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BOND INSURANCE AS A FORM OF CREDIT ENHANCEMENT IN CALIFORNIA'S MUNICIPAL BOND MARKET

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The purchase of credit enhancement can play an important role in the municipal debt issuance process. Evidence of this importance can be found by looking at historical statistics. In 2000, more than half of all California municipal debt was credit-enhanced, primarily through bond insurance. The prevalence of bond insurance as a form of credit enhancement points to the need for a resource for municipalities to use when contemplating the use of this tool. The following is a summary of a CDIAC report entitled *Bond Insurance as a Form of Credit Enhancement in California's Municipal Bond Market*. It is intended to provide general concepts for public issuers, particularly those who are infrequent participants in the bond market or those who have never used bond insurance. The full report can be ordered from CDIAC by phone at (916) 653-3269 or can be downloaded from the Internet at **www.treasurer.ca.gov/cdiac**.

Available Types of Credit Enhancement

There are two main types of credit enhancement that are used most often in municipal bond deals. Bond insurance is represented by a bond insurance policy that provides a guarantee of payment of scheduled principal and interest over the life of the insured bonds should the issuer default. A letter of credit (LOC) is an irrevocable commitment typically issued by a commercial bank and will customarily provide that the trustee or fiscal agent may draw on the letter when necessary to make payments of principal and/or interest on bonds. LOCs are typically used for variable rate bonds and are a declining share of the California credit enhancement market. The other three types of credit enhancement, used to a much smaller degree, are lines of credit, mortgage insurance, and private guarantees. This article focuses on the primary form of credit enhancement currently used in the marketplace – bond insurance.

Costs and Benefits of Bond Insurance

Issuers should compare the cost of obtaining insurance to the benefits derived from using bond insurance. The costs are usually paid up front but benefits could accumulate over the life of the bond. Therefore, it is important that the present value of the savings be greater than the premium charged (together with the current value of any other costs).

The premium cost of purchasing bond insurance varies depending on the market conditions for bonds of different credit quality and the degree of risk perceived by the insurer in adding the bonds to its portfolio. In most cases, the capital charges incurred by the insurer in connection with adding a given transaction to its portfolio also will play a role in the premium charged. There are also other costs, such as separate insurance policies against hazards, earthquakes, or business interruptions, that must be maintained over the life of the bonds.

Issuers should also estimate the benefits derived from using bond insurance. In determining whether bond insurance is cost-effective, an issuer should look at the interest rate savings or "spread" between an insured and an uninsured bond. For example, in 2000, the interest rate differential between an average AAA-rated, insured bond and an average A-rated bond was 8-13 basis points, depending on maturity. Therefore, depending on the bond issue amount and the maturity, it may make sense to purchase insurance for A-rated bonds. In addition, issuers also must take into consideration any new ongoing costs of compliance with bond insurer requirements.

As part of a decision to purchase bond insurance, the issuer must also consider the marketability of a bond and its role in reducing the bond yield demanded by investors. A bond's marketability is affected by its perceived credit risk and liquidity risk. Bond insurance reduces these two forms of risk; therefore, the ratings, and, subsequently, the marketability of the bonds are improved. In addition, bond insurance also could alleviate an investor's concern about a

Credit and Liquidity Risk

"Credit risk" is defined as the potential loss from an investment as a consequence of an issuer defaulting on its debt or failing to repay principal and interest to its investors in full or on time. Investors in insured bonds are insulated from credit risk because they can depend on the insurer to make timely payment of scheduled principal and interest.

"Liquidity risk" is defined as the risk that an investor may not be able to sell a security in the secondary market quickly and at competitive prices. For example, if an issuer encounters financial problems and the rating on the security is cut, the market value of these bonds likely will decline. Such a decline in market value could cause secondary market liquidity problems because other investors may not want to assume the risk of purchasing such bonds due to fears of further decline in value. Investors in insured bonds are insulated from liquidity risk associated with the issuer's circumstances because the bond's value relies on the rating and financial condition of the insurer.

particularly complex deal because it provides a commonly understood means to evaluate the credit quality of complex financings by transferring the risks associated with these complexities from the investor to the bond insurer.

The Mechanics of Bond Insurance

Once the decision to consider bond insurance has been made, the next step is to seek a bond insurance company. Ambac, FDIC, FSA, and MBIA are the four major AAA-rated monoline municipal bond insurers in terms of total par value of obligations insured. Each major firm has different areas of expertise. In addition to these insurers, specialty insurers (ACA and AGIC) focus on lower quality, low-rated, or non-rated debt not considered by the four main companies.

To gain an understanding of the strength of a bond insurance company, one can look at the credit rating of that company. For the municipal bond insurance company, a AAA rating reflects a particular kind of financial strength – the ability to pay claims. Rating agencies continually evaluate bond insurers' claims-paying abilities through detailed analyses of financial resources, operations, and exposures.

Insurers' underwriting criteria for evaluating credit quality differ by bond type and include economic, financial, socio-political, and structural factors of the issue as well as revenue and financial history, demographics, and the quality of the issuing entity as a whole. All AAA-rated firms subscribe to a "zero loss" or "remote loss" underwriting standard by focusing on insuring securities with a low risk of default. To further insulate against loss, insurers typically set conservative limits on single and aggregate risk and diversify their portfolios by sector and geographical region.

The actual process of purchasing bond insurance depends on whether an issue is sold through a negotiated or competitive sale. Typically, in a competitive sale, the issuer either decides to buy insurance, makes arrangements to qualify the issue for insurance and then lets the bidders buy it if they choose, or requests bids for both insured and non-insured issues. The investor can also purchase bond insurance once the bonds are sold and the insurance can be tailored to meet the needs of the individual investor.

Framework for Decision Making

Local government officials should consider certain factors when deciding whether to use bond insurance for a financing:

- **Decide which type of credit enhancement best suits the situation.** The various types of credit enhancement, including bond insurance, letters of credit, lines of credit, mortgage insurance, and private guarantors each have their place. Although most credit enhancement is bond insurance, there may be circumstances when another form may be more efficient.

- **Know what insurers consider when evaluating applicants.** By knowing some of the insurers' underwriting criteria, the issuer can determine if the transaction is viable. For instance, specialty firms target low investment grade and high non-investment grade issues. If an issue is in this range, it might be beneficial to talk to one or more specialty firms. In addition, keep in mind the insurer's underwriting criteria including economic, financial, socio-political, and structural factors of the issue and the revenue and financial history, demographics, and the quality of the issuing entity as a whole.

- **Approach the bond insurers.** An issuer should look at the specific insurers to decide which best serves its needs. For instance, an issuer should compare the characteristics of the transaction with the specialties of the various insurers. An issuer can approach an insurer that specializes in the appropriate area or approach a firm that is seeking to get into the area, and might provide a price break. In many cases, an issuer will benefit from obtaining approval and premium quotes from all of major monoline insurers if the transaction fits its criteria. In other cases, an "exclusive" approach may be beneficial, especially if time is of the essence or the insurer is offering attractive incentives.

- **Do a cost-benefit analysis.** Issuers should look at the new present value cost savings after taking into account all of the projected costs and savings associated with purchasing bond insurance. The issuer should evaluate the premium costs and costs of meeting insurer requirements compared to the projected interest savings and increased marketability of the bond. This analysis should be done for the issue as a whole and by specific maturities. On occasion, it may make financial sense to insure only specific maturities of an issue.

- **Determine the appropriate method of obtaining bond insurance.** Depending on its circumstances, the issuer also may need to decide on the method of purchase. For instance, if the bond sale is to be competitive and the potential benefits of insurance are uncertain, the issuer can rely on a bidder's option or multiple bid approach with appropriate bid parameters to meet its needs. In a negotiated sale, the issuer would decide whether to insure the issue (or portions of it) in close consultation with its underwriters near the time of the pricing. Alternatively, the purchase of bond insurance can be left up to the individual investors in the secondary market.

This Offprint was previously published in DEBT LINE, a monthly publication of the California Debt and Investment Advisory Commission (CDIAC). CDIAC was created in 1981 to provide information, education, and technical assistance on public debt and investment to state and local public officials and public finance officers. DEBT LINE serves as a vehicle to reach CDIAC's constituents, providing news and information pertaining to the California municipal finance market. In addition to topical articles, DEBT LINE contains a listing of the proposed and final sales of public debt provided to CDIAC pursuant to Section 8855(g) of the California Government Code. Questions concerning the Commission should be directed to CDIAC at (916) 653-3269 or, by e-mail, at cdiac@treasurer.ca.gov. For a full listing of CDIAC publications, please visit our website at http://www.treasurer.ca.gov/cdiac.