Minding the gap

The ripples from the US sub-prime mortgage market have widened since midsummer and spread to a group that usually attracts little attention – the monoline bond insurers. The leading players, principally MBIA and Ambac, are relatively unaffected but those specifically insuring mortgage-backed debt, such as Radian Group and MGIC, have seen their shares fall sharply as doubts arise over their capital base when compared against the volume of assets they insure. The setback could prove only a blip in the steady growth of monoline insurance, but it has drawn attention to the sector's increasing influence in determining whether a capital markets deal gets under way and, if so, the structure of that deal.

Monolines have developed significantly over the past three decades. They started life in the US in the early 1970s as a means of giving regional public administrations access to cheaper funding. Since then, the guarantors have insured over $2.5 trillion. Triple–A financial guarantors are a relatively small group, but since the late 1990s, there has been consolidation, with two new entrants increasing competition.

Over the years, monolines have moved further into the structured finance sector and providing guarantees to cover asset-backed bonds and tranches of collateralised debt obligations (CDOs).

The monolines started working in the EU in the mid-1990s and grew as a result of the disintermediation of the banking system and growth of the capital markets. The main focus in the EU has been on corporate securitisation, as well as wrapping public-private partnerships (PPP) and private finance initiative (PFI) projects.

Guarantors are now well established in the global capital markets. They guarantee the securitisation of structured finance transactions on behalf of banks and finance companies, and also the debt issued by utilities, infrastructure projects and other public finance entities.

RESTRICTED CUSTOMER BASE Unlike traditional insurers, a monoline insurer restricts its customer base to investment-grade financings. The product that it offers is in the form of an irrevocable financial guaranty policy which, in turn, confers a AAA rating on the financing. In return for a fee, the insurer provides a financial guarantee that results in the underlying security obtaining a rating equal to that of the monoline – AAA from Moody's, Standard & Poor's and Fitch in the case of established monolines such as MBIA and Ambac. The guarantee commits the monoline to make up any shortfall in interest or principal payments.

In providing credit enhancement – or wrapping – to such transactions, monoline insurers provide investors with financial security and liquidity, which can make it easier for underwriters to distribute debt. It also enables the issuing company to secure a higher credit rating than it would otherwise attract. Thus, financial guarantors provide value to investors, issuers and underwriters.

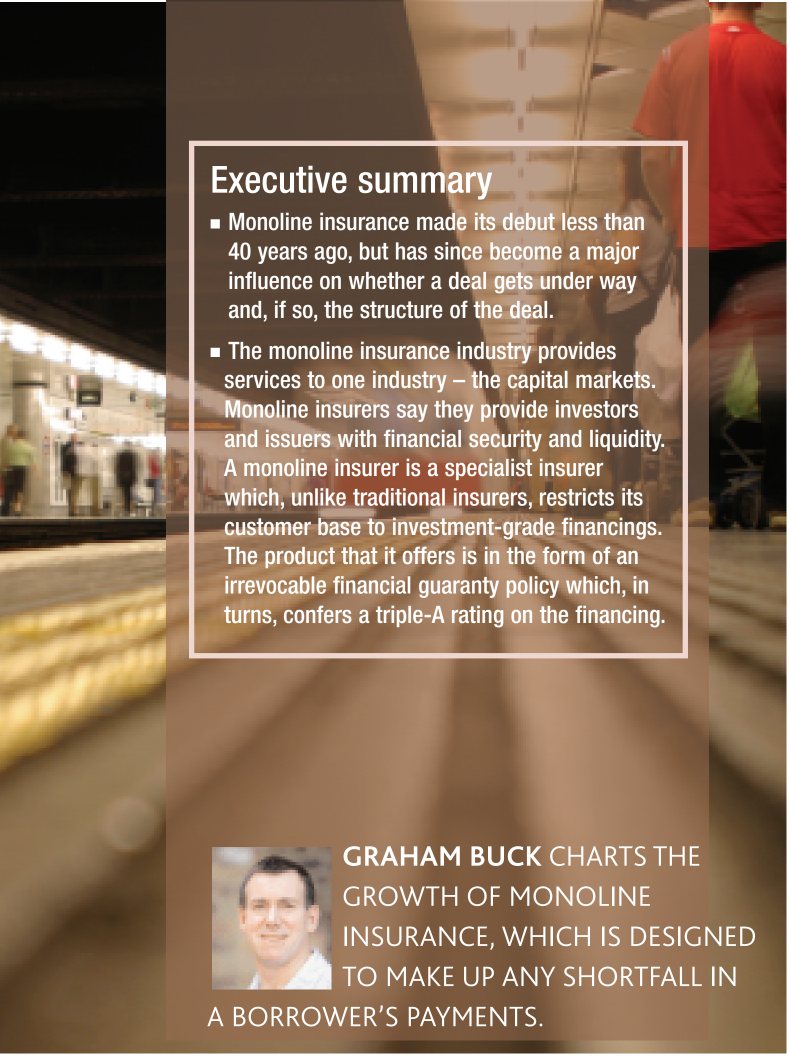
According to the Association of Financial Guaranty Insurers, the main benefits offered by monoline credit enhancement are as follows:

- confidence that an insured security will pay in full, even under worst-case stress scenarios;
- expertise in credit analysis that allows for the application of conservative, zero-loss underwriting criteria to insured transactions;
- monitoring of collateral and servicer performance so as to take any action necessary to avoid deterioration of assets or underlying credit quality;
- a level of scrutiny and analysis beyond the rating agencies, ensuring most transactions are seen as investment-grade before they are wrapped.

NOT STANDARD INSURANCE Monoline insurance differs from standard insurance in that it is not subject to the same, potentially lengthy, claims submission and adjustment process that follows a loss. Instead, monoline insurers make debt service payments as and when the issuing company is unable to do so.

Securities backed by a monoline insurance guaranty are closely monitored to address potential problems at any early stage. Monoline insurers also tend to have specialised reinsurance relationships with both monoline and multiline (where the risk exposures of multiple insurance obligations are put into one insurance contract) reinsurance companies, enabling them to spread the risk and ensure that the required capacity for new risks is available.

But not everyone is convinced. One hedge fund manager, who is short on MBIA and Ambac, recently suggested that even the biggest monolines kept inadequate reserves against likely future credit losses, transforming "a very risky insurance scheme into a gold-plated credit rating for questionable debt issuance". The insurers themselves dispute such suggestions and claim they have always built high-quality, diverse portfolios that have maintained their AAA credit ratings, and steadily honed the sophistication of their risk management practices. They also point out that claims are paid slowly over time (typically allowing for the completion of the remediation) rather than in massive, immediate outlays. This key benefit allows the monoline to



Executive summary

- Monoline insurance made its debut less than 40 years ago, but has since become a major influence on whether a deal gets under way and, if so, the structure of the deal.
- The monoline insurance industry provides services to one industry – the capital markets. Monoline insurers say they provide investors and issuers with financial security and liquidity. A monoline insurer is a specialist insurer which, unlike traditional insurers, restricts its customer base to investment-grade financings. The product that it offers is in the form of an irrevocable financial guaranty policy which, in turns, confers a triple-A rating on the financing.

GRAHAM BUCK CHARTS THE GROWTH OF MONOLINE INSURANCE, WHICH IS DESIGNED TO MAKE UP ANY SHORTFALL IN A BORROWER'S PAYMENTS.

proactively manage its liquidity. Unlike a bank, there is no risk of a run on a monoline.

So do the recent sub-prime mortgage concerns and market volatility threaten their stability? Standard & Poor's says not. Its recent report found that the insurers' underwriting standards, together with "sound risk-management practices" and "conservative capital management strategies" enabled them to weather the storm without any serious effects to their capital adequacy. Of the two largest, MBIA holds $5.1bn in direct sub-prime residential mortgage-backed securities, equal to about 0.8% of its total portfolio, and Ambac has $9.3bn, about 1.7% of its portfolio.

PUBS AND UTILITIES The water utilities sector was one of the first in the UK to use monoline, with Anglian Water, Southern Water and Welsh Water employing it for bond issues. Until the end of the 1990s, its use had mostly been in financing major infrastructure projects.

Anglian, which planned a whole-business securitisation in 2002, used MBIA to wrap £1bn of debt and transferred existing debt on top of this figure. Group Treasurer Jane Pilcher explains at that time it was a fairly new phenomenon for a company in the sector to gear itself up and the prevailing market conditions were "choppy". "The monoline provided security, reassuring investors that the deal was being policed," she says. "It also gave the regulator Ofwat a degree of comfort."

Anglian has subsequently used monolines to raise index-linked debt, which has generally proved difficult and expensive for corporate issuers. In 2005, it raised £400m of index-linked debt through the issue of index-linked bonds, which were acquired by an independent special purpose vehicle (SPV), Freshwater Finance, set up for the purpose. Freshwater then entered into a swap with HSBC, which issued £400m in fixed-rate notes that were privately placed with an investor who obtained a 'secondary markets' wrap from a monoline.

An increasing number of recent transactions in the industry have involved monolines being used to wrap debt on a secondary basis and they have been used by companies in other utility sectors. Anglian intends to keep using them, says Pilcher: "As a company that carries a significant amount of debt, we want to have access to the full range of markets and investors." She adds that while many investors look for the extra protection offered by the presence of a monoline, those who have carried out a fair amount of research might prefer to go without and take extra remuneration on a coupon.

The pub sector has also benefited from financial guarantees. Over the last 15 years, the industry has been transformed through divestments by the brewers and substantial mergers and acquisition activity. The monolines have played a major role in guaranteeing a large part of the debt that has financed such activity, including issuances by groups such as Punch, Pubmaster, Spirit and Unique.

Unique Pub Properties (UPP) completed an initial securitisation in 1999 to finance the purchase of 2,614 pubs. The first tap under this programme in February 2001 financed an additional 677 tenanted pubs. The 2002 tap issue enabled UPP to blend an additional 888 pubs from the Voyager estate into the existing securitisation pool of 3,291 pubs, increasing the total pool to 4,079. The combined estate was valued by Christie's Property Management at £2.2bn against total debt (senior and mezzanine) of £1.8bn. The aggregate outstanding amount of the senior notes (class A) after the 2002 tap was £1,400m or 77% of total debt, resulting in a senior debt loan-to-value ratio of 66%. After an in-depth review and analysis, MBIA wrapped the £300m senior A2R tranche with a final maturity of 12 years and an average life of nine years – much longer than the average bank financing. S&P and Fitch assigned shadow ratings of single-A to the senior notes.

The transaction used an issuer/borrower structure common in UK whole business securitisations. In this instance, the issuer was an SPV set up to issue bonds and lend the proceeds to UPP. UPP used the borrowing to purchase portfolios of pubs and undertake capital expenditures. The structure took advantage of existing UK insolvency laws that gave a secured creditor a significant degree of control over the borrower and its assets in the event of default/enforcement.

A guarantor requires in-depth analysis and due diligence of the transaction often helps to improve its structure. In the event of a default, the monoline guarantees timely payment of interest and principal payments when due to holders of the guaranteed bonds. The guarantor draws on its expertise in executing complex transactions and, as a result, attracts a wider investor base. In addition, investors benefit from the portfolio diversification.

Whole-business securitisations are also being done in France and the US demonstrating a growing trend for businesses to turn to the capital markets as an alternative to bank facilities. In 2004, MBIA wrapped the €600m operating lease securitisation for the Fraikin Group, a French vehicle leasing company. This provided Eurazeo, the group's owner, with a significantly cheaper financing alternative to a classic leveraged buyout funding and also offered more flexibility for future development. In April this year, MBIA and Ambac completed the largest fast-food restaurant securitisation to date for Domino's Pizza in the US. The deal allowed the company to recapitalise and has created opportunities for other fast-food chains to pursue similarly structured transactions.

Insured penetration in the global capital markets has steadily grown since the arrival of the monolines in the EU and furthered their continued expansion, driven by investor demand for longer-dated paper, the structuring expertise that monolines offer and the security of the AAA rating.

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