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Credit FAQ:

Bond Insurers And The Recent Downgrades Of Puerto Rico's Public Corporations

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The recent credit deterioration of Puerto Rico's public corporations and enactment of legislation that would enable some of the entities to restructure their debt have prompted investor questions on the potential impact on bond insurer ratings. (See also "Puerto Rico GO Rating Lowered One Notch To 'BB' Following Debt Legislation; Outlook Negative," published July 11, 2014.) Below Standard & Poor's Ratings Services provides answers to the most frequently asked questions.

Frequently Asked Questions

What are the ramifications for bond insurers' solvency and Standard & Poor's ratings following the Commonwealth of Puerto Rico's legislative changes and comments with regard to the various public finance authorities?

We believe that there are no negative ratings or solvency implications at this time, based on our capital adequacy analysis for Assured Guaranty Ltd. (Assured) and National Public Finance Guarantee Corp. (National). Despite the significant recent credit deterioration of their various Puerto Rico exposures, as well as existing or potential incurred losses due to each insurer's Detroit exposures, our view is that the legacy bond insurers maintain very strong and sufficient capital cushion to sustain actual or theoretical losses from their insured exposures. Assured's capital cushion is approximately $1.45 billion-$1.55 billion and National's is approximately $400 million-$450 million. These cushions are additional losses, actual or theoretical, beyond what we already assess in our analysis of each bond insurer's exposure to issuers in Puerto Rico that Assured and National cold incur and still retain the current ratings.

It is difficult for Standard & Poor's to comment on the precise loss-given default for the bond insurers' exposure to issuers in Puerto Rico. Claim payments and ultimate incurred losses would be contingent on the insurers' recovery prospects and ultimate economic losses, which tend to be determined following a long period of bankruptcy litigation and negotiation. Based on the various distinct issuer exposures, and their respective debt service claim payments, we believe that the current capital adequacy cushion is sufficient to sustain the bond insurers' financial risk profiles and ultimately the financial strength ratings.

How does Standard & Poor's determine a bond insurance company's capital adequacy and its ability to sustain insured losses?

Our capital adequacy model was developed to capture a 'AAA' period of stress similar to the U.S. Great Depression in 1929 (see "Bond Insurance Rating Methodology And Assumptions," published Aug. 25, 2011). The capital model creates a pro forma seven-year profit and loss projection and balance sheet, with cash flow stresses to project an initial three-year growth period followed by four years of severe stress. The model captures each individual insured obligation's underlying credit characteristic as well as its recovery expectation through the application of capital charges. The model is designed to capture severe, wide-scale theoretical losses that occur systemically.

Following the occurrence of a major event with credit implications--such as an economic recession or severe natural catastrophe--incremental theoretical losses are generated for the purpose of a sensitivity analysis relative to an insurer's existing capital base. This is the type of analysis we have conducted relating to the bond insurers' exposure to Detroit and Puerto Rico.

Would a bond insurer have to pay the total claim amount immediately after a missed or partial debt service payment?

At the core of bond insurers' policy is the following statement: "Upon the obligor's failure to pay, the insurer unconditionally and irrevocably guarantees payment of principal and interest to the debt holder as it comes due." To avoid confusion, the policy spells out the payment obligation of the bond insurer as stated in the bond indenture, bond documents, or the principal and interest amortization schedule. The policy also points out that the insurer will make no payments prior to any scheduled payments, regardless of any acceleration or early redemption of the obligation unless the bond insurer approves such. These features of the insurance policy allow bond insurers to manage their liquidity needs.

Is it a concern that the legacy bond insurers' exposure to issuers within Puerto Rico is large relative to their surplus?

Although the reported exposure may be large relative to statutory capital, we don't expect it to result in claim payments equal to 100% of the bond insurers' total exposure if there is any restructuring of debt or any defaults. Some issuers are weaker than others, as reflected in our ratings, and the bond insurers' exposure to the weaker issuer is manageable--in our view. In addition, the introduction of the framework by the commonwealth did not necessarily convey that all the authorities highlighted in the legislation would proceed with a restructuring of their debt.

Is Standard & Poor's considering any change to its bond insurance criteria, given the recent legislative action?

As legislative actions are taken and current bankruptcy cases develop and set new legal precedents, we may evaluate the validity of our recovery assumptions imbedded in the capital charge we use to assess bond insurers' capital adequacy. To do so, we consider each legislative action and bankruptcy case individually, as well as the issues it raises for bond insurer recoveries.

If a growing number of plans to improve an issuer's financial condition involve significant, and permanent, haircuts to bond payments, we may lower our recovery assumptions. A change in recovery assumptions would lead to a rise in theoretical loss assumptions in our capital adequacy analysis, which could have a negative effect on the financial risk profile of the bond insurers.