

# Municipal Bond Insurance: Necessary? Or Necessary Evil?

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# *Monoline History*

- What Happened in 1971?
  - Walt Disney World opens in Orlando, Florida
  - *Lawrence Welk, Ed Sullivan and The Beverly Hillbillies* air last shows
  - *Intel* Introduces the first commercial microprocessor chip
  - Simon & Garfunkel win Album of the Year – *Bridge Over Troubled Water*
  - 5-Year US Treasury bond yields 7% and gas costs 36¢ per gallon
  - NASDAQ Stock Market Index debuts
- AND**
- MGIC Investment Holdings forms American Municipal Bond Assurance Co – AMBAC, the first monoline insurer
  
- 1973 – Municipal Bond Insurance Association (MBIA) is formed by Aetna, Cigna, CNA and Fireman’s Fund
- 1974 – MBIA receives AAA rating
- 1979 – AMBAC receives AAA rating

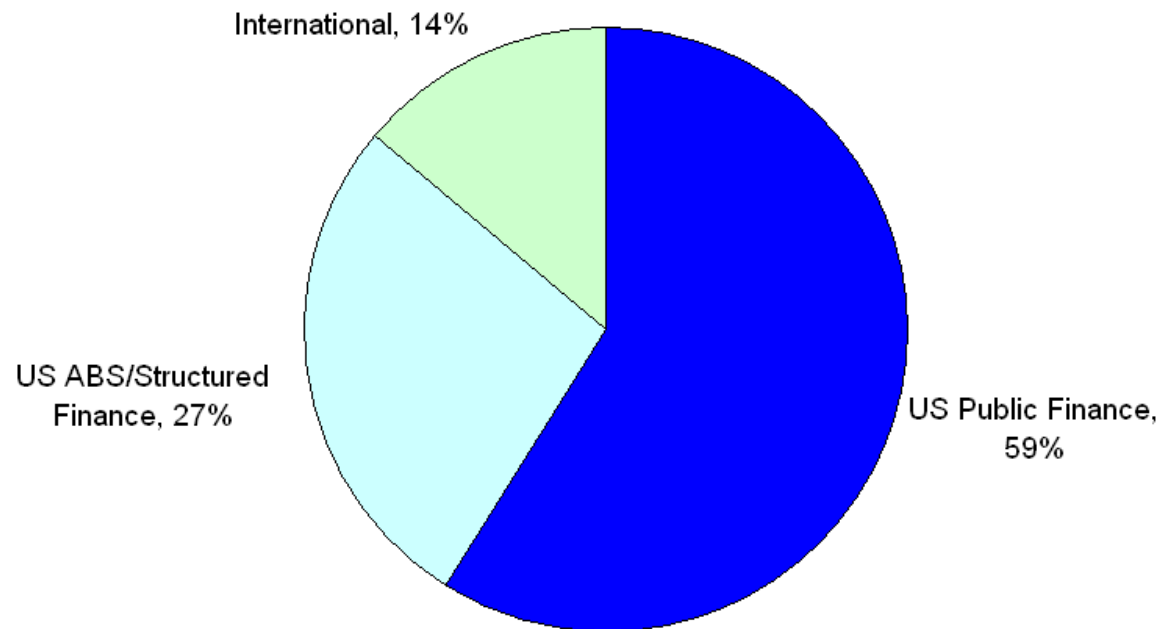
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## *Monoline 101*

- A monoline insurer is a company that specializes in a single type of insurance.
- Monoline insurers sell one product – A financial promise that represents the unconditional and irrevocable pledge to pay principal and interest, when due, in a timely manner if the insured issuer defaults on its obligation.
- The insurer may, but does not have to, accelerate payments if the insured issuer is unable to fulfill its obligation.

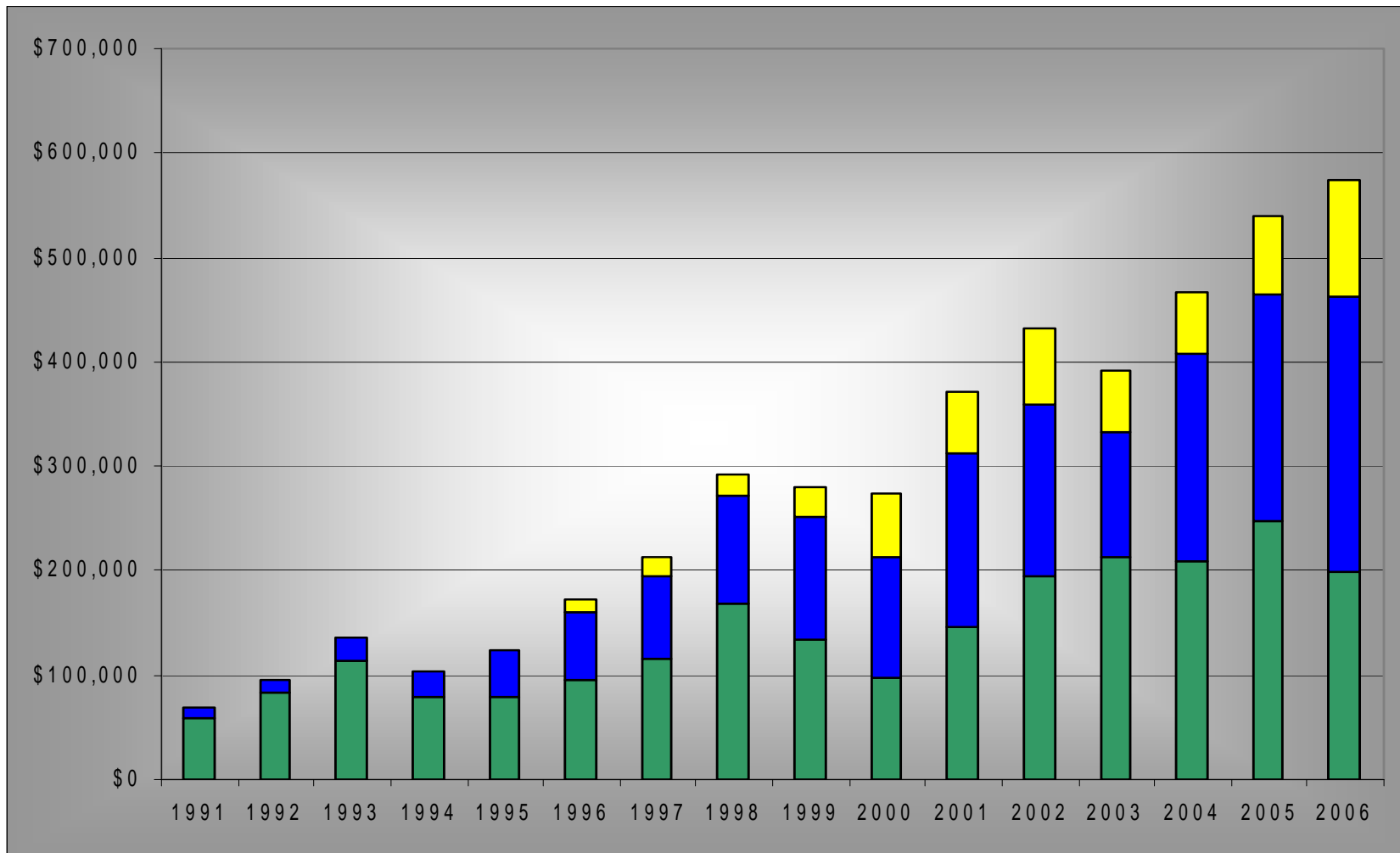
# Monoline Industry Business Mix

As of 9/30/07



Source: AGFI, UBS

# Industry Net Par Risk Insured by Business (\$mm)



Source: Company documents, AGFI, UBS



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# *Reasons for the Growth of the Structured Finance Markets*

## Originator Perspective

Enabled originators to distance themselves from the impact of underwriting decisions

Turned 80-85% of every dollar of sub-prime loans into 'AAA' rated securities

## Investor Perspective

Provided investors with false sense of security as many believed that they were insulated from significant losses

Allowed investors the opportunity to “reach for yield” as expected returns on other investment alternatives remained low

## Bond Insurer Perspective

Provided monolines an additional revenue stream, while margins on traditional business lines were shrinking

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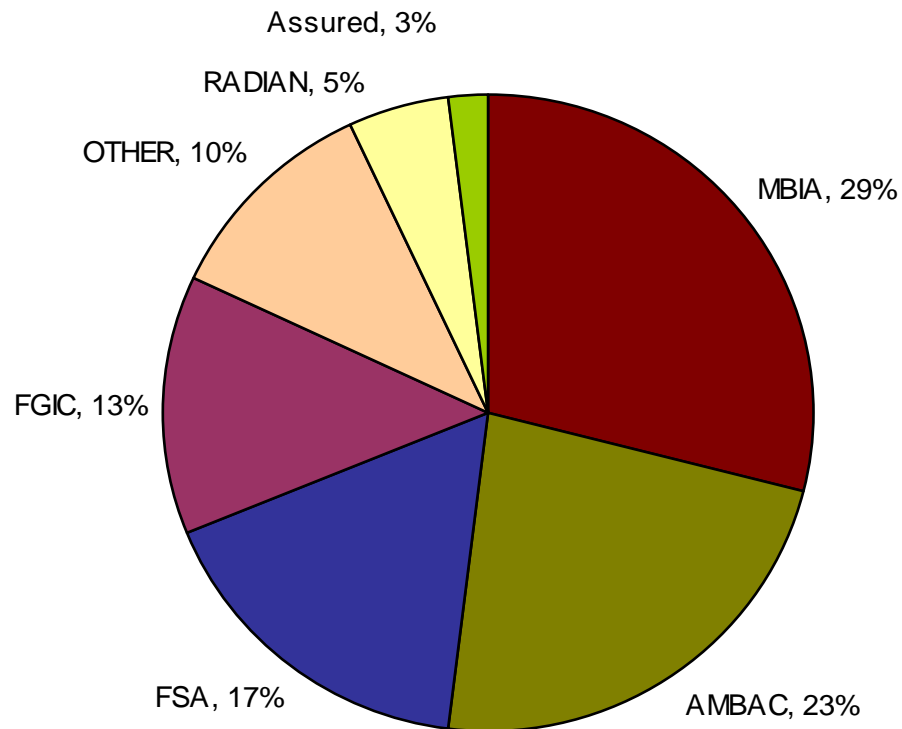
# What Went Wrong?

- Delinquency rates on poorly underwritten sub-prime mortgages spiked as property prices declined
- Liquidity dried up as new originations/issuance came to standstill
- Rating agency models failed to quantify the embedded risks as deals became more complex
- Valuation problems arose, as deals became more complex and “mark-to-model” did not match “mark-to-market”
- Wall Street firms active in structured finance/sub-prime were caught with large pipelines and unsold positions
- For the first time, bond insurers were potentially faced with significant *realized* losses

**Therefore, problems in the Structured Finance Market have caused investors to question the ability of bond insurers to meet future obligations.**

# *Total Insured Market Share: \$2.3 Trillion*

*As of 9/30/07*



Source: S&P, UBS

# Monoline Ratings/Ownership

As of 4/28/08

	<b><u>Ratings</u></b> (S&P/Moody's/Fitch)	<b><u>Ownership</u></b>
<b>AMBAC</b>	AAA/Aaa/AA	100% Publicly Owned
<b>MBIA</b>	AAA/Aaa/AA	100% Publicly Owned
<b>Assured Guaranty</b>	AAA/Aaa/AAA	100% Publicly Owned
<b>FSA</b>	AAA/Aaa/AAA	Subsidiary of Dexia, a Belgian-French firm
<b>FGIC</b>	BB/Baa3/BBB	PMI Group 42% Blackstone Group 23% Cypress Group 23% CIVC Partners 7% % GE Capital 5%
<b>Berkshire Hathaway</b>	AAA/Aaa/AAA	Berkshire Hathaway 100%

# *Rating Action on the Bond Insurers*

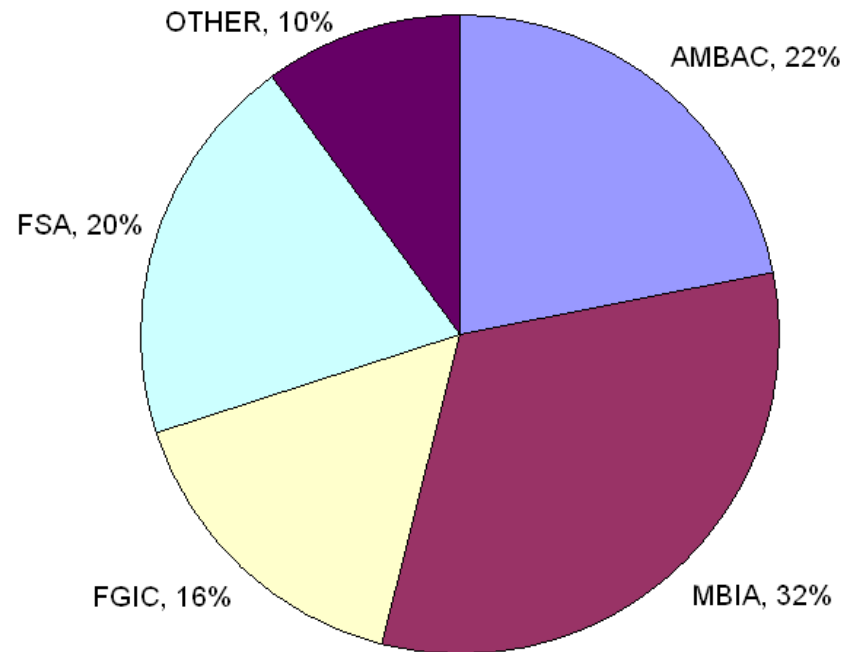
*As of 4/28/08*

	<b>MOODY'S</b>	<b>S&amp;P</b>	<b>FITCH</b>
<b>AMBAC</b>	Negative Outlook	Negative Outlook	Rating Watch Negative
<b>FGIC</b>	Negative Watchlist	Negative Outlook	Negative Outlook
<b>MBIA</b>	Negative Outlook	Negative Outlook	Negative Outlook
<b>FSA</b>	Stable Outlook	Stable Outlook	Stable Outlook
<b>Assured Guaranty</b>	Stable Outlook	Stable Outlook	Stable Outlook
<b>Berkshire Hathaway Assurance</b>	Stable Outlook	Stable Outlook	Stable Outlook

# *Municipal Market*

*As of 9/30/07*

- 54% of \$2.3 trillion outstanding municipal debt is insured
- Of the \$1.2 trillion of insured municipal debt.....



Source: JP Morgan

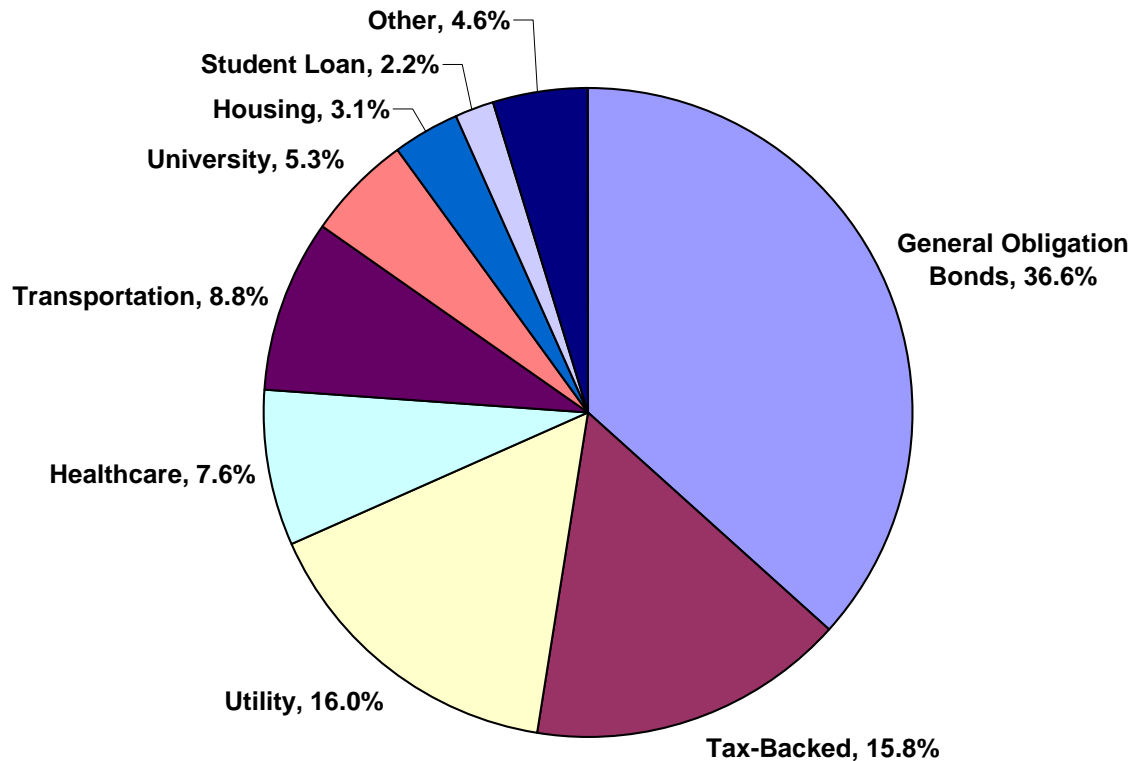
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# Benefits of Municipal Bond Insurance

- Lower cost of financing for issuer
- Easier access to capital markets for smaller, non-rated issuers
- Improves liquidity of security and market
- Lowers investor's credit risk
- Lowers price volatility

# *Types of Insured Municipal Issues*

*As of 9/30/07*



- Municipal assets are considered by many to be the safest securities in the fixed income market. A recent study published by Moody's found that there have been only 41 municipal defaults since 1970.
- Moody's concluded that the 10-year cumulative default rate for investment grade municipals was approximately 5x lower than that of the Aaa-rated corporate backed debt.
- When an insurer gets downgraded, the security derives its quality rating from the higher of either the rating of the financial guarantor or credit rating of the underlying issue.

Source: JP Morgan

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# Bond Insurance Pricing

## Old Days (Pre-2007):

	<u>AA</u>	<u>A</u>
General Obligation Yield:	4.00%	4.25%
Cost of AAA Insurance*:	<u>0.03</u>	<u>0.10</u>
New Yield (as AAA):	3.95%	4.00%
<b>Savings:</b>	<b>0.02%</b>	<b>0.15 %</b>

\* MBIA, FGIC, AMBAC or FSA

AA = Massachusetts General Obligation  
A = California General Obligation

# Bond Insurance Pricing

As of 4/1/08

## New Days (2008):

	<u>AA</u>	<u>A</u> AMBAC	<u>A</u> MBIA	<u>A</u> FSA
General Obligation Yield:	4.00%	4.50%	4.50%	4.50%
Cost of AAA Insurance*:	<u>0.06</u>	<u>0.18</u>	<u>0.18</u>	<u>0.21</u>
New Yield (as AAA):	3.95%	4.50%	4.45	4.20%
<b>Savings:</b>	<b>(0.01)%</b>	<b>(0.18)%</b>	<b>(0.13)%</b>	<b>0.09%</b>

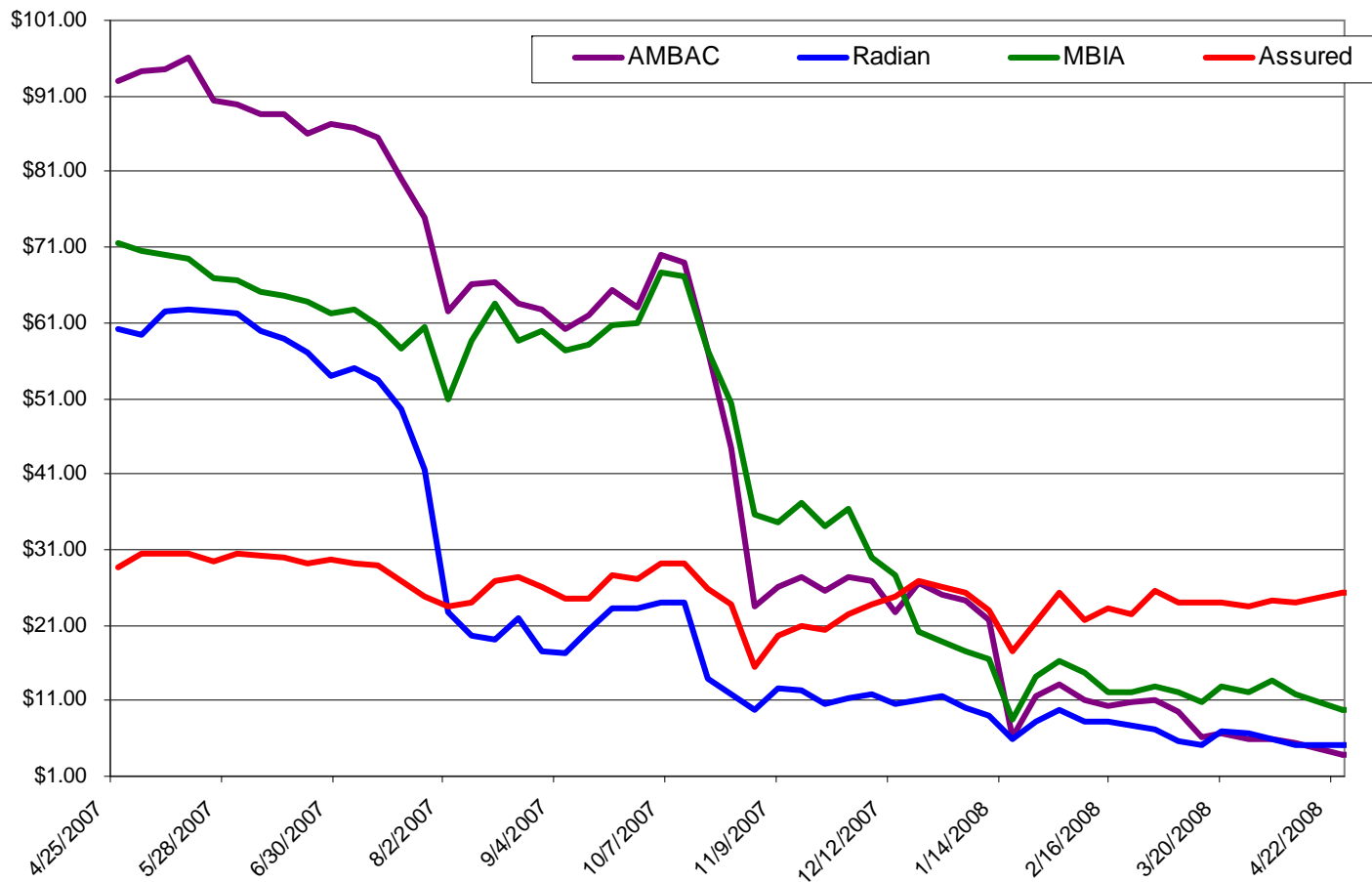
\* FSA, Assured Guaranty, or Berkshire Hathaway

AA = Massachusetts General Obligation

A = California General Obligation

# Price Declines of Publicly Traded Monolines

As of 4/25/08



Source: Bloomberg

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# *Summary*

Uncertainty rules the day

- Declining home values
- Future rating actions
- Capital requirements of monoline insurers
- New monoline insurers