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U.S. Municipal Bankruptcies May Cause Bond Insurers To Change Up Their Game Plans

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Table Of Contents

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Recent municipal bankruptcy filings and payment defaults have caused investors to worry about the municipal debt market, and such credit uncertainties are now commonplace--especially in light of ongoing court proceedings and speculation about potential future filings. While the outcomes of these bankruptcies will likely be precedent-setting, Standard & Poor's Ratings Services does not believe they are representative of widespread municipal stress. Though bond insurers are likely to incorporate lessons learned into their underwriting guidelines, we believe they have sufficient capital to withstand the potential stress of their legacy books. We don't currently expect rating migration within the legacy bond insurers' U.S. public finance portfolios or actual defaults that would result in any rating actions on the bond insurers.

Overview

- Recent defaults are not widespread and the public finance sector remains stable overall.
- Bond insurers are well capitalized and continue to actively participate in restructuring negotiations and court proceedings with obligors.
- Bond insurers may alter their underwriting guidelines and new business writings based on lessons learned.
- We don't currently expect rating migration within the legacy bond insurers' U.S. public finance portfolios or actual defaults that would result in any rating actions on the bond insurers.

Bond Insurers' Capital Is Sufficient To Withstand Stress

If municipalities default on payments, investors holding insured bonds would be made whole by the "unconditional" and "irrevocable" guarantees that bond insurers provide. When the city of Detroit defaulted on its bond payment on Oct. 1, 2013, bond insurers Assured Guaranty Ltd. (Assured) and National Public Finance Guarantee Corp. (National) both provided payments to investors when payment was due. While municipal bankruptcy filings and potential payment defaults may test the bond insurers' capital, we believe they have sufficient capital cushions to withstand the resultant stress and maintain the ratings at the current level.

In June 2013, we affirmed our financial strength ratings on Assured at 'AA-' and on National at 'A'. One factor supporting the ratings is the companies' extremely strong capital adequacy, with a capital adequacy ratio in excess of 1.00x. Our capital adequacy analysis incorporates claims reflecting theoretical losses in a 'AAA' stress environment. The capital charges we assign to all insured transactions reflect this level of stress loss estimates based on the ratings of the underlying transactions.

The transition history of our ratings on distressed municipalities reflect the lengthy nature of bankruptcy proceedings, including deterioration in municipal finances, bankruptcy filings, and potential payment defaults (see table 1). We incorporate these rating changes in the capital charges we assess to bond insurers--which are relatively high for speculative-grade entities versus their investment-grade peers. By the time municipalities filed for bankruptcy protection, our ratings had fallen well into the speculative-grade range. Periodically, we will also perform sensitivity analyses following the occurrence of major events with possible credit implications. Based on our year-end 2012 capital analysis, Assured had a capital adequacy cushion of $450 million-$500 million and National had $350 million-$400 million (see table 2).

Table 1

City of Detroit General Obligation Bonds -- Select Rating History

Rating date	Rating
Oct. 2, 2013	D
July 18, 2013	C/Negative
June 14, 2013	CC/Negative
June 12, 2013	CCC-/Negative
March 15, 2013	B/Stable
March 27, 2012	B/Negative
Jan. 7, 2009	BB/Stable

Table 2

Bond Insurers -- Capital Statistics

	--Year ended Dec. 31, 2012--	
(Mil. $)	Assured Guaranty Ltd.	National Public Finance Guarantee Corp.
Portfolio risk		
Municipal insurance weighted average capital charge (% of average annual debt service)	14.7	16.4
Model capital inputs		
Statutory capital	5,944	3,248
Contingent capital	400	--
Excess of loss reinsurance	435	--
Unearned premiums	3,833	2,041
Loss reserves	512	(109)
Present value of installment premiums	1,005	217
Capital adequacy		
Capital remaining at end of depression test	450-500	350-400
Capital adequacy ratio (x)	>1.00	>1.00

As part of our rating analysis, we incorporate a largest-obligors test (LOT) to assess bond insurers' capital and credit stability in the event of occasional large discrete defaults by individual obligors. As of year-end 2012, both Assured and National had a number of LOT violations, which directly weakens our capital adequacy scores on them. Our analysis reflects the possibility that a small number of large exposures (relative to insurers' statutory capital) could threaten their financial risk profiles due to ratings migration or actual defaults.

Case Studies: The Issues Surrounding Municipal Bankruptcies And Bond Insurers' Executed Control Rights

While our capital charges represent losses of 'AAA' severity, they also reflect an assumption of relatively high recoveries. In his 1971 study, "The Postwar Quality of State and Local Debt," published by National Bureau of Economic Research Inc., financial analyst George H. Hempel shows that recoveries on defaulted municipal bonds were high following the Great Depression. Our capital charges assume recoveries better than those Hempel reported because of the value of insurers' control rights, loss mitigation efforts, enterprise risk management strategies, underwriting, and active surveillance of insured portfolios. Bond insurers have demonstrated the effectiveness of these measures with recovery rates on defaulted issuers that are generally higher than those in Hempel's study.

Before potential defaults or bankruptcy filings, bond insurers monitor the financial condition of municipalities and offer advice on how the municipality can restructure its debt, control expenses, or maximize revenues. As representatives of large groups of creditors (the bondholders) before defaults, and as creditors after defaults, bond insurers directly partake in restructuring plans and negotiations. Municipalities can come to an agreement more easily and efficiently when dealing directly with the bond insurers, as opposed to individual bondholders of uninsured debt obligations. When necessary, bond insurers may take legal action, particularly in precedent-setting cases. At bankruptcy exits, a bond insurer may assist the municipality's debt restructuring by providing credit enhancement on future bonds.

In the past, we've seen ample evidence of these loss mitigation efforts. As current bankruptcy cases develop and set new legal precedents, we may need to evaluate the validity of our recovery assumptions based on the actual success of bond insurers' remediation efforts. To do so, we consider each bankruptcy case individually, as well as the issues it raises for bond insurer recoveries.

Table 3

Recent Municipal Bankruptcy Filings And Developments

Entity	Year filed	Developments
Vallejo, Calif.	2008	Two years since exited bankruptcy
Central Falls, R.I.	2011	Constructed debt reorganization plan and exited bankruptcy
Harrisburg, Pa.	N/A	Under receivership; Pa. law made city ineligible for bankruptcy
Jefferson County, Ala.	2011	Exited bankruptcy in December 2013
San Bernardino, Calif.	2012	Granted eligibility for bankruptcy protection
Stockton, Calif.	2012	Granted eligibility for bankruptcy protection
Detroit, Mich.	2013	Granted eligibility for bankruptcy protection

Vallejo, Calif.

It's been more than two years since the city of Vallejo, Calif., exited bankruptcy, and the current economic condition of the city provides a good case study of the impact of restructuring after a municipal bankruptcy. Vallejo's troubles resulted from the economic and housing market downturn, coupled with multiyear labor contracts with formula-based pay raises. Vallejo's situation has raised the issue of whether municipal bondholders, and by extension bond insurers, or current and retired employees would incur the most losses in restructuring--an issue still prevalent across the country and for which no identical outcomes have emerged. A potential legal battle with the California Public

Employees' Retirement System (CalPERS) deterred the city from reducing pension costs and, instead, the cuts hit retiree health benefits and bondholder payments. National was, however, able to secure a deal whereby the city resumed making its property lease payments and the insurer recovered all amounts it had paid investors, with interest, albeit over an extended period. Further, in the event of a subsequent payment default by the city, vehicle-license fees are available to pay investors without interruption.

Central Falls, R.I.

In stark contrast with Vallejo, Central Falls, R.I., emerged from bankruptcy with a plan that fully repaid bondholders while cutting pension payments. The state passed a law that explicitly protected bondholders by providing a lien on property taxes. As this case illustrates, there is no consistent approach to creditor protection, rather, each state has its own laws and legislative intervention. Different governments have different priorities: for some, it's retaining their workforce and standing by existing pension plans, while for others, like it was for Central Falls, it's preventing a bond default that may have more severe consequences.

Harrisburg, Pa.

Unlike Vallejo, Harrisburg's woes stem from debt incurred for the failed expansion of a waste-to-energy incinerator. A Pennsylvania law made the city ineligible for Chapter 9 bankruptcy. The case of Harrisburg raises the issue of eligibility: Before a city can benefit from the restructuring a bankruptcy affords, it must demonstrate that it's permitted to do so under state law, that it's insolvent, and that it has tried to negotiate in good faith with creditors. As part of Harrisburg's current restructuring plan, the incinerator will be sold, and financing for the city parking system will come from new bonds issued through a state economic development agency. Assured is insuring a portion of the parking system transaction, which will carry the same rating as that on the bond insurer, and the company will receive payments from both the sale of the incinerator and from the parking system.

Jefferson County, Ala.

Once the largest U.S. municipal bankruptcy, Jefferson Co., Ala., has closed on $1.8 billion in sewer-refinancing warrants as part of its plan to emerge from bankruptcy, a portion of which will be secured by a senior exclusive lien on gross revenues and insured by Assured. Troubled by the financing of a massive sewer renovation project, the county was able to make partial payment for its obligations after receiving concessions from sewer fund creditors, including a significant portion from JP Morgan Chase and smaller concessions from the bond insurers, hedge funds, and liquidity banks. This case is one where bond insurers, as credit enhancers, can provide a bankrupt municipality with access to the capital market.

Stockton and San Bernardino, Calif.

In our view, declining revenues related to the Great Recession and the housing downturn contributed to San Bernardino's and Stockton's financial distress, but we also believe that both cities had distinct challenges relative to other California cities in the timely monitoring of their true financial positions and in reducing expenditures. The cities have diverged in their management of pension payments during the past two years, with San Bernardino temporarily halting payments to the state pension manager, CalPERS, while Stockton has, to date, made its full CalPERS payments. CalPERS has argued in both cities' bankruptcy cases that pension payments should not be affected by bankruptcy, while bond insurers argue that pension payments do not hold priority over all other creditors. Part of Stockton's plan of adjustment is a voter-approved sales-tax increase to generate additional revenues, and while payments to Assured will be deferred, Assured will receive a share of the city's future revenue growth and will receive title to its office building.

Detroit, Mich.

Of all these municipal bankruptcies, Detroit's case stands out; the city is seeking to cut both retirement benefits and payments to general obligation bondholders. Retirement benefit cuts are at odds with protections under the Michigan state constitution. The federal judge's recent ruling, however, suggests that the city may try to reduce employee retirement benefits in federal bankruptcy. Never before has the payment of a general obligation been contemplated as on par with a pension obligation.

As these cases show, municipalities have varying ways of dealing with bankruptcies. While the process can be lengthy and expensive, it is often the only option left for some municipalities. If a growing number of bankruptcy exit plans involve significant, and permanent, haircuts to bond payments, we may adjust our recovery assumptions. Currently, we do not see enough evidence to consider making any changes in our recovery assumptions.

U.S. Public Finance Sector And Nationwide Bankruptcies

In 2012, 11 of the U.S. public finance (USPF) issues we rate defaulted--a relatively low number. We believe the municipalities we rate have shown significant credit stability over time and that the distribution of our ratings has remained relatively stable despite the economic stress from the Great Recession (see "2012 U.S. Public Finance Defaults And Rating Transition Data: Defaults Increase, But The Sector Remains Stable Overall," published March 28, 2013, on RatingsDirect).

We believe that U.S. municipal bankruptcies will remain unlikely to occur outside a very small minority of the obligors we rate because of the financial, reputational, and economic effects that come with bankruptcy. We note that, if municipalities are able to emerge from bankruptcy with significantly lower long-term fixed costs, other troubled local governments may decide to risk the fiscal and economic damage that often accompanies bankruptcy (see "Stockton, CA's Bankruptcy Eligibility May Influence Local Government Management Decisions," April 8, 2013). Still, we believe significant deterrents to bankruptcy exist (such as the stigma such actions continue to carry), that it may take years for a municipality to restore market access, and that a considerable share of a local government's tax revenue typically will go to pay for the legal and advisory costs of bankruptcy proceedings (see "Municipal Bankruptcy: Standard & Poor's Approach And Viewpoint," Oct. 4, 2012).

With regard to the municipal bankruptcies in California, we expect to see a bifurcation of credit quality among the different cities. Though most have made difficult budget adjustments and preserved their credit quality, for a few, the slow economic recovery and intractable expenditure commitments have been impediments to maintaining fiscal balance. However, we believe that overall local governments have been quite resilient (see "Ratings On Most California Cities Likely Hit Bottom In 2012," Jan. 29, 2013).

Navigating The Road Ahead: Bond Insurers' Lessons Learned

Though we believe that the overall USPF sector remains stable, ongoing developments related to municipal bankruptcies require an evaluation of lessons learned. While it may be too early to form final conclusions from these Chapter 9 proceedings, bond insurers' underwriting guidelines will likely incorporate some key takeaways.

In our discussions with the bond insurers, they have indicated that when performing credit due diligence, as a first line of defense, they now use additional considerations based on their experience with bankrupt municipalities. One such consideration is whether or not the locality has large underfunded pension and other post-employment benefit liabilities, since this could not only lead to severe financial stress for the municipality, but may also cause bondholders to compete for payment priority in a bankruptcy. Another consideration is rapid municipal growth (and the subsequent boosts in wages and benefits), which may not be supportable in potential future economic downturns. Finally, bond insurers may demand improved financial disclosures by municipalities.

Bond insurers place a greater emphasis now on legal due diligence. When choosing to wrap an issue, bond insurers may consider whether the state where the municipal issuer resides has restrictions on filing for bankruptcy and if there are any laws or statutory liens securing bond repayments, as well as examine the state's track record in overseeing its local governments and its ability to intervene if necessary.

Bond insurers may also look for certain structural characteristics of obligations that they believe will fare better in bankruptcy proceedings. For example, voter-approved general obligation bonds may provide safeguards in the form of restricted funds allocated to debt payment. Issuers may also prioritize payments to bondholders whose debt is associated with essential properties. Lastly, insurers may look to explicitly spell out pledges and liens in bond documents.

Notwithstanding the significant demand from market participants for clarification of the federal bankruptcy law, a consistent approach to municipal bankruptcy may never emerge. Laws and creditor prioritization may continue to vary greatly from state to state. Just as there may be pockets of municipal stress nationwide, so too may certain local governments and exposures be "off limits" to bond insurers.