


Financial Guaranty Insurance: Practical Gambit or Folly

**Presented to:
The Society of
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**Presented by:
Terence M. Smith
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Financial Guaranty Insurance

- The Past (The First Flowering and Failure)
- The Present (The Second Flowering)
- The Future...

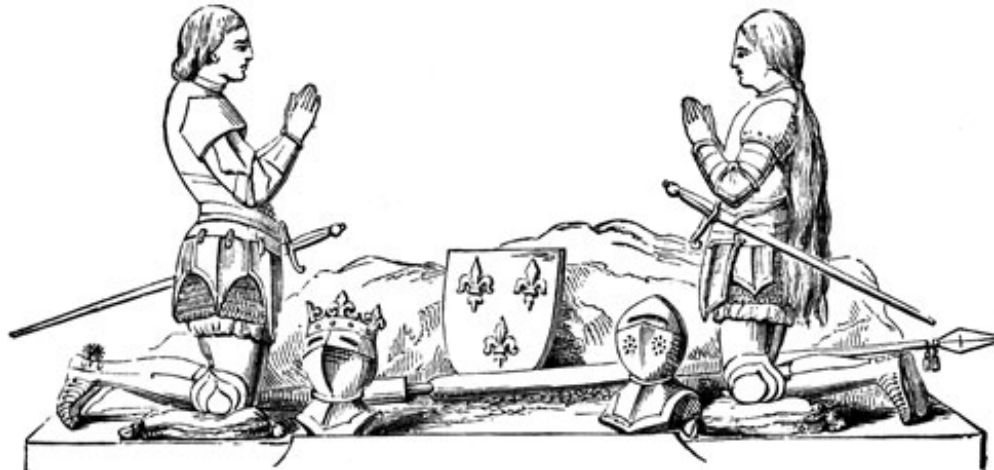
Past is Prologue

- Financial Guaranty
 - Etymology: Middle French *garantie*, from the Old French *garantir*, which meant to guarantee, from *garant* warrant, of Germanic origin. Akin to Old High German *werEnto* which meant guarantor. Date: 1592



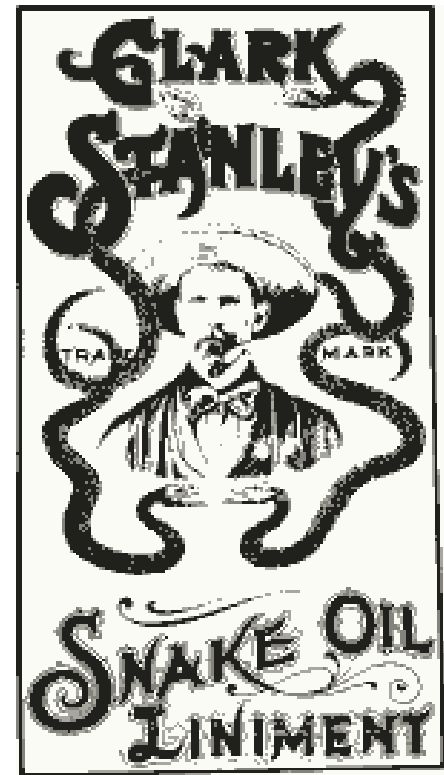
Financial Guaranty

- Etymology: Some evidence in Middle German of Guaranty being associated with “Bail Bonds”.
- The Hanseatic League (in particular 1321, when Hamburg joined with its duty free shipping on the Elbe and North Sea.)



Financial Guarantee

- Guarantee
 - Etymology: probably alteration of guaranty
 - Date: 1710
 - Author's Note: 18th Cent. English: A manufacturer's explicit or implicit statement of authenticity or promise of performance.
 - **CAUTION: SNAKE OIL! USE IT WHEN YOUR LEG IS BEING PULLED**



The First Flowering of Financial Guarantee Insurance in the UK

- Financial Market Panics of 1800's
 - Post Civil War Panic of 1865-1869
 - Crisis of the Gilded Age 1873
 - Panic of 1884 (President Grant)
- Ship Building
- Railroad Bonds
 - Northern Pacific/Morgan Guaranty

The First Flowering of Financial Guarantee Insurance in the UK

- Lloyd's of London: Although the exact date of its establishment is unknown, evidence exists that Lloyd's coffee house was well known in London business circles by 1688.



Lloyd's of London

- Exemptions To Lloyd's Prohibition of 1924 Against Brokering Financial Guarantees
 - Surety Bonds
 - Trade Credit, Surety Bonds, Mortgage Indemnity, Salvage & Collision Guarantees.
 - Mortgage Indemnity

Lloyd's of London

- But, What Was Permitted Under the Old Underwriting Rules Before 1924?

Financial Guarantee Prior to 1924

- Permitted

- Surety Bonds
- Title Insurance
- Trade Credit Insurance
- Mortgage Indemnity
- Casualty Insurance
- Collision Insurance
- Rent Insurance
- MUNICIPAL BONDS
- Ships (Boats)
- Auto Receivable
- Investment Guarantee

- Excluded

- Commodities
- Options Contracts Foreign Exchange

The First Flowering of Financial Guarantees in America

- Law and Property Assurance Society existed in Pennsylvania in 1853
- Plan by “Title Warranty Company” was published in 1871. Pennsylvania
- The Lawyer’s Title Insurance Company was formed in 1876. Pennsylvania
- Clarence H. Kelsey (1856-1930), was president of the (NJ) Title Guarantee and Trust Co., which he had helped to found in 1881.
- Shakman v United States Credit System Co. 1896 Only Rated Credit.
- American Credit Indemnity Co. (PA) Introduced The Use of Third-Party Capital & Credit Ratings in 1917 (Bradstreet).

The Glorious Guarantee Boom

- The London Guarantee Building, now better known as 360 North Michigan Avenue, is a remarkable landmark in Chicago, situated at a prominent site at the Chicago River at the termination of Wacker Drive. It was built by Alfred Schuler for the London Guarantee and Accident Company, just after the completion of the neighboring Wrigley building in 1922. Due to the special shape of its site, the 22-story limestone building has a trapezoidal ground plan.



The First Failure of the Financial Guarantee Industry

- Stanley Harrison, the underwriter of a five-name syndicate.
- Lost £367,787 by guaranteeing the value of used cars in dealers' lots.
- Given a 0.23 pound to U.S. Dollar in 1924 or A Loss of U.S. \$1.471 Mln.
- Today the Loss Would Be \$171,000,000.00

The Dark Ages (1924-1971)

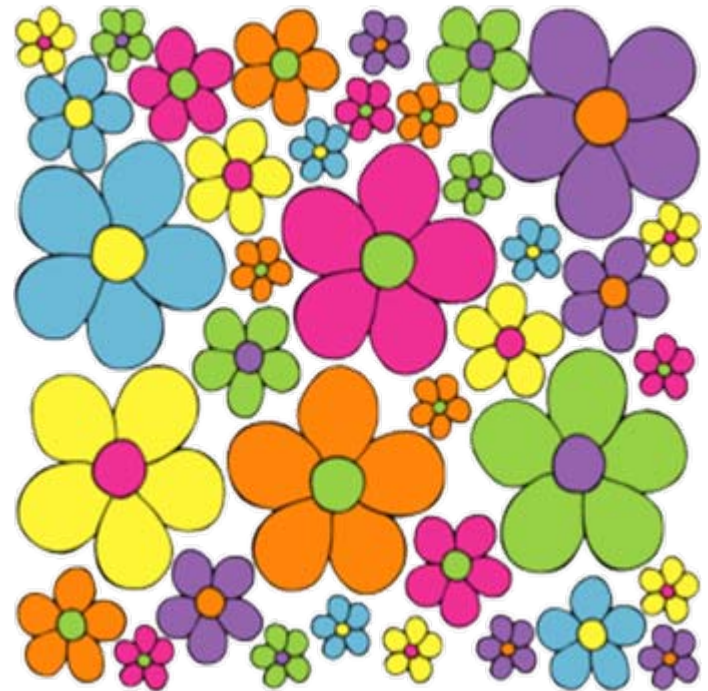


The Second Flowering

- The Modernaires

Flower Power (Yeah Bay-be)

- Lloyd's of London Exemptions To Financial Guarantee Prohibition Trade Credit, Surety Bonds, Mortgage Indemnity, Salvage & Collision Guarantees.
- Mortgage-Backed Securities/Mortgage Insurance Credit Enhancement Were The "Go Go" Investments.



Founding Fathers of Modern Era

- Mortgage Indemnity
 - Max Karl (MGIC)
 - Frank Carr (Nuveen)
 - Gerald Friedman
 - American Municipal Bond Assurance Company (AMBAC) 1971
 - Monoline
- Surety Bond
 - W. James Lopp
 - Municipal Issuers Service Corporation (Managing Agency)
 - Municipal Bond Insurance Association (multi-lines)
 - Kutak Rock & Campbell

Indemnity Model

- Monoline Insurance
 - Zero-Loss Underwriting
 - Secondary Market
 - Retail Product
 - Packaged Products

Surety Model (Shag “AAA” – delic)

- Aetna Casualty & Surety
 - Providing Corporate Guarantees for Private Companies
 - Capacity of Constraints Led To Syndication by Bankers of Surety Bonds.
 - New Issue Product (To Go Beyond 10 Years)

Monoline Indemnity Model Wins

- Triple-A Multi-lines Did Not Manage To Triple-A Credit Quality
- Model Financial Guaranty Law Favors Monoline Indemnity Model
 - Prohibits Access to State Guaranty Fund
 - Requires Separate Risk-Based Capital Reserving

The Pure Portfolio

- Pure Portfolio (MBIA/FSA/CapMAC)
- Consistent With Triple-A Credit Ratings
 - FitchRatings Default Study
 - Monte Carlo Analysis
- Major Risk: Moral Hazard

The Ratings Race

- Started in 1983 By Gerald Friedman's Formation of FGIC
 - “Never Do Corporates Because We Cannot Guaranty Against Obsolescence” GF
- MBIA Rushed To Be First
- BIG Delays Start Due To Rating (1987)
- Ambac “Aaa”/AAA in 1988
- FitchRatings Makes It Triple-Crown

Blended Book Strategy

- Long-tail risk of municipal bond book of insured business produces predictable rates of return
- Asset-backed Securities super-charged the premium earnings power with shorter-average lives.
- Early 1980s through mid-1990s
- Major Risk: “New Asset Class”/Unfamiliar Risk

Financial Guaranty Insurance Holding Company Strategy

- Diversified Portfolio of Businesses
 - Look For GICs, Guaranteed Annuities, Residual Risk, Catastrophic Risk Covers, Pension Guarantee
- Leverage
- Spread Costs
- GE Capital; Radian Guaranty; XL Ltd.
- Major Risk is Correlation

The Future

As One Sows, So
One Reaps



Financial Guarantee Growth

- What Are The Real Risks?
 - Moral Hazard
 - Unfamiliar Risks
 - Correlation

Areas of Concern

- Transparency
 - Top 50 Problem Credits (WatchList)
 - Equipment Finance Trusts For Airplanes
 - Toll Roads
 - Healthcare
 - CDOs

Areas of Concern

- Capital Adequacy
 - Leverage Ratio
 - Rating Agency Models
 - State Insurance Department Regulations
 - Access To Capital
 - Public Markets
 - Ownership Agreements

Areas of Concern

- Management
 - Ability to Attract and Retain Top Talent
 - “Managing” The Numbers
 - Changing Formulas (i.e. CLAIMS PAYING RESOURCES)
 - Net P&I – AND Net Par
 - Reserving Practices
 - Where’s the Growth?
 - Capacity Constrained (Buyside and Sellside)

CDO's

- Rating Agency Model Driven
 - Miniscule Capital Charge For Super Triple-A
 - Single Digit Premiums (5 bps)
 - Wildly Profitable
- Credit Derivatives Market
 - Charging 150 bps (+) to Wrap “Aaa/AAA/AAA” Insured CDOs With Five Year Maturities
 - 1) Risks in Insured CDOs
 - 2) Correlation
 - 3) Diversity

Lloyd's Market

- Renewal of Interest
- Three syndicates express interest in financial guarantee insurance in 2002
- Simon Johnson of Lloyd's has written a paper for ART team of Lloyd's of London.

Can Distinctions Be Made?

- Monoline v Multiline
- Bond Insurers v Insured Bonds
- Composition of Book
- Risk to Capital Measures

Selected Financial Highlights

Bond Insurance Industry 2001

Selected Financial Highlights

Overview (\$ Mln.)

	AMBAC	FGIC	FSA	MBIA	XLCA	2001
Net par outstanding ¹ (Bln.)	\$ 318.0	\$ 152.7	\$ 217.1	\$ 452.4	\$ 0.7	\$ 1,140.9
Net insurance in force (Bln.)	\$ 476.2	\$ 297.5	\$ 300.6	\$ 722.4	\$ 1.0	\$ 1,796.7
Gross premiums written						
Net premiums written	\$ 683.3	\$ 154.6	\$ 485.6	\$ 865.0	\$ 52.3	\$ 2,240.8
Net Premiums earned	587.8	135.9	319.6	629.9	3.4	1676.6
Net investment income	378.7	102.5	237.7	524.0	0.2	\$ 1,243.1
Investment management income	267.8	125.0	128.9	413.0	5.7	940.4
	0.0	0.0	0.0	63.0	0.0	63.0
Insurance expenses ²						
Investment management expense	88.0	23.7	94.6	180.0	18.9	405.2
Interest expense	21.8	0.0	0.0	62.9	0.0	84.7
	40.4	--	16.9	56.4	0.0	113.7
Income before taxes	568.7	280.8	269.5	791.0	-12.1	1897.9
Net income	432.9	215.3	209.5	570.0	-6.2	1421.5
Cash & Total Investments						
Total assets	10,364.4	2,602.5	3,221.9	14,631.2	156.5	30,976.5
Deferred premium revenue	12,267.7	2,858.2	4,306.9	16,200.0	218.4	35,851.2
Long-term debt	1,780.3	612.8	1,090.3	2,565.0	44.9	6,093.3
Shareholders' Equity	619.3	--	330.0	805.0	--	1,754.3
Qualified statutory capital	2,983.7	2,006.9	1,636.0	4,783.0	126.0	11,535.6
Weighted Avg Shares outstanding (Mln.)	3,261.9	1,939.7	1,593.6	4,940.0	109.7	11,844.9
	105.7	--	--	148.2	--	253.9
Insurance Expense Ratio	23.2%	23.1%	39.8%	34.4%	9450.0%	32.6%
Cash+ Total Investments/Assets	84.5%	91.1%	74.8%	90.3%	71.7%	86.4%
Net Investment Income/Premiums Earned	70.7%	122.0%	54.2%	78.8%	2850.0%	75.6%
Net Investment Income/Net Income	61.9%	58.1%	61.5%	72.5%	-91.9%	66.2%
Par Outstanding/Insurance in Force	66.8%	51.3%	72.2%	62.6%	70.0%	63.5%
Return On Equity	14.5%	10.7%	12.8%	11.9%	-4.9%	12.3%
Return On Average Equity	15.5%	10.7%	13.5%	12.7%	-5.9%	13.0%
Return on Assets	3.5%	7.5%	4.9%	3.5%	-2.8%	4.0%
Net insurance/Shareholders Equity	159.6	148.2	183.7	151.0	7.9	155.8
Net Insurance/Statutory Capital	146.0	153.4	188.6	146.2	9.1	151.7
Underwriting Expense ¹	72.4	26.0	124.5	85.4	18.1	326.4

¹ (Statutory Accounting Basis Source: S&P Bond Insurance Book)


² Includes losses & loss adjustment, policy acquisition cost & operating expenses

³ 1996 and prior year numbers for MBIA do not reflect mergers with CapMac & 1838 Investment

⁴ FSA stock not publically traded at the end of 1993 and 2000.

⁵ Ambac Shares Outstanding are Split Adjusted for 1997 & 1999

**It's Better to Say "I Told You So" Than
"They Told Me So..."**



**SMITH's Corollary No. 2 To
Murphy's Law**