September 23, 2009

GFOA Presentation

The New Word of Municipal Bond Insurance and Its Impact on the Ohio Market

History of Participants

- The municipal bond insurance industry is not that old. Early 1970's.

- There were six that had AAA at one time or another.

- Bond insurance is a financial commitment by a bond insurance company to make the scheduled principal and interest payments on a bond issue if the obligor does not. A credit enhancement refers to a financial instrument or structural feature of a transaction that enables the obligation to be rated higher than the creditworthiness of the obligor or underlying asset. These two are integrally involved with one another.

- AMBAC was founded in 1971 in Milwaukee, Wisconsin as a subsidiary of MGIC Investment Corp. It started with AA from Standard & Poor's Corporation. It received AAA from S&P in 1979.

- MBIA formed as a consortium of four major insurance companies in 1974 with AAA from Standard & Poor's. These two companies represented the municipal bond insurance industry in the early 1980's.

- FGIC was established in 1983; started insuring municipal bonds in 1984 and established credit default swap execution capability in 2005. This company, early on, would not insure limited tax general obligation debt in Ohio!

- Assured Guaranty Ltd., Bermuda based holding company began operations in 1988; but only recently in municipal finance. It didn't have AAA from the rating agencies early on.

- XL Capital founded as EXEL Limited as a liability insurance company. XLCA, the municipal insurance arm, formed in 1999. It received Aaa from Moody's Investors Service in 2001.

- FSA was founded as the first monoline insurance company to focus on financial guarantees for asset-backed securities. The original investors were a group of institutional investors. FSA entered the U.S. Municipal Bond Market in 1990.

- Another more recent Company was CIFG NA. It was granted a New York license in 2002 and entered the municipal insurance business.

- Assured Guaranty is the only insurance company that still has at least one AAA rating. It is currently rated AAA by Standard & Poor's Corporation, Aa2 by Moody's Investors Service and AA by Fitch Investors.

Catalyst

- The 1975 New York City Debt and Default crisis focused attention on the need for municipal bond insurance. Only 1.8% of municipal issues were insured in 1975.

- Then the Washington Public Power Supply System (WPPSS) default in 1982 again focused attention on the need for municipal bond insurance.

- Few issues were actually insured in the early 1980's even after these two major municipal debt finance crises.

- Applying for Municipal Bond Insurance was more involved in the beginning.

- We (the Financing Team) actually made presentations to the various insurance companies in the early 1980's in New York.

- MBIA was in White Plains at the time and the analysts would take a train into the City and meet with the issuer at the bond counsel's New York office.

- First the Insurance presentation; and then the rating agency presentation.

You didn't have to accept the insurance if the rating was strong enough!

- The rating agencies set up regional offices in Chicago, encouraged issuers from Ohio to go to the Chicago offices. Everything changed.

Present Value in the Early 1980's

- Insurance was typically used when a Present Value savings in interest rate expense could be demonstrated over a non-insured issue.

- In the early years up to a 50 basis point spread difference could be demonstrated. We insured the entire issue on refunding back then.

- There was even a difference in spread between AMBAC and MBIA, depending on which insurer one used.

- One of the rating agencies included the insured rating as part of the insurance company's premium, or vice versa.

- The rating agencies insured all the insurance companies back then.

- Some said back then and have even said recently, that Ohio General Obligation debt doesn't need insurance, but? Especially voted unlimited tax debt issues?

- There are many different categories of debt that were insured outside this area: hospital & Healthcare debt, enterprise fund debt, sport facility financings, port authority issues, airports, and other types of debt outside of good old general obligation debt issues – and these were not and are not the causes of the meltdown we experienced starting last October!

- Advance refundings.

- It was the structured derivative products attached to many of these issues and the collapse of the Housing Market.

Rules of Engagement

- Municipal bond insurance quickly became very popular. Once insured, you were AAA credit. Politically this was very popular and it helped the sale of the bonds.
- Insured Ohio paper was easier to sell than rated Ohio paper.
- Back then, we were able to apply for insurance even if there was no outstanding rating on the underlying debt – and we were not required to get a rating on the underlying debt.
- The insurance companies did internal ratings on the issues they were willing to insure; and the premium reflected what they thought the credit should have been had they applied for a formal rating.
- This is not the case today – the insurance companies, now company fully expects you to get a rating on the bond issue.
- And in light of what has happened, this is in the issuers' best interest. There are many outstanding issues where the underlying rating of the issuer is now a higher rating than that of the insurance company on the deal.
- Municipal bond insurance provided the issuer a way to enter the tax-exempt market without making a formal rating agency presentation – which were, for the most part, much more stressful in the 1980's. One could insure an issue with less information than we need today.
- A change in Tax Law in 1986 slowed down the number of advance refunding going on.
- A change in Ohio law probably also helped the increase in the use and understanding of municipal bond insurance. In 1988, issuers were allowed to negotiate general obligation bond issues and they were also allowed to include the costs of issuance of hiring a financial advisor or underwriter in the transactions.

The Computer

- Getting AAA rating in this manner, without having to apply for an underlying rating, was less stressful and much quicker than in today's world.

- By 1988, 25% of municipal bonds were insured. This percentage grew very quickly after that. So did the way in which debt was and became insured.

- In the early years, issuers insured the entire issue, and that was it.

- The computer made us extremely more creative.

- I think 50% of bond issues were insured by the early 1990's.

- We were able to structure financing and insure just those maturities that made mathematical sense.

- Structured products were developed once the computers were introduced. The late 1980's were the insurance and structured products heyday.

- Then the insurance companies strayed from the path – they started insuring structured finance and derivative based products: asset backed bonds, collateralized debt obligations, residential mortgages through mortgage backed securities and credit default swaps. Some of them strayed faster and quicker than others.

    Since there were 6 insurance companies by now and premiums sometimes dipped below 10 basis points?

- The commercial banks, the institutional investors, the funds, the rating agencies, investment banks, all became part of what is known as the "shadow banking" system.

- $3.3 Trillion was insured in 2006 and backed or secured by only $34 billion of equity capital. In fact, no one is sure of the actual amount of money leveraged during the collapse in 2008.

- Much of this was secured or related to the Housing Market. Whether the actual house, the loan on the house, the second mortgage or equity loan, and the number of credit card and other assorted assets all secured by insurance.

- And then the hedging instruments created and developed by Wall Street.

- The markets collapsed.

- Today there is only Assured Guaranty with only one AAA form Standard & Poor's, Aa2 from Moody's and AA from Fitch.

Results

- The financial world melted last year (2008) – remember. And depending where you are on the political spectrum, the causes are many and never agreed upon.

- As the insurance companies started to get downgraded by the very rating agencies that rated these structured derivative products, the Ohio market place along with the rest of the world became affected!

- The tax-exempt bond anticipation note issue market which is about $3 or $4 billion dollars a year in Ohio stumbled from October 2008 - March 2009?

- I think it was hurt more and more quickly than the long-term market. We issue notes almost every day somewhere in Ohio.

- It is better, and getting better with each month. We just did two issues and received 5 and 7 bids respectively – both under 1.00% NIC.

- There was great uncertainty on so many financial fronts last year and going into this year.

- As the rating agencies started downgrading the insurance companies, things started rolling downhill picking up speed. The variable rate letter of credit enhanced deals started unraveling. This impacted the Ohio short term note market.

- No one knew the extent of the problem yet. The rating agencies started downgrading, ratings fell and there was only the Bond Buyer – who subscribes to the Bond Buyer?

- Since there was so much leveraged structured products, no one really knew how much, or how to value them in this market. Utter Chaos.

- Since we are talking about thousands and thousands of credits across three different rating agencies, they didn't even know how to do this.

- The issuers were never contacted individually. And yet, they were responsible for notifying the NMSIRS.

- The short-term securities out there that this should have been directed at from the start should have been the variable rate, auction rate derivative based, swap related type of debt that had nothing to do with Ohio short term notes.

- These were secured by Letters of Credit or Municipal Bond Insurance, or parts of the structure.

- But everything was thrown out with the baby in the bath water. So Ohio's essential purpose general obligation bans during this time frame suffered more than they should have.

- The institutional investors stopped investing! It was the only safe thing to do. No one knew what their losses would eventually be.

- Preserve Capital at all costs. Every one now bought Treasuries and even at a negative yield?

- The rating agencies were in the middle of all of this. They rated everyone. There was widespread finger pointing. It is still going on today!

- The meltdown provided an opportunity to postpone any corrections in rating methodology. Corporate and municipal methodology in rating credits has always been disputed.

- This impacted the note and the bond market here in Ohio.

- And on top of this, The Federal Government, the Federal Reserve and the rest of the World's financial markets all started solving the problem.

- The Federal Reserve got involved, they have lowered the Discount Rate; tax - exempt rates are lower.

- The Stimulus package, or The American Recovery and Reinvestment Act.

  Build America Bonds (BAB), or tax-exempt debt that could be done as taxable debt.

  Qualified School Construction Bonds (QSCBS) bond depending on tax-credits.

  The limit on Bank Qualified debt was raised to $30,000,000.

  And a few other provisions in the Law.

Ohio Specific

- Ohio sells its notes predominantly on a negotiated basis and for the most part non-rated.

- Those that were rated were highlighted during this time frame as the negotiated notes were still getting done but at much higher interest rates.

- Then the rating agencies become more involved and almost panicked as they started to draft new regulations to deal with short-term debt.

- We kept telling them that there was a huge difference between a Massachusetts State $400,000,000 short term note, other structured product short-term notes; and the hundreds of smaller notes that general government had been doing in Ohio year after year.

- The rating agency reaction made selling both the competitive and negotiated notes more difficult to sell.

- Ohio is blessed and cursed by having major banks headquartered in Ohio. They were involved in many letter of credit transactions that were going nowhere. As the insurance companies were downgraded, and the banks were downgraded, the letter of credit backed issues with our major banks were not remarked because the rating deteriorated, they no longer ha an appetite for notes. They started preserving capital.

- The structured short term products started to hyper ventilate as the interest rates kept ratcheting up. Auction rate securities and Letter-of-Credit issues were not being remarketed – Not Good.

- Some failed as there were limits on the ceilings or maximum rates. Many tried unsuccessfully to unwind some of these issues, but the covenants were not flexible enough.

- Many of the Issuers now realized they really did not know what they had gotten themselves into.

- A few Ohio Note issues did not receive bids in a competitive setting at this time, also.

- It is now more important than ever to use qualified financial advisors and/or investment advisors to understand these products before using them. Many of you should develop policies with respect to structured finance. On 60 Minutes a former high level rating executive admitted that she did not know what these products were and how they actually worked. But the fee revenue from rating them was great.

- So the panic had set in. Many issuers do not subscribe to the Bond Buyer, and were not aware of exactly what was going on. They tried to sell their notes as they had before. On the negotiated side they experienced higher interest rates as detailed in the Bond Buyer. And on the competitive side, a few did not receive any bids! Bond issues also slowed way down during the later part of 2008.

- Many of the major financial institutions were heavily invested in many of these structured, enhanced, insured, letter of credit instruments. The insurance companies were investing in the same products as they were insuring?

- The mortgage backed securities and credit default swap are two of the major culprits in this collapse. The banks were also significant institutional investors. So as they all started to lose money, some went out of business, some merged, some regrouped and tried to hold on to their capital. No one was left to invest. They hadn't figured out how much they lost yet.

- These historically significant events affected the Ohio market place very negatively. Notes were affected immediately. Insured bonds or trying to get an issue insured was a

gradual more of a gradual progression. When you applied for insurance in the first quarter 2009 you didn't know if you would have the rating promised by insurance by the time you sold your issue!

Going Back to the Future

- Issuing debt in Ohio is no longer the same as it was at the beginning of 2009! There is a great deal more preparation involved, more disclosure is needed. You must plan for contingencies. You must prepare financial documents, develop management and financial policies, allow for more time in sales, apply for ratings and keep your fingers crossed. Bonds and Notes.

- There is also the likelihood of additional regulation on good old fashioned vanilla General Obligation debt issues. This is not fair.

- You can no longer assume that issuers of notes will sell and receive sufficient bids based on last year's unaudited financial or financial statements from two years ago. This used to be commonplace.

- An Ohio Municipal Advisory Commission Report is very important in the sale of one's notes; and ending general fund balances need to be healthy.

- Some rating agencies are looking at the ending fund balance as the pot of money that will pay a note off if you do not receive any bids. They are referring to the rolling of the note issue as "reinvestment risk".

- It is extremely important to have as current as possible audited financial statements prior to a sale. You may want to make sure you have annual audits and not bi-annual audits.

- The number of bidders and institutional buyers has decreased. They have tightened up their internal credit criteria. Many have told us, they cannot bid unless there is a current financial audit – even if they are a customer of the bank.

- Many of the funds also have tightened up their requirements. This is the case whether you sell an issue competitively or on a negotiated basis. Everything still sells, it's the price that hurts.

- Rating securities today is much more important than early last year. An issuer should have at least an underlying bond issue rating before issuing a non-rated note.

- You should also have a current audited financial statement if you plan on selling a non-rated note. There is at least a 25 basis point spread between rated and non-rated.

- Without an audited financial available and a healthy ending general fund balance, this spread gets very close to 100 basis points!

- The rating agencies will no longer give you a short term rating without also doing a rating on the communities' long term credit.

- If you have a non-rated note and no underlying, you can get both for the price of a short term rating. The presentations for rating a short-term note issue are no longer short.

- Besides the financial statements, the rating agencies are very interested in your adopted financial management policies, debt policies, fund reserve and liquidity policies and best management practices.

- They know that many of you have done and are doing a great job, but what happens when you leave? Adopted policies will reinforce your presentation.

- This is now the case for both note issue and bond issue transactions.

- The collapse of the municipal bond insurance industry made it more difficult for competitive and negotiated sales of the weaker credits. Whether in the number of bids or the ultimate re-offering yield.

- Many of the bidders do not want to risk capital unless they have an issue sold. In a negotiated sale they have much more time to sell an issue.

- Many of these bidders do not bid on notes. Many of the banks who used to bid are not bidding. Bank qualified does not appeal to banks which have lost money. Although, there is a strong market for bank-qualified paper. Two recent Ohio Bond issues received 4 – 5 bids on small BQ deals.

- Since there is only one insurance company standing, they get to rewrite the rules of engagement.

    The premiums earlier this year for municipal bond insurance were three times last years‘ rates – there were still a couple of insurance companies that were writing premiums with acceptable ratings.

    Now there is only one. It has plenty of applications. It takes more time to get through, some issues are discarded quickly based on size or existing credit, or the manner in which the issue will sell.

- Bond issues now require the same type of additional information as short-term note issues.

- EMMA evolved and went into existence July 1, of 2009. EMMA stands for The Municipal Securities Rule Making Board's Electronic Municipal Market Access Data Base. It became effective July 1, 2009. It is a comprehensive source for the official statements, continuing disclosure documents, advance refunding documents and real-time price information on Municipal securities. It is assuming the role as the centralized, electronic repository for al municipal bond disclosure documents and trade data. This expanded capability of disclosure is already affecting our market place.

- BABS are affecting the market place. They have helped keep interest rates down in the tax-exempt market. They require a better understanding on successful implementation.

Summary

- Be prepared;
- Assemble a qualified and experienced finance team;
- Consider rating debt issues;
- Consider preparing management and financial debt management plans;
- Do not assume that issuing debt is the same as last year;
- Be prepared for new regulations;
- Jump in the water is fine!

Credit Default Swaps (CDS) are financial instruments used as a hedge and protection for debt holders, in particular, Mortgage Backed Securities (MBS), from the risk of default.

Mono-line Insurance companies are companies whose sole line of business is to provide bond insurance services to one industry. In our case, the municipal bond industry. No mono-line had ever been downgraded or defaulted prior to 2007.