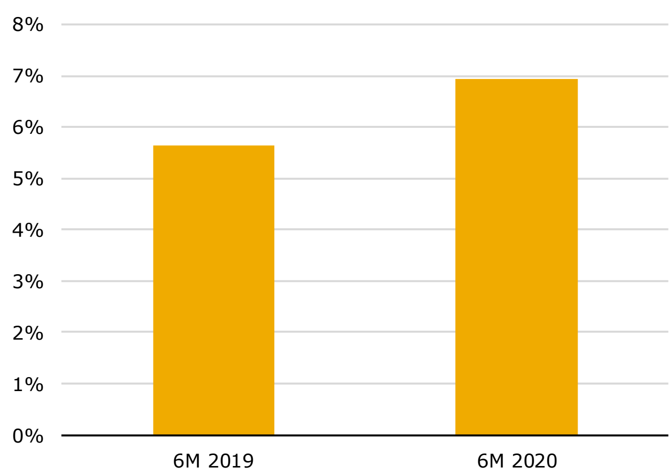
Coronavirus (COVID-19): Pandemic Fears Spur Market Demand for Bond Insurance

Financial Guaranty | Research

The COVID-19 pandemic has overturned global markets and impacted multiple bond sectors. One of the pandemic's many knock-on effects is a shift in investor appetite for insured debt. Kroll Bond Rating Agency (KBRA) notes the following market changes in the demand for bond insurance:

- Bond insurance penetration spiked sharply higher (nearly 7%) in the first half of 2020 (1H 2020), a level not seen since the global financial crisis (GFC).
- That said, KBRA notes that insured penetration remains well below historical highs of over 50%, with a return to that level as unrealistic.
- The root causes of the rise in demand are widening credit spreads as well as increased investor concerns across many sectors of public finance, where the impact of COVID-19 continues to cause extensive financial and economic stress for issuers and heightened uncertainty.
- While putting capital to work to replace the run-off of legacy exposure is a long-term positive for the financial guaranty industry, adherence to strict underwriting standards will remain critical to avoid erosion of the overall conservative risk profile of the remaining active players.

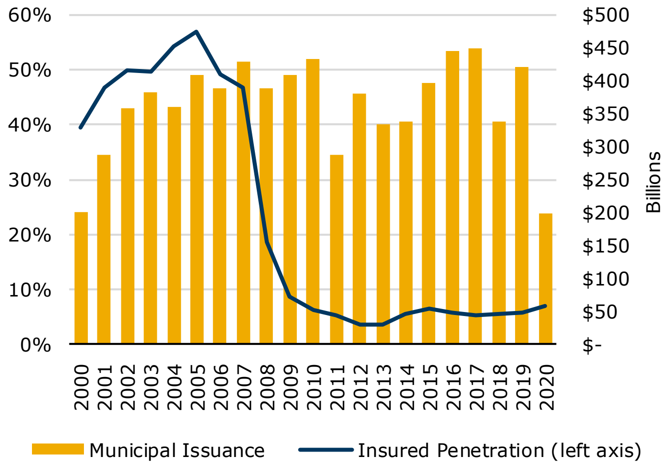
Figure 1: Insured Penetration Rate



Source: Refinitiv as accessed through Bondbuyer.com

The percentage of new issuance insured municipal bonds (i.e., the insured penetration rate) has hovered in the mid-single digits since 2010, even as annual issuance levels have varied. Current levels have increased to nearly 2x post-GFC lows. However, penetration remains in stark contrast to levels which exceeded 50% leading up to the GFC. Notably, insured penetration for 1H 2020 was 6.9% compared with 5.6% for the same period in 2019. If the 1H level persists for the remainder of the year, it would be the highest level since 2009.

Figure 2: Insured Penetration and Municipal Issuance Since 2000 Through 1H 2020



Source: Refinitiv as accessed through Bondbuyer.com

A main reason an issuer or investor may decide to "wrap" a bond includes the benefit derived from lower interest costs coupled with improved liquidity and credit protection. These benefits are derived from the strength of the insurer's balance sheet behind each policy. Over the last few years, interest rates and credit spreads have steadily declined, which makes the economics of insurance less favorable, resulting in lower insured penetration. Further, since the GFC, there has been heightened emphasis on in-house credit analysis instead of relying solely on a financial guaranty policy. Low insurance penetration combined with steady run-off of legacy portfolios have led to historical lows in leverage ratios for financial guaranty insurers.

The COVID-19 pandemic has generally widened credit spreads as fiscal pressures for credits across numerous sectors emerge and contribute to investor unease. The wider credit spreads, in combination with weakened credit fundamentals in the medium to near term, may yield increased opportunities for the utilization of bond insurance. While KBRA's **Financial Guaranty Global Rating Methodology** focuses on claims-paying resources and does not explicitly factor in new business origination or market share, all things being equal, an increased demand for insurance would be a positive credit factor for the industry. However, in KBRA's view, a return to the 40% or 50% penetration level is not a realistic possibility at present. One key factor is that, due to methodology and rating changes by the legacy rating agencies, the "insurable market" is considerably smaller today than pre-GFC.

The current environment may present financial guarantors an opportunity to grow their insured portfolios to replace legacy exposure run-off. While this would potentially bolster balance sheets and support future earnings potential, such a development would need to be balanced by adherence to conservative underwriting standards. KBRA will monitor the new business writings of its rated FG universe. As KBRA previously noted, while COVID-19 is a much more formidable and stressful macroeconomic event than the GFC, KBRA believes the pandemic should remain largely a liquidity event for the bond insurers, with the exception of Puerto Rico.

KBRA will continue to monitor the impact of the demand for bond insurance on the municipal market and on the financial guaranty industry.

Contacts

Jack Morrison, Associate Director
+1 (646) 731-2410
jmorrison@kbra.com

Peter Giacone, Managing Director
+1 (646) 731-2407
pgiacone@kbra.com

Paul Kwiatkoski, Managing Director
+1 (646) 731-2387
pkwiatkoski@kbra.com

Karen Daly, Senior Managing Director
+1 (646) 731-2347
kdaly@kbra.com

Related Report

Access for free at **www.kbra.com**

- **Coronavirus (COVID-19): Battle-Tested Assured Guaranty Grapples With the Pandemic**