MEMORANDUM

TO: Economic Recovery Initiative File

FROM: Mark H. Vacha

SUBJECT: Considerations Related to Recent Proposals for A Mutually Owned Municipal Bond Insurer

DATE: March 11, 2009

Background and Purpose

Economic and financial market events of the last several months have brought considerable disruption to the municipal capital markets. Deterioration in the sub-prime mortgage market and in the mortgage asset-backed securities markets contributed to the downgrading of various bond insurers and the contraction of insurer capacity for new municipal bond issues. As a consequence of limited access to highly rated bond insurance, as well as other factors, many municipal issuers have faced greater difficulties accessing the capital markets and have faced a higher cost of funds, especially for lower-rated credits. These adverse effects have been experienced despite the fact that the vast majority of municipal bond issuers have not had their credit ratings downgraded.

Recent proposals, intended to assist the municipal markets, include creating a mutually owned bond insurer[1] (the "Insurer") to provide bond insurance capacity and fill some of the void left by the deterioration of private municipal bond insurance. In such a structure, state/local governments would form a monoline bond insurer entity owned or capitalized, in whole or significant part, by such state/local governments and analogous to a mutual benefit insurance society[2]. This article will identify and begin to analyze certain issues related to an Insurer.

Issues and Considerations

How will the entity be capitalized?

The Insurer, like any corporate entity, could be capitalized with some combination of debt and equity. Absent a change in law, any debt issued by the Insurer would most likely be taxable. Three potential sources of capitalization would be state/local governments, the federal

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[1] See "Bond Summit Eyes U.S. Backing for Munis" in the February 20, 2009 edition of The Bond Buyer. See also a commentary in the February 23, 2009 edition of The Bond Buyer regarding a National League of Cities led commission which has advocated an entity described as a "nonprofit, national mutual credit-enhancement company".

[2] This article is not intended to analyze any specific proposal but rather to address issues that may be common to several variations of the general structure discussed in this article. Throughout this article, references to "mutual" are often intended to capture the concept that state/local governments would be involved in the capitalization of the Insurer and would retain a significant degree of the risks and rewards from the prospects of the Insurer. These references are not meant to only relate to a mutual insurer in the most technical sense.

government or private investors[3]. A practical issue is that the Insurer would need capital prior to receiving its first premiums. Private investment may not be realistic in the current or foreseeable economic environments.[4]

Could initial capitalization be addressed through conditioning underwriting on a capital contribution?

One mechanism for providing for some or all of the initial capitalization of the Insurer would entail conditioning eligibility for a particular state's issuers' bonds being insured upon the Insurer receiving a capital contribution from that state. This capital contribution, for either business or legal reasons, might be treated as a prepayment of insurance premiums on behalf of that state's issuers which credit would be reduced over time as issuers from that state applied and qualified for municipal bond insurance.

What fiscal considerations may pertain to a federal role in the initial capitalization of the Insurer?

Municipal bonds have historically had a low default rate. This is particularly true for bonds issued for traditional governmental purposes, as opposed to certain types of private activity bonds. Consequently, if managed appropriately, the Insurer may achieve decent net earnings. A portion of the Insurer's net earnings received over time could be used to repay an initial provider of funding such as the federal government. Thus, the federal government may eventually recover most if not all of its capital.[5]

What should the geographic reach of the Insurer be?

The Insurer might be organized as a single entity that is national in scope. Another structure would involve several similar entities organized on a state-by-state basis. In the latter case, the respective entities might be completely independent of each other. A national entity should be better diversified against default risks. It may also create certain economies of scale for day-to-day operations. However, it would implicate various states' insurance regulatory

[3] It is recognized that variations in the manner in which the Insurer is capitalized may make it resemble to a lesser or greater degree a mutual insurer. In broad terms, however, this article is focusing on arrangements where the Insurer is capitalized by the public sector.

[4] Public comments from Berkshire Hathaway Inc. in 2008 provide a good discussion of certain issues faced by state and local governments and otherwise related to private bond insurance. These tend to reinforce the author's concerns over the prospects for private capital to be raised for monocline bond insurers. Were it to become realistic financially, the mixture of public and private capital would create issues about the relative positions of the parties in their claims on the earnings of the entity. Satisfying legitimate business terms sought by private investors may hinder the ability of the Insurer to achieve certain policy goals that may be in tension with a profit motive (e.g. underwriting some amount of debt of unrated fiscally distressed communities).

[5] A federal role in capitalizing the insurer would raise certain federal tax issues relating to restrictions on the ability of tax-exempt bonds to have a federal guarantee. This is one example of likely several regulatory considerations that this proposal would entail. Another obvious category of considerations is the disclosure under the securities laws related to the Insurer. Many of these issues are beyond the scope of this article, but may, at the very least, have the practical impact of affecting the time and transaction costs in the start-up process for the Insurer.

schemes and could be subject to a very complicated form of political oversight. It also raises fairness considerations which may be in tension with risk considerations. For various reasons, the best portfolio of insured bonds from a default risk perspective may not match a portfolio that is required to have issuers from every state or that is required to insure issuers in a manner proportional to population.

What types of municipal bonds should be insured?

For several reasons, it may be appropriate for the Insurer to insure a few basic types of bonds (e.g. general obligation bonds, revenue bonds such as for basic municipal services such as water and sewer revenue bonds[6]). These bond structures, in and of themselves, are relatively manageable to evaluate from a credit underwriting perspective. Relatively few and uniform types of bond covenants can be sought from these issuers. The traditional governmental functions generally financed by these bonds provide a decent argument in support of committing any public funds for the capitalization and operating costs of the Insurer.

The Insurer could for policy reasons deliberately try to insure greater amounts of bonds for certain categories of projects to promote a particular policy goal (e.g. bridge rehabilitation, energy conservation, housing, etc…). Such a decision should take cognizance of both the additional public benefits from these projects and any effect this may have on the optimal risk diversification within the Insurer's portfolio of insured bonds.

How will premiums be priced?

As a non-profit entity, the Insurer does not have to set premiums to maximize net earnings, but could take account of other policy goals. Subject to needs for capital reserves, the Insurer might price its premiums below levels that a private credit enhancer would provide. This would provide an up-front benefit to state and local government issuers. If premiums are priced at the highest levels the market will bear, then the Insurer may have higher net earnings which could be utilized for any number of purposes (e.g. building up capital reserves to enable the underwriting of slightly higher-risk credits, rebates to member governmental entities, etc…).

Under what law should the insurer be organized?

Insurance is generally regulated on a state-by-state basis. While, the choice of a particular state for organization is beyond the scope of this article, it is worth noting that differences among state insurance laws may present advantages for utilizing a particular state.[7]

[6] Revenue bonds can vary widely in their complexity. For instance, a municipally-owned water facility may have a stable operating and revenue history and might arguably be as good a credit as that municipality's GO bonds. Other revenue bonds, such as airport or solid waste revenue bonds, may involve complicated related contracts with private entities. The scope of revenue bonds which the Insurer might underwrite policies for would significantly impact credit risks and the diligence and other administrative costs of providing insurance.

[7] Given the presence of several of the bond insurers in New York, New York's well-developed body of insurance law, and the volume of issuance in New York, it would be a leading candidate for the state under which the Insurer would be organized, absent some overriding federal legislation. Although not intended to be addressed in detail in this article, one variation on the Insurer might be entail it being formed by a few states (e.g. New Jersey and Pennsylvania) but issuing policies to issuers both within those states and in other states. In such a situation, the Insurer would be functioning in quasi-public and proprietary roles.

That issue, however, presupposes that the Insurer would be under the same regulatory regime as other insurance companies. The more fundamental question then is whether the Insurer should be established pursuant to a federal charter that would remove it from the typical state by state regulatory framework. This may make sense given the number of regulatory complexities related to establishing the Insurer on a nation-wide basis. A federal charter may be a way to manage governance issues and collective action challenges of an entity that may have participation from governmental entities from numerous states. A federal charter, however, would also have to address the question of who would be the regulator(s) of the Insurer.

What considerations are raised by the expectation that the Insurer would have day-to-day operations?

Municipal bond insurers are operating companies with employees, offices and a collection of practical issues faced by various businesses. The Insurer would presumably face many of these same issues. This raises the threshold question as to whether the amount of capital committed to the Insurer might better support the municipal markets in some other way that does not entail the same operating costs. A second issue involves how streamlined should the Insurer's operations be. Generally speaking, a more streamlined and standardized approach to underwriting and investments would minimize costs. It might, however, necessitate foregoing certain opportunities-such as the ability to insure more unique credits (e.g. a multi-faceted urban economic redevelopment project with TIFs, PILOTs, etc...). Should cost-containment be pre-eminent, then presumably, some very straightforward underwriting criteria could be used (e.g. issuers who have an investment grade rating; issuers who have obtained private credit enhancement in the last x number of years; etc…). The Insurer might invest its capital in a very straightforward and conservative manner that would forego some investment returns for the sake of greater safety and simplicity.

Are there state law issues (non-insurance) that could affect the structure of the Insurer?

State and local governments must be able to transfer funds to the Insurer in a manner consistent with state law, particularly state constitutional provisions. The payment of premiums by state and local governmental entities is a payment for a purchase of a financial service (i.e. insurance) which is frequently purchased by governments and, generally, should not be problematic under state law. Should a state or local governmental participant in the Insurer be characterized under state law as a holder of a security of the Insurer, then the applicable state's permitted investment laws will come into play. Also, some states may have constitutional restrictions on the lending of credit or the ownership of a private entity which may require analysis.

How would the governing body (e.g. board of directors) of the Insurer be composed?

The composition and selection of the Insurer's governing board raises several questions. How large should it be? Who should select its composition? Should it be composed according to some formula that provides representation among the states? Should representation be based upon the proportion of policies written within the respective states? Should the composition of the board reflect its capitalization? For example, if the State of XYZ (and issuers within that

state) contributed 15% of the initial capitalization of the Insurer, should the State of XYZ be able to control 15% of the board? Similarly, if the federal government provided some capitalization, perhaps the President should appoint a certain number of directors.

What are the advantages of the Insurer being a non-profit entity?

First, the Insurer may not need to incorporate as large of a profit margin into the pricing of its premiums as would a private bond insurer and thus may be able to offer lower premiums. Second, being under less pressure to achieve high returns on the investment of its capital, the Insurer can invest more conservatively with a view toward capital preservation. Third, the Insurer will not need to lower its underwriting standards to pursue market share.

What are some criteria for evaluating such an insurance arrangement?

The Insurer would involve public sector entities functioning to some extent like private sector companies. This results in very different ways to evaluate its effectiveness. A private sector perspective would look at the Insurer's net earnings and return on capital. A public sector perspective would assess its ability to expand market access for issuers, its effect on the level of premiums in the bond insurance market, and its impact on the borrowing costs faced by issuers. According to the latter three criteria, the Insurer might be successful even when not insuring bond issues due to exerting competitive pressures on private sector credit enhancers.

What are some possible collateral consequences that may result from a Municipal Mutual Insurer?

Acknowledging that there are many unknowns with any new proposal, the following are some speculations about possible ramifications that a Municipal Mutual Insurer may have:

- It may put pressure on certain private credit enhancers and drive certain marginal providers out of the market-thereby decreasing (in some parts of the United States) the number of credit enhancers;

- It may dominate certain portions of the market (possibly GO issues) and put pressure on private credit enhancers to insure riskier or more marginal credit risks;

- It may lead to more standardization nationally in various bond practices; or

- If the Insurer requires a federal capital contribution, this may entail more federal regulatory involvement in the municipal markets.

<u>Conclusion</u>

A municipal mutual insurer is a proposal deserving of considerable time and attention. It is aimed at bolstering a vital portion of our capital markets which furthers important fundamental governmental purposes. There are, however, many complexities associated with it. Much of its ultimate effectiveness may depend on whether its basic role will be to simply fill a vacuum caused by the decline of the private municipal bond insurers (thereby acting as much as possible like a

commercial entity) or whether it would pursue broader policy goals by enhancing bonds for certain types of purposes or issuers.

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