For the first time since the financial crisis, and the brief foray of Berkshire Hathaway into the municipal bond insurance arena, there is a new insurer on the block.

- Build America Mutual Assurance Co. (BAM) received its license from the New York Department of Financial Services in July 2012.
- S&P assigned a AA rating and stable outlook to BAM and bonds insured by BAM.
- A key point of differentiation for BAM, compared to other municipal bond insurers, is its mutual structure with ownership by issuers it insures rather than stockholders.
- By charter, BAM will insure only municipal issues focusing on traditional core issuers, avoiding healthcare issues, private colleges and universities and other peripheral municipal issuers.
- Although Assured Guaranty has given up some market share to BAM, we believe the competition will reinvigorate the bond insurance market and ultimately increase the overall insurance market share.
- For most investors, municipal bond insurance has worked as advertised, despite the 2008 insurer downgrades.

For the past four years, Assured Guaranty has had the bond insurance market to itself, accounting for 99.8% of the $13.2 billion of insured new municipal issues in 2012, but for the first time since the financial crisis, and the brief foray of Berkshire Hathaway into the municipal bond insurance arena, there is a new insurer on the block. In September of last year, Build America Assurance Co. (BAM) insured its first municipal issue, a $10 million deal for York Suburban School District in Pennsylvania. Licensed by the New York Department of Financial Services in July 2012, BAM subsequently received a AA rating from Standard and Poor’s with a stable outlook.

AA RATING FROM S&P

S&P assigned its AA rating and stable outlook to BAM in July 2012. S&P noted strengths including:

- BAM’s low-risk business profile focused on insuring municipal bonds
- Lack of legacy risk and structured finance exposure
- Strong and experienced management team
- Expected extremely strong capital adequacy ratio likely to extend for at least the first 5 years of operation
- Capital will build as capital contributions from issuers grow

Challenges for the startup insurer include:

- Success depends on whether bond insurance will be fully re-embraced by investors and issuers
- Potential competitor cannibalization of the company’s pricing/structure model

The S&P rating is the only rating applied for by BAM. Fitch currently rates no bond insurers and BAM did not request a rating from Moody’s, which recently lowered ratings for Assured Guaranty’s bond insurers to the A category. S&P rates Assured at AA- with a stable outlook.
**Structure and Capitalization**

BAM is unique among bond insurers, past and present, in that it is structured as a mutual company, with no equity owners. Ownership resides in the municipal issuers or members insured by BAM. Initial capitalization consists of $503 million, provided through issuance of surplus notes by BAM to HG Holdings, Ltd and its subsidiary HG Re, Ltd which in turn are owned by a Bermuda corporation controlled by White Mountain Insurance Group. The amount of premium received on each transaction is divided into a risk premium and a member contribution. The member contribution becomes part of the capital base, allowing for capital growth without the earnings and dividend pressure of a traditional equity structure, although it is anticipated that dividends will eventually be paid to the municipal owners under the mutual structure. Additional claims paying resources are provided through a reinsurance agreement supported by collateralized trusts funded with $100 million in cash transferred from HG Re. In exchange for receiving a portion of the premium, these HG Re trusts provide insurance against any loss incurred in an amount up to 15% of the par amount of each policy. As the amount of member contributions grows, BAM plans to pay down the notes, increasing the claims paying resources of the trusts and thus providing reinsurance resources beyond the initial $100 million of financing.

**Build America Mutual Capitalization - Step by Step**

1. At inception, BAM received cash through issuance of $503 million in surplus notes to White Mountain subsidiaries - $203 million from HG Holdings and $303 million from HG Re.
2. Most of cash received was invested in bonds, which together with remaining cash, but minus cash burn from operations, comprise capital base of BAM ($484 million 12-31-12).
3. Additional capital support is provided by reinsurance of up to 15% of par amount of any loss on insured obligations. This reinsurance obligation is secured by collateralized trusts which includes $100 million from a cash payment by White Mountain subsidiary, HG Re.
4. As the amount of members’ contributions grow, amounts will be used to repay surplus notes (upon approval of NY Insurance regulator) until notes are repaid and capital is 100% member funded contributions.
5. As the $300 million HG Re portion of the note is repaid, proceeds are transferred to the reinsurance collateralized trusts to supplement the initial $100 million cash deposit.
6. Eventually, members (municipal owners) may be paid dividends, but only after surplus notes are repaid, criteria for sufficient capital are met and approval is received by NY Insurance regulator.


**BAM’s Business Model**

BAM’s model is unique among financial guarantee insurers given its mutual structure, but its narrow focus on core municipal issuers also differs from other insurers. BAM’s list of permitted sectors is limited to:

- GO, general fund and appropriation backed bonds
- Utility revenue bonds (water, sewer, gas and electric)
- Transportation revenue bonds (airport, toll roads, ports, mass transit)
- Public colleges and universities
- Dedicated tax revenue bonds (sales, income, excise, gas, public service, motor vehicle registration)

Language in both the company charter and underwriting agreements specifies that entities eligible for insurance mean “states, political subdivisions, and integral part of states or political subdivisions or entities otherwise eligible for exclusion of income under Section 115 of the IRS code of 1986.” Healthcare issuers, senior living communities, private universities, private K-12 schools, charter schools and other nonprofit organizations will not be eligible for BAM insurance. BAM will focus on investment grade issuers in the core municipal sector.
In the initial few months of its participation in the insurance marketplace, BAM has already generated a more competitive environment.

BAM will only insure fixed rate bonds (no floating rate, put bonds, swaps etc.). At least one public, underlying investment grade rating from one of the rating agencies is required. The benefit of an underlying rating is the additional third party surveillance provided by the rating agency. The troubled Harrisburg Resource Recovery Bonds, insured by then AAA rated FSA, had no underlying rating, so investors and analysts had no rating agency surveillance or reporting to supplement credit assessment and monitoring as the situation deteriorated. Many outstanding issues insured by Ambac and other insurers, which lost their ratings in 2008, carried no underlying rating, so even though they may have been of A or AA credit quality, the lack of a rating generates lower valuations.

The Market for Bond Insurance

In the initial few months of its participation in the insurance marketplace, BAM has already generated a more competitive environment. BAM and Assured Guaranty often offer insurance on the same issues, with the cost of the premium now a competitive consideration for underwriters and investors. So far BAM has focused on smaller issues, with the largest issuer insured to date being a $35 million California school district issue.

Through mid March BAM insured 87 new issues totaling $559 million compared to 105 issues adding up to $965 million for Assured. In its initial rating report, S&P projected that BAM would originate $10 billion of insured par in the first 12 months of operation, with $15 billion in the subsequent 12 month period. It remains to be seen if this pace will be achieved, but BAM’s average of $45 million per week in the last three weeks of January accelerated to $78 million on average in the first three full weeks of February. California, the state with the most municipal bond issuance, only recently licensed BAM. Within a few weeks BAM had insured 3 CA issues totaling $50 million, including the largest issue insured by BAM so far. BAM may not insure $10 billion in 2013, but we believe they could be writing insurance at close to a $1 billion per month pace by year end.

Assured Guaranty faces challenges from both an aggressive new competitor in BAM and the recent rating downgrade from Moody’s, but retains advantages in both its strong brand recognition and solid capital base. In round numbers, BAM’s $500 million in capital well covers its approximately $550 million of insurance in force, but of course this nearly one to one ratio of exposure to capital will grow as BAM writes more business. Assured, with $12.3 billion in claims paying resources will be more able to weather an extended drought in usage of bond insurance, which as a percent of total new issuance, is at the lowest point in many years. We expect the insurance market share of new issuance to grow in 2013 and beyond. The current low interest rate and tight credit spread environment hobbles bond insurance by making it more difficult to provide value to issuers and underwriters. It will not last forever.

Insurance Market Share Bottomed in 2012

Source: Janney Fixed Income Strategy, Bond Buyer
Bond Insurance Has Worked

As effects of the financial crisis recede, we expect individual investors to increasingly appreciate the value of the belt and suspenders approach that bond insurance offers. Investors who own high profile distressed municipal credits such as Harrisburg, Stockton, San Bernardino, Detroit, and Jefferson County, have largely been insulated from defaults, with not only Assured Guaranty backstopping timely interest and principal payments, but National (Baa2/BB - former MBIA) continuing to support all claims on its $337 billion in municipal par outstanding obligations. Even Ambac, which operates under the supervision of the Wisconsin Insurance Commissioner, has paid claims on its municipal exposure (with Las Vegas Monorail bonds a notable exception).

Much as Burger King and McDonalds often benefit when their fast food locations exist on the same corner, by drawing more potential customers, the competition between BAM and Assured will energize the bond insurance proposition, with each company participating in a growing insurance market. Depending on the outcome of ongoing litigation, we could see National reemerge as an active insurer in coming years, and if/as the insurance market expands other start ups are possible. The 50% share years of the pre-2008 market may not reappear, but with the household sector holding about 45% of outstanding municipal bonds, we believe increasing individual investor interest will enable bond insurance to regain much of its lost luster and broad utility.

Analyst Certification

I, Alan Schankel, the Primarily Responsible Analyst for this report, hereby certify that all of the views expressed in this report accurately reflect our personal views about any and all of the subject sectors, industries, securities, and issuers. No part of my compensation was, is, or will be, directly or indirectly, related to the specific recommendations or views expressed in this research report.

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