ROCKFLEET financial services

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MUNI MARKET UPDATE

June 14, 2010

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BOND INSURANCE:PAST, PRESENT AND FUTURE-PART II

By Larry Levitz

Last week, our review of bond insurance looked at the history of this industry. This week, we look at the current state and likely future of bond insurance.

The Bond Insurance Industry Today

The municipal bond landscape looks very different today from three years ago. FGIC, CIFG and Syncora (XL) have had their ratings withdrawn or are rated well-below investment grade making it unlikely that they will fully operate again.

Assured is the only insurer regularly providing bond insurance, although there are problems with its structured finance book of business. These concerns led Moody's recently to downgrade Assured's rating to Aa3 from AAA.

MBIA and AMBAC have proposed forming new bond insurance ventures. MBIA created a new subsidiary, National Public Finance Guarantee Corporation (National) to operate as a public finance-only insurer. However, MBIA is involved in litigation regarding its transfer of capital to National. Until the litigation is resolved, National will have to wait on the sidelines.

AMBAC's position is so precarious that the insurance

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MUNICIPAL MARKET UPDATE

The European Central Bank extended its cash lifeline for banks last Thursday and urged national euro zone regulators to take steps to resuscitate confidence in the health of their financial institutions. These steps were taken to address the ongoing fears among European banks in regards to their respective creditworthiness which has caused them to cut back lending to each other.

Household ownership of municipal bonds moved over the $ 1 trillion mark for the first time. This amount represents roughly 35% of the$ 2.8 trillion in outstanding debt through the end of the quarter that ended March 31, 2010.

According to new Federal Reserve data released last Thursday, foreign investors held $ 71.9 billion of municipal debt which represents their largest-ever presence in the market. This gain in ownership is a direct result of participation in the issuance of taxable Build America Bonds.

Tax exempt yields rose across the yield spectrum last week due in part to a "rate protest" by some investors given the low nominal yield environment. As measured by MMD's AAA scale, 5 year yields rose 3 basis points to 1.62 %, 10 year rates were 12 basis points higher at 2.93%, while 20 year and 30 year yields ended the week with rates rising 6 basis points to 3.73% and 5 basis points to 4.04%, respectively. ♣

THIS WEEK'S CALENDAR

E.D.T.	Amount	Ratings	Issuer	State	Structure	
Monday, June 14						
11:15AM	20,230M	UR/UR	Conewago Valley Sch Dist	PA	2011-2022	BQ
12:00PM	17,030M	UR/UR	Pocantico Hills CSD	NY	2011-2030	BQ
11:00AM	2,557M	UR/UR	T/O Ayer	MA	2011-2023	BQ
Tuesday, June 15						
10:30AM	1,247M	UR/UIR	Eastchester UFSD	NY		BQ
	66.986M	A3/NR	C/O Trenton	NJ		
10:45AM			$58,813M - Various Purposes		2011-2040	
11:45AM			$8,173M - School Bonds		2011-2036	
11:00AM	2,065M	UR/UR	C/O Attleboro	MA	2011-2025	BQ
11:00AM	2,353M	UR/UR	Camden Co	NJ	2011-2020	BQ
11:00AM	31,300M	UR/UR	Toms River Twp	NJ	2011-2020	BQ
11:15AM	11,800M	UR/UR	T/O Hammonton BOE	NJ	2011-2030	BQ
11:15AM	1,350M	UR/UR	Mt Pleasant CSD	NY	2011-2025	BQ
12:00PM	3,139M	UR/UR	C/O Rensselaer	NY	2011-2025	BQ
	66,986M	Aa1/AA+	Onondaga Co	NY		
10:30AM			$48,720M - T/E or TAXABLE		2012-2026	
11:30AM			$4,905M - TAXABLE		2011-2036	
11:00AM	2,353M	UR/UR	Burlington Co	NJ	2011-2020	BQ
11:00AM	11,650M	UR/UR	Sayville UFSD	NY	2011-2029	BQ
Wednesday, June 16						
11:00AM	44,168M	UR/AA+	T/O Brookhaven	NY	2011-2027	
11:00AM	14,243M	UR/UR	T/O Chelmsford	MA		BQ
			$9,903M - Series A		2011-2030	
			$4,340M - Series B - RFDG		2011-2021	
11:00AM	4,365M	UR/UR	C/O Englewood	NJ	2011-2030	BQ
11:00AM	16,045M	UR/UR	C/O Long Beach	NY	2011-2030	BQ
	95,340M	UR/UR	Nassau Co	NY		
11:00AM			$7,675M - Series A		2012-2015	
11:30AM			$87,665M - Series B (T/E or BABs)		2016-2037	
11:00AM	2,166M	UR/UR	C/O Rochester,NY - TAXABLE	NY	2011-2015	
11:00AM	1,539M	UR/UR	C/O Saratoga Springs	NY	2011-2037	BQ
11:15AM	14,990M	UR/UR	Franklin Twp	NJ	2011-2020	BQ
11:30AM	65,000M	Aa2/AAA	C/O Virginia Beach - BABs	VA	2011-2035	
Thursday, June 17						
11:00AM	2,675M	UR/UR	T/O Eastchester	NY	2010-2018	BQ
11:00AM	7,665M	UR/UR	C/O Jamestown	NY	2011-2030	BQ
11:15AM	8,720M	UR/UR	Council Rock SD	PA	2011-2027	BQ
11:30AM	6,788M	UR/AA	Passaic Valley RSD #1	NJ	2012-2024	BQ
12:30PM	22,770M	Aa2/AAA	C/O Virginia	VA	2010-2027	

Click here for calendar updates.

VISIBLE SUPPLY

The 30-day visible supply of municipal bonds totaled 8.896 billion, down $411.0 million from the previous session, according to The Bond Buyer.

That comprises $1.598 billion of competitive bonds, which is down $386.0 million and $7.297 billion of negotiated bonds, which is down $25.0 million.

Week of June 14, 2010

Total supply: $5.72B

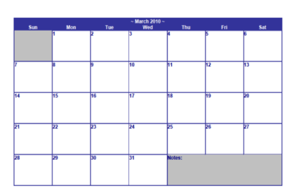
Taxable/BABs: $1.54B

Tax-Exempt: $4.18B

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. 6/11/2010.

ECONOMIC CALENDAR



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

regulator of Wisconsin, where it is based, recently seized the troubled structured finance portion of its business. The firm has been teetering on bankruptcy.

There are a number of efforts to start new public finance-only bond insurers. The Macquarie Group of Australia has formed the Municipal and Infrastructure Assurance Group (MIAC) to compete with Assured. However MIAC has had trouble securing the necessary capital to commence operations.

Another start-up bond insurer, BondModel, now BondFactor, was formed in late 2009 but has yet to attain any traction.

There have also been some innovative proposals to provide bond insurance. The National League of Cities, a non-profit association of cities has presented a plan to form a non-profit, issuer-run mutual municipal bond insurance firm. Supporters continue to seek funds from the federal government to capitalize operations, but there has been no federal support to date. Several other ideas have been floated for new bond insurance capacity but to no avail.

Despite the opportunities that prospective insurers see in this market, recent history and ongoing market developments may hamper their efforts. The demise of the bond insurers is still a fresh memory for issuers and investors alike. Issuers of insured auction rate or variable rate debt were particularly burned from the collapse of the insurers, as many were forced to restructure their debt or face higher costs. Investors who paid a premium for the safety and comfort of owning insured bonds saw the value on their insured investments drop solely because of the insurance. While the insurance industry was not responsible for all of the losses experienced by municipalities and investors during this period, the decline of the insurers played a central role in the drama.

The move by the rating agencies to global scale ratings will also narrow the universe of issuers requiring insurance. For years, the rating agencies had rated municipal bonds and corporate bonds on different scales. Ratings for bonds in each sector were based on credit relative to other bonds within that sector. Municipal officials have complained that this system has led to lower municipal bond ratings and higher bond costs. Default rates for municipal securities are many times lower than default rates for similarly rated corporate securities. A single global ratings scale would recognize these differences, leading to higher ratings for most municipal bonds. With Congress poised to make global ratings scale mandatory, rating agencies have acted quickly to adopt them. The result has been to push thousands of municipal ratings upward, many into the AA and AAA rating categories. Because the higher rated bonds should trade better, they should have less need for bond insurance.

Given recent experience in the industry, it is highly unlikely that any of the new bond insurers will secure multiple AAA ratings when launched. Top rated start-ups will work with ratings in the AA-category.

Between 2004 and 2007, 40% of public finance bonds insured by then-AAA rated MBIA were rated AA. Those bonds and others, which will have migrated into the top rating categories due to the global scale ratings conversion, would not be candidates for insurance.

Perhaps one of the biggest obstacles for bond insurers is the loss of investor confidence in the bond insurance model. The decisions taken by bond insurers to move outside their traditional public finance realm into structured products can be rationalized. The extent to which they did, putting their franchises at risk to unforeseen tail events, cannot. This has left many market participants disillusioned with the industry. Any new insurer will have to build a reputation of probity and adherence to strong underwriting principles over time.

Despite the challenges, the municipal market presents some real opportunities for bond insurers. Most state and local governments are struggling with falling revenues, high levels of expenditures, and formidable budget deficits. These problems are likely to worsen with the end of Stimulus funding this year, depletion of rainy day reserve funds, and sizable fixed obligations. As investors grow increasingly concerned about governmental credit, the value of bond insurance should expand.

In addition, there are many issuers in the A and BBB rated categories that have had trouble accessing the market since the financial crisis began in 2008. It has been estimated that these issuers could comprise about a quarter of the total mar-

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

ket that could benefit from insurance. While the insurers must be careful not to insure a disproportionate amount of lower rated bonds, the A-rated issues may just be the "sweet-spot" where a new insurer can build a portfolio.

With the current monopoly in the insurance market, some institutional investors may be reaching their exposure limits to Assured, creating opportunities for new entrants. Credit spreads, especially in A and BBB categories, are robust and other enhancement options such as bank letters of credit are less available and much more expensive than three years ago.

The Future of Bond Insurance

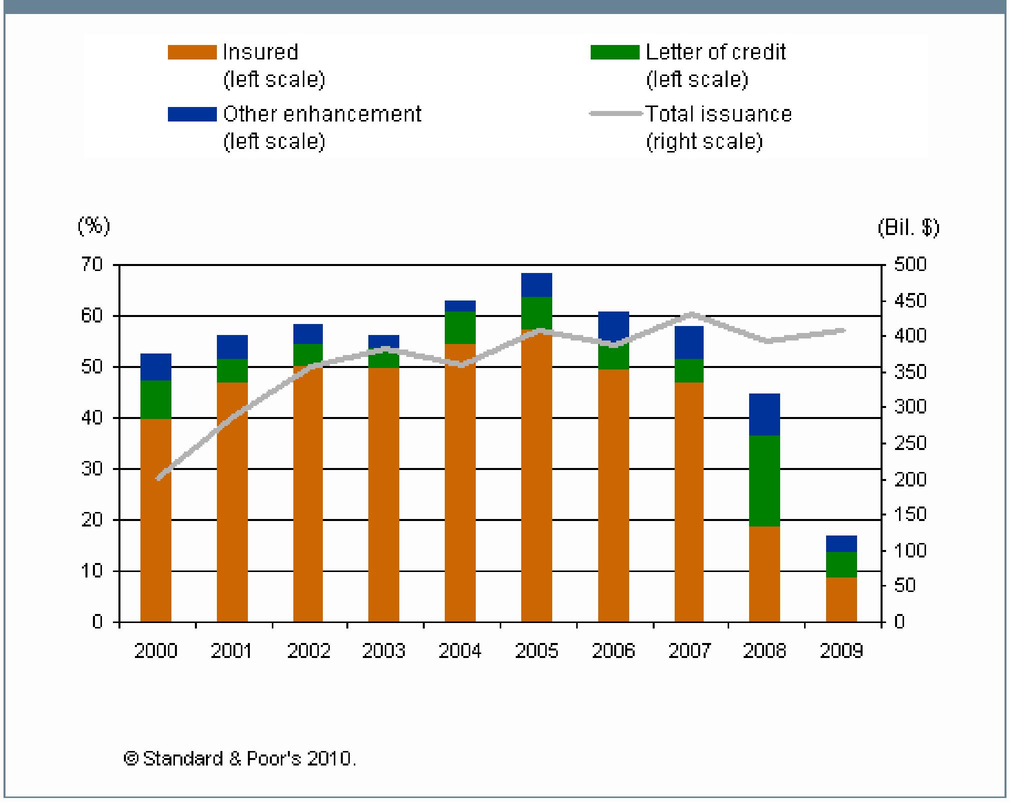
For the last three years, the municipal bond industry has undergone what can only be described as a near death experience. Perhaps more than any other industry, and taking into account banking and autos, the municipal bond insurance sector has been utterly devastated by the Great Recession (see chart to the left). Most of the industry players have either disappeared or are now in run-off mode. Municipal bond insurance firms have lost their AAA ratings, their financial strength, and their credibility. Many institutional investors see little value in bond insurance.

However, it is important to reflect back to the roots of bond insurance. Nearly 40 years ago in Wisconsin, AMBAC founders identified a need in the marketplace. Lesser-known creditworthy issuers were having difficulty selling their bonds and bond insurance could help them. Investors would be more apt to buy these bonds if they were protected from default. These same conditions exist today.

There are a great number of issuers rated in the A and BBB rating categories who can only sell their bonds at above market interest rates if they can sell them at all. These issuers may represent about 15% to 20% of all bond issues. It is this segment of the market that Assured is targeting. A 20% market penetration rate at current issuance volumes represent approximately $80 billion of insured par.

The skyrocketing BABs market presents another potential opportunity for bond insurers, although BABs issues so far have generally sold without insurance. BABs, or Build America Bonds, were a creation of the Stimulus Act whereby municipal issuers sell taxable bonds and the federal government reimburses the issuers for 35% of their regular interest payments. (See "The Allure of BABs" for more information.) To the issuer, the interest payment net of the subsidy is close to or less than the interest payment they would make on their tax-exempt debt. BABs have proven to be extremely popular with issuers and now constitute a significant portion of market volume. Over $100 billion

Credit Enhancement Penetration Trends



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

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

have been issued to date. Buyers include non-traditional investors in the municipal bond sphere such as foreign investors, pension funds, life insurance companies, etc. Very few BABs carry bond insurance to date because the BABs issuers have tended to be highly rated, large, well-known state and local entities. However, as lower-rated issuers enter the BABs market, the demand for bond insurance from these new, less knowledgeable municipal investors should grow.

Near term, bond insurance should continue to be a relatively minor factor in municipal bond sphere. However, bond insurance activity historically jumps after a default or crisis with a major issuer, especially highly rated ones, when investors actually experience losses. These events periodically rock the market and there is nothing to suggest that it won't happen again. When it does, and it may take some years to occur, insurance penetration could leapfrog to the 35% to 40% range. This prediction is higher than those of most other analysts. However, the bond market is cyclical and a 40% bond insurance penetration rate is still well below the 50% and above insured penetration rates of the mid-2000s.

Bond insurance was created to fill a market need that many at that time did not fully understand. Those needs still exist and bond insurance will have a significant role meeting them 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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