STANDARD & POOR'S
RATINGS SERVICES
McGRAW HILL FINANCIAL

RatingsDirect®

FINANCIAL INSTITUTIONS

RESEARCH

U.S. Bond Insurers And The Financial Guarantee Sector Stand At A Crossroads

Primary Credit Analyst:
David S Veno, Hightstown (1) 212-438-2108; david.veno@standardandpoors.com

Secondary Contact:
Marc Cohen, CFA, New York (1) 212-438-2031; marc.cohen@standardandpoors.com

Table Of Contents

Business Prospects Are Likely To Increase

U.S. Public Finance Macroeconomic Trends

Bond Insurers Economic Trends

Ratings Hinge On Future Developments

1279187 | 300001356

U.S. Bond Insurers And The Financial Guarantee Sector Stand At A Crossroads

In Standard & Poor's Ratings Services' view, there is still a need for municipal bond insurance in the U.S. public finance market. Meaningful value is assigned to the financial guarantees provided by the bond insurers. Yields on insured issues trading in the secondary market--as compared to yields on uninsured issues of the same issuer and similar maturities--indicate that pricing is strong for insured bonds.

We expect business volume for bond insurers to rise through 2015 and for the industry's risk-adjusted pricing ratios to improve. Municipal bond market participants in the public finance arena we have spoken to generally feel that bond insurance has proven its worth during the past several years.

Overview

- Municipal bond insurance is still necessary in the U.S. public finance market.
- We expect business volume for bond insurers to rise through 2015 and for the industry's risk-adjusted pricing ratios to improve.
- If interest rates rise as expected and insured par volume does not increase or the increase in competition leads to poor pricing decisions, we could take rating actions on the bond insurers.

Business Prospects Are Likely To Increase

The prevailing lower yield environment and the spread compression it created hurt the financial guarantee market for much of 2013, making it difficult for bond insurers to attract insurable issuers and investor demand. Issuers already benefited from all-time low market yields. Investors searched for the highest-yielding fixed-income municipal assets available and were not willing to give up yield for the credit protection and liquidity provided by a financial guarantee.

If municipal yields widen by 50-75 bps through 2015 based on our analysis, there should be a corresponding increase the insurable primary U.S. public finance market, as bond insurers should be able to create yield savings that would make it economical for issuers to pay for insurance. We have asked bond insurers their expectations for the U.S. public finance market and the insurable market in 2014. In a period of rising interest rates, they expect total U.S. public finance new issue par to be $285 billion to $300 billion, including refundings of approximately $90 billion. The estimate for total new issue insured public finance par volume is $20 billion to $25 billion, equating to 7%-8% of total public finance issuance in 2014.

The bond insurers expect secondary market insured par to total $2 billion to $4 billion in 2014, depending on municipal market headline events, yield widening, and institutional investor capital market and hedging activities. In late 2013, insured secondary transaction picked up for the bond insurers as a result of Detroit's bankruptcy filing, headline events about Puerto Rico, and general investor worries about the municipal debt market. There are still pockets of stress in the U.S. that might spur retail investors' demand for secondary market insurance.

1279187 | 300001356

We believe the market can support three bond insurers with the reemergence of National Public Finance Guarantee Corp. (National). In fact, U.S. public finance market participants have indicated a demand for a third insurer for diversity. In the near term, expansion of the insurable market with the expected rise in interest rates, combined with the disparate underwriting strategies of the bond insurers, should lead to sufficient underwriting opportunities to support each company's underwriting strategy. In the long term, as the bond insurers continue to prove the value of their product, the demand for financial guarantees should increase and the insured penetration of the U.S. public finance market should rise, but not to the same levels as prior to 2008.

To gauge demand for bond insurance, we spoke to various municipal bond-market participants who have different applications in the public finance arena. The findings of our discussions included the following:

- The overall sentiment was that bond insurance is a product that has proven its worth during the past two-to-three years.
- There is high demand for bond insurance in the middle-market space.
- There is investor and issuer demand for three players in the financial guaranty sector.
- Investors, especially the retail investors who are the primary end-users of bond insurance, do not see legacy bond insurers' structured finance portfolios as a detriment.

U.S. Public Finance Macroeconomic Trends

The 30-year Municipal Market Data (MMD) 'AAA' benchmark yield rose to 4.5% in September 2013 after the Federal Reserve announced quantitative easing tapering and headline risk associated with Puerto Rico increased. The current 30-year yield is 3.7%--65 basis points (bps) less than its recent peak, and 35 bps less than in January 2014.

We expect a gradual increase in long-term interest rates, with U.S. municipal rates rising through 2014 and 2015 by 50-75 bps. Standard & Poor's economists estimate a U.S. Treasury 10-year average yield of 3.0% for 2014 and 3.3% for 2015 (see U.S. Forecast Update: A Recovery Postponed Not Canceled, published Feb. 10, 2014, on RatingsDirect). This is a 30-bp widening for 2014 and 70 bps for 2015.

The correlation of U.S. treasuries to the 'AAA' MMD general obligation yield curve has historically been close to the 0.9x-1.0x range, except during 2007-2009 both on 10-year. We therefore expect yields to widen by 25-50 bps by year-end 2014 and an additional 25-30 bps in 2015, increasing in total by 50-75 bps by the end of 2015.

Bond Insurers Economic Trends

With credit spreads forecast to widen in 2014 and 2015, we expect the bond insurers' risk-adjusted pricing (RAP) to improve from 2013 levels. We base this view on our assumption that the bond insurers will be able to capture a greater amount of the wider credit spread in the form of higher premium rates. We also assume that the rise in the premium rates will result in better pricing per dollar of risk as measured by our transaction capital charges and that the rise in premium rates will be greater than any rise in capital charges. In first-quarter 2013 when interest rates began to rise, this pricing dynamic was illustrated as the bond insurers experienced stronger pricing with relatively minimal change in underwriting risk. Interest rates in January 2014 began to decline toward the end of the month, but bond insurers

were able to execute on strong pricing, with RAPs on primary and secondary market transactions higher than those in 2013.

Ratings Hinge On Future Developments

Although we believe there is still a need for municipal bond insurance in the U.S. public finance market, the next two years will be crucial in determining the health of the financial guarantee sector. If interest rates rise as expected and insured par volume does not increase, we would likely reevaluate all our ratings in the sector.

The reemergence of National has introduced another layer of competition to the pricing dynamics of the financial guarantee market. In this competitive environment, insurers must exercise discipline when pricing insured transactions. If the increase in competition leads to poor pricing decisions or the current spread compression persists and insurers' RAPs are projected to fall and remain less than 4%, we could lower our ratings on the bond insurers.

Copyright © 2014 Standard & Poor's Financial Services LLC, a part of McGraw Hill Financial. All rights reserved.

No content (including ratings, credit-related analyses and data, valuations, model, software or other application or output therefrom) or any part thereof (Content) may be modified, reverse engineered, reproduced or distributed in any form by any means, or stored in a database or retrieval system, without the prior written permission of Standard & Poor's Financial Services LLC or its affiliates (collectively, S&P). The Content shall not be used for any unlawful or unauthorized purposes. S&P and any third-party providers, as well as their directors, officers, shareholders, employees or agents (collectively S&P Parties) do not guarantee the accuracy, completeness, timeliness or availability of the Content. S&P Parties are not responsible for any errors or omissions (negligent or otherwise), regardless of the cause, for the results obtained from the use of the Content, or for the security or maintenance of any data input by the user. The Content is provided on an "as is" basis. S&P PARTIES DISCLAIM ANY AND ALL EXPRESS OR IMPLIED WARRANTIES, INCLUDING, BUT NOT LIMITED TO, ANY WARRANTIES OF MERCHANTABILITY OR FITNESS FOR A PARTICULAR PURPOSE OR USE, FREEDOM FROM BUGS, SOFTWARE ERRORS OR DEFECTS, THAT THE CONTENT'S FUNCTIONING WILL BE UNINTERRUPTED, OR THAT THE CONTENT WILL OPERATE WITH ANY SOFTWARE OR HARDWARE CONFIGURATION. In no event shall S&P Parties be liable to any party for any direct, indirect, incidental, exemplary, compensatory, punitive, special or consequential damages, costs, expenses, legal fees, or losses (including, without limitation, lost income or lost profits and opportunity costs or losses caused by negligence) in connection with any use of the Content even if advised of the possibility of such damages.

Credit-related and other analyses, including ratings, and statements in the Content are statements of opinion as of the date they are expressed and not statements of fact. S&P's opinions, analyses, and rating acknowledgment decisions (described below) are not recommendations to purchase, hold, or sell any securities or to make any investment decisions, and do not address the suitability of any security. S&P assumes no obligation to update the Content following publication in any form or format. The Content should not be relied on and is not a substitute for the skill, judgment and experience of the user, its management, employees, advisors and/or clients when making investment and other business decisions. S&P does not act as a fiduciary or an investment advisor except where registered as such. While S&P has obtained information from sources it believes to be reliable, S&P does not perform an audit and undertakes no duty of due diligence or independent verification of any information it receives.

To the extent that regulatory authorities allow a rating agency to acknowledge in one jurisdiction a rating issued in another jurisdiction for certain regulatory purposes, S&P reserves the right to assign, withdraw, or suspend such acknowledgement at any time and in its sole discretion. S&P Parties disclaim any duty whatsoever arising out of the assignment, withdrawal, or suspension of an acknowledgment as well as any liability for any damage alleged to have been suffered on account thereof.

S&P keeps certain activities of its business units separate from each other in order to preserve the independence and objectivity of their respective activities. As a result, certain business units of S&P may have information that is not available to other S&P business units. S&P has established policies and procedures to maintain the confidentiality of certain nonpublic information received in connection with each analytical process.

S&P may receive compensation for its ratings and certain analyses, normally from issuers or underwriters of securities or from obligors. S&P reserves the right to disseminate its opinions and analyses. S&P's public ratings and analyses are made available on its Web sites, www.standardandpoors.com (free of charge), and www.ratingsdirect.com and www.globalcreditportal.com (subscription) and www.spcapitaliq.com (subscription) and may be distributed through other means, including via S&P publications and third-party redistributors. Additional information about our ratings fees is available at www.standardandpoors.com/usratingsfees.