

## The U.S. Bond Insurance Industry Is On A Path To Reemergence, But Of A Different Profile

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Standard & Poor's Ratings Services believes there's still a need for municipal bond insurance, particularly for smaller, less-frequent issuers and small retail investors. The bond insurance sector has the potential to grow, but it will be of a different profile than it was a decade ago. We expect the overwhelming amount of business underwritten by the insurers to be U.S. public-finance par. (Watch the related CreditMatters TV segment titled, "The U.S. Bond Insurance Industry Is On A Path To Reemergence," dated July 27, 2012.)

At their peak in 2005, bond insurers covered about 57% of new municipal bond issuance. That fell to about 9% in 2009. In 2011, that percentage was slightly more than 5%, with Assured Guaranty Ltd. (AGL) as the only active provider of financial guarantees. Within U.S. public finance market, based on our current ratings on bond insurers, the insurable market is much smaller than in the past, which will lead to lower overall total new issue insured penetration.

Competition has increased in the industry with the formation of Build America Mutual Assurance Co. (BAM); however, the divergent underwriting strategies of BAM and AGL support the notion that total insured new issue paper may increase. We believe the bond insurance industry could end up insuring 20%-30% of the new issue par in the U.S. public finance market with enough potential insurable par available for additional insurers.

### ***Bond Insurers Suffered From Structured Finance Exposure***

In 2007, as the U.S. housing crisis began to take hold, bond insurers began to experience stress in their insured structured-finance exposures, more specifically in their exposure to residential mortgage-backed securities (RMBS) and collateralized debt obligations of asset-backed securities that include RMBS. As housing markets declined, losses on structured securities

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mounted from late 2007 through 2009, and bond insurers' capital eroded, we lowered our ratings on most bond insurers to below investment grade (lower than 'BBB-'). We currently rate five bond insurer groups and stand-alone companies. We have taken one rating action in 2012: assigning a 'AA' rating and stable outlook to BAM, the first start-up rating following the release of our updated bond insurance criteria on Aug. 25, 2011.

Table 1

| <b><i>Current Bond Insurers</i></b>       |   |  |
|---|---|--|
|   | <b><i>Long-term financial strength rating and outlook</i></b> | <b><i>Current state and underwriting strategy</i></b>                        |
| Build America Mutual Assurance Co. (BAM)  | AA/Stable   | Start-up, U.S. public finance only   |
| Assured Guaranty Ltd. operating companies | AA-/Stable  | Active, U.S. public finance/limited structured finance and international     |
| National Public Finance Guarantee Corp.   | BBB/Developing  | Currently inactive, but with potential to provide value to municipal issuers |
| Berkshire Hathaway Assurance Corp.        | AA+/Negative  | Currently inactive   |
| Radian Asset Assurance Inc.               | B+/Negative   | Run-off  |
| MBIA Insurance Corp.                      | B/Negative  | Run-off  |

### ***Bond Insurers Should See Modest Growth During The Next Several Years***

The majority of par insured in recent years has been U.S. public finance. Based on insurers' underwriting strategies, we expect this to continue. Bond insurers' business prospects, therefore, are closely linked to municipal new issue volume and investor demand for financial guarantees.

We have been informed by market participants about potential market growth, and we believe there is a reasonable expectation that U.S. public finance bond issuance will continue to grow incrementally each year for the next several years. The driver of overall U.S. public finance par volume, however, will be refundings due to the current low interest rate environment, with little new money borrowing. We expect demand for municipal bonds to remain high, notwithstanding the low yields, as investors seek investments to replace a significant amount of higher-coupon issues that are maturing or have reached their call date.

From a credit perspective, we continue to expect any severe credit distress to be concentrated among relatively few obligors. We don't expect a significant increase in the number of local governments seeking bankruptcy, but we expect those that have built fixed costs to have very limited flexibility in the short term. Local governments filing for or considering bankruptcy recently or otherwise experiencing stress could hurt other issuers when they come to market by raising borrowing costs. As history demonstrates, negative headlines and market dynamics may provide underwriting opportunities for bond insurers.

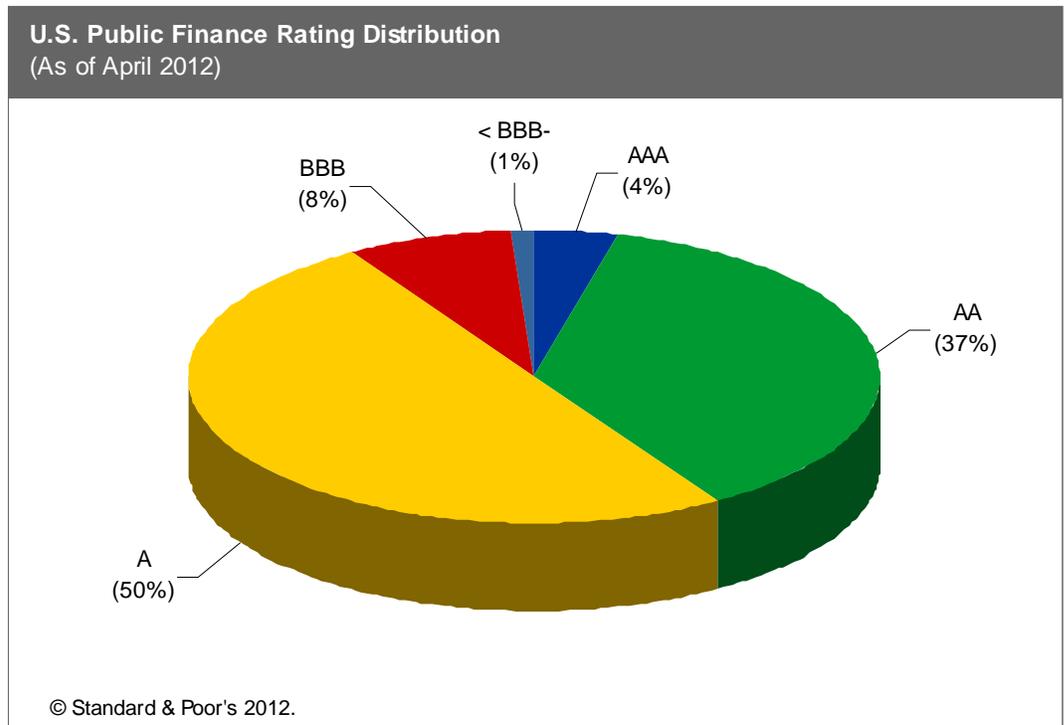
In our view, there's still a need for municipal bond insurance. In particular, smaller and less-frequent issuers rely on the credit enhancement that bond insurers provide. We expect these issuers to be the predominant users of bond insurance as it provides liquidity to insured issues more than spread savings in the current environment. Bond insurance helps homogenize the market's view of insured credits, which typically increases market liquidity and access.

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Discussions we have had with market participants and our review of independent studies suggest that independent financial advisors and retail investors have the greatest need for credit enhancement. These investors tend to purchase smaller, less-liquid issues, maintain nondiversified public-finance investments, and lack the credit differentiation skills and resources to determine credit quality and relative value. Retail investors alone account for approximately 45% of the demand for municipal securities. They would seek credit enhancement via a layer of loss protection in the form of bond insurance and assistance with the restructuring and requisite amendments/approvals of deteriorating credit investments.

A key indicator of market demand for financial guarantees is the fact that the AGL operating companies continue to write business even though various rating actions have occurred in recent years. In 2011, AGL reported \$15.1 billion of U.S. public finance gross par insured on 1,228 transactions. On average, each transaction totaled approximately \$12 million, compared with an average of \$33.5 million for the four years from 2004 through 2007 for the bond insurance industry. Insured general-obligation bonds contributed the most to business production, representing 56% of U.S. public finance par insured, followed by municipal utilities and tax-backed issues at 15% and 13%, respectively.

Once the demand for bond insurance has been identified, now the question becomes, how big is the insurable market? We do not expect insured penetration to approach 50% of total new issue volume in the next five years for two reasons. First, insurers achieved new-issue penetration of 50% or more with 'AAA' financial strength ratings, thereby creating more insurable opportunities on the investment-grade ratings spectrum. Second, larger issuers can still tap the debt markets without insurance at attractive rates.



Because our ratings on the two active bond insurers are in the 'AA' category and each insurer focuses on investment-grade underwriting, issuers in the 'A' and 'BBB' categories would likely benefit the most

from the credit enhancement these insurers provide. Using our U.S. public finance rating distribution-by-transaction count as a proxy for insurable new issues, approximately 57% of the market is in the 'A' and 'BBB' categories. That is not to say that 57% of the issues will be insured. This measure does not take into account each insurer's sector underwriting strategy, which will limit total insured volume, nor does it assume that an investor may buy credit protection on a higher-rated issue to add diversity to its investment portfolio.

Although more investor demand for insurance in a stressful credit environment might increase insurance penetration, sector issuance volume and historical investor demand for insurance in certain sectors contribute to the industry's total underwriting volume. For example, the utility and electric utility sectors tend to have high levels of insurance penetration, averaging approximately 67% and 55%, respectively, during 2004 to 2007. For the same four-year period, the insured penetration rate for the transportation sector averaged approximately 68%. These trends bode well for bond insurers, as much has been written recently relating to needed improvements in infrastructure across the U.S.

### ***Competitive Dynamics Are Changing***

Although our view is that there is still demand for bond insurance in the U.S. public finance market, since 2008 issuers have had few options for credit enhancement. The launch of BAM reintroduces competition to the bond-insurance industry. Our view is that a new financial guarantor won't take market share from AGL, but will provide some much-needed diversity for investors.

The differences between these companies' underwriting strategies support the expected increase in total insured new issues. Furthermore, we believe there is sufficient investment-grade insurable par for both companies.

BAM's underwriting guidelines are limited to municipal general obligation and revenue bonds that are secured by pledged tax revenues or essential public-purpose revenues. The guidelines principally correspond to our risk categories 1 and 2. AGL writes financial guarantees in a broad number of U.S. public-finance sectors that cross all our risk categories. This underwriting strategy provides AGL the flexibility to capitalize on growth trends and pricing opportunities in one sector while trends or pricing are less favorable in others.

For financial guarantors looking to form new insurance subsidiaries or affiliates focused on U.S. public finance, a key question is whether disparately rated entities can exist under the same holding company structure. There could be rare situations in which we recognize that a subsidiary has operational characteristics in its own right—other than just superior capital adequacy—that cause it clearly to merit consideration for a rating above the core group level. We typically rate such subsidiaries at most up to two notches higher than the applicable core group rating. However, to be so rated, the subsidiary must exhibit, in our view, superior business and operating characteristics relative to the rest of its group and be demonstrably severable and independently sustainable if the parent group for some reason gets into serious difficulties.

Currently, alternative forms of financial guarantees are limited. As bond insurer ratings declined and market confidence eroded in 2008, banks significantly stepped up their offerings of liquidity and credit enhancement through letters of credit (LOCs). However, the credit stress at U.S. banks led to a significant decline in LOCs backing municipal issues beginning in 2009. In addition, because LOCs typically are not as long-dated as bonds that municipalities issue, they are not widely used for credit

enhancement. A structured finance approach to credit enhancement through limited-purpose vehicles has not emerged as an alternative to financial guarantees.

### ***Looking Ahead By Looking Back***

The modern bond insurance industry began in 1971 with the guarantee of a \$600,000 bond issued by Juneau, Alaska. Things were slow at first and market penetration was small. The defining moment in the bond insurance industry's early years was the 1975 "moratorium" on debt issues by New York City. Throughout the mid-to-late 1970s, bond insurance was discussed as other cities had their financial crises (notably Cleveland, Ohio). Insurance volume increased steadily through the 1970s but did not make much of a dent in the overall market. In the 1990s, market events began to occur that had a positive impact for bond insurers. The refunding boom of 1993 brought new insurance opportunities with insurers guarantying 37% of bonds issued. By the end of the decade, insurance penetration had reached 46% due to various municipal credit events.

Today, bond insurers are focusing their underwriting on U.S. public finance once again. We believe demand may increase for bond insurance in the future, but it will take time. The industry could end up insuring 20%-30% of the new issuance in the municipal market, with enough capacity for additional bond insurers. The increased competition presented by new entrants in the market, however, has the potential to reduce profit margins. We expect bond insurers to demonstrate conservative underwriting, sound surveillance, and other risk-management capabilities. Investors may be unforgiving of bond insurers whose underwriting focus drifts.

### ***Economic Indicators Affecting Bond Insurers***

When formulating our view of the credit environment for the bond insurance sector we focus on economic indicators that have the greatest impact on U.S. state and local governments as these issuers represent the main component of the bond insurers insured portfolios. Those economic indicators on which we focus are the U.S. GDP, federal government spending, consumer spending, the S&P 500 stock index, housing starts, employment and unemployment, and the consumer price index (CPI). The baseline economic assumptions that inform our ratings on bond insurers in 2012 and 2013 are:

- Real GDP growth of 2.0% in 2012 and 2.0% in 2013;
- A decline in federal spending of 2.7% and 3.0% in 2012 and 2013, respectively;
- Consumer spending growth of 3.6% and 3.4% in 2012 and 2013, respectively;
- Total housing starts around 760,000 in 2012 and 920,000 in 2013;
- Equity market gains of 8.4% in 2012 followed by 4.3% return in 2013, as measured by the S&P 500 stock index;
- Contained rates of inflation, with the core CPI rising by 2.1% in 2012 and 1.8% in 2013; and
- The unemployment rate declining to 8.2% in 2012 and 8.0% in 2013.

Each quarter, we also project two additional scenarios: an optimistic outlook with faster growth and a pessimistic outlook with slower growth. We set these scenarios approximately at one standard deviation from the baseline (roughly the 20th and 80th percentiles of the distribution of possible outcomes). We use the downside case to estimate the credit impact of an economic outlook that is weaker than our baseline scenario.

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Table 2

| <b>Forecast/Scenarios For Bond Insurers</b> |                   |        |               |        |                   |        |            |   |                            |
|---|-------------------|--------|---------------|--------|-------------------|--------|------------|---|----------------------------|
|   | — Pessimistic —   |        | — Baseline —  |        | — Optimistic —    |        |            |   |                            |
|   | — June 2012 —     |        | — July 2012 — |        | — June 2012 —     |        | — Actual — |   |                            |
|   | 2012              | 2013   | 2012          | 2013   | 2012              | 2013   | 2011       | Comment/outlook   | Baseline impact on sectors |
| Real GDP (% change)                         | 1.21              | (0.03) | 1.95          | 1.97   | 2.48              | 3.85   | 1.74       | Relatively slow economic growth portends sluggish tax revenue growth for state and local governments.   | Somewhat favorable         |
| Federal government spending (% change)      | (3.03)            | (3.09) | (2.71)        | (2.96) | (2.80)            | (2.89) | (1.94)     | Reduced spending pursuant to terms of BCA could directly affect state budgets and indirectly affect local government budgets.   | Unfavorable                |
| Unemployment rate (%)                       | 8.37              | 9.08   | 8.15          | 7.98   | 8.01              | 7.00   | 8.95       | Pace of job gains unlikely to offer substantial social service budget relief but could support gradual retail sales growth.   | Somewhat favorable         |
| Real consumer spending (% change)           | 2.98              | 1.92   | 3.56          | 3.35   | 4.37              | 4.48   | 4.69       | Modest improvement in the near term and more significant growth thereafter in-line with economic improvement; could weaken if gas prices stay elevated or rise sharply. | Somewhat favorable         |
| Housing starts (mil. units)                 | 0.67              | 0.62   | 0.76          | 0.92   | 0.81              | 1.23   | 0.61       | Meaningful growth expected in 2013 and beyond, but from historically low levels; any benefit to assessed value trends likely to lag.                                    | Somewhat favorable         |
| Core CPI (% change)                         | 1.99              | 1.29   | 2.14          | 1.75   | 2.34              | 2.42   | 1.66       | Expected to remain contained with minimal formulaic cost-driver implications; some upward pressure as effect of higher fuel prices pushes core rate higher.             | Favorable                  |
| S&P 500 Common Stock Index                  | 1,186             | 1,163  | 1,375         | 1,434  | 1,392             | 1,599  | 1,269      | Strengthening corporate earnings may support revived investor optimism, which is favorable for income tax revenues, although tempered by global considerations.         | Somewhat favorable         |
| S&P 500 Common Stock Index (% change)       | (6.57)            | (1.94) | 8.35          | 4.29   | 9.67              | 14.87  | 11.37      |   |                            |
| Sector economic outlook                     | Slightly negative |        | Negative      |        | Slightly negative |        | Stable     |   | Stable                     |

### ***Related Criteria And Research***

- U.S. State And Local Governments To See Gradual But Uneven Revenue Improvement, May 10, 2012
- U.S. Public Finance Credit Quality Began To Stabilize In First-Quarter 2012, But With Pockets Of Stress, April 24, 2012
- Bond Insurance Rating Methodology And Assumptions, Aug. 25, 2011

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