



Market Flash

March 3, 2008

WHAT'S NEXT FOR U.S. BOND INSURERS?

By Markus Schomer, Global Economic Strategist
And the AIG Investments Global Economic Strategy Group

"Rating downgrades for U.S. bond insurers could trigger a tsunami-like event comparable to the subprime market collapse," Deutsche Bank's CEO Joseph Ackermann said in a recent interview on Bloomberg.

The business of bond insurance has been very much in the spotlight over the past few months. Recently, new proposals to split the banks' business models according to "good" or "bad" business has brought further uncertainty to the sector. Since bond insurers cover over \$2 trillion in securities, what happens to the sector is clearly important.

What are Bond Insurers?

Bond insurers are often referred to as Monoline insurers or Monolines, due to their sole focus on one insurance product that guarantees payment of bond interest and repayment of principal to a security holder, in case the original issuer defaults. Types of insured securities range from municipal and corporate bonds to structured finance bonds and collateralized debt obligations (CDOs).

The bond insurance business officially began in 1971, focusing primarily on providing AAA ratings for municipal bond offerings, which reduced the financing cost for states and municipalities. Later, during the 1990s, providers began insuring other securities, such as more complex structured financial bonds. This became a key growth area — and now a key source of pain — for the entire Monoline industry.

The major reason for launching this business was to insure investors against the risk of systemic municipal defaults. To prevent that from occurring, bond insurers needed a AAA rating. The rating agencies — S&P, Moody's and Fitch — use complex valuation models to help ensure that bond insurers are able to withstand severe economic downturns and still retain the strongest financial stability ratings.

Today, the total outstanding value of insured (also known as wrapped) bonds stands at US \$2.3 trillion. Almost 60% (US \$1.35 trillion) of that coverage consists of municipal bonds, representing about half of the overall municipal bond market, while about 40% represents the structured finance business.

What is the Issue?

Today the valuation crisis in structured finance is threatening the solvency of the entire bond insurance industry. In order to remain in business, Monolines have been scrambling to raise billions of dollars in capital, or risk losing their AAA credit rating, which would directly affect the ratings of the US \$2.3 trillion of insured bonds. The ripple

effect would impact investors in such securities, forcing them to either reduce exposure (sell or write down their holdings) or commit more capital to hold the now lower-rated assets.

Ratings agencies have come under fire for "being asleep at the wheel" while the subprime market imploded, and have tried to restore investor confidence by aggressively scrutinizing existing credit problems. As a result, a number of smaller bond were downgraded, and almost all the others had seen their outlook lowered to "negative."

Most analysts agree a ratings downgrade would have little impact on existing municipal bondholders, as long as the underlying issuer ratings remain in the medium- to high-quality investment grade range. As The Wall Street Journal points out, even BB-rated municipal bonds have a 10-year average default rate of just 1.72%, compared to almost 30% for BB-rated corporate issuers.

However, without the AAA rating, Monoline insurers would be unlikely to bring in new business. They also become vulnerable to new entrants to the sector. Warren Buffet of Berkshire Hathaway signaled his intention to pursue a slice (if not all) of the highly lucrative municipal bond insurance market.

How Can the Monoline Solvency Crisis be Resolved?

Most analysts believe that the bond insurers are collecting enough premiums (most issuers pay the full premium amount upfront) and investment income to support potential claims, even under an extremely bearish economic scenario. As AIG Investments' fixed income analyst Ken Weliczka noted, "*Monolines only step in when an obligor actually defaults.*" During the lifetime of the wrapped bond, the insurer is only liable to pay the interest on the loan and is not accountable for the principal, until the original security matures.

Banks and brokerage firms, which hold large numbers of wrapped bonds, and the regional Treasury Departments, which benefit from reduced financing costs, have considerable incentive to prevent a large-scale Monoline downgrade. So, the possibility of an industry bailout by a consortium of banks, aided by the U.S. Government, is one solution. Under such a scenario banks would trade the threat of billions of dollars in asset write-offs for an investment in newly issued Monoline stock. Another possibility now under discussion is to split the business into two separate entities, one that continues to insure municipal securities and the other that ensures some level of guarantee on structured securities.

The main issue is the fact that bond insurers need to continue raising their capital base to withstand much greater-than-expected default assumptions. Failure to do so would not only result in downgrades and further large-scale asset write-offs, but also spark questions about the regulators' ability to deal with the current financial market crisis.

Increasing Monoline capitalization would prevent a rapid trickle-down from widespread ratings downgrades, yet S&P has commented that the source of the problem is poor risk assessment at all levels of the analysis chain (security issuer, rating agency, bond insurer and investor). Therefore, the ratings agencies, as well as the banks and the bond insurers, have a strong interest in preventing these broad-based ratings downgrades. However, as Sonia Hamstra, Head of AIG Investments' Structured Credit Business, points out, *"any long-term solution still depends on restoring confidence based on the performance of the underlying assets."*

New York State Insurance Commissioner Eric Dinallo has been especially focused on finding a solution by initially calling upon a consortium of banks to provide capital injections that would ease the pressure on rating agencies to downgrade bond insurers. Many experts, including those at AIG Investments, argue that the momentum towards some type of capital solution for bond insurers continues to grow, although it could well take the form of company-specific rescues, rather than an industry-wide solution.

Dinallo's second solution has focused on the possibility of separating the municipal insured securities business from the insured structured business. But this solution also has its problems. There is no doubt that this approach is positive for the municipal bond business, but it leaves the Monolines open to even greater risk in relation to insured structured securities.

The recent ratings affirmation for the industry's two largest insurers buys time for the Monolines. If, during this time, analysts can clarify valuations within these insured assets, confidence may very well return to the market. The underlying cause of calling the current business model into question still remains, and other, smaller, bond insurers continue to have difficulty raising capital to shore up their credit ratings. If the valuation pressure on the underlying investment portfolios persists, or, even worse, if defaults start to increase, we may well see another round of ratings downgrade concerns.

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Bottom Line

The predicament surrounding the Monoline business has added another source of instability to the fixed income markets. While the ensuing sell-off in financial markets represents a real monetary loss, the underlying issue is the spread of market dislocations to the municipal bond market, where we have seen auctions of previously considered "safe" investments fail. This, in turn, has driven up short-term funding costs for state and municipal entities.

In order to restore investor confidence, financial markets are looking for real solutions. If the Monoline crisis can be solved through regulation, a voluntary capital injection or restructuring of the industry with the help of new capital-rich entrants, such as Warren Buffet, confidence in the problem-solving ability of our market economy could return. This would allow investors to look beyond the current crisis and could stimulate renewed risk-taking. ■

Major contributors to this MarketFlash included Sonia Hamstra, Managing Director, Fixed Income Capital Markets and Kenneth Weliczka Vice President, High Grade Taxable Fixed Income Research