Bond Insurance Makes a Comeback - And It Might Be Worth the Cost

The COVID-19 pandemic has put a lot of pressure on municipal bonds. While general obligation bonds remain safe, revenue bonds backed by universities, senior housing, and convention centers are at risk. Fortunately, the resurgence of bond insurance has helped many investors gain peace of mind amid the evolving crisis.

Let's examine the history of muni bond insurance and how it's staging a comeback amid the COVID-19 pandemic.

A Brief History of Bond Insurance

Bond insurance guarantees the payment of principal and interest in the event of a default. In addition, bond insurance is also a form of "credit enhancement" that helps issuers reduce borrowing costs. Insurers essentially lend their high credit rating to issuers by guaranteeing the bonds, making them less risky for investors.

While bond insurance was commonplace before 2007, MBIA, Ambac and other large insurers were hard-hit by exposure to mortgage-backed securities and structured finance. Rating agencies promptly cut their credit ratings in response to their failure to make insured bondholders whole, resulting in less than 5% of bonds insured.

Then, in 2014, the City of Detroit defaulted on $18.5 billions' worth of municipal debt. Bond insurers redeemed themselves during the crisis by keeping insured bondholders whole. And in 2015, Puerto Rico defaulted on its debt, and bond insurers again kept insured bondholders whole. These events helped restore investor confidence in bond insurance.

Why Bond Insurance Is Coming Back

The COVID-19 crisis further reignited demand for bond insurance. With the unpredictability of lockdowns, many investors sought insurance to protect them against default risks. Bond insurance has been particularly valuable for revenue bonds backed by COVID-19-hit assets, such as convention centers or amusement parks.

Bond insurance may also offer alpha to active investors. The spread between insured bonds and 10-year Treasuries rose from 20 to 190 basis points during the height of the crisis. Since then, they've come down from their highs, but they remain above pre-crisis levels, suggesting that yields could fall and prices could rise over time.

As of December 2020, insured munis represented about 10% of all muni bond issues, with more high-quality issuers offering insurance as a way to reassure investors concerned about ratings downgrades and defaults. And, the insurance costs just an average of just 20 basis points, making it an extremely affordable way to achieve peace of mind.

The Bottom Line

Bond insurance may not be as popular as before the 2008 financial crisis, but the COVID-19 pandemic is increasing demand for safety. Given the unpredictability of the pandemic and the low cost of insurance, many high-quality issuers are offering insurance to reassure investors and draw in capital at the lowest possible rates.

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