecution rates) leave the most money on the table.
- **Conflicts of interest among underwriters and municipal advisors:** Municipalities hiring large, influential advisors or underwriters leave the most money on the table

The results commend additional regulatory efforts to enforce municipal advisor standards and better educate municipal issuers (heterogeneous in their sophistication) regarding the conflicts of interest inherent in underwriter incentives.

Read the full paper here»

The Brookings Institute

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