American Insurance Association

Financial Guaranty Insurance
Frequently Asked Questions
February 2008

Recent turmoil in the financial guaranty insurance market has raised questions about the role of financial guaranty insurance, the current problems besetting the industry, and what this all means for consumers. This paper attempts to identify and answer some of these questions.

What is financial guaranty insurance?

Financial guaranty insurance is a type of credit protection for investors in debt obligations such as municipal bonds, commercial mortgage-backed securities (CMBS), and auto or student loans. In essence, it provides financial recourse in the event of a default on the bond or other debt instrument. The terms "monoline," "financial guaranty insurer," and "bond insurer" are often used interchangeably to reference a company that provides this type of insurance.

The purchase of financial guaranty insurance generally allows the debt issuer to "wrap" the credit rating of the insurer around the debt obligation that is being issued in order to raise the credit rating of the debt, and thus qualify the debt for lower interest rates. For example, many municipalities use bond insurance to obtain an AAA rating, which lowers their borrowing costs, saving money on the overall transaction. For this to occur, it is essential that the financial guaranty insurer maintain a very high credit rating for wrapping the debt obligations it insures.

What role does it play in the financial system?

Financial guaranty insurance improves the efficiency of the capital markets from a cost and accessibility perspective.

As noted above, financial guaranty insurance allows debt issuers to lower their overall borrowing costs. This occurs because the premium paid for the insurance is less than the amount they can save through the lower interest rates that can be obtained with a higher credit rating. In the case of municipal bonds, the Association of Financial Guaranty Insurers (AFGI) estimates that since the industry began in 1971, municipalities and their taxpayers have saved more than $35 billion in interest costs as a result of bond insurance.

Financial guaranty insurance also provides some issuers with greater access to the capital markets and easier deal execution. This is the case, for example, for small municipal issuers that may otherwise have difficulty attracting investor capital due to their size and lack of diversification.

How is the industry structured?

Financial guaranty insurance is provided almost exclusively by "monoline" insurers that write no other line of insurance. This is the result of a public policy decision made in the 1980s (see regulatory discussion below) that financial guaranty insurers face unique risks that should be isolated from the broader insurance system.

The financial guaranty industry comprises about a dozen firms, the largest three being MBIA Group, Ambac Financial Group, and Financial Security Assurance Group. According to AFGI, there are currently more than $3 trillion in net financial guarantees in force (principal and interest) for the industry as a whole. Of the total net par outstanding, approximately 62 percent pertains to public finance (municipal general obligation bonds, tax-backed revenue bonds, transportation, university, and housing revenue bonds, and so forth), while approximately 38 percent relates to structured finance (e.g., CMBS, other asset-backed securities, and mortgage-backed securities).

What is the history of the financial guaranty sector?

During its early years, the financial guaranty industry was primarily involved in municipal bonds. Municipal bonds have extremely low default rates—by one count, only 41 defaults have occurred since 1970.

Starting in the 1980s, the industry began to expand from its municipal bond base to structured finance and asset-backed securities, including subprime collateralized debt obligations (CDOs). Today, financial guaranty insurers have a wider role in the financial system than in their earlier years and thus have become vulnerable to a wider range of economic strains.

How are financial guaranty insurers regulated?

In its early years, financial guaranty insurance was regulated generally in the same manner as property/casualty insurance, usually under the same statutes as surety. (Surety is a type of insurance product protection that guarantees the performance of an individual or company through a bond, such as a construction bond.) As the market grew and expanded in the 1980s, there were a series of bond defaults that led to a number of insurer insolvencies, causing concern about the potential for contagion in the broader insurance system.

In response, insurance regulators began to develop a new regulatory approach, resulting in the approval by the National Association of Insurance Commissioners

(NAIC) of the Financial Guaranty Insurance Model Act in 1986 (amended in 1987). The stated purposes of the Model Act include the following:

- to define financial guaranty insurance as a separate line of insurance,
- to authorize the formation and licensing of financial guaranty insurers, and
- to prohibit multiline insurers from writing financial guaranty insurance.

In 1989, New York added Article 69 ("Financial Guaranty Insurance Corporations") to the New York Insurance Law. Article 69 is based on the NAIC Model Law, including the requirement that financial guaranty insurance be provided only by monoline insurers. The law applies to <u>all</u> insurers licensed in New York, regardless of the location of the risk, removing almost any possibility of a multiline insurer's writing financial guaranty insurance even in a state that does not require monoline status. In other words, the financial guaranty insurance sold anywhere must only be written by a monoline insurer if the company wants to write in New York.

What is the reason for the current market turmoil?

One area where financial guaranty insurers expanded over the years involves mortgage-backed securities relating to loans to borrowers with less than preferred credit. These mortgage-backed instruments have fallen in value due to what many term the "subprime lending crisis," after an inordinate number of defaults in the housing market occurred involving these mortgages. Concerned about excessive defaults in the mortgage markets, credit-rating agencies have required financial guaranty insurers that have backed securitizations consisting of these subprime loans to make significant increases in their capital levels to maintain their AAA ratings. This has led to widespread concern about the adequacy of the current capital levels of financial guaranty insurers and the consequences of a rating downgrade.

Why did this occur? In terms of the underlying economy, the unprecedented deterioration in the mortgage market was extremely rapid and exceeded any previous experience and the most conservative predictions. The roles of the credit-rating agencies and the state insurance regulators also have been questioned, in terms of their ongoing financial oversight and the rate at which they took action once problems were identified.

What happens when a financial guaranty insurer is downgraded by a rating agency?

In the event that a bond insurer is downgraded, each of the bonds it insures is downgraded to the same level (the result of "wrapping" the insurer's rating around the underlying instrument), or to the level that it would have had without insurance. The decrease in rating does not by itself make the bond any riskier, as the bond is really the same product it was prior to gaining a better rating through the bond insurer. However, the holder of the bond is not likely to gain as much money if a sale of the bond is

required prior to maturity, because the bond no longer has the backing that originally helped to increase its value in the purchaser's eyes.

In some instances, investors in the bonds, which may include banks and insurance companies, are required to write down the value of their bonds to account for the change in market value; however, this does not affect interest or principal payments on a bond that is held to maturity. As noted above, municipal bonds have very low default rates, and analysts do not believe that the downgrading or loss of a bond insurer is likely to result in any material increase in actual defaults of such bonds.

Even if a bond insurer is downgraded, it may have the resources available to pay for any defaults on the bonds it insures. Should a default occur, the bond insurer is required to pay interest and principal on the bond only as they become due, which may be as much as 30 years in the future. Thus, a financial guaranty insurer with insufficient capital to maintain an AAA rating to write new business may have enough resources to pay losses as it runs off its existing business over time, while earning investment income to finance any losses.

How might the current problems be resolved?

There have been discussions in New York and elsewhere of a private sector solution. This might involve an infusion of private capital to help existing bond insurers strengthen their balance sheets.

New sources of capital also appear to be coming into the industry to provide financial guaranty insurance on a prospective basis. For example, Warren Buffett's Berkshire Hathaway has been granted a license by New York to operate a new bond insurer (Berkshire Hathaway Assurance Corporation), and the NAIC is working to expedite the licensing process in other states. Billionaire Wilbur Ross also is said to be considering an investment in a new or existing bond insurer. These types of investments will assure that financial guaranty insurance continues to play a vital role in capital formation and investment, as the financial markets and public policy debate move forward.