Do Capital Markets Need Financial Guaranty Insurers?

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The last five years have not been kind to oracles and prognosticators. The arc of the Great Recession and our ongoing recovery from it has repeatedly thwarted the pronouncements of the hopeful and skeptical alike. Through this period, predictions relating to the structured finance and securitization markets have proved to be particularly hazardous. The proclaimed disappearance of collateralized debt obligation/collateralized loan obligation structures has been turned on its head by the sale of over $80 billion of CLO securities in 2013 and a record pace of issuance to date in 2014, along with the reemergence of CRE CDOs (now rebranded as "commercial real estate CLOs") and even more exotic CDO structures.

Surely, however, the epitaphs for the financial guaranty insurance industry were not penned prematurely. Certainly those insurance companies must have the good grace to comprehend that their day has passed. Yet even in this case, the expectations—nay the certitude—of market-watchers appears likely to be foiled.

Many (though not all) financial guaranty insurers suffered mightily as a result of the sudden crisis that struck the capital markets in 2008—the bursting of the U.S. real estate bubble, the dizzying spike in residential mortgage defaults that followed, and the resultant collapse of the vast pool of residential mortgage-backed securities (RMBS) and collateralized debt obligations backed by asset-backed (mostly mortgage-backed) securities (so-called "ABS CDOs"). Although each of these insurers chose a different path to weather the storm, most of the major monoline insurance companies—MBIA, Syncora, FGIC, Assured and Radian, to name but a few—remain very much in existence. They continue to monitor, manage, work out and aggressively exercise and enforce their rights and powers under very substantial portfolios of exposures.

Indeed, some of these insurers (or newly formed affiliates) continue to write new business. While the portion of municipal bonds that are issued with "primary" (i.e., built-in) financial guaranty insurance policies has fallen significantly from a pre-crisis level that reached or exceeded 50 percent of new issuances, nonetheless more than 3.5 percent of newly issued muni bonds were "wrapped" by such a policy in 2013 (and well over 4 percent in the first quarter of 2014)—still a significant amount in absolute dollars. Moreover, even within the structured finance arena, some insurers of asset-back securities—Assured Guaranty, in particular (which, along with Radian, emerged from the capital markets crisis with a notably healthy balance sheet)—have continued to issue new policies, and now it seems very likely that more will do so in the not-too-distant future.

The reasons for the unexpected recovery by this industry from its near-death experience bear consideration. It suggests that contrary to the common view of the last several years, the capital markets may yet conclude that there is meaningful value offered by the much-maligned business model of financial guaranty insurance companies. However, because these insurance companies play such a multifaceted role in the capital markets, one which goes well beyond simple credit enhancement, the source of that value may not be immediately evident.

For example, one of the less appreciated functions of financial guaranty insurance companies is that of active and ongoing monitoring of the performance of wrapped securities and the collateral backing them. While the monolines' activities in this area may seem to duplicate a role performed by the rating agencies, they do not. There is no doubt—despite the stream of utter calumnies (along with the occasional well-grounded critique) leveled by the popular press and certain congressmen—that the rating agencies continue to play a key and valuable function in the capital markets generally, and in the structured finance markets in particular. Nonetheless, there is an essential difference between the continued monitoring performed by the rating agencies and that conducted by the financial guaranty insurers—in the latter case, the insurers have significant amounts of their own money at risk in these monitored liabilities. That is a fundamental commercial distinction that every investor understands keenly. It confers an urgency, and a credibility, to the insurer's oversight efforts that cannot be gainsaid.

A similar analysis applies to another, better-understood, set of pre-closing/pre-investment functions of the monoline insurers: (i) analysis and negotiation of documentation, structure and collateral, and (ii) assessment and mitigation of key risks, both credit and non-credit. The weight and import of this analysis is likewise enhanced by the fact that the insurers are much more than gadflies or academicians, backing up their assessments with their balance sheets and acting, in effect, as mezzanine investors in the deals that they analyze and negotiate. Through these activities, financial guaranty insurance companies have helped to shape the structures and documentation, and investor rights and remedies, for a wide range of securitized asset classes. The results of this broad influence continue to be felt in (among other things) the litigation that has flowed from the mortgage crisis.

Let us not forget the monolines' key role—providing credit enhancement to transactions and conferring their ratings on the bonds and debt obligations they guarantee. This guaranty is, of course, the core function of the financial guaranty insurance companies. Even in this regard the role played by monoline insurers is more subtle than may appear at first blush. As I finalized this article (and by felicitous coincidence), Fitch Ratings published an August 2014 report captioned "Monolines Can Add Value Even with 'A' Category Ratings" in which Fitch makes the thoughtful observation that "the core value of bond insurance is the credit enhancement it provides when a wrapped bond comes under stress, as opposed to the historic practice of focusing mainly on the ratings uplift applied to the wrapped bond at the time of issuance." Fitch goes on to note the following:

> Fitch believes bond insurance can have significant value, even when the bond insurer is rated the same or lower than the underlying rating on the wrapped bond upon issuance. In Fitch's view, the more important rating relationship is the relative difference between the bond insurer's rating and the underlying bond rating at the time the wrapped bond comes under stress. As long as the bond insurer remains financially viable, which would be expected for those with financial strength ratings in the 'A' category, the insurer will enhance the credit quality of the wrapped bond.

Beyond the direct benefit of credit enhancement described above, these guarantees have also served to permit capital markets investors to take exposure to new asset classes in which the complexity of the structures and/or the nature of and risks attendant upon the underlying assets are not easily evaluated by individual bondholders. The early Regulation Triple-X reserve funding transactions come to mind as a good example of this catalyzing role (although there are many). The new structures developed by Lehman, Goldman and others for transferring extreme mortality risk in respect of large pools of term life insurance policies required potential investors to evaluate actuarial risk. At the time, most capital markets investors did not maintain such capabilities in-house, and hiring external actuaries to assess such a pool of term policies was very costly—in fact, was uneconomic for anyone other than an investor taking a very large position in the related deal (such as a financial guaranty insurance company). Note that the imprimatur of rating agencies, standing alone, was apparently not sufficient to launch this now well-established asset class. All, or virtually all, of the early deals were wrapped, which suggests that the capital markets sought more than rating agency approval: they demanded a lead investor to evaluate—and then take—the risks underlying the transactions. The monolines were key participants in the structuring of the first generation of Regulation Triple-X reserve funding transactions, and in the incubation of the then-emerging field of structured insurance finance.

The perceived benefit of the credit enhancement offered by bond insurers was, naturally, bruised by their struggles following the mortgage crisis. The split of MBIA into good bank/bad bank entities, the Wisconsin proceeding that suspended payments by Ambac, the bond buybacks at discounted prices undertaken by various monoline insurers and other similar events called into question the very business model of financial guaranty insurers. Was there value in a policy guaranteeing current interest and ultimate principal payments under a long-dated bond? Would the insurer be there when the bond matured? Many market observers were compelled to ask these questions, as bond insurers were intensely challenged by the wave of RMBS and CDO defaults.

Yet financial guaranty insurance policies today continue to be issued in reasonable volume, particularly in the municipal bond market. Recent events—the threat of default by certain Puerto Rico public corporations, for example, along with expectations that wrapped bonds will likely be paid in full—has restored a broad sense of the inherent worth of these policies.

Fitch, in the above-referenced "Monolines Can Add Value" report, likewise highlights the renewed appreciation of financial guaranty policies that has been encouraged by current incidents of municipal and quasi-sovereign distress:

> Most recently, the value of bond insurance has clearly emerged in the examples of Puerto Rico and Detroit. Investors who purchased these issuers' bonds with insurance from a solvent monoline enjoy much stronger valuations today versus equivalent unwrapped bonds. Insurance can also provide increased market liquidity for issuers and assist smaller or less frequent bond issuers in accessing the market.

It also bears brief mention that the monolines' capacity to manage and work out distressed and insolvent credits has been significantly sharpened by their post-crisis experience. The Great Recession was a crucible that, through the sheer volume and weight of troubled transactions, shaped and toughened the monolines, and provided a wealth of experience in exercising rarely used remedies, leveraging contractual rights and privileges and managing losses. As a result, their internal staffs, although generally diminished in size, have gained a level of expertise in distressed assets, workouts, insolvencies and litigation that, I suspect, far exceeds their pre-crisis capabilities.

All of this intimates that the financial guaranty insurance industry may be on the cusp of a largely unanticipated (and somewhat remarkable) recovery. I offer that rather qualified prediction with some reluctance. This article began by casting aspersions upon a supposed class of oracles and prophets of the capital markets, and it has now come full circle by suggesting its own vision of things to come. Perhaps the safer approach is simply to recap the fairly compelling set of facts presently before us: Despite predictions of their imminent demise, financial guaranty insurers are (for the most part) very much alive and, in many cases, quite well and active. They continue to manage large portfolios of credits, and they have been deeply, and often prominently, involved in some of the larger insolvencies and litigations of the past years. A number of them continue to write new policies, in fairly significant volume, and other bond insurers (including new entrants) seem poised to do so. Moreover, there appears to be renewed investor—and rating agency—appreciation of the value of bond insurance, despite the trials of the recent past. Where will this ultimately lead the financial guaranty insurance market? I won't hazard a guess.

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