

# **Bond Case Briefs**

*Municipal Finance Law Since 1971*

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## **Municipal Bond Defaults Will Be A Wake-Up Call For Bond Insurers.**

The coronavirus has had a devastating effect on the short-term finances of every state and municipal entity dependent on sales and payroll taxes for the revenues. The short-term effect, however, may well have very long-term implications for the finances of these entities. In turn, insurers of the bonds—those that guarantee interest and principle against default—are going to be asked to share the pain.

The 2008 Financial Crisis had a devastating effect on the monoline bond insurance industry, which used to be dominated by names like Ambac Financial, MBIA MBI and FGIC. Only one insurer, Assured Guaranty, came through the crisis relatively unscathed and rose to become the industry leader from a previous third or fourth place. Its success, however, was unrelated to its municipal bond underwriting. Rather, it was due to its prudence in not plunging into the insuring of corporate and structured mortgage backed securities.

It was this segment of the business that brought down all the industry leaders. The actual business of insuring municipal bonds came through the crisis without immediate losses, so Assured Guaranty gained market share and prospered. But the industry shrunk dramatically and the seeds for future troubles soon became clear.

Two major changes came out of the financial crisis that threatens the health of this important industry. The first was that interest rates declined to where the insurance fees dropped as much as 80 percent. This is because bond insurance had traditionally been structured to be of no cost to the issuer, i.e. the fees were based of the savings in interest expense due to the bonds being rated AAA versus the issuers rating which were usually A- or BBB.

In theory, this ignoring of traditional underwriting principles was justified on the assumption that the insurer was writing coverage to a zero losses standard. This was, of course, a stretch in logic but was supported by Moody's and Standard & Poor's so long as they could get a piece of the fees on each deal for rendering their AAA imprimatur. The insurance fee structure was furthermore negatively impacted when S&P, and eventually the other rating agencies, downgraded the United States from AAA to AA+. This led to then downgrading the monoline bond insurers as well as the credit enhancement they actually could render. Along with the decline in interest rates, this proved to be a massive hit to the industry's fee structure. Still, they forged on, but failed to convince bond buyers that their insurance was worth more than the credit enhancement differential which had become miniscule. This of course was reflected in minuscule yield differentials.

A second negative event for bond insurers since 2008 has been a redefining of just who is being insured. The financial problems of states and municipalities have been growing for decades as unfunded obligations for pensions and health care have ballooned in anticipation of a crisis sometime in the future. In my view, the pandemic has accelerated that crisis point.

I have been reporting on municipal bond defaults for more than thirty years through the

Forbes/Lehmann Distressed Municipal Debt Report. We are seeing numerous municipalities assuming that, since they paid for the bond insurance, they are entitled to its benefits. Hence, there are an increasing number of instances of municipalities refusing to make their contractual debt service payments thereby requiring the bond insurers to step up and pay. Puerto Rico has gone so far on its insured issues that it now collects the interest payments as they come due from the insurer, and keeping the money rather than pay out interest to bondholders! The presumption in such actions by the municipal bond issuer is ludicrous, but defensible with taxpayers. Bondholders have yet to be heard from.

This pandemic provides an opportunity for distressed bond issuers to come together, declare a financial emergency and essentially renege on future interest and principal payments. And why not, they may even decide to renege on their uninsured debt as well. We see the extraordinary actions taken so far at the federal level by both the Federal Reserve Bank and the Federal Government. Some of these municipalities only have enough cash to either pay employees or to make interest payments. Their choice is obvious. Will the Fed or Washington intercede, probably, but this is far from certain.

For monoline bond insurers the future choices are clearer. For too long, bond insurance has been treated as a credit enhancement tool. It has become a true insurance product. It's time to treat it and price it as such or face possible ruin. One solution is to focus on selling insurance to the bondholders rather than the issuers. This concept has been tried in the past with very limited success since it could not compete with the low fees and higher costs from the credit enhancement approach. Now is the time for change.

## **Forbes**

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