Insurance Industry And Country Risk Assessment:

U.S. Bond Insurance

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PRIMARY CREDIT ANALYST

David S Veno
Princeton
(1) 212-438-2108
david.veno
@spglobal.com

SECONDARY CONTACT

John Iten
Princeton
(1) 212-438-1757
john.iten
@spglobal.com

Major Factors

Strengths	Risks and weaknesses
Very strong capitalization for the industry, which has benefited from conservative capital management practices	Potential insured exposure to rating migration, given the economic fallout from the coronavirus
Favorable pricing that may stabilize premium volume, given an expected decline in insured par volume	Continued low interest rates weighing down investment income yields
Strong regulatory track record with an effective state-based insurance framework	

Rationale

S&P Global Ratings assesses the industry and country risk of the U.S. bond insurance sector as low.

The sector benefits from strong economic fundamentals through high wealth and economic diversification, while bond insurers' underwriting activities continue to be heavily weighted toward municipal issuers with strong records of favorable performance during economic downturns. Additionally, our view reflects stable long-term profitability, high barriers to entry, and strong regulatory oversight and frameworks.

Country Risk: Very Low

We view country risk in the U.S. as very low, reflecting the country's large, diversified, and resilient economy; extensive economic policy flexibility; relatively strong track record of economic growth; and broad financial markets. These characteristics provide bond insurers with favorable operating conditions and business prospects.

Somewhat offsetting these strengths are high general government debt, rising fiscal deficits, and somewhat uncertain prospective policy developments. The U.S. now faces its largest trade deficit in history, despite its unique position as the issuer of the world's leading reserve currency.

Industry Risk: Low

We assess industry risk for the U.S. bond insurance sector as low. This reflects our view of the sector's favorable industry risk characteristics--high operational barriers to entry, stable revenue and profitability, and the modest volatility of insured losses. Additionally, in the current macroeconomic environment, demand for the financial guarantee product appears to be growing in the U.S. public finance market.

U.S. municipal issuers represent the majority of business written by bond insurers, and these issuers have strong records of favorable performance during economic downturns. Generally, insured U.S. municipal bonds have covenants that require issuers to take steps to ensure funds are adequate to meet debt service requirements, which may include a debt service reserve fund with up to a year's worth of debt service coverage.

While the COVID-19 pandemic is causing significant volatility in the U.S. financial markets and presents fiscal challenges ahead for all U.S. public finance sectors, we view the potential impact to U.S. bond insurers as somewhat low at this time. Notwithstanding the current macroeconomic environment, defaults of issues insured by bond insurers are not expected to be widespread, but there is potential for rating migration for some insured issues.

However, we do not expect these possible rating changes to put excessive stress on the bond insurers' capital adequacy, given the industry's robust capital positions. In addition, company-specific underwriting and risk-management guidelines result in insured portfolios that do not reflect the overall U.S. municipal market and may perform better in a stressful economic environment. We are monitoring the potential ratings migration of the following sectors within U.S. bond insurers' insured portfolios in our capital adequacy analysis:

- Tax-supported debt: sales, gas, excise, and hotel/motel
- Transportation: airports, ports, toll roads, and parking facilities
- Special revenue: public and private universities, community colleges, and independent schools
- Health care

With regard to new business volume, uncertainty in the U.S. public finance market has forced many municipal issuers to delay, not abandon, their transactions until market volatility lessens and market access improves. Bond insurers, however, have experienced an increase in secondary market business with strong pricing as credit spreads have widened, which somewhat offsets the decline in new issue volume. Once the new-issue market is reestablished, bond insurers may see an overall increase in business activity, given investors' focus appears to be on credit risk as a result of current macroeconomic conditions.

Factors supporting profitability

- For bond insurers, operating return on equity (OROE) is the primary metric that informs our view of the sector's and individual insurers' profitability. The U.S. bond insurance industry average OREO over the past five years (2015-2019) is 8.7%. The forecast 2019-2021 OREO is 7%, in line with more recent years, given the high levels of capital in excess of current ratings. Further supporting our view of the strength of the OROE is the long-term earnings power of U.S. public finance business. Bond insurers typically collect premiums associated with U.S. public finance business up front and earn them over the life of the underlying transaction, 20 years on average. A decline in premiums over one or two years would not materially affect revenue because of this method of earning premiums.

- Current uncertainty in the U.S. public finance market has led to many municipal issuers generally delaying new-issue transactions, which limits bond insurers' underwriting opportunities. Somewhat offsetting this market dynamic is the growth in insured secondary market issues, driven by more credit-sensitive investors and credit spreads widening among municipal issues. Additionally, outflows in mutual funds have forced massive selling, which has contributed to spread widening. These market dynamics allow bond insurers to insure issues in the secondary market that they could not insure in the primary market prior to COVID-19 market conditions, and with stronger pricing power. This bodes well for bond insurers because of the previously mentioned method in which premiums associated with U.S. public finance business are earned, creating a stronger, steady revenue stream.
- We expect premium written levels to remain flat as pricing strengthens, but overall par insured may decline due to investor uncertainty and capital markets volatility.
- We consider the U.S. institutional framework to be strong, based on our assessments of regulatory oversight and its track record. We see no deficiencies in governance or transparency. We view the state-based insurance supervisory framework as effective, though this decentralized structure can impede regulatory change. Regulatory oversight has strengthened in recent years with the implementation of the own risk and solvency assessment (ORSA) standards.

Factors limiting profitability

- The economic fallout from the coronavirus has become more acute, and sector-specific issues could weigh on the credit quality of issues insured by bond insurers.
- Continued lower interest rates challenge investment returns. The investment portfolios, however, do not represent a significant risk to the industry because the investments are predominantly high-quality, liquid fixed-income securities.

Related Criteria

- Insurers Rating Methodology, July 1, 2019
- Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013

Related Research

- All U.S. Public Finance Sector Outlooks Are Now Negative, April 1, 2020

This report does not constitute a rating action.