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FINANCIAL SERVICES

Developments in the Financial Guarantee Industry

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Preface

This staff study addresses the development and use of financial guarantee products provided by the insurance industry. We undertook this review to obtain an understanding of the mechanics of the financial guarantee industry in light of public reports of problems in the industry. Our objectives were to define the scope of the financial guarantee industry; develop information on various organizational structures used; and determine the type and degree of industry regulation taking place. In order to accomplish this, we have conducted a literature search and met with state and federal regulators, industry officials, officials of securities rating agencies, and academicians. For additional details, see our objectives, scope, and methodology section on page 14.

There is no widely agreed upon definition of a financial guarantee. However, in a generic sense it can be described as an independent party guaranteeing, for a fee, that another party's obligations will be met in a financial transaction. The primary purpose of such guarantees is to reduce risks to investors and the borrowers' cost of obtaining financing.

Increased investor and creditor demand for security in complex financial transactions has led to a significant increase in the use of financial guarantees. This demand has resulted in the development of new types of financial guarantees and the emergence of a number of new providers. Significant among these new providers are a number of new and traditional insurance companies. Much of the recent growth in financial guarantees can be attributed to the new firms that have entered the market.

While it is clear that the financial guarantee market is growing rapidly in size and scope, there is no comprehensive, accurate data available on the actual size of the industry, the participants, the types of products being offered, and the risks being assumed. Regulators and analysts have noted some of the risks involved, but are unable to quantify the overall industry risk.

The National Association of Insurance Commissioners (NAIC), the organization of state regulators, is taking the initial steps in developing the necessary data. The staff of the Securities and Exchange Commission (SEC) is requesting companies with significant financial guarantee activities to disclose more about the size and type of risks they are underwriting. The NAIC, through its membership, is also requiring greater disclosure. However, as we discuss in Chapter 3, it is not yet clear if the information being requested will be sufficient to enable regulators to properly fulfill their responsibilities and, thereby, provide investors with the security they are seeking. Additionally, the NAIC has developed model financial guarantee legislation, which it hopes will become the basis for similar legislation by state legislatures to improve regulation. Currently, the federal government has no direct role in the regulation of insurance.

We provided draft copies of this staff study to the SEC and the NAIC to obtain their official comments. Members of SEC's Office of the Chief Accountant involved with the financial guarantee issue proposed clarifications to the text which we have incorporated. The Office of the Chief Accountant pointed out that its response should not be considered an official SEC response since the Commission did not review the draft.

The Superintendent of Insurance for the State of New York (also the Chair of the NAIC's Financial Guarantee Task Force, an association ad hoc study group formed to address this developing issue) took strong exception to what he characterized as our conclusions on the structure of the financial guarantor. The Superintendent favors a form that requires that only specialized companies offer guarantees and no other products. He indicated that we had given too much prominence to another form which would permit non-specialized firms to offer guarantees along with other products. Our intention was to cite opinions on each form and not to conclude which form was the most appropriate.

We are sending copies of this report to the Chairman of the SEC, the Chairman of the NAIC, and interested members and committees of Congress. If there are any questions regarding the contents of this staff study, please call Craig A. Simmons, Senior Associate Director, on (202) 275-8678.

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William J. Anderson
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Abbreviations

NAIC	National Association of Insurance Commissioners
SEC	Securities and Exchange Commission
S&P	Standard and Poor's

Introduction

In recent years, there has been a rapid expansion in the underwriting of financial guarantees by insurance companies and other financial intermediaries. A primary purpose of the financial guarantee is to reduce risks to investors. This is accomplished by transferring some portion of the risk to a guarantor.

There is no widely agreed upon definition of a financial guarantee. For example, one definition describes a financial guarantee as insurance that guarantees an investor that the party making a financial commitment has the ability to financially perform under the terms of the transaction. Another definition states that financial guarantees ensure that the interest and principal payments owed by corporations, municipalities, and limited partnerships will be made. Still another states that a financial guarantee is an unconditional guarantee that a financial obligation established by a business transaction will be fulfilled. These descriptions could cover a wide range of both common and uncommon financial transactions.

Sources within the financial guarantee industry divide financial guarantees into two broad categories: those that protect against economic loss and those that provide a financial service.

The first type of financial guarantee, sometimes referred to as risk insurance, includes mortgage insurance and limited partnership guarantees. These protect the investor against loss by transferring, in the event of default by the original party, economic risks to the guarantor.

The other type of financial guarantee, referred to as credit enhancement insurance, which includes financial products such as municipal bonds and corporate securities seeks to improve the insured instrument's credit rating. This type of guarantee, in effect, makes an already acceptable credit rating even better thus enabling the entity purchasing the guarantee to sell its bonds or paper at a lower cost than otherwise would be possible (even after considering the effect of the insurance premium). Additional discussions of both categories will be found in chapter 2 of this study.

How Large Is the Financial Guarantee Industry?

Little concrete information exists on the exact size and growth of the financial guarantee industry. Part of the problem is the lack of a standard definition for what constitutes a financial guarantee. Additionally, a majority of what is perceived as financial guarantee business is reported by insurance companies in their annual operating reports to insurance regulators as part of their surety line[1] of business and is not distinguishable from the sureties. Although financial guarantee premium figures are not generally reported separately, the Surety Association of America (the surety industry's trade group) estimates that financial guarantee premiums have risen rapidly from 9 percent ($73 million) of all surety premiums in 1980 to an estimated 26 percent ($390 million) in 1984. The association estimates that municipal bond guarantees alone represent about 20 percent ($300 million) of total surety premiums in 1984. An association official estimated that the premium charged for written financial guarantees in 1985 could be as high as $1 billion and was at the very least $330 million.

Other estimates cited in newspaper articles and trade publications differ widely from the association estimates. Examples of these are:

- American Banker,[2] "So far municipal bond insurers have guaranteed an estimated $125 billion to $150 billion in principal and interest, collected an estimated $750 million to $1 billion in premiums, and paid only about $5 million in cash losses."
- American Banker,[2] "Financial guarantees sold by insurers now represent at least 55 percent of the nearly $2 billion in surety bond market premiums—up from 33 percent four years ago."
- American Banker,[2] "Estimates of the total annual financial guarantee insurance premiums today range from $600 million to $3 billion."
- Forbes,[3] "Last year alone insurers guaranteed nearly $85 billion in mortgages and municipal bonds. Now insurers are turning their attention to the estimated $500 billion corporate debt market."
- Best's Review,[4] "Outstanding guarantees backed by banks and insurers have increased from $161 billion in 1980 to more than $437 billion in 1984, according to one estimate".[5]

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[1] A surety is a bond which guarantees performance of a contract, for example, to complete construction of a building within a specified timeframe.

[2] L. Brenner, Booming Financial Guarantees Market Generates Profits and Some Questions, American Banker, June 14, 1985, p. 1.

[3] M. Clifford, Spores of Disaster, Forbes, Oct. 7, 1985, p. 68.

[4] M. Freedman, Financial Guarantees: Too Hot to Handle?, Best's Review, Oct. 1985, p. 16.

[5] Financial Security Assurance, a guarantor of corporate debt, recently reported identical industry growth statistics.

- 1987 The Bond Buyer,[6] "Credit enhancements were used for $1.61 billion, or about 19% of the 1986 housing volume.
- National Underwriter,[7] "Even though the financial guaranty insurance industry has had relatively few losses, legislators and regulators are becoming increasingly worried the stakes could be very high and very dangerous in coming years. The industry is still very young, has an estimated $220 billion of obligations insured, and is continuing to grow in leaps and bounds."
- Institutional Investor,[8] "For example, of the $47 billion of insured muni bonds issued in 1985, 30 percent was Financial Guarantee Insurance Corporation issues and 35 percent went to Municipal Bond Insurance Association..."

While we were unable to obtain verifiable figures from the industry or regulators, indications are that the financial guarantee industry is growing very rapidly and has the potential to grow even larger. Table 1.1 shows the estimated size of some significant financial market segments into which insurers can expand their financial guarantee business.

Table 1.1: Significant Financial Market Segments

Figures in billions of dollars

Market segment	Potential amount	Source of data reported as of year-end 1985
Private limited partnerships	7.4	The Stanger Register
Industrial development bonds	22.5	The Bond Buyer IDBI Managers, Inc
Commercial paper	303.1	Federal Reserve Board, Washington, D.C.
New public corporate bond issues	119.1	Federal Reserve Board, Washington, D.C.
Bank loans outstanding	718.3	Federal Reserve Board, Washington, D.C.

(Note: Table reproduced from the Insurance Information Institute 1986 monograph titled: "Financial Guarantee Insurance.")

[6] M. Kreps, $8.63 Billion Tax-Free Housing Debt Sold in '86, Least in 5 Years, The Bond Buyer, Mar. 3, 1987.

[7] L. S. Howard, NY Financial Guaranty Monoline Bill Gains Ground, National Underwriter, Oct. 11, 1986, p. 2.

[8] J. W. Milligan, A One-Man Assault on the Muni-Guarantee Business (Gerry Friedman of Financial Guaranty Insurance Co.), Institutional Investor, June 1986, p. 239.

Problems Facing the Financial Guarantee Industry

We undertook this review because of public reports of problems in the financial guarantee industry. The following are examples of the types of situations reported.

According to a banking industry publication,[9] the Bank of America in 1985, agreed to pay $133 million to several savings institutions that had purchased nearly worthless mortgage backed securities for which the bank had acted as a financial intermediary (escrow agent/trustee) in the transactions. These securities were guaranteed by Glacier General Assurance Company and Pacific American Insurance Company. Both insurers' guarantees proved worthless. These guarantors were financially unable to honor their guarantees. Furthermore, it appears that the bank, as well as the thrifts, did not carefully examine the quality of the mortgages backing the securities.

A business magazine[10] reported that in November 1984, Buttes Gas and Oil Company, a California energy firm, attempted to raise short-term money (debt repayable in 1 to 2 years). Industrial Indemnity Financial Corporation, a subsidiary of Xerox's Crum & Forster insurance unit, insured a $10 million revolving line-of-credit for Buttes. In May 1985, Buttes defaulted and Industrial Indemnity paid the claim. Regulators and industry participants have questioned whether Industrial Indemnity had either examined Buttes' assets that secured the guaranteed loans, or adequately monitored Buttes' loan performance.

Newspaper[11] and insurance industry sources reported that in 1985, Equity Programs Investment Corporation, a real estate syndicating subsidiary of a Maryland thrift, unexpectedly filed for bankruptcy after it could not make principal and interest payments on $1.4 billion in mortgages and mortgage-backed securities it had sold. Several leading mortgage guarantee firms—including Ticor Mortgage Insurance Company—are obligated to honor the guarantees they wrote on Equity Programs Investment Corporations's obligations. Ticor could lose as much as $161 million, which represents two-thirds of its capital. Ticor took a risk by guaranteeing such a large single transaction. Also, Ticor reportedly did not scrutinize the creditworthiness of the parties to whom the loans were made.

[9]M. Carroll, Task Force Formed to Probe Mortgage Pool Loss, Bank of America Names 6 Employees in Lawsuits, American Banker, Mar. 4, 1985, p. 1.

[10]M. Clifford, Spores of Disaster, Forbes, Oct. 7, 1985, p. 68.

[11]M. Sullivan, EPIC Had a Warning on Shelters-Report, Boston Globe, Sept. 6, 1985.

Evolution of the Financial Guarantee Industry

Although financial guarantees have become an important borrowing tool in the last few years, the concept is not new. Mortgage guarantees, performance bonds, and municipal bond guarantees have existed for years. For example, mortgage guarantee insurance, designed to protect financial institutions from mortgage defaults, dates back nearly a century. Insurers who wrote such guarantees, however, were so badly harmed by real estate foreclosures during the 1930s depression that most dropped out of the market. Federal programs such as Federal Housing Administration and Veterans Administration loan guarantees subsequently were developed to help fill the void in the mortgage guarantee market. By the late 1950s, after years of successful government insurance programs, a few private insurers began to write mortgage guarantee insurance again.

Municipal bond guarantees were introduced about 1970 to insure the payment of both principal and interest on municipal bonds, thereby increasing their credit ratings and making them more appealing to investors. The premium for the insurance was more than offset by the savings resulting from the lower interest costs associated with issuing higher rated bonds. Today, municipal bond insurance accounts for a major portion of financial guarantee premiums.

More recently, other types of guaranteed products have surfaced. These new products cover a broad range of financial transactions and obligations. For example, commercial paper guarantees are written to cover short-term corporate indebtedness, typically for 2 years or less. These guarantees are written for firms not rated by the rating services or for companies with relatively low credit ratings. These guarantees facilitate the sale of products by improving their credit ratings and result in reduced overall interest costs.

Limited partnerships had been quite popular under prior tax laws[12] as tax shelter investments. They allow investors in real estate and other business ventures to finance their involvement with little cash down while still sharing in the partnership's tax deductions for depreciation, interest, and other expenses. Typically, individual investors make a small down payment and issue promissory notes to pay off the balance of their shares in installments over a short period—usually 5 years or less. Until recently, bank letters of credit were usually the security that guaranteed payment of the limited partners' notes. Currently, an increasing number of these arrangements are being secured by insurance

[12]It is too early to judge whether they will remain popular under the 1986 tax code revisions.

company guarantees. A limited partnership guarantee for the entire venture ensures the payment of the individual investor's debts—avoiding the necessity of securing letters of credit from each limited partner. For a listing and description of many of the financial guarantees that reportedly exist today, see appendix I.

Reasons Investors Seek Financial Guarantees

Investors today desire greater security in their transactions. Today's volatile economy has intensified the riskiness of financial instruments. In the corporate world, Chrysler and Lockheed have needed government assistance, in the form of loan guarantees, in recent years. Also, hundreds of banks and savings and loans, including several large ones, have failed since 1980. In addition, the technical default of New York State Urban Development Corporation notes in 1975, followed closely by New York City's financial problems, and more recently, the 1983 default by Washington Public Power Supply System on $2.25 billion in revenue bonds, have greatly stimulated the growth of municipal bond guarantees.

While there may be many reasons for the increased popularity of financial guarantees, the following statement by the senior vice president and director of reinsurance and regulation, Municipal Bond Insurance Association, may best explain the growth of guarantees in the municipal bond area. In 1986, he said:

> "fiscal difficulties caused individual investors buying municipal bonds to become much more security conscious. Where once the issuer's credit rating was enough to provide security, investors now began demanding an additional layer of protection in the form of a guarantee. At the same time, the market started to expand. As the high interest rates and runaway inflation of the early 1980s push more taxpayers into higher tax brackets, the tax exempt nature of municipal securities became increasingly attractive. Motivated by a desire for a secure tax shelter, individual investors began purchasing insured municipal bonds in record numbers and now buy over 80 percent of all new municipal obligations..."

Who Provides Financial Guarantees?

A wide variety of participants have been involved in the growth of the financial guarantee industry. The guarantees are being provided by both monoline (insurers providing only one line of insurance) and multiline (insurers providing multiple lines of insurance) companies. The multiline firms are traditional companies in the insurance industry, such as Aetna Life and Casualty, Travelers, United States Fidelity and Guaranty, and Fireman's Fund, who have added financial guarantees to their product lines. The monoline firms were created solely by individual and groups of companies to write financial guarantees; some of the parent firms are multiline insurance companies, while other parent firms are not insurance companies.

Some of the newer entrants that have focused on narrower segments of the financial guarantee industry are Clarendon Insurance Company, which provides residual value insurance[13] and municipal guarantors, such as Financial Guaranty Insurance Corporation and Bond Investor Group Inc. In addition, new companies, such as Financial Security Assurance, which guarantee corporate obligations, are emerging. Companies such as these, unlike the multilines, have dedicated their capital specifically to financial guarantees. Some experts believe these monolines will continue to expand their presence in the market.

Since financial guarantees generally have not been reported separately from sureties, it has not been possible to identify all the insurers involved. Table 1.2 identifies some of the companies involved in the municipal bond insurance industry.

Table 1.2: Municipal Bond Insurance Industry (As of November 1986)

Insurer	Year founded	Financial backing
AMBAC Indemnity Corp (formerly American Municipal Bond Assurance Corp.)	1971	Citibank AMBAC employees Xerox Corporation Stephens, Inc.
Municipal Bond Insurance* Association	1973	Casualty and Surety Company Fireman's Fund Insurance Company Travelers Indemnity Company Aetna Insurance Company (now part of CIGNA) The Continental Insurance Company
Financial Guaranty Insurance Company	1983	Merrill Lynch & Co. Inc. Shearson, Lehman/ American Express, Inc. General Electric Credit Corporation General Reinsurance Corporation Kemper Group J.P. Morgan & Co., Inc.
Bond Investors Guaranty Corporation	1984	American Insurance International Group, Inc. Bankers Trust New York Corporation Government Employees Insurance Company Phibro-Salomon, Inc. Xerox Credit
USF&G Financial Security Company	1985	United States Fidelity & Guaranty

[13]Residual value insurance guarantees the value of an asset after a period of time.

(Note: Table reproduced from the Insurance Information Institute monograph titled: "Financial Guarantee Insurance".)

*Municipal Bond Insurance Association converted to a monoline insurer in December 1986 and Travelers Indemnity Company is not associated with the new entity.Many insurers view financial guarantees as a relatively high growth area capable of generating significant premiums. However, some experts believe that there will be multiline insurers who will either reduce their involvement in or withdraw totally from the financial guarantee industry due to the level of capital required by credit rating agencies as well as competing uses for limited capital. Some multilines have indicated a desire to maintain capital flexibility and to be able to move it from business line to line as needed. Tying capital to financial guarantees would restrict flexibility.

Reinsurers[14] thus far, have been somewhat less enthusiastic about the financial guarantee industry. Reportedly, they have been fairly cautious as they have previously experienced losses in residual value insurance. This hesitancy by reinsurers has forced some primary carriers to retain a greater portion of their own guarantee business than they would normally in other insurance markets. Some experts believe the larger retentions may significantly increase the risk to some of the primary underwriters.

Besides insurance-related participants, banks have competed in some segments of the financial guarantee industry through the use of letters of credit. An industry source indicated that domestic bank competition will decline as the Federal Reserve Board attempts to control banks' "off-balance sheet exposure[15] by increasing bank capital requirements. However, foreign banks are participants and will be unaffected by the Federal Reserve's attempts to control off-balance sheet exposure.

Objectives, Scope, and Methodology

We undertook this study because of reported problems in the industry. Several insurance companies have either failed or have been taken over by state agencies due to their inability to honor their guarantees. Our objectives were to

- determine the scope of the financial guarantee industry by reviewing products offered, participants, and trends;
- gather information on the various organizational structures that exist in the financial guarantee industry;
- examine the disclosure issue by looking at what information regulators currently have to monitor the industry; and

[14]Reinsurers are insurance firms that insure all or part of a risk previously assumed by another insurance company.

[15]Off-balance sheet exposure is the sum of the contingent liabilities that are not included in a firm's balance sheet.

- identify current and proposed regulatory efforts, with particular emphasis on the NAIC's model bill.

We conducted a literature search on financial guarantees. Our data sources included the ABI/INFORM data base,[16] the Federal Reserve Bank of Boston's technical library, the Boston Public Library, several Boston area university libraries, and the University of Connecticut's Center for Research and Development in Financial Services. We met with insurance regulators in California, Connecticut, Florida, Illinois, Massachusetts, New York, Pennsylvania, Texas, and Virginia to discuss guarantees in general, and to determine what role, if any, each has in regulating the industry. We also held similar discussions with officials from two federal regulatory agencies, the Office of the Comptroller of the Currency, and the Securities and Exchange Commission (SEC). In addition, we spoke with officials from three independent credit rating agencies—Standard and Poor's (S&P), Moody's, and A.M. Best—to determine their involvement with financial guarantees.

We also held extensive discussions with representatives of 11 insurance firms headquartered in California, Connecticut, New York, and Massachusetts that were involved either directly or indirectly with financial guarantees. We held additional meetings with officials from the Financial Accounting Standards Board; the Insurance Department of the University of Pennsylvania's Wharton School, the American Council of Life Insurance, the Federal Financial Institutions Examination Council, and the Association of Financial Guaranty Insurers. Finally, we discussed the subject of pending financial guarantee legislation with New York State Senator John R. Dunne who has been active in the insurance area.

Insurance companies operating in the nine states in our study accounted for more than 50 percent of all surety premiums written in this country in 1984 (the most recent data available at the time we began our work). As previously noted, financial guarantees are part of the surety line of insurance. Furthermore, five of the nine states (New York, California, Illinois, Texas, and Virginia) were chosen because their state insurance commissioners had participated in the NAIC Financial Guarantee Insurance Study Group.

The 11 insurance firms included in our study were selected early in the assignment. At the time, we were uncertain as to which ones actually

[16]The ABI/INFORM data base provides worldwide business and management information dating back to 1971. More than 500 publications are abstracted in this file.

were writing financial guarantee insurance. Several are large multiline insurers, while others are monoline firms, specializing in one or more types of financial guarantee insurance. We contacted these companies because of their large size, their prominence in the insurance industry, the types of insurance provided and, in some cases, their reported involvement in the financial guarantee industry. Our field work was conducted between October 1985 and May 1986, in accordance with generally accepted government auditing standards.

Agency Comments

We provided copies of the draft of this study to staff of the SEC and to the NAIC for their review and comment. SEC's Deputy Chief Accountant responded for that agency. His response is included in this study as appendix III. His comments were of an editorial nature to enhance the information provided or to clarify points we made. We considered these comments in finalizing our report.

The NAIC, a professional organization established to assist individual state regulators in addressing concerns and problems in the regulation of insurance, requested the Superintendent of Insurance for the State of New York and the Insurance Commissioner of the State of Illinois to respond for the organization. The Superintendent's response is included in this study as appendix IV. The Illinois Commissioner did not respond in time to be included in this study.

The Superintendent's comments, as were the SEC's, were mainly of an editorial nature to enhance the information provided or to clarify points we made. Beyond the editorial comments, however, the superintendent took strong exception to what he characterized as our conclusions on the monoline versus multiline form for a financial guarantor. He believes that the monoline form should be mandated and said we gave too much prominence to the presentation of the advantages and disadvantages of the multiline approach and to comments of the former California insurance commissioner who favors the multiline approach. We understand the superintendent's concerns; however, the section presents the views of a segment of the industry and those of an insurance commissioner of a leading insurance state rather than any conclusions that we have drawn. As a result we have decided to retain this information. The superintendent also had comments regarding the role and performance of the industry's rating agencies. We have added his views to the appropriate section of this study.

Important Aspects of Financial Guarantees

Although the financial guarantee insurance industry is relatively new and has grown rapidly in the past decade, financial guarantees have their roots in the traditional insurance company surety bonds and bank letters of credit. As with these more traditional products, financial guarantees are not risk free. The potential risk of financial guarantees varies with the type of guarantee and, specifically, with the individual guarantee itself. Furthermore, a financial guarantor's own organizational structure, its position within the parent corporation, and its relationship with other companies in the insurance industry affect the stability of any given firm as well as the entire industry.

Relationship Between Financial Guarantees, Surety Insurance, and Bank Letters of Credit

As with financial guarantees, surety bonds and bank letters of credit are used to replace or augment the credit of an individual, partnership, or corporation with that of the bank or insurer. The following will discuss these traditional products, as well as some of the innovations taking place and the regulatory response to these innovations.

Surety Insurance

A surety bond is a contract between three parties—the principal, the obligee, and the surety. Normally, the principal contracts to provide a service to the obligee. The principal then pays a premium to the surety to ensure the contracted service is performed. In the event the principal defaults on his/her obligation, the surety can either be required to complete the contract or to pay some indemnification to the obligee. The transfer of risk through a surety bond resembles insurance and corporate sureties are considered insurers under state laws.[1] However, unlike other forms of insurance where losses are expected and provided for through product pricing, surety bonds ideally are written without expectation of loss. C. A. Williams and R. M. Heins in their book, Risk Management and Insurance, state the following:

> "Ideally, there would be no losses under a surety bond because the surety would not write the bond if there were any chance of loss and the surety would discover any potential losses in its investigation.... Ideally, a surety bond would not have to contain any expected-loss allowance. The premium would thus cover only the surety's investigation and other expenses and provide some margin for profit and contingencies.... In practice, sureties do incur some losses because their investigations are not completely effective."

[1] C. A. Williams and R. M. Heins, Risk Management and Insurance, fifth edition (New York: McGraw-Hill Book Company, 1985), p. 215.

According to the Superintendent of Insurance for New York, surety losses have been substantial in the past several years. He reported the following loss ratios:[2]

Table 2.1: Surety Loss Ratios

1983	87.5%
1984	95.6%
1985	112.5%

Bank Letters of Credit

Banks have long provided letters of credit to serve similar purposes as insurance company surety bonds. By placing guarantees behind individual contracts, banks are able to facilitate transactions between two parties. International banks use commercial letters of credit to facilitate international trade by setting up mutually agreed upon lines of credit under which exporters could have payment for their goods guaranteed. The exporters' bank relies on foreign correspondent banks, who guarantee the credit of the importers and their payments. The exchange of certain predetermined documents triggers the payment to the exporter.

A modification to the letter of credit is the standby letter of credit. While in the older letter of credit a bank provides the funds to consummate a successfully conducted transaction, in a standby letter the bank only pays when it receives notification of default or nonperformance on the part of the account party. A small percent of standby letters of credit are presented to the bank for payment. As with surety bonds, banks do not expect losses and, therefore, try not to write a standby letter of credit when they perceive even a remote possibility of default.

Standby letters of credit are currently used to guarantee a number of financial transactions and performance contracts for bank customers around the world; their use over the past 10 years has steadily increased. In 1976, U.S. commercial banks recorded less than $20 billion of standby letters of credit (equal to about 15 percent of capital). By 1985, standby letters of credit had grown to almost $160 billion (close to 100 percent of total bank capital).[3]

[2]Loss ratio is the relationship between the losses incurred and the premium paid.

[3]B. Bennett, Off-Balance Sheet Risk in Banking. The Case of Standby Letters of Credit, Federal Reserve Bank of San Francisco, Economic Review, Winter 1986.

Since standby letters of credit are considered to be contingent liabilities, they are not shown on banks' balance sheets and do not count in calculations of their capital adequacy. Banks have found that issuing standby letters of credit increases their ability to earn additional fees without necessarily utilizing bank funds.

The Federal Reserve Board has approached the issues of increased use of standby letters of credit and other off-balance sheet exposure. Efforts have focused on adjusting capital requirements to take account of standby letters of credit and other off-balance sheet exposures. For example, on January 13, 1986, the Board was presented with a staff proposal to obtain public comment on risk-based capital measures that would adjust current capital adequacy requirements to expand coverage to off-balance sheet risks.

Riskiness of Guarantees

We believe the financial guarantee industry can be divided into four major groups: municipal bond insurance, corporate debt insurance, mortgage insurance, and miscellaneous or unusual insurance products. A brief analysis of the potential general risk of each follows along with a general discussion of the risks involved with individual transactions.

Municipal Bond Insurance

Municipal bonds are generally considered to be low risk.[4] Even in the event of a municipal default, the result tends to be only temporary. The municipality may recover and the insurer/guarantor is frequently legally protected. Additionally, there may be some state or federal assistance available. After municipal recovery, the insurer may be able to collect payments made on behalf of the municipality during default. Some concerns we see regarding this type of guarantee include the following:

- The existence of the guarantee reduces the interest rate needed to borrow the funds. The current practice in determining the premium charge is to share the interest savings resulting from a guarantee between the municipality and the insurer. Regulators are concerned that this pricing practice may not adequately provide for the associated risks and potential for losses, particularly when interest rates are low and the spread must therefore be less.

[4] An exception to this is the industrial development bond which is actually a corporate obligation issued in the name of municipalities and is a concern to regulators.

- While there have not been many losses in the business, this could change as economic sectors deteriorate. The Washington Public Power Supply System losses are one indication that the loss potential is real and has to be accounted for in pricing and reserving decisions.[5] Even though a guarantor attempts to underwrite only "good" risks in order to obtain a zero loss situation, there is still a potential for loss after the guarantee is written.
- When the municipal bonds guaranteed are general obligation bonds, the full revenue gathering ability of the municipality generally supports them. However, in the case of specific revenue bonds, the revenue from a certain entity is used to meet the obligations and to support the guarantee. If the project should fail to meet its obligations, the financial guarantor would have to meet the obligations. Even if the guarantor were to have a lien or claim on the property, it is questionable as to whether it could be repossessed and what the recovery value would be.
- Failures can occur for reasons other than the traditional reasons of mismanagement and weak economy. Failures can also occur for reasons such as the decisions of government. For example, the construction of a nuclear power plant might be cancelled because of public sentiment.

Corporate Debt Insurance

The insurance of corporate debt is a newer, growing segment of the financial guarantee market. It is considered riskier than municipal securities insurance because of the higher default rate. There is also a concern that, as more companies enter the business, competition is likely to result in overall underwriting standards being lowered since there can only be a limited amount of quality business available. Guarantees have been written for money market funds, eurodollar notes, leases, investment contracts, receivables, and commercial paper. Other types of corporate obligations being guaranteed are securitized loans, including groups of car loans, mortgages, and other types of consumer debts. A leading issuer of corporate financial guarantees has stated that guarantees benefit the investor. The transaction would appear to be more advantageous to the investor than other similar unguaranteed transactions because it

- is more secure since the insurer adds its credit rating to that of the issuer;
- will give an investor a higher yield than U.S. Treasury Bonds;

[5] AMBAC Indemnity Corp had guaranteed some of the obligations of the Washington Public Power Supply System which defaulted. It is liable for losses of $75 million and had to set aside reserves of $28 million in 1985.

- can be sold efficiently in the secondary market which exists to permit the resale of previously issued securities;
- will be more marketable since the investor need not undertake an independent investigation of the insured transaction; and
- will not be downgraded if the fortunes of the issuing firm should decline.

Companies in the corporate guarantee business cite two reasons why they are able to provide guarantees. The most frequently cited reason is that they are able to structure the deals so that potential losses are small. By taking extensive, even overlapping collateral, including standby letters of credit, securities, and property, the insurers are able to protect themselves from loss.

The second reason cited was the guarantor's ability to eliminate the uncertainty that would otherwise have a negative impact on rating a financial product. For example, some privately held companies or organizations may not wish to publish complete financial statements, thereby opening their books to the public. A guarantor, having a long-term relationship with such an organization or given confidential access to records, can reduce uncertainty.

Mortgage Insurance

Mortgage insurance is considered by some insurance industry officials and regulators, but not all, to be a financial guarantee product. We believe mortgage insurance is riskier than municipal bond guarantees, because it is tied to the volatile real estate market. According to the Wall Street Journal,[6] property values in some areas of the country have dropped significantly in recent years. Also, American Banker cited instances where appraisals of mortgaged properties allegedly have been inflated either through fraud, incompetence, or honest error.[7] Additionally, with the use of adjustable rate mortgages, there is the potential for significant and burdensome increases in individuals' mortgage payments that adversely affect the mortgagor's ability to pay the debt. According to industry sources and several articles in newspapers, including The New York Times, and the Boston Globe, mortgage insurers have been

[6] L. Cohen, Mortgage Insurers Last Year Posted First Operating Loss, Wall Street Journal, May 21, 1986, p. 5.

[7] M. Carroll, Task Force Formed to Probe Mortgage Pool Loss; Bank of America Names 6 Employees in Lawsuits, American Banker, Mar. 4, 1985, p. 1.

called upon to honor their guarantees and some have incurred severe losses; some have even gone bankrupt.[8, 9]

Unusual Forms of Financial Guarantee Insurance

In addition to the previously discussed categories of financial guarantees, there are a number of unusual types that are reportedly offered by insurance companies. These include items such as guaranteeing future interest rates, providing insurance coverage beyond the limits of the Federal Deposit Insurance Corporation depositor coverage, guaranteeing the compensation of executives after company takeovers (golden parachute contracts), or providing key man insurance. (See app. I for a description of these and other financial guarantees being offered.) The financial guarantors we spoke with did not offer all of these unusual types of guarantees. The diverse and innovative nature of the products already in existence indicates that there may be a significant opportunity for expansion and growth in this area. There are literally an inestimable number of possibilities.

How Does Risk Relate to Financial Guarantee Insurance?

Literature that we have reviewed disclosed that the risks associated with guarantee products generally vary with the circumstances of individual transactions. As we previously noted, sources within the industry divide financial guarantees into two basic types—credit enhancement and risk insurance.

Credit Enhancement

From an industry perspective, credit enhancement does not involve a high degree of insurer risk. In such a transaction, the insurer's guarantee reduces investor risk, thereby improving the financial product's rating. Meanwhile, the insurer acquires nearly full protection against loss. In this kind of financial guarantee, the insurer requires a well-structured financing that results in a sound, quality issue for investors. Not only does the insurer obtain collateral to protect itself, but it demands additional collateral as back-up protection in the unlikely event of a default. The collateral can take the form of letters of credit, liens on property, or securities.

[8]M. Sullivan, EPIC Had a Warning on Shelters - Report, Boston Globe, Sept. 6, 1985.

[9]S&P Lowers Its Ticor Rating, The New York Times, Oct. 10, 1985.

Credit enhancement is, therefore, in theory, based on a zero-loss standard. The guarantor does not expect any losses from issues it underwrites. The guarantor's goal is to improve the marketability of an already sound security, rather than insure against a loss based on statistical probability tables. As a result, the premium on a credit enhancement type of financial guarantee is not based on risk exposure. Instead, the premium reflects the benefit that the credit enhancement provides to the debt issue by increasing its marketability, especially among major quality conscious investors.

Risk Insurance

The industry sees the second type of financial guarantee, risk insurance, as transferring economic risks to the guarantor. Risk insurance is much like traditional insurance in that it accepts the eventuality of some losses. The guarantor assumes that a loss, if not certain, is at least likely. The question is when, not if, a claim on some of the guarantees will be made. In these types of insurance, guarantors believe claims can be statistically forecast from prior experience.

The insurer uses historical data as the actuarial basis for setting premium levels to compensate for risk. Over the long term, overall losses are expected to be less than the overall premium and related insurance company investment income. In this way, the risk insurance type of financial guarantee functions in basically the same way traditional insurance does.

Writing risk insurance guarantees requires experience and care if the insurance is to function properly for the securities issuer and investor, and if the insurer is to make adequate returns. Some defaults can be reasonably expected and the securities investor, therefore, must be certain that the insurer has the ability to survive such defaults, particularly if they are severe. One great concern to those observing risk insurance is whether companies actually have the ability to accurately predict losses without loss experience in some of the new, sophisticated products.

A somewhat different view of financial guarantees has the guarantees falling into three general categories:

- transactions where some losses are expected, but the insurers are willing to accept losses because the large number of transactions minimizes the impact of any one loss;

- structured transactions, which include redundant layers of security and collateral to insulate or reduce the risk exposure of the guarantor; and
- transactions where no losses are expected.

Large Numbers of Transactions

In this category, the insurer expects and is willing to accept losses on some transactions. It is willing to assume these losses because it anticipates that their impact will be fully offset by a number of other similar transactions without losses. This is very close to the historical approach used in evaluating more traditional insurance products.

Layers of Protection

In the area of structured or layered financing, the insurer is willing to accept the risk because it views itself as being one of several risk bearers. That is, the insurance company has access to additional layers of protection such as reinsurance or collateral and may not be called upon first or individually to satisfy a loss. This layered protection concept is again comparable to some of the more standard lines of insurance whereby reinsurers are used so that the insurer does not bear the entire risk.

Risk-Free Transactions

The last approach involves guaranteeing transactions where no losses are expected. This may be due to what management perceives as risk-free transactions, or the anticipation of no losses may be due to the fact that sufficient security, such as letters of credit from top quality banks, provides the initial backstop to satisfy any losses. In addition, security may consist of collateralizing the issuers' obligation with real estate or other marketable assets. Some of the larger insurers who are guaranteeing corporate debt obligations are currently using this approach. In other instances, such as when privately owned corporations or foundations wish to sell securities without opening their records to the public, i.e., potential buyers, the guarantee is needed to market the product. In such situations, the insurer would have access to the confidential information, and base its guarantee on its own private evaluation, which presumably would reveal minimal risk.

The Cost of Unprojected Risks

Literature addressing risk points out that the ability to analyze financial guarantee risks is particularly important because financial guarantee exposure levels can be much higher than those for more traditional products. In many guarantee contracts, the guarantor commits to making both principal and interest payments according to the original schedule as long as the insured is unable to do so. While the guarantor is liable for both the principal and interest, the economic impact can be lessened because the payments are made over a period of time. The insured's default may be temporary, allowing the guarantor to avoid some later year payments as well as providing an opportunity to recover some portion of claims previously paid.

Some experts believe several factors make the assessment of financial guarantee risk difficult. They note it is virtually impossible to develop standardized risk profiles since each transaction may be very different from the previous one. Also, unlike more traditional insurance lines, many financial guarantee products are composed of risks, such as the possibility of a political decision or a fraud, that are beyond the traditional insurance company's underwriting expertise. With traditional insurance products, insurers are generally able to look to historical data, develop estimates of future losses, and use actuarial techniques to define risks. Many of the guarantee products do not have a track record. As a result, individual risks often must be evaluated separately in the underwriting decision.

We believe there are three reasons why the financial community should be interested in the risks associated with the financial guarantee industry. First, even a small number of poorly underwritten financial guarantees could lead to significant losses and adversely affect an insurer's ability to honor all its guarantees. Second, significant financial guarantee losses could reduce the ability of the insurance firm to honor other types of policy holder contracts. Third, the failure of one insurer could be contagious and spread to other firms. The latter concern could occur either directly by threatening company solvency through means such as reinsurance failures or indirectly by diminishing public confidence in the insurance industry and limiting the industry's ability to attract capital and assume risk.

Relationship Between Structure and Risk in the Financial Guarantee Industry

The organizational structure of the individual financial guarantor (whether operating as a monoline or multiline insurer), the position of the guarantor within the overall corporate structure (consortia, subsidiary, or internal unit), and the structure of the insurance industry as a whole (insurance firms backed by reinsurance) are important to the health of any given firm as well as the overall well-being of the industry. This section will examine how these various structures are utilized by financial guarantee firms within the industry.

rganizational Structure

There is considerable debate regarding whether a financial guarantee firm should be monoline or multiline. Both have advantages and disadvantages. Evidence is inconclusive as to which, if either, is more appropriate.

Since a financial guarantee monoline only writes financial guarantee insurance, there is no possibility of passing the financial guarantee risk and losses to other lines of insurance. Also, because monoline companies are separate legal entities, it is, therefore, easier for regulators to evaluate and monitor the operations of individual companies.

The multiline, on the other hand, is able to achieve greater diversification. With multilines, however, there is a possibility that financial guarantee losses will be passed on to other lines and eventually lead to broader company failures and losses to the state insurance guarantee funds.[10] On the other hand, if the risks of financial guarantees and other lines of insurance are not closely related, the insurer may be able to reduce overall levels of risk because the large number of transactions minimizes the impact of any single loss. Where the financial guarantee is written within the corporate structure determines the overall level of support available from the parent organization, as well as the degree to which the parent organization can be insulated from the financial difficulties related to financial guarantees.

Corporate Structure

We found three types of corporate structures that have been adopted by the financial guarantee industry.

- An investment in a separately capitalized, legally independent firm writing financial guarantees. The investing firm may hold a minority, majority, or even sole interest. While the investing firm's exposure or liability is legally limited to its investment, there may be reasons why an investor might desire to support a troubled firm. If the financial guarantor is closely associated (by the public or regulators) with the investor firm, the investor may feel it needs to protect its public image. The investor might voluntarily provide additional financing if needed.
- Participation in a consortia financial guarantor where the members individually share at a pre-determined percentage in each guarantee. In this

[10]State programs which set up funds that are used to secure the validity of certain types of insurance in effect in a state.

structure, each participating firm is fully responsible for the liabilities of the subsidiary in proportion to its investment.[11]

- The direct underwriting of financial guarantees. In this situation, there is no insulation from the other segments of the corporation. The financial guarantee contracts are underwritten directly by the parent company as part of its overall insurance business.

The Role of Reinsurance

Reinsurance is the manner by which the insurance firms spread their individual risks through the industry. The amount of risk a single company can underwrite is limited by its capital (including surplus and reserves). The reinsurance market was developed in order to allow insurers to increase the effectiveness of their capital; it allows them to underwrite more business. Reinsurers effectively "rent" their capital to other insurance companies by underwriting a portion of the companies' risk. The reinsurance markets have been instrumental in developing capacity in the insurance industry and stabilizing underwriting results from year to year.

Two types of reinsurance are available. (1) Treaty reinsurance is an agreement by which the reinsurer agrees, in advance, to underwrite some portion of the insurers' policies. (2) Facultative reinsurance, on the other hand, is based on a specific underwriting. The reinsurer is presented with a policy, analyzes the risk, and decides whether or not to participate. Treaty reinsurance is generally preferred by the insurer as it allows greater flexibility and faster response. Reinsurance treaties also demonstrate confidence in the underwriting ability of the insurer.

In the credit enhancement/financial guarantee market, reinsurance has been conspicuously absent. The lack of reinsurance coverage has been cited in the industry as one of the limiting factors to the market, and is viewed as additional evidence of the riskiness of the market by critics. For example, according to the American Banker,[12] Lloyds of London, as a matter of policy prohibits any kind of financial guarantees. However, several insurers have recently organized or are in the process of doing so with the exclusive purpose of reinsuring financial guarantees.

[11]As previously noted, as of December 1986, the Municipal Bond Insurance Association converted to a monoline insurer (the previously described type of structure) and there may no longer be any active firms of the consortia type.

[12]L. Brenner, The Illusory World of Guarantees: Good Can Look Bad and Bad Good, American Banker, June 25, 1985, p. 1.

Regulation of Financial Guarantees

Federal regulators, state insurance regulators, and independent credit rating agencies have only recently begun to regulate or control the insu: ance side of the financial guarantee industry. Some preliminary efforts are underway to establish disclosure requirements, operating guideline: and reserve and capital standards. Without adequate regulation and di: closure, regulators have not been able to keep abreast of developments in the guarantee industry, such as the types of guarantee products bein written, volume of business, industry trends, and actual and potential problems.

Federal Regulatory Efforts

The regulation of the insurance industry has been traditionally a state responsibility. The federal government has virtually no role in regulating the insurance industry. The SEC staff have an interest in financia guarantees because of their potential impact on securities and began addressing the financial guarantee issue during 1985. The SEC is respon sible under the federal securities laws to ensure full disclosure to investors, including disclosure of the risks associated with guarantee products.[1]

The SEC staff's recent concern stemmed from the fact that the volume c business and the variety of products insured has increased very rapidl In the past, insurers appear to have been guaranteeing the activities of fairly strong entities. However, with increased industry expansion and greater competition, SEC staff is concerned that insurers may guarante riskier deals resulting in a greater potential for future losses without adequately disclosing these risks.

To ensure that financial guarantee exposure is adequately disclosed to investors, SEC issued Staff Accounting Bulletin No. 60 on December 20, 1985. It recommends, in part, that insurers should disclose

- a general description of the type of obligation guaranteed,
- the amount of exposure,
- how revenue will be recognized,
- the amount of unearned premiums, and
- provisions for reserves.

[1]The Commission is studying the financial guarantee market as directed by Congress in Section 10E the Government Securities Act of 1986 (P.L.99-571). The study will examine the impact of the exer tion to registration requirements set out in Section (3)(a)(2) of the Securities Act of 1933 on investc protection and the public interest and on competition between banks and insurance companies and domestic and foreign guarantors, and whether debt securities guaranteed by insurance policies sho be exempt from registration under the Securities Act.

SEC's disclosure guidelines do not include discussions of individual guarantees or the specific circumstances related to them.

State Regulatory Efforts and Concerns

State insurance commissioners have recently begun to address the need for regulating those financial guarantees provided by insurance companies. California and New York have either enacted or are considering specific financial guarantee legislation. Also, in June 1986, the NAIC unanimously adopted model legislation to regulate financial guarantees. Several state insurance regulators that we spoke with believed that similar legislation would be introduced in their states during their next legislative sessions. Others were uncertain about the prospects for future legislation. All expressed concern about their inability to properly regulate the industry.

Financial Guarantee Insurance Study Group

The New York State insurance superintendent chaired a special NAIC Financial Guarantee Insurance Study Group. This group, consisted of the insurance commissioners from New York, California, Illinois, Nebraska, Texas, Virginia, and Wisconsin. The study group has been evaluating the financial guarantee area for over a year in order to develop a comprehensive model bill to govern financial guarantee insurance and to regulate its growth across the country. The group's creation came about from state insurance commissioners being concerned with the potential riskiness of financial guarantees. Issues faced by the study group included defining financial guarantees, determining the types of guarantees that should be allowed, and examining the issues of capital adequacy and structure (monoline vs. multiline). The group concluded that there was a need to insulate the traditional insurance business from potential catastrophic losses on accumulated financial guarantee exposure. To accomplish this, it proposed that financial guarantee insurance be conducted on a monoline basis by either establishing (1) companies that do only financial guarantees or (2) financial guarantee subsidiaries of multiline property/casualty insurers. The study group also proposed that financial guarantees be removed from coverage under state guarantee funds. The study group drafted a model bill incorporating its proposed changes. The NAIC, when it feels the need, develops model legislation dealing with specific issues. However, it remains up to individual state legislatures or regulators to adopt them.

There was considerable industry opposition to the proposed model bill, especially by multiline insurance companies that disagreed with the monoline approach. The Association of Financial Guaranty Insurers, a newly formed trade association comprised of nine multiline and monoline insurers, stated that the model bill restricts the availability of guarantees for municipal obligations. Therefore, municipalities would be prevented from enjoying the savings resulting from financial guarantees. The chairman of the Industry Advisory Committee to the NAIC study group offered an alternative proposal that would permit multilines to write financial guarantees. The study group, however, unanimously rejected the advisory committee's alternative.

The California insurance commissioner, during our inquiry in 1986, also disagreed with the monoline approach and the minimum capital and surplus requirements. He pointed out that the financial guarantee firms that failed in the 1930s were monolines. He stated, "the legal separation of classes of business through a monoline company structure is archaic and a step backward to a post-1930s' Depression mentality." Also, he said "the imposition of minimum capital and surplus requirements is generally self-serving and anticompetitive." The commissioner believes multilines should be allowed to write financial guarantees providing they are properly regulated.

On June 12, 1986, after several months of meetings and discussions, the NAIC membership unanimously adopted the financial guarantee model bill as drafted by the study group. The bill defines financial guarantee insurance. It permits companies presently writing authorized types of financial guarantees to continue doing so for a period not to exceed 2 years from the effective date of the approved state legislation, providing they apply for a license to establish a financial guarantee corporation (monoline). It also establishes capital requirements of combined paid-in capital and surplus of $50 million.

According to New York State Senator John R. Dunne, Chairman of the State Senate Judiciary Committee and a member of the Conference of Insurance Legislators, the NAIC adopted model bill is merely a guideline for the states to consider. The senator believes that if a bill he has proposed passes over the model bill, it will have a greater impact on other major money center states. (See the next section of this study for discussion of Senator Dunne's bill as well as others.) He stated few NAIC model bills have led to the adoption of state legislation and he believes this case may be no different. In contrast, a New York insurance department official believes some of the small states will adopt the model bill within a year of NAIC approval. In responding to our draft study for the NAIC, the New York state superintendent took exception to the senator's statement that few NAIC model bills have been adopted by the states. The

Superintendent asserted that many model bills have been adopted, in most cases verbatim.

Current Regulatory Efforts

California enacted limited financial guarantee legislation in 1985. This legislation, effective January 1, 1986, authorized insurance companies that were presently writing surety insurance to guarantee municipal bonds.[2] It required these insurers to establish contingency reserves equal to 50 percent of the earned premiums on municipal bond policies. The legislation also sets exposure limits on aggregate risks—$200 of exposure (net liability after reinsurance) for each $1 of combined capital, surplus, and contingency reserves. Additionally, detailed individual exposure limits were set.

California also addressed the disclosure issue. In 1985, the Department of Insurance issued instructions to insurance companies for disclosing financial guarantee exposure on their annual insurance statements. Beginning with their 1985 statements, companies began disclosing their aggregate exposure under three classifications of financial guarantees:

- municipal bond insurance,
- guarantees of obligations that have underlying security or collateral and that could be satisfied with periodic principal and interest payments, and
- all other guarantees.

Also, for each of the three classifications of guarantees, data must be reported separately on any guarantee in which the annual amount due for unpaid principal and interest exceeds a specified percentage of the insurer's capital and surplus.

According to the then California insurance commissioner, it was impossible before these disclosure requirements to identify the volume of guarantee business being written by multiline insurance companies. All financial guarantees were reported as surety business. He stated California's reporting requirements were proposed to the NAIC. Since then, all state insurance departments have adopted them. These NAIC reporting requirements are referred to as "footnote 12." For an example of this disclosure, see appendix II.

[2]New York has regulated municipal bond insurance since 1970. The 1985 California law as well as a more recent Illinois law reportedly were also patterned after New York. Wisconsin reportedly has regulations in place that parallel New York's.

In New York, three separate financial guarantee bills were submitted to the state legislature in 1986. New York State's Senator Dunne and several of his colleagues submitted a bill to both the Senate (S.9078—A) and Assembly[3] (A.11348) on May 6, 1986, and May 28, 1986, respectively. Senator Dunne's bill

- defines financial guarantee insurance;
- permits multiline insurance companies to continue writing municipal bond insurance;
- permits companies presently writing all other authorized types of financial guarantees to continue doing so for a period not to exceed 4 years from the act's effective date, providing they apply for a license to establish a financial guarantee corporation (monoline); and
- establishes capital requirements for financial guarantee corporations of $75 million in paid-in capital and surplus.

On June 22, 1986, Senator Dunne's bill passed in the Senate but did not proceed further. According to Senator Dunne, the Assembly has shown little interest in his bill because it is more concerned with other insurance issues. As recently as February 1987, he still believed the bill would pass the Assembly. As of April 1987, it had not passed. However, the Superintendent of Insurance for the State of New York advised us that with the conversion of the Municipal Bond Insurance Association to a monoline insurer, the Dunne bill is no longer relevant and, therefore, passage in either house is doubtful.

The New York Insurance Department submitted its bill, a slightly modified version of the draft NAIC model bill then under consideration, to both the Senate (S.9228) and Assembly (A.11347) on June 2, 1986, and May 28, 1986, respectively. This bill

- defines financial guarantee insurance;
- does not permit multiline companies to write municipal bond insurance (unlike the Dunne bill);
- permits companies presently writing authorized types of financial guarantees to continue doing so for a period not to exceed 2 years from the act's effective date, providing they apply for a license to establish a financial guarantee corporation; and
- establishes capital requirements for financial guarantee corporations (the combined paid-in capital and surplus requirement is $50 million).

[3]The New York legislature's other house.

Finally, the Industry Advisory Committee to the NAIC Financial Guarantee Insurance Study Group submitted the insurance industry's version of a financial guarantee bill to the New York Assembly (A. 11349) on May 28, 1986. It likewise defines financial guarantee insurance. However, unlike the Dunne and department bills, the industry bill does not require that the business be conducted by a separate (monoline) financial guarantee corporation. While the bill does not specifically address the issue of paid-in capital and surplus, it does require a minimum of $50 million for policyholders' surplus and special reserves.

The New York state insurance superintendent advised us that the industry bill's capitalization requirement is meaningless because "special reserves" are liabilities established to cover future losses. Thus, a company could theoretically write guarantees without any surplus.

Prospects for Future Legislation

California has enacted financial guarantee legislation while the New York legislature was, as previously stated, considering separate financial guarantee bills. The following summarizes the situation in the remaining seven states as of April 1987:[4]

Connecticut - The insurance department has no formal plans to prepare a financial guarantee bill. It will discuss the issue and possibly draft a bill similar to the NAIC model bill for legislative consideration in the future.

Florida - The insurance department has proposed that the NAIC model act be adopted in the State insurance code. A bill doing so has been introduced in the legislature's house but not in the senate.

Illinois - The insurance department has drafted comprehensive financial guarantee legislation patterned after the NAIC model bill, but has not introduced it into the legislature.

Massachusetts - The insurance department plans to look at the NAIC model bill and believes there is a good possibility that it will prepare a similar bill for future legislative consideration.

Pennsylvania - As of April 1987 the insurance department was evaluating the NAIC model bill as well as legislation passed or considered in

[4]NAIC has indicated that the Iowa and Wisconsin insurance departments are submitting the model bill to their legislatures.

California and New York. No decision had been reached on whether to seek legislation.

Texas - As of April 1987 the insurance department had no plans to prepare a financial guarantee bill for submission to the legislature.

Virginia - The legislature has approved a bill to become effective July 1, 1987. The bill authorizes the state licensing of monoline financial guarantee firms and limits the amount of risk that any firm may assume on a municipal security.

Regulators' Concerns Regarding the Financial Guarantee Industry

Insurance regulators in the nine states included in our work generally knew little about the financial guarantee industry and were openly concerned about this. Until recently, regulators had little information on the extent to which companies in their respective states were writing financial guarantee insurance. For example, Florida insurance department officials said they knew little about the scope and nature of the financial guarantee business in their state. They noted their department had not been able to identify how much financial guarantee business was being conducted, who was writing it, or what types of guarantees were being written. An Illinois official said the department generally only learned that a company was writing financial guarantees during field examinations, which are performed on the average of once every 5 years.[5] Most other state regulators expressed similar views.

Several regulators said that the increased disclosure in the 1985 insurance company annual operating statements enables them to determine, at a minimum, who is writing financial guarantees. However, some regulators questioned the value of this information. Since there is no standard for what constitutes a financial guarantee, some firms may not be reporting full and accurate information. A Pennsylvania insurance official said that the data derived from the new disclosure requirement has no inherent value other than targeting firms for closer scrutiny.

In his comments on this study the superintendent of insurance for the State of New York said that beginning with the 1986 insurance company annual operating statements, which will be filed with several states March 1, 1987, financial guarantees will be reported on a separate line. He said the instructions for completing the statement include a definition of financial guarantee insurance which parallels the definition in

[5]The frequency of field examinations is set by individual state law which varies.

the NAIC model act. Once the model act becomes law, a special reporting blank will be designed.

Most regulators we spoke with were unaware of any specific problems in their states relating to financial guarantees. This is understandable in light of the scarcity of information available to regulators. Insurance department officials from two states, however, were aware of specific problems and expressed their concerns to us.

The Pennsylvania Deputy Commissioner of Insurance said that insurance examiners, during routine examinations, identified two insurance companies that are in trouble due to their financial guarantee involvement. One of the firms had written, through a managing general agent,[6] $494 million in financial guarantees (exposure) during a 13 month period. Although the company had reinsured 70 percent of the coverage, it was still in serious trouble. The guarantees were on limited partnerships and many had defaulted. At the time of our meeting, the company still had about $190 million of potential liability outstanding ($57 million after reinsurance), more than its capital including surplus. The company is a multiline insurer and has relied heavily upon the managing general agent to evaluate the risk and price the product. According to the deputy commissioner, if this insurer fails to honor the guarantees, a midwestern savings bank will fail. This bank got involved through its purchase of limited partners' notes that were guaranteed by the insurer. It had not evaluated the investment and relied solely on the guarantee. The deputy commissioner believes this bank is not unique and that others are in the same situation because they know little about evaluating insurance companies.

The former California insurance commissioner identified three insurance firms that became "financially distressed" due to mismanaging their financial guarantee business. He said that

> "two companies had a reasonably stable book of insurance in force that was destroyed in a matter of months by their unpropitious venture into the financial guarantee insurance market. . .These insolvencies clearly demonstrate that financial guarantee insurance is a very specialized coverage that requires a financial expertise and knowledge not usually possessed by the traditional underwriter and risk manager."

[6] A managing general agent is a dealer/broker who represents an insurer and evaluates risk and sets premiums.

The pricing of financial guarantee insurance is another area of great concern to regulators. The former California insurance commissioner said that competition drives the prices down and may be too low to cover risk. The New York superintendent of insurance said that pricing of guarantees appears to have little or no relationship to risk. Insurance firms believe all they are selling is their credit rating. The Pennsylvania deputy commissioner said his department lacks the expertise to evaluate the adequacy of rates when risks are to be considered. Illinois insurance officials also expressed concern about financial guarantee pricing. They said they have no specific knowledge as to how rates are established.

The following are examples of other concerns cited by state regulatory officials:

- Insurance companies are jumping into the financial guarantee business without knowing what they are getting into, thus causing possible solvency problems for other products.
- Insurance examiners have not received the necessary training to be knowledgeable about the financial guarantee area.
- It is difficult to monitor the financial guarantee industry due to the rapidly changing types of guarantees.
- Managing general agents that lack expertise are writing financial guarantees and other insurance products for insurance companies that also lack the expertise. They receive their commission regardless of whether they write "good or bad business." It is important that insurers establish adequate controls over managing general agents.
- There is no real spreading of risk in the financial guarantee business. Unlike other insurance areas, financial guarantees protect against economic risk and losses tend to be cyclical. When economic risks are involved, reinsurance makes little sense. Companies that are writing the guarantees are also reinsuring other companies' guarantees. In an economic crisis or downturn, everyone would be hurt.
- A multiline insolvency may have an adverse impact on state insurance guarantee funds.

Credit Rating Agencies' Role

Independent credit rating agencies such as S&P and Moody's, though not regulators, have established standards that place limitations upon a major segment of the financial guarantee industry—the guarantors of municipal and corporate debt. These standards deal with such factors as the capital adequacy of the guarantor, management structure, and underwriting practices.

According to a S&P managing director, about $140 billion of corporate and municipal bonds are issued in the nation's public debt market each year, and another $20 billion are privately placed outside the market with individual investors or groups of investors. The repayment of these debts has become dependent upon not only the creditworthiness of the issuer, but also the backing of a third party such as a bank or insurance company. A rating agency's credit assessment or rating of a bond issuer and issue affects the marketability of publicly issued debt, and to some extent, privately placed debt as well. Likewise, in the financial guarantee insurance marketplace, the credit rating of the insurance company is of critical importance. An insurer's credit rating is important because it is an assessment of the company's financial capacity to meet the terms of its financial guarantee contract.

Credit rating agencies develop standards that insurers must meet to obtain various credit ratings. For example, an S&P official stated that as part of its rating process, it determines capital adequacy levels for monoline insurance companies and the capital that multiline companies should set aside to cover potential financial guarantee losses. The original model for determining the capital necessary to meet a period of economic stress was based upon a study by Professor George Hempel, from Southern Methodist University, of municipal defaults during the Great Depression. This study showed that at the Depression's peak, 16 percent of the annual debt service on all outstanding municipal obligations, was in default. Thus, in the past, to receive S&P's highest credit rating (AAA), a guarantor had to have sufficient capital to meet this 16 percent default scenario.

The S&P's managing director said that although the Hempel study was a reasonably accurate measurement of municipal defaults during the Great Depression, its applicability to the current municipal market has diminished. Thus, for the last 2 years, S&P has been developing its own capital adequacy model. The S&P model currently addresses capital adequacy levels for guarantees of more than 20 different categories of municipal debt. Unlike the previous methodology, the S&P model relates capital levels needed to meet a future depression, to both the amount of principal and interest insured, and to the degree of risk being incurred. For example, general obligation bonds are considered far less risky than hospital or nuclear facility bonds. S&P also plans to develop similar capital adequacy guidelines for other classes of debt.

In rating a monoline insurer, in addition to analyzing the insurer's capital in its ability to meet a depression scenario, S&P also looks at several other factors including management, underwriting standards, and primary capital. As part of its requirement for an AAA rating, S&P requires the insurer to have primary capital of at least $150 million, plus $50 million of reinsurance from strong insurance companies. For multiline insurers, S&P's rating is based upon the creditworthiness of the entire company and is not restricted to any capital that might be allocated solely to support the financial guarantee business. According to the S&P managing director, the companies that have been analyzed and currently participate in the financial guarantee arena are all large, diversified property/casualty firms. S&P allocates capital to both the property/casualty line of business and to the financial guarantee business to determine if sufficient capital exists within the consolidated entity. For a multiline company with an AAA rating, both the traditional business and financial guarantee business should measure up to AAA standards.

Moody's also rates insurance companies that provide financial guarantees. Moody's officials stated that, for these companies, it is difficult to determine the amount of capital that adequately covers risk. In its rating process, Moody's puts firms through a worst case depression scenario. It analyzes insurers' underwriting standards and the type of guarantees the insurer gives and looks at the premiums to be charged, the competition, the riskiness of the guarantees, and what reinsurance companies are being used. Additionally, Moody's does a stress analysis to determine the likely potential for losses over time and capital requirements. Unlike S&P, however, it does not use preset capital requirements. Rather, Moody's relies on its in-house capital market expertise to establish capital requirements.

In his response to our study, the New York superintendent commented on the performance of the rating agencies. He stated:

> "We are also troubled by the lack of oversight of the rating agencies over the type of obligations guarantied [sic] by multiline insurers. The rating agencies review the monoline insurer's book of business and, in many instances, the specific issues guarantied; for multiline no such review takes place. The 'AAA' rating is based entirely upon the multilines perceived 'claims paying ability'. In other words, the rating agency is relying on the cash flow from the guarantor's property/casualty business to cover the guaranties. This piggybacking is precisely what state insurance regulators are trying to avoid through the imposition of a monoline structure. Some multilines have had their 'AAA' ratings reduced to 'AA' as a result of adverse property/casualty experience. The question arises as to whether the purchasers, who are getting a lower rate of return based upon the 'AAA' ratings, now have an actionable claim for the difference in rate of return..."

The superintendent has raised some interesting issues regarding the rating of guarantors. We believe that many of these issues will evolve as the industry grows and develops and finite answers may be long in coming.

Financial Guarantee Products[1]

Accounts Receivable Insurance— Indemnifies a company for unpaid debts due to the bankruptcy or insolvency of its customers or customers' slow payment.

Appraisal Inaccuracy Insurance— Insures the accuracy of appraisals that are made by preapproved appraisers and protects buyers, lenders, syndicators, and borrowers from the adverse effects of an incorrect appraisal.

Closure/Post Closure Insurance— Provides funds to close a hazardous waste facility if considered necessary by public authorities.

Collateral Value Insurance— Guarantees the value of collateral pledged for a loan.

Commercial Credit Insurance— Indemnifies policyholders for sums that they cannot collect from clients who have filed for bankruptcy or who are otherwise unable to pay.

Commercial Lease Insurance— Timely payment of guarantee installments by lessee to lessor.

Commercial Paper and Corporate Debt— Guarantees corporate debt issues, which result in a higher rating on intermediate term debt and a rating of A-1 or P-1 on commercial paper.

Equipment Lease Termination Indemnity— Indemnifies a lessor for the financial loss resulting from an equipment lease not being renewed.

Excess Federal Deposit Insurance Corporation/Federal Savings and Loan Insurance Corporation Insurance— Provides excess coverage above the FDIC/FSLIC limit for depositors of financial institutions.

Excess Securities Investor Protection Corporation— Provides excess coverage above the guarantee fund for customer investment accounts with brokerage firms.

[1]There is no full agreement as to whether all these products are guarantees. Because the types of products are continually changing, this list may not be all inclusive. This listing was compiled from Financial Guarantee Insurance Coverages (Marsh & McLennan), Business Insurance, May 14, 1984, and an Alexander and Alexander Financial Guarantee Seminar in Hartford, Connecticut, May 30, 1985.

Force Majeure— Insures a firm for circumstances beyond its control such as changes in laws or regulations, strikes, and other perils excluded from standard insurance policies. This is also referred to as change in law coverage.

General Partnership Liability Insurance— Protects the general partner in suits alleging wrongful acts, and in cases where the partnership has agreed to indemnify the general partner, the partnership is made whole.

Golden Parachute Insurance— Guarantees the salary and benefits of a corporate executive if an acquiring company refuses to honor the employment contract.

Hospital Guarantees— Provides that payment will be promptly made in the event of the hospital authority's failure to make payment to the paying agent of guaranteed bonds.

Industrial Development Bond Insurance— Guarantees principal and interest on tax-exempt industrial development bonds.

Interest Rate Insurance— Protects corporate borrowers against rising interest expenses on variable rate loans.

Investment Tax Credit Recapture Indemnity Insurance— Protects against tax credit recapture due to a casualty and/or theft loss. It also protects against a casualty or theft loss that prevents the taxpayer from claiming the credit on his return.

Key Man Insurance— Compensates an employer for financial hardships due to the death of an employee whose service was of vital importance to a corporation.

Letter of Credit Guarantees— Guarantees the payment on letters of credit issued by both rated and non-rated banks.

Limited Partnership Investor Bond— Guarantees the promissory notes of limited partners.

Merger and Acquisition Coverage— Covers the expenses of the insured's attorneys, investment bankers, etc. during the successful resistance of a hostile or unfriendly takeover attempt.

Mortgage-Backed Security/Industrial Revenue Bond— Guarantees that principal and interest on the bonds will be paid even if the issuer defaults.

Mortgage Default Insurance— Guarantees the timely payment by the mortgagor for loans secured by first or second mortgages.

Movie Completion Bond— Assures a movie company's backers that a production will be delivered on time and within budget.

Municipal Bond Insurance— Guarantees that payment will be promptly made in the event of a municipality's failure to make payment to the paying agent of guaranteed bonds.

Municipal Nonappropriation Coverage— Guarantees that municipal funding will continue past the expiration of a particular legislative body that initially appropriated the subject funds.

Pension/Deferred Payment Guarantee— Guarantees payment to the plan participants for the corporate obligations that are due in accordance with the terms and conditions of the retirement and/or benefit plans.

Performance Systems Guarantee— Insures the designer/manufacturer and sometimes the owner against loss arising out of faulty design, workmanship, and materials.

Residual Value Insurance— Guarantees the value of an asset at a future point in time.

Resource Availability Coverage— Provides for payment of debt service in the event that an unanticipated reduction of a natural resource occurs.

Retrospective Claims Guarantee— Guarantees the funding of incurred but not realized losses.

SEC Liability Insurance— Provides liability coverage for inadvertent acts under the securities laws.

Special Hazard Insurance— Guarantees residential mortgage-backed securities in the event that there is a default on a mortgage in the portfolio.

Surety Bond— Guarantees monetary payment or completion of a project should a party fail to perform specified acts within a stated period.

Tax Anticipation Note Guarantee— Guarantees that the holder of such a note will receive principal and interest when the note matures.

Example of NAIC Footnote 12

Financial Guarantee Exposure

The company's aggregate par value exposure under all class I financial guarantee bonds in force as of December 31, 1985, was $8,218 million. At December 31, 1985, there were no class I financial bonds for which the maximum amount due for unpaid principal and interest covering the same risk exceeded 10% of capital and surplus.

The company's aggregate par value exposure under all class II financial guarantee bonds in force as of December 31, 1985, was $770 million. The company uses letters of credit and holds other collateral to reduce its exposure to class II financial guarantee bonds. At December 31, 1985, the company held $289 million of letters of credit and collateral resulting in a net exposure of $481 million to class II financial guarantee bonds.

Class II financial guarantee bonds covering the same credit risk in which the maximum annual amount due for unpaid principal and unpaid interest exceeded 5% as of December 31, 1985, capital and surplus are summarized as follows:

Ratio (percent)	No. of bonds	Annual amount
5.9	4	$327 million

Under class III financial guarantee bonds, the company participates with other affiliated companies in underwriting coverage for 44 brokerage companies, which indemnifies investors to a maximum of $2 million in the event of fraudulent loss of securities in excess of basic Securities Investor Protection Corporation coverage. The company also participates in underwriting coverage for commercial paper and other miscellaneous guarantees.

Comments From the Securities and Exchange Commission

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

OFFICE OF
THE CHIEF ACCOUNTANT

January 27, 1987

Mr. Craig Simmons
Senior Associate Director
U.S. General Accounting Office
Washington, D.C. 20548

Dear Mr. Simmons:

Thank you for the opportunity to review your draft staff study entitled, "Developments in the Financial Guarantee Industry".

We have the following comments (which are limited to those areas of the draft study that mention the SEC):

Now on p. 1.

- Page 2 (2nd full paragraph) Delete the reference to the SEC in the 1st sentence. Change the second sentence to read as follows: "The SEC staff is requesting that companies with significant financial guarantee activities disclose more about the size and type of risks they are underwriting."

Now on p. 28.

- Page 30 (2nd paragraph) In the 2nd sentence the statement that "the Securities and Exchange Commission (SEC) began addressing the financial guarantee issue..." should be amended to "the Securities and Exchange Commission (SEC) staff began addressing the financial guarantee issue...." Delete the last 2 sentences and replace them with "This agency is involved because of its responsibility under the Federal securities laws to ensure full disclosure to investors, including disclosure of the risks associated with guarantee products." At the end of this sentence there should be a reference to a footnote, which should state: "In addition, the Commission is conducting a study of the financial guarantee market, as directed by Congress in Section 105 of the Government Securities Act of 1986 (Pub. L. No. 99-571). That study will examine the impact of the exemption in Section 3(a)(2) of the Securities Act of 1933 on investor protection and the public interest and on competition between banks and insurance companies and domestic and foreign guarantors, and whether debt securities guaranteed by insurance policies should be exempt from registration under the Securities Act."

Page Two

Now on p. 28.

- Page 30 (3rd paragraph) Revise the first sentence to say "The SEC staff's recent concern...." Change the second sentence to read as follows: "In the past, insurers appear to have been guaranteeing the activities of fairly strong entities." Change "SEC fears" in the third sentence to read "SEC staff is concerned."

Now on p. 29.

- Page 31 (1st paragraph) Change the last sentence to read as follows: "SEC's disclosure guidelines do not include discussions of individual guarantees or the specific circumstances related to them."

See p. 2.

We believe that the above changes will more accurately reflect the role of the SEC in this area. It should be noted that the Commission has not reviewed this draft study and neither it nor the staff endorse its contents. Rather, the comments in this letter reflect solely the views of certain members of the staff that have been involved in this issue. If you have any questions or need further information please contact me at 272-2050.

Sincerely,

Edmund Coulson
Deputy Chief Accountant

Comments From the State of New York Insurance Department

Note: GAO comments supplementing those in the report text appear at the end of this appendix.

STATE OF NEW YORK
INSURANCE DEPARTMENT
160 WEST BROADWAY
NEW YORK, NEW YORK 10013

JAMES P. CORCORAN
SUPERINTENDENT OF INSURANCE

January 23, 1987

Mr. Alfred Vieira
U. S. General Accounting Office
100 Summer Street, Room 1907
Boston, Massachusetts 02110

Re: Draft Report "Developments in the Financial Guarantee Industry

Dear Mr. Vieira:

The General Accounting Office's concern over the recent proliferation of financial guaranty insurance is well founded. Insurance regulators are concerned that investors are placing more reliance on the presence of the guaranty than on the quality of the underlying investment. Discipline in the investment community is eroding and the risk is being assumed by the insurance industry. Losses which result in insolvency, under the present structure, ultimately devolve upon the general public through imposition of higher premiums.

As you are aware, I am the Chair of the NAIC Financial Guaranty Insurance Task Force. This task force has recently completed work on a Model Financial Guaranty Insurance Act which, as you noted, was unanimously adopted by the NAIC. About a year and a half ago, the NAIC became very concerned about the sudden and rapid growth of this "insurance" product, both as to volume and the types of guaranties being issued. Single exposures can be enormous and the premiums are generally quite low in relation thereto. There is no historical basis upon which to predict future losses, other than scenarios of the Great Depression which are inappropriate when applied to the types of investments currently guarantied, many of which were not even imagined in the 1930s. The scenarios are also inappropriate because there has been a significant change in the judicial climate as evidenced by the decision of the highest court in the State of Washington in the WPPSS default.

The explosive growth of financial guaranty insurance, particularly with respect to the guaranties of riskier obligations, occurred at a time when property and casualty insurers were restricting their writings of traditional and essential coverages. Insurers were devoting their scarce capital to the offering of guaranties, coverages that could hardly be deemed essential. Demand for this coverage has been largely manufactured by investment bankers who saw it as a means to market public and private debt to unsophisicated small investors and by insurers who saw this new product as a "riskless" means to replace the cash flow lost when they cut back on essential coverages.

As you point out in your draft, no one knows the actual size of the industry, its participants, the range of products being offered, nor the magnitude of the risks being assumed. Through 1985, there was no separate reporting for this kind of insurance; it was lumped in with surety business.

Discussed on p. 34.

Beginning with the 1986 Annual Statement, which will be filed with the several states March 1, 1987, financial guaranties will be reported on a separate line therein. Included in the instructions for completing the Statement is a definition of financial guaranty insurance which parallels the definition in the Model Act. Once the Model Act, requiring financial guaranties to be written exclusively by monoline insurers, becomes law in New York and, hopefully, in other states, a special reporting blank will be designed.

Now on p. 25.

We have some editorial comments on the draft. Before getting to them, we must take the strongest exception to the conclusions contained in the draft on pages 27 and 28 concerning the appropriate organizational structure for financial guaranty insurers. It was the judgement of all the insurance regulators of the United States that the monoline structure should be the only permissible form of organization. The comments of the former California Insurance Commissioner, cited by you, appeared in a monograph published by an insurance trade association which was written shortly before he resigned to go into the private sector. I suggest that they are given much too great a prominence, particularly since California voted for the NAIC Model Act. To permit multiline operations negates all of the other safeguards contained in the NAIC Model Act (copy attached together with a Model Bill Memo) as the property and casualty lines will be exposed to the potential of catastrophic losses so long as financial guaranty insurance is written by multilines. Catastrophic losses are a real possibility since success in this line of insurance depends not only on good underwriting but upon a continuing sound economy. It is questionable whether guarantors can predict the likelihood that the obligors will be around and financially solid when their debts mature many years into the future. Catastrophic financial guaranty losses sustained by a multiline insurer could bankrupt the entire company or severely restrict its writing capacity since <u>the surplus supporting financial guaranty writings is the same surplus supporting all of the lines written</u>. Castastrophic losses so severe as to bankrupt the multiline insurer would adversely affect all other property and casualty insurers and cause depletion of the state guaranty funds covering losses under covered property/casualty policies. (Note: Guaranty funds and the potential impact of financial guaranty insurance upon them are not mentioned in your draft report.) Insurers assessed by the guaranty funds would temporarily experience capacity shrinkage and would, in turn, recoup their assessments through higher insurance premiums. The general public would thus bear a burden which should be borne exclusively by investors as part of their investment risk, which anticipates a higher rate of return.

See comment 1.

Dedication of capital combined with exclusion of financial guaranty insurance from guaranty fund protection is the only way to insulate the property/casualty insurance industry from the adverse effects of financial guaranty losses. Dedication of capital can only be accomplished through a monoline structure. Walling off of property/casualty business from financial guaranty losses can only be accomplished through the setting up of monoline subsidiaries. Protection of the guaranty funds can only be accomplished by both mandating the monoline structure and excluding financial guaranty insurance from guaranty fund protection. Removal of financial guaranty insurance from the protection of the guaranty funds, without the imposition of a monoline requirement, will not protect the guaranty funds because the property/casualty claims of any multiline insurer bankrupted by financial guaranty losses will still have to be paid out of these funds.

- 3 -

The fact of the matter is that the companies which have entered the field in recent years with the intent to become significant players have organized as monolines. This is largely because they recognize the uniqueness of this business, which requires specialized expertise unrelated to property and casualty underwriting. Each entrant has further specialized in one area of debt in recognition that the expertise required to underwrite each area is unique. For example, FSA specializes in guarantying corporate debt while BIG concentrates on municipal debt. This past December MBIA, the largest financial guaranty insurer of municipal obligations, converted from an association to a monoline.

See pp. 36-39.

Any company which is unwilling to commit the necessary capital to obtain a "AAA" rating is also unlikely to make the necessary commitment to acquire the expertise. We are also troubled by the lack of oversight of the rating agencies over the type of obligations guarantied by multiline insurers. The rating agencies review the monoline insurer's book of business and, in many instances, the specific issues guarantied; for multiline no such review takes place. The "AAA" rating is based entirely upon the multilines perceived "claims paying ability". In other words, the rating agency is relying on the cash flow from the guarantor's property/casualty business to cover the guaranties. This piggybacking is precisely what state insurance regulators are trying to avoid through the imposition of a monoline structure. Some multilines have had their "AAA" ratings reduced to "AA" as a result of adverse property/casualty experience. The question arises as to whether the purchasers, who are getting a lower rate of return based upon the "AAA" ratings, now have an actionable claim for the difference in rate of return. I strongly urge that this portion of your report be reconsidered. Its release, as currently drafted, could frustrate the efforts of the States to enact the NAIC Model Act.

I am attaching for your information a copy of my testimony before the New York Assembly Insurance Committee which amplifies many of the comments made above.

Editorial Comments

Now on p. 7.

Page 5 - The Surety Association can probably supply estimates for 1985 financial guaranty premiums which we believe represent an ever growing percentage of total surety premiums.

Now on p. 12.

Page 12 - As noted above, MBIA converted to a monoline insurer in December of 1986; Travelers Indemnity Company is not associated with this new entity.

Now on p. 17.

Page 17 - It should be noted that surety losses during the past several years have been substantial, the following are the combined ratios:

1983	87.5%
1984	95.6%
1985	112.5%

Now on p. 18.

Page 19 - 1. Discussion of municipal bond insurance - The draft's comment that municipal bonds are generally considered to be low risk does not take into account industrial development bonds (IDBs) which, in reality, are corporate obligations issued in the name of the municipalities. IDB's should be highlighted in your report as one of the listed concerns.

Now on p. 19.

2. Suggested revision for your first listed concern:
The current practice in determining the premium charge is to share the interest savings resulting from a guarantee between the municipality and the insurer. This practice may not adequately provide for the associated risks and potential losses, particularly when interest rates are low and the spread must therefore be less.

Now on p. 18.

Page 20 - 1. We suggest the following concern be added:
As more companies enter the business, competition is likely to result in underwriting standards being lowered since there can only be a limited amount of the good business available.

Now on p. 19.

2. Other types of corporate obligations being guarantied include securitized loans, including bundled car loans, mortgages and other types of consumer debts.

Now on p. 22.

See comment 2.

Pages 23 & 24 - Page 23 contains the conclusive statement that "... claims can be statistically forecast from prior experience." This conclusion is inconsistent with the concern on page 24 "... whether companies have the ability to accurately predict loss without loss experience in some of the new, sophisticated products." The concern more properly reflects our opinion that there is no historical basis on which to predict losses for the new types of guaranties.

Now on p. 19.

Page 26 - Note that a default on a guarantied debt may be the result of political decision or fraud, matters not generally included in risk profiles.

Now on p. 26.

Page 28 - Corporate structure - With the conversion of MBIA into a type one structure, type two no longer exists in the financial guaranty industry and we recommend either its deletion or inclusion as an historical footnote.

Now on p. 26.

Page 29 - Several insurers have recently been organized or are in the process of doing so with the exclusive purpose of reinsuring financial guaranties.

Now on p. 33.

Page 31 - State Regulatory Efforts and Concerns - Note that Virginia and Iowa are also considering enactment of the NAIC Model Act.

Now on p. 31.

Page 32 - Current regulatory efforts - New York has regulated municipal bond insurance since 1970 (Regulation No. 61 - 11NYCRR63). The 1985 California law as well as one recently enacted in Illinois are patterned after the New York Regulation. Wisconsin also has a regulation in place which parallels New York's.

See p.34.

The disclosure requirement mentioned here applies to all states requiring the NAIC blank as it was adopted by the NAIC Blanks Task Force. As noted earlier, the disclosure requirement for 1986 parallels the definition of financial guaranties contained in the NAIC Model Act.

Now on p. 32.

Page 33 - With conversion of MBIA, the Dunne bill, which permits multiline insurers to guaranty municipal bonds, no longer appears to be relevant. Therefore passage in either house of the 1987 New York Legislature is doubtful.

Now on p. 33.

Page 34 - With reference to the Industry bill, it should be noted that its capitalization requirement is meaningless because "special reserves" are liabilities established to cover future losses. Thus, a company could theoretically write guaranties without any surplus.

- 5 -

Now on p. 29.

The discussion entitled "Financial Guarantee Insurance Study Group" more logically follows "State Regulatory Efforts and Concerns" on page 31.

Now on p. 30.

Page 34 & 35 - References to the California Insurance Commissioner should be preceded by the word "former".

Now on p. 29.

Page 35 - Last line of first runover paragraph, reference to "assurance funds" should be changed to "guaranty funds".

Now on p. 30.

Page 36 - Senator Dunne's comment, cited here, that NAIC model bills are merely guidelines and are rarely adopted is incorrect. The General Counsel of the NAIC, Sandra L. Gilfillan, Esq. should be contacted concerning the scores of NAIC model bills that have been adopted, in most cases verbatim, by the states.

Now on p. 33.

Page 37 - The list is incomplete. We understand that Iowa and Wisconsin are both submitting the NAIC model bill to their legislaturers.

Now on p. 36.

Page 40 - The list of regulatory concerns omits the adverse impact that a multiline insolvency may have on the guaranty funds.

Now on p. 38.

Page 41 - Note our earlier comment concerning the lack of review by the rating agencies of debts guarantied by multiline insurers.

I appreciate the opportunity to review the draft. Both I and my staff will be pleased to discuss our comments with you at your convenience, should you so desire.

Sincerely,

James Corcoran

JAMES P. CORCORAN
Superintendent of Insurance

cc: S. Gilfillan, NAIC

The following are GAO's comments on the Superintendent of Insurance for the State of New York's letter dated January 23, 1987.

GAO Comments:

1. We have addressed the issues of state guarantee funds and the potential impact of of financal guarantees upon them on page 36.

2. We do not believe we were inconsistent in our treatment of the forecasting of potential losses. Rather, we presented differing points of view, without comments on the validity of either.

Glossary

Annual Debt Service	The payments to creditors scheduled during a year consisting of the sum of interest payments and principal amortizations.
Capital Adequacy	A measurement of the adequacy of capital funds to absorb losses and protect creditors.
Commercial Paper	Unsecured short-term promissory notes issued by corporations and sold to corporate and individual investors.
Contingent Liability	A liability that becomes due if and only if certain events take place (i.e., a guarantee is due only when the principal defaults).
Credit Rating	An independent assessment of a firm's ability to meet its financial obligations.
Credit Enhancement	Financial guarantees designed to increase the marketability and/or to reduce interest cost of issuing debt.
Financial Guarantee	The guarantee of the financial obligations by a third party (e.g., a bank or insurer).
General Obligation	Bonds that are usually backed by the full faith, credit, and virtually unlimited taxing power of a state or local government.
Letter of Credit	A customary banking transaction whereby the bank places its credit behind that of one of its customers to facilitate transactions between two independent parties.
Limited Partnership	A legal structure of a commercial undertaking in which investors are able to join with general partners. The limited partners are able to enjoy the tax benefits of a partnership while avoiding the unlimited liability associated with a general partnership.

Market Value	The price at which any given stock, commodity, financial instrument, etc., is traded in open markets.
Monoline Insurer	An insurance company authorized to underwrite insurance for only one specific product.
Mortgage Backed Security	Securities which are backed by a mortgage on specific properties.
Multiline Insurer	An insurance company authorized to underwrite a number of different insurance products.
Off-Balance Sheet Exposure	The sum of the contingent liabilities that are not included in a firm's balance sheet.
Paid-In Capital	That portion of the stockholders' equity paid-in by stockholders as opposed to capital arising from profitable operations.
Paid-In Surplus	Paid-in capital in excess of the par value of capital stock.
Premium	The payment to the insurer for underwriting an insurance contract.
Privately Placed Debt	Debt placed directly with individual investors or groups of investors.
Publicly Placed Debt	Debt placed with individual investors or groups of investors through open sales in the national market.
Rated Security	A security (debt, stock, etc.) that has been rated by an independent credit rating agency.
Reinsurance	Insurance coverage purchased by the insurer to share the risk of specific insured transactions.

Standby Letter of Credit	A letter of credit, which will come into effect only in the event of default by the underlying contract.
State Assurance Fund	A fund established by many of the states to protect consumers from the bankruptcy of specific insurance companies. Often funds are set up for separate lines (or related groups of lines) of insurance. These may be funded (i.e., insurers pay into the funds prior to losses) or unfunded—a form of reinsurance.
Structured Financing	A financial transaction structured to grant additional layers of security to the insurer.
Surety	A form of insurance whereby the insurer (surety) agrees to indemnify the beneficiary against default by a third party.
Underwriter	The company that agrees to assume risk for a fee.
Unearned Premium	An accounting classification for the portion of the insurance premium that has been pre-paid (the premium is not earned except over the life of the contract).

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