

U.S. Bond Insurers' Capital Adequacy Is Likely Sufficient To Handle Potential Losses Related To Their Puerto Rico Insured Exposure

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Despite the stress experienced by various insured issuers in Puerto Rico, S&P Global Ratings' view is that Assured Guaranty Ltd. (Assured) and National Public Finance Guarantee Corp. (National) generally maintain a sufficient level of capital adequacy to sustain such actual or theoretical losses, with no change in our rating. This assumes that the bond insurers will continue to experience refundings and normal amortization in their insured portfolios and limited new business production to replace the greater run-off of insured risk. This dynamic has led to accelerated growth of their capital and generally stronger capital adequacy.

Build America Mutual Assurance Co. does not have any Puerto Rico-related debt exposure in its insured portfolio. Berkshire Hathaway Assurance Corp. has an immaterial amount of Puerto Rico-related debt exposure for which the company provided a guarantee on a bond already guaranteed by a bond insurer we do not rate. At this time, although we don't expect to take any negative rating actions on the legacy bond insurers as a result of stress in their U.S. public finance insured portfolios, we may need to revise our view if we believe the legacy bond insurers' liquidity or capital is under stress.

Overview

- Exposure to insured Puerto Rico issuers appears manageable for legacy bond insurers.
- Persistent low interest rates continue to limit business opportunities, which may have a negative long-term effect on the U.S. financial guarantee market.
- Bond insurers have proven their worth in the past three-to-four years.

In terms of business prospects, at their peak in 2005, bond insurers covered about 57% of new municipal bond issuance. That fell below 9% in 2009, with Assured as essentially the only insurance provider. Insured penetration has not changed much since 2009 as a result of a persistent compressed credit-spread environment. During this period, many issuers and investors learned to go without bond insurance, so it is possible that the market might never recover to more than low-double-digit penetration. This outcome would likely change our assessment of the overall industry risk, which would pressure the business risk profile of the bond insurers. However, we continue to hear this sentiment from market participants that bond insurers have proven their worth in recent years, which should improve business prospects.

Insured Exposure, Leverage, And Claim Payments

Assured's total insured debt service to issuers in Puerto Rico following the July 1 scheduled debt-service payment will be \$8.1 billion, and its statutory capital totaled \$6.9 billion as of March 31, 2016. The same figures for National are \$8.5 billion and \$3.4 billion, respectively. Although the bond insurers' aggregate exposure to issuers in Puerto Rico may be

large relative to current statutory capital, any claim payments resulting from actual losses are made based on the payment schedule of the underlying issue.

The core principle of a bond insurer's policy is that, upon the obligor's failure to pay, the insurer unconditionally and irrevocably guarantees payment of principal and interest to the debt holder as it comes due. To avoid confusion, the policy spells out the payment obligation of the bond insurer as stated in the bond indenture, bond documents, or the principal and interest amortization schedule. The policy also points out that the insurer will make no payments prior to any scheduled payments, regardless of any acceleration or early redemption of the obligation unless the bond insurer approves such. These features of the insurance policy allow bond insurers to manage their liquidity needs.

It is difficult for us to comment on the precise loss-given default for the bond insurers' exposure to issuers in Puerto Rico. Claim payments and ultimate incurred losses would be contingent on the insurers' recovery prospects and ultimate economic losses, which tend to be determined following a long period of negotiation and litigation. Based on the various distinct issuer exposures and their respective debt-service payments, we believe that the current level of capital adequacy is sufficient to sustain the bond insurers' financial risk profiles and ultimately the financial strength ratings. However, from a business risk perspective, we would evaluate the effect of claim payments on investors' confidence in the bond insurers and each company's ability to write new business, which could result in a change in the financial strength rating.

We expect the bond insurers to make some claim payments for their exposure to issuers in Puerto Rico. The question we are asked most often is what amount of losses could lead to a rating action?

Scenario Analysis

The tables below present, for each insurer's exposure to the key issuers in Puerto Rico, the total remaining debt service for each issuer as of July 31, 2016. The PV 100% column assumes that all issuers defaulted on 100% of their debt service through 2020 and that the insurers are required to make claim payments equal to 100% of debt service. This scenario makes no assumptions for claim payments beyond 2020.

The PV 15% claim column represents the discounted present value of 15% of the remaining debt service coming due beginning in 2016. This represents the present value of claims made by the bond insurers if they were required to make claim payments equal to 15% of the remaining debt service. The 15% figure was chosen as it is similar to the required claim payments on recent insured municipal defaults. The remaining columns follow the same logic but for claim payments equal to the percentage indicated in the column heading. The theoretical claims payments for all five scenarios were not tax affected.

Table 1

Assured Guaranty Ltd. Scenario Analysis						
Insured issuers (\$ 000s)	PV 100% for four years claim					
	PV 100% claim	PV 15% claim	PV 25% claim	PV 35% claim	PV 45% claim	
PR Commonwealth GO	596,976	233,531	389,219	544,907	700,594	
PR Highways and Transportation Authority	390,999	196,327	327,212	458,097	588,982	

Table 1

Assured Guaranty Ltd. Scenario Analysis (cont.)						
Insured issuers (\$ 000s)	PV 100% for four years claim	PV 15% claim	PV 25% claim	PV 35% claim	PV 45% claim	
PR Electric Power Authority	185,124	109,480	182,467	255,454	328,440	
PR Municipal Finance Agency	263,104	59,421	99,036	138,650	178,264	
PR Aqueduct and Sewer Authority	68,669	60,565	100,941	141,318	181,694	
PR Sales Tax Financing Corporation	52,273	45,375	75,624	105,874	136,124	
Other	100,629	54,146	90,243	126,340	162,437	
Total	1,657,775	758,845	1,264,742	1,770,639	2,276,536	

Table 2

National Public Financial Guarantee Corp. Scenario Analysis						
Insured issuers (\$ 000s)	PV 100% for four years claim	PV 15% claim	PV 25% claim	PV 35% claim	PV 45% claim	
PR Commonwealth GO	547,126	147,297	245,496	343,694	441,892	
PR Highways and Transportation Authority	187,381	130,843	218,072	305,300	392,529	
PR Electric Power Authority	555,169	218,386	363,976	509,566	655,157	
PR Sales Tax Financing Corporation (Zero)		274,433	457,388	640,343	823,298	
Other	38,842	19,293	32,155	45,017	57,878	
Total	1,328,518	790,251	1,317,085	1,843,920	2,370,754	

Based on this analysis, Assured's capital position could absorb losses in each scenario and, without accounting for any other factors, there would be no change in Assured's capital adequacy score or financial risk profile. A loss severity of approximately 55% on all issuers would pressure Assured's capital adequacy score and possibly our financial strength rating. National's capital positions could absorb all losses up to a 35% loss scenario and, without accounting for any other factors, there would be no change in National's capital adequacy score or financial risk profile. A loss severity of approximately 45% on all issuers would pressure National's capital adequacy score and possibly our financial strength rating.

Our scenario analysis included the bond insurers' exposure to The Puerto Rico Electric Power Authority (PREPA). In February 2016, Puerto Rico lawmakers approved the Securitization Special Legislation and Legislative Reform Package legislation to allow PREPA to restructure its debt. The passage of the legislation allowed Assured and National and certain holders of PREPA bonds to move forward with a restructuring plan. Under the plan, the bond insurers would not experience a loss on their exposure to PREPA. Most of the provisions that would allow for the final implementation of the restructuring plan are in place. If we were to exclude the PREPA exposure from our analysis, National's capital could absorb losses assumed in the 45% loss scenario.

It is important to note that each bond insurer's capital adequacy improves with the passage of time due to significant deleveraging of risk. In 2015, Assured's statutory capital increased by 5%, while its net par exposure decreased by 12%. National's statutory capital increased by 4% while its net par exposure decreased by 28%. Therefore, with a rise in statutory capital and a decrease in risk exposure, we expect, without accounting for any other factors, the capital

adequacy ratio to improve. This assumes that the legacy bond insurers will continue to experience refundings and normal amortization in their insured portfolios and limited new business production to replace the run-off of insured risk.

Business Prospects

We view the U.S. bond insurance sector's market growth prospects as neutral. We believe that there is still a need for municipal bond insurance in the U.S. public finance market, and market participants say they generally feel that bond insurance has proven its worth over the past three to four years. Although headlines relating to Puerto Rico and Detroit have highlighted the benefits the bond insurers provide to investors, compressed credit spreads continue to limit enhancement opportunities somewhat. The bonds that these companies are insuring are high quality, but the premiums that they are able to charge are much lower than they have been in past years. With credit spreads likely to remain low through 2016 because of limited upside movement in long-term interest rates, and investors not willing to give up yield for the credit protection and liquidity provided by a financial guarantee, we expect the spread created by the low interest rates to limit growth opportunities somewhat for the bond insurers and in turn could pressure our assessment of each insurer's business risk profile.

Over the long term, we do not expect insured penetration to approach 50% of total new issue USPF volume as it did prior to 2008 for two reasons. First, new issue penetration of 50% or greater was achieved with higher insurer ratings, thereby creating more insurable opportunities on the investment-grade ratings spectrum ('AA' to 'BBB'). Second, larger issuers continue to be able to access the debt markets at attractive rates without insurance.

With the ratings on the bond insurers in the 'AA' category, and each focused on investment-grade underwriting, issuers in the 'A' and 'BBB' categories would likely benefit the most from credit enhancement provided by these insurers. Using our U.S. public finance rating distribution by transaction count as a proxy for insurable new issues, approximately 60% of the market is in the 'A' and 'BBB' category. This measure does not take into account the sector underwriting strategy of each insurer, nor does it assume that an investor may buy credit protection on a higher-rated issue to add diversity to an investment portfolio. Assuming that the bond insurers could insure 50% of the 'A' and 'BBB' categories, and interest rates rise, we could see the bond insurers insure 25%-30% of the new-issue U.S. public finance market.

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