Celebration of SCHOLARS

Performance of Insured Bonds after the Insurers' Downgrades: Some Preliminary Results

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Celebration of Scholars 2013: Exposition of Student and Faculty Research, Scholarship and Creativity

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Abstract

Prior to 2008, many municipal bond investors bought bonds that were insured by third party corporations, accepting lower yields in return for the risk reduction provided by the insurance. During the financial crisis, the seven AAA/Aaa financial guaranty insurers which dominated this industry all lost their AAA/Aaa status. We study the effect these downgrades had on yields in the municipal bond market on insured debt versus uninsured debt. We find that the downgrades on average pushed required yields on insured bonds up.

Introduction

Financial guaranty insurance played an important role in the municipal bond market during the years up to the financial crisis, covering over 50% of new issuance at its peak in 2005. The par value of bonds being insured has declined every year since 2007 (Figure 1).

Prior research (Lau, 2012), has shown that on average bond insurance reduced issuance cost for municipalities. During the financial crisis, the seven AAA/Aaa financial guaranty insurers which dominated this industry all lost their AAA/Aaa status. We study the effect these downgrades had on yields in the municipal bond market.

Since the insurers' financial strength fell as the markets weakened, the insurance did not protect insured bond investors from market turmoil. In fact, a yield inversion has occurred with insured bonds now trading close to A bonds. Investors in these insured bonds therefore lost both the AAA protection they had paid for and must accept lower prices if they sell their holdings.

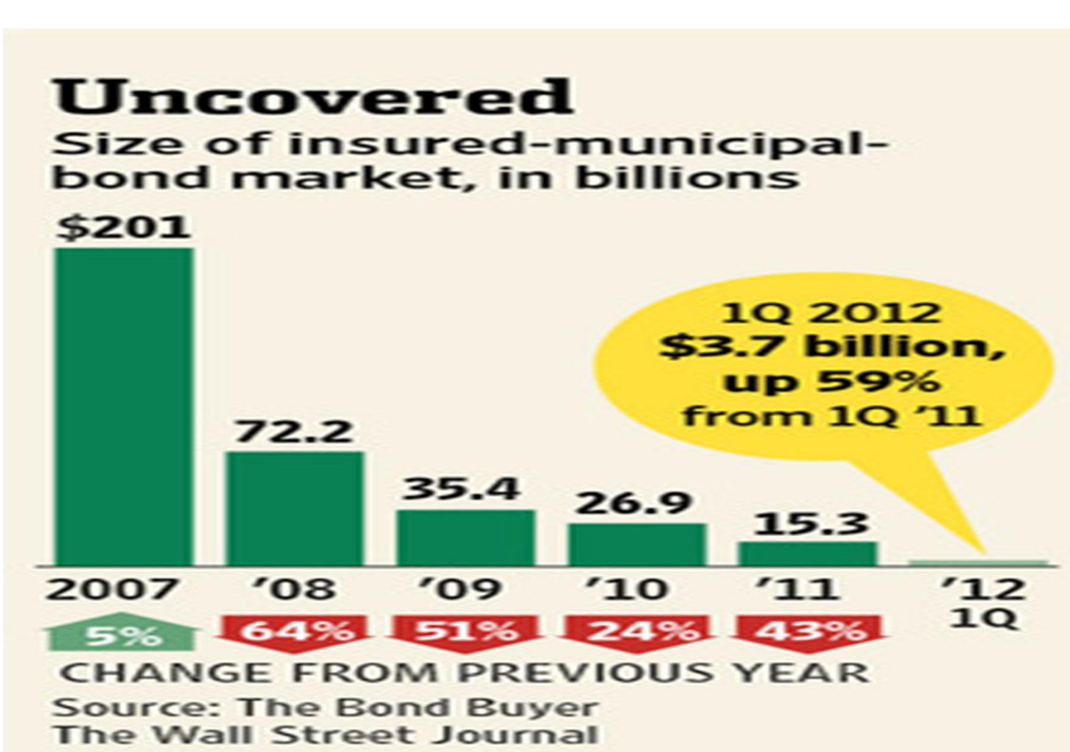

Figure 1

Research and Discussion

We compiled available information (SIFMA) to look at how insured bonds performed in 2011 versus the municipal bond index (Figure 2). Returns on insured bonds are higher than the index throughout the year.

We also compare yields on AA bonds to insured bonds, controlling for bond tenure (Zion's Direct). (Figure 3)

Then to see whether the spread inversion phenomenon has lessened as the markets have stabilized, we compare 2010, 2011, 2012: (Figure 4)

We end by looking at nonprofit hospital bond yields from 2002 to 2011 and see a clear pattern change. (Figure 5)

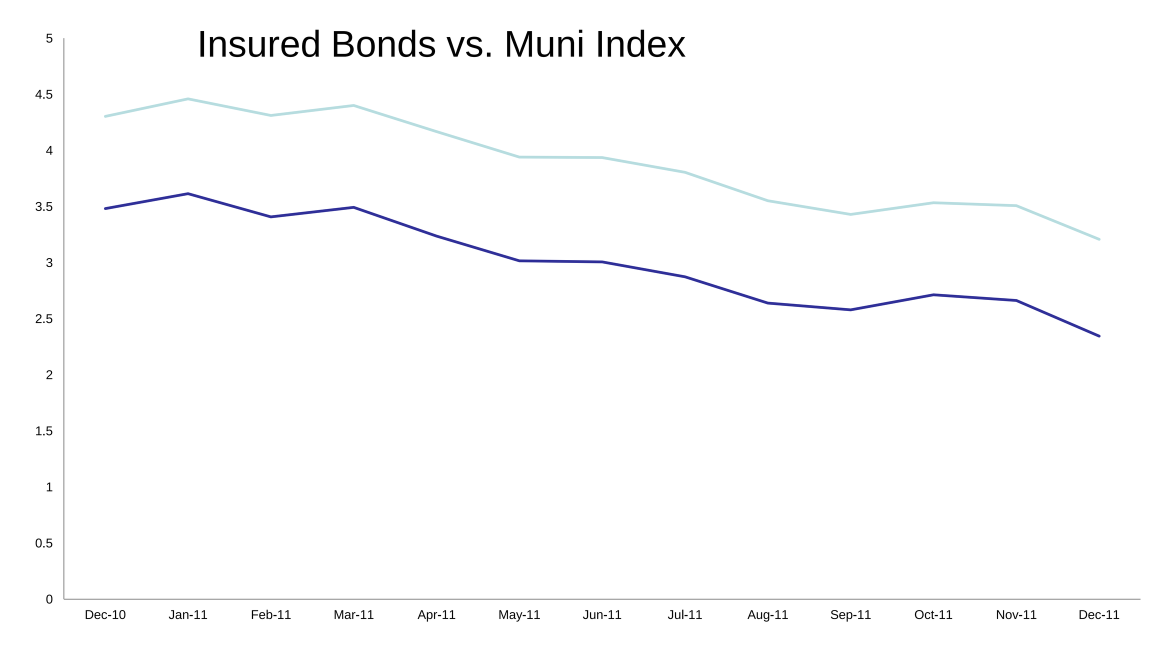

Figure 2

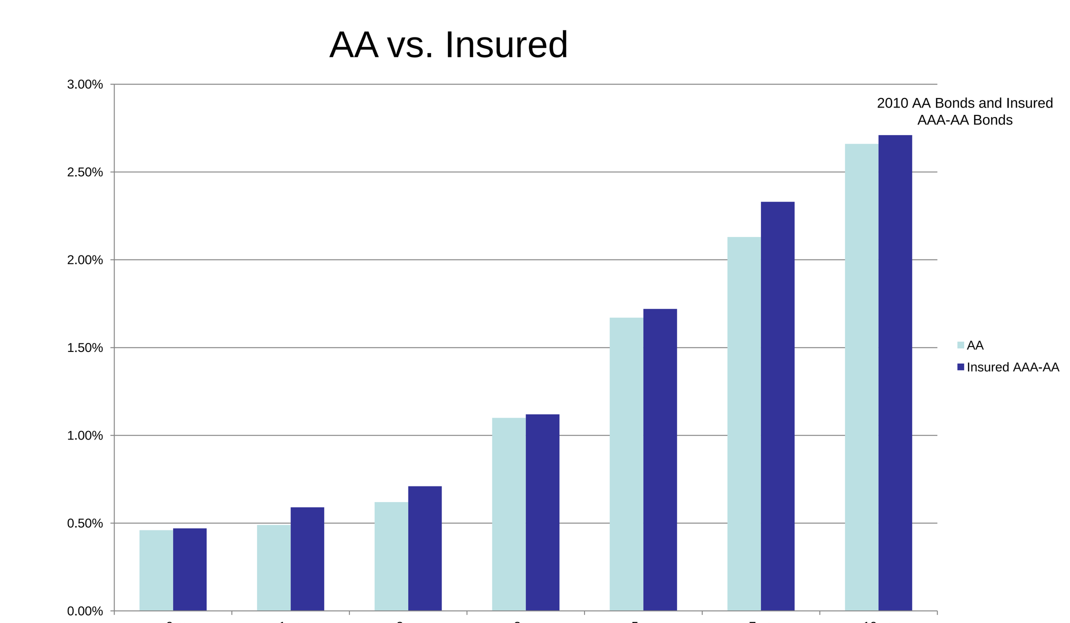

Figure 3

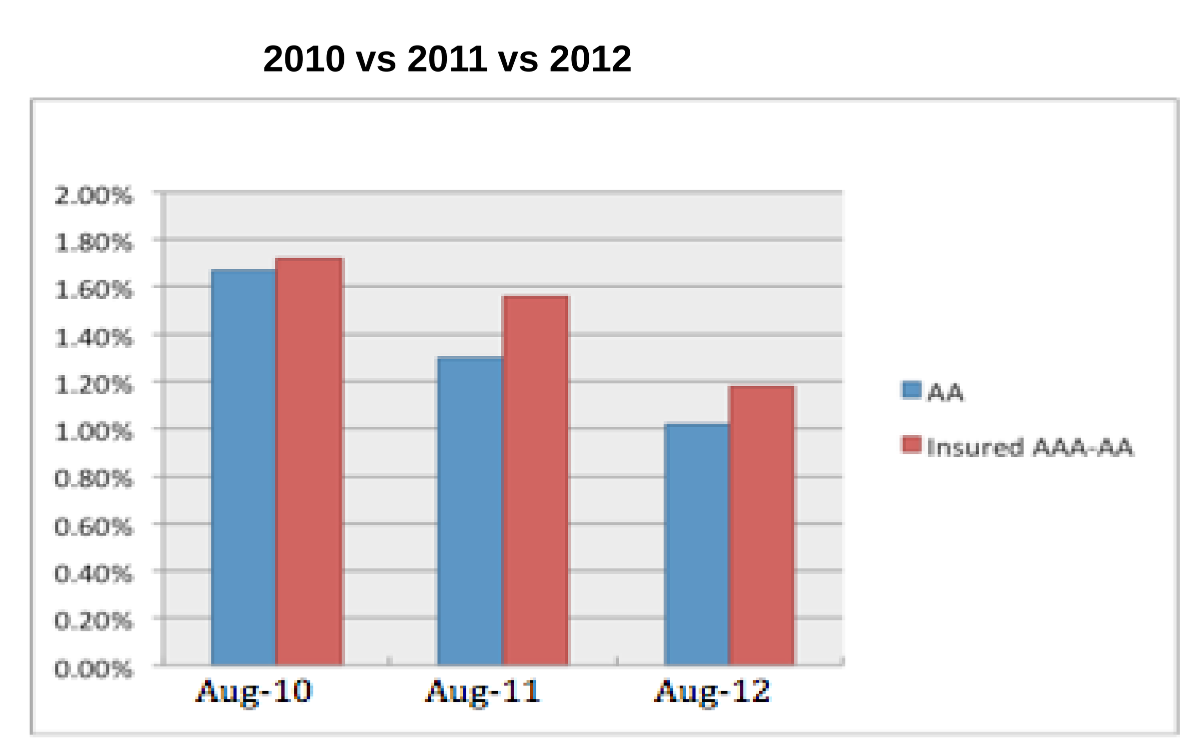

Figure 4

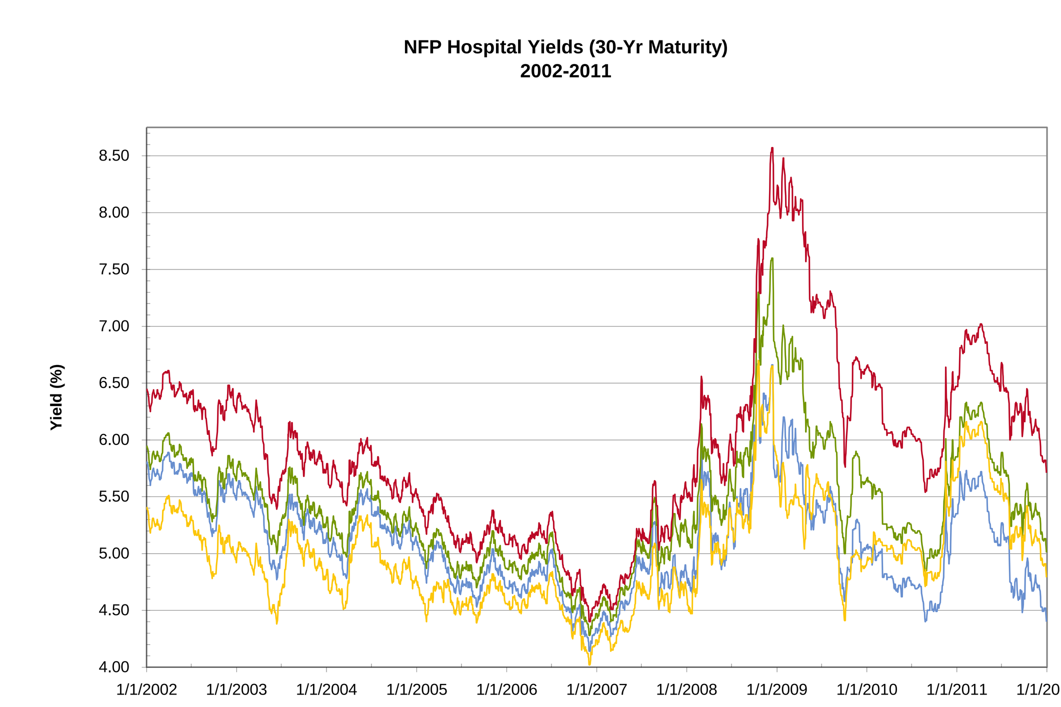

Figure 5

Acknowledgements & References

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