ROCKFLEET financial services

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MUNI MARKET UPDATE

June 7, 2010

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BOND INSURANCE: PAST, PRESENT AND FUTURE

By Larry Levitz

In late 2007 and 2008, the municipal bond insurance industry imploded as a result of its substantial exposure to the collapsing housing market. The industry had guaranteed billions of dollars of mortgage-backed securities over the previous five years, leaving itself vulnerable to the unprecedented financial meltdown. During 2008, all but one of the top-rated legacy insurers lost their coveted triple A ratings – the highest rating from each of the three main rating agencies; Moody's, Standard & Poor's (S&P) and Fitch. These rating actions effectively ended their ability to write new business. This once-dominant force in the municipal marketplace, which insured about half of all municipal bonds issued between 2002 and 2007, today consists of only one active player, Assured Guaranty (Assured).

Today, municipal bond insurance is a much-diminished factor in overall bond market activity. The question arises as to whether it will ever again play a major role in the market. Have investors become accustomed to buying bonds without the insurance wrap? Is there still a need in the market for insurance? This article will

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MUNICIPAL MARKET UPDATE

Credit-default swaps on sovereign bonds surged last Friday on speculation Europe's debt crisis is worsening after Hungary said it's in a "very grave situation" because a previous administration lied about the state of the economy.

The volume of loans to foreign banks in the commercial-paper market dropped by $5.3 billion in the last week, the steepest fall since early March, according to Federal Reserve data. Participants say the drop offers further evidence that investors are shying away from lending to European banks that hold large amounts of bonds from Greece, Spain and other heavily indebted European countries.

Treasury yields fell sharply Friday as investors again" fled to quality" given the events unfolding in Europe as well as reacting to the disappointing Employment Report released by The Bureau of Labor Statistics.

Institutional municipal secondary flows remained muted as investors remained focused on the primary market (despite lower supply) for price discovery (credit spreads) and coupon structure values.

Tax exempt yields were largely unchanged across the yield spectrum last week. As measured by MMD, 5 year yields were unchanged at 1.59%, 10 year rates were 1 basis point higher at 2.81%, while 20 year and 30 year yields ended the week with a 1 basis point rise to 3.67% and a 1 basis point decline to 3.99%, respectively. ♣

THIS WEEK'S CALENDAR

Tuesday, June 8

10:45AM	3,015M	UR/UR	Mayfield CSD	NY	2011-2025	BQ
11:00AM	2,315M	UR/A	Chenango Valley CSD	NY	2011-2024	BQ
11:00AM	1,936M	UR/UR	Brockport CSD	NY	2011-2015	BQ
11;00AM	8,782M	UR/AA-	Niskayuna	NY	2011-2023	BQ
11:30AM	4,196M	UR/UR	East Irondequoit CSD	NY	2011-2015	BQ
11:45AM	6,380M	UR/UR	Heuvelton CSD	NY	2011-2025	BQ
11:00AM	4,824M	UR/UR	Hamilton Twp BOE	NJ	2012-2026	BQ
11:15AM	9,662M	UR/A+	Montclair Twp	NJ	2011-2030	BQ
12;00PM	9,390M	UR/AA-	Hunter-Tannersville CSD	NY	2011-2024	BQ

Wednesday, June 9

11:00AM	120,670M	Aa3/UR	Newark - Gen'l Impt - Series A	NJ	2015-2028	
11;15AM	5.283M	Aa3/UR	Newark - Gen'l Impt - Series B	NJ	2029-2030	
11:30AM	43,917M	Aa3/UR	Newark - Sch Bds - Series C	NJ	2016-2025	
11:45AM	5,487M	Aa3/UR	Newark - Water Utility - Series D	NJ	2011-2039	
11:00AM	3,250M	UR/AAA	Natick	MA	2011-2020	BQ
11:00AM	126,000M	UR/UR	MD Dep't of Transportation	MD	2016-2025	
12:00PM	2,185M	UR/UR	Southampton	MA	2011-2030	BQ
11:00AM	6,450M	UR/UR	Fayetteville Vlg	NY	2011-2025	BQ
11:45AM	2,596M	UR/UR	New York Mills UFSD	NY	2011-2025	BQ
11:00AM	25,400M	UR/UR	Miller Place UFSD	NY	2011-2030	
10:45AM	14,000M	UR/UR	Maryland DOT	MD	2013-2015	
11:00AM	89,190M	UR/UR	San Francisco Pub Util	CA	2011-2030	
11:15AM	312,055M	UR/UR	Denver City & Co BABs	CO	2017-2030	
12:00PM	380,280M	UR/UR	San Francisco Pub Util - TAXABLE	CA	2019-2040	
12:15PM	37,910M	UR/UR	Denver City & Co	CO	2011-2016	

Thursday, June 10

11:00AM	1,880M	UR/UR	Acton	MA	2011-2020	BQ
11:00AM	13,057M	UR/UR	Syracuse	NY	2011-2022	
10;45AM	158,595M	UR/UR	NYSDA (Municipal Health)	NY	2012-2027	
11:30AM	2,085M	UR/UR	Tupper Lake CSD	NY	2011-2025	BQ
11:00AM	8,600M	UR/UR	Essex Co College Bonds - BABs	NJ	2023-2025	
11:00AM	15,577M	UR/UR	Essex Co Coll Bonds - Series C	NJ	2011-2025	
11:00AM	1,177M	UR/UR	Essex Co Coll Bonds - Series D	NJ	2011-2025	
11:00AM	60,250M	UR/UR	Essex Co Coll Bonds - Series A	NJ	2011-2025	
11:00AM	37,550M	UR/UR	Essex Co Gen'l Impt Ser E - BABs	NJ	2023-2025	
11:00AM	3,200M	UR/UR	Essex Co - Voc Sch Bds - Series B	NJ	2011-2025	
11:00AM	3,549M	UR/AA	Burnt Hills Ballston Lake CSD	NY	2011-2024	BQ
11:00AM	7,600M	UR/UR	Bedford Hills FD	NY	2011-2030	BQ
11:00AM	4,287M	UR/UR	Clifton-Fine CSD	NY	2011-2025	BQ
11:00AM	3,066M	UR/UR	Waterford Twp	NJ		BQ
10:00AM	34,630M	UR/UR	Louisville/Jefferson Co Metro	KY	2010-2019	

Click here for calendar updates.

VISIBLE SUPPLY

The 30-day visible supply of municipal bonds totaled $12.028 billion, up $1.499 billion from the previous session, according to The Bond Buyer.

That comprises $2.797 billion of competitive bonds, which is up $84.5 million and $9.231 billion of negotiated bonds, which is up $1.414 billion.

Week of June 7, 2010

Total supply: $8.54B

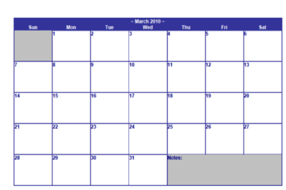
Taxable/BABs: $5.49B

Tax-Exempt: $3.05B

The 30-day visible supply is calculated by The Bond Buyer and reflects the total dollar volume of bonds to be offered at competitive bidding and through negotiation over the next 30 days.

Source: Thomson Reuters. 6/4/2010.

ECONOMIC CALENDAR



BUILD AMERICA BONDS UPDATE: IRS AUDITS

In last week's newsletter, we reported that the IRS indicated it plans to audit 1 in every 2 BABs transactions to ensure compliance. This week, Steven Miller, deputy commissioner for services and enforcement, said in an interview with the Bond Buyer stated that there is no percentage targeted.

Also reported in the Bond Buyer, municipal issuers and their bond lawyers are discussing whether the IRS' compliance push on BABs Bonds will deter issuers from issuing the bonds in the future. Also under consideration is modifying the provisions of the bond purchase agreement in negotiated sales to permit the issuer to terminate the deal if it discovers the underwriter did not publicly offer all of the bonds at the initial offering price. ♣

BOND INSURANCE: PAST, PRESENT AND FUTURE (CONT'D)

explore these questions with a brief review of the history of bond insurance – how it works and the benefits it brings to issuers and investors. We will conclude by examining today's municipal market and exploring those factors that undermine and support the prospects of a revitalized bond insurance presence.

Beginnings and Growth

Bond insurance was created in 1971 with the formation of American Municipal Bond Assurance Corporation (AMBAC) by MGIC Investment Corporation, a Wisconsin-based mortgage insurance firm.

At the time of formation, AMBAC officials pointed out that only about one in four bond issues had an investment grade rating. This presented a problem for many municipal issuers trying to sell their bonds. As AMBAC President, Frank Carr noted, "the lack of a rating handicaps the issuer in obtaining the most favorable terms of the sale and the investor who finds it necessary to sell his bonds in the secondary market before they mature". AMBAC insurance could help the multitude of locally known issuers, especially those without ratings, more effectively market their bonds.

At launch, AMBAC received a AA rating from S&P and it insured its first bond issue that year, a $650,000 general obligation bond for a medical arts building and sewerage treatment facility in Greater Juneau, Alaska.

A consortium of property and casualty insurance companies formed MBIA (Municipal Bond Insurance Association) in 1973. In 1974, MBIA was the first bond insurer to receive a AAA-rating, this from S&P. The AAA rating was based on the rating agency's assessment of the insurer's financial strength and claims-paying ability. Rating factors include available capital, quality of the insured portfolio, risk management policies, and business viability. Once an insurer was assigned AAA, every bond that they insured was rated AAA as well.

Both insurers focused almost exclusively on public finance. In 1989, New York State passed a law prohibiting insurance companies that sell multiple lines of business from providing bond insurance. From then on, monoline insurers would run the industry, i.e., firms that concentrate only on financial guaranty insurance and do not participate in other insurance lines of business.

Other insurers gradually entered the market:

- FGIC (1983)
- Financial Security Assurance (FSA) (1985)
- XL Capital Assurance (now Syncora) (2000)
- CIFG (2001)
- Assured Guaranty (2007 – received third AAA)

By 2007 all of these insurers were rated AAA by all three major rating agencies, Moody's, S&P and Fitch. Despite similar ratings, insured bonds of XL Capital and CIFG did not trade as well as those of the four more established insurers: MBIA, AMBAC, FGIC and FSA. This was due to their smaller size and lower name recognition. To compete with the four better-known insurers, XL Capital and CIFG would charge lower premiums to compensate for their trading differentials or insure issues which were passed over by the other insurers.

Assured Guaranty received its third of three AAA ratings in July 2007, adding a seventh triple "AAA" competitor to the landscape. Assured had been the last insurer to

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BOND INSURANCE: PAST, PRESENT AND FUTURE (CONT'D)

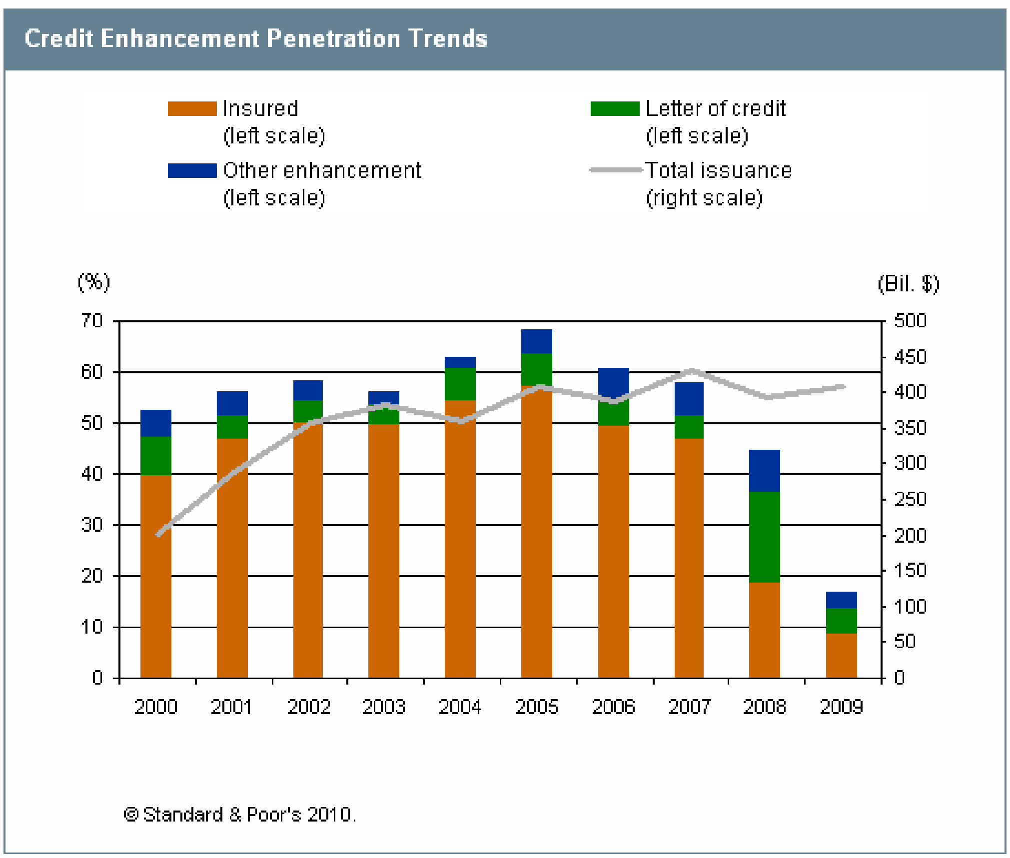
join the triple AAA club, receiving its third AAA rating in mid-2007, just before the onset of the financial crisis. Because Assured had entered the AAA club so late, it had fewer opportunities to load up on toxic securities than did the other insurers. For this reason, Assured has been able to retain relatively high ratings – AAA by S&P and Aa3 by Moody's.

Nonetheless, Assured's exposure to residential mortgage backed securities (RMBS), while less than the other insurers, is still significant, and was expanded through its acquisition of FSA in 2009. Potential losses in this sector remain a concern. Both rating agencies have placed negative outlooks on their ratings of Assured, which increases the likelihood that Assured's ratings could drop again in the near future.

As the only remaining insurer actively writing new policies, Assured managed to insure just 8.6% of all bonds issued in 2009. First quarter results for 2010 reveal a further drop in market penetration to 6.3%.

The bond insurance industry was lifted over the years by a number of timely bond market crises or defaults including the New York City financial crisis in 1975, Washington Public Power Supply System (WPPSS) default in 1983, and the Orange County, California bankruptcy in 1994. These events served to remind investors that risk was present in the municipal market.

As shown in the chart below, the bond insurance industry's market penetration grew from about 3% in 1980 to over 50% in 1998. In 2005, municipal bond insurers combined to insure 57% or over $200 billion of total bonds issued, the peak year of penetration.



Source: Standard & Poor's | RatingsDirect on the Global Credit Portal | January 20, 2010

The Grand Demise

Until the mid 1990s, the bond insurers focused primarily on the lower-risk public finance sector. With the preponderance of bond insurers competing against each other in a mature municipal market, insurers began to look outside of public finance to maintain long-term revenue growth. Almost all of the insurers in the late 1990s branched out into the more lucrative structured finance sector, insuring billions of dollars of issues backed by mortgage payments, credit card receivables, auto loans, and the like.

By 2007, the financial guaranty industry had insured over $1 trillion of asset-backed securities, including over $200 billion of RMBS and securities backed by home equity loans.

With the collapse of the U.S. mortgage market beginning in 2007, the insurers' huge exposures to these sectors and continuing losses resulted in a domino-like series of ratings downgrades that decimated the industry. Today, Assured Guaranty

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BOND INSURANCE: PAST, PRESENT AND FUTURE (CONT'D)

is the only remaining highly rated bond insurer from the group of seven and the only one still active in the market.

Berkshire Hathaway Assurance Corporation (BHAC) was formed in late 2007 to pursue opportunities, which opened up in the municipal insurance market when other insurers tumbled.

In 2008, BHAC insured $3.3 billion of new issue municipal bonds, accounting for almost 5% of the insured market. BHAC was an even larger player in the secondary markets, insuring over $15 billion that year, mostly on top of issues previously insured by the now-troubled legacy insurers.

BHAC began to pull back from the insurance market in early 2009. Berkshire Chairman Warren Buffett claimed, "We basically don't like the pricing" and added, "If you have the wrong pricing, you can lose a lot of money." Also in early 2009, BHAC lost its Moody's AAA and was put on negative outlook by S&P. S&P and Fitch subsequently downgraded BHAC into the AA category. Currently, BHAC remains inactive in the insurance market and it is unclear what direction it will take. ♣

Next week: the bond industry today and in the future.

The Fundamentals of Bond Insurance

Bond insurance provides investors with a guarantee of full payment of principal and interest on their bonds should there be a default. Premiums for insurance are usually paid upfront at the time the bond issue closes by either the issuer or investors. The premium amount is generally based on a percentage of total debt service costs expressed in basis points of 1/100th of one percent. The size of the premium generally varies inversely with the bond's underlying credit. Other determining factors include insurer internal rates of return, capital requirements, and competitive bids from other insurers.

While bond insurance offers investors protection against default, the insurers' AAA ratings afford important benefits to the issuers. The gilt-edge ratings that were previously conferred on insured bonds helped issuers fetch higher prices for their bonds enabling them to lower their interest costs. Bond insurance made economic sense if the cost of the premium was less than the savings to the issuer as a result of using bond insurance. Issuers would estimate the yield spread, i.e. the bond costs with insurance versus their costs on the same bonds if issued on their own rating without bond insurance. The wider the yield spread, the greater the value of bond insurance. The estimated yield spread was used by insurers to calculate their premium rates and by issuers and their advisors as the basis from which to evaluate the benefits of insurance. When the insurers ran into trouble in 2007 and their ability to maintain their AAA ratings was called into question, yield spreads quickly narrowed, limiting and then eliminating their ability to write new business.

Besides protection against default for investors and lower costs for issuers, bond insurance provided other important benefits to the market. Its AAA stamp on every insured issue homogenized credit, enabling numerous smaller, and lesser-known issuers to access the municipal market. Complicated bond issues were much easier to sell with the insurance guaranty. Bond insurance enhanced market liquidity, by facilitating secondary market trading. Bond insurers filled the role of 'credit cop', insuring only those credits which demonstrated an ability to pay debt service, negotiating stronger credit structures and bond covenants, and providing ongoing surveillance and remediation on troubled credits.

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