

# RatingsDirect®

---

**FINANCIAL  
INSTITUTIONS**

.....  
**RESEARCH**

**Credit FAQ:**

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

**Primary Credit Analyst:**

David S Veno, Hightstown (1) 212-438-2108; david.veno@standardandpoors.com

**Secondary Contact:**

Marc Cohen, CFA, New York (1) 212-438-2031; marc.cohen@standardandpoors.com

### **Table Of Contents**

---

Frequently Asked Questions

## Credit FAQ:

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

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

## Frequently Asked Questions

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

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

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

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

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

Following the occurrence of a major event with credit implications--such as an economic recession or severe natural

catastrophe--incremental theoretical losses are generated for the purpose of a sensitivity analysis relative to an insurer's existing capital base. This is the type of analysis we have conducted relating to the bond insurers' exposure to Detroit and Puerto Rico.

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

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

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

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

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

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

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

Copyright © 2014 Standard & Poor's Financial Services LLC, a part of McGraw Hill Financial. All rights reserved.

No content (including ratings, credit-related analyses and data, valuations, model, software or other application or output therefrom) or any part thereof (Content) may be modified, reverse engineered, reproduced or distributed in any form by any means, or stored in a database or retrieval system, without the prior written permission of Standard & Poor's Financial Services LLC or its affiliates (collectively, S&P). The Content shall not be used for any unlawful or unauthorized purposes. S&P and any third-party providers, as well as their directors, officers, shareholders, employees or agents (collectively S&P Parties) do not guarantee the accuracy, completeness, timeliness or availability of the Content. S&P Parties are not responsible for any errors or omissions (negligent or otherwise), regardless of the cause, for the results obtained from the use of the Content, or for the security or maintenance of any data input by the user. The Content is provided on an "as is" basis. S&P PARTIES DISCLAIM ANY AND ALL EXPRESS OR IMPLIED WARRANTIES, INCLUDING, BUT NOT LIMITED TO, ANY WARRANTIES OF MERCHANTABILITY OR FITNESS FOR A PARTICULAR PURPOSE OR USE, FREEDOM FROM BUGS, SOFTWARE ERRORS OR DEFECTS, THAT THE CONTENT'S FUNCTIONING WILL BE UNINTERRUPTED, OR THAT THE CONTENT WILL OPERATE WITH ANY SOFTWARE OR HARDWARE CONFIGURATION. In no event shall S&P Parties be liable to any party for any direct, indirect, incidental, exemplary, compensatory, punitive, special or consequential damages, costs, expenses, legal fees, or losses (including, without limitation, lost income or lost profits and opportunity costs or losses caused by negligence) in connection with any use of the Content even if advised of the possibility of such damages.

Credit-related and other analyses, including ratings, and statements in the Content are statements of opinion as of the date they are expressed and not statements of fact. S&P's opinions, analyses, and rating acknowledgment decisions (described below) are not recommendations to purchase, hold, or sell any securities or to make any investment decisions, and do not address the suitability of any security. S&P assumes no obligation to update the Content following publication in any form or format. The Content should not be relied on and is not a substitute for the skill, judgment and experience of the user, its management, employees, advisors and/or clients when making investment and other business decisions. S&P does not act as a fiduciary or an investment advisor except where registered as such. While S&P has obtained information from sources it believes to be reliable, S&P does not perform an audit and undertakes no duty of due diligence or independent verification of any information it receives.

To the extent that regulatory authorities allow a rating agency to acknowledge in one jurisdiction a rating issued in another jurisdiction for certain regulatory purposes, S&P reserves the right to assign, withdraw, or suspend such acknowledgement at any time and in its sole discretion. S&P Parties disclaim any duty whatsoever arising out of the assignment, withdrawal, or suspension of an acknowledgement as well as any liability for any damage alleged to have been suffered on account thereof.

S&P keeps certain activities of its business units separate from each other in order to preserve the independence and objectivity of their respective activities. As a result, certain business units of S&P may have information that is not available to other S&P business units. S&P has established policies and procedures to maintain the confidentiality of certain nonpublic information received in connection with each analytical process.

S&P may receive compensation for its ratings and certain analyses, normally from issuers or underwriters of securities or from obligors. S&P reserves the right to disseminate its opinions and analyses. S&P's public ratings and analyses are made available on its Web sites, [www.standardandpoors.com](http://www.standardandpoors.com) (free of charge), and [www.ratingsdirect.com](http://www.ratingsdirect.com) and [www.globalcreditportal.com](http://www.globalcreditportal.com) (subscription) and [www.spcapitaliq.com](http://www.spcapitaliq.com) (subscription) and may be distributed through other means, including via S&P publications and third-party redistributors. Additional information about our ratings fees is available at [www.standardandpoors.com/usratingsfees](http://www.standardandpoors.com/usratingsfees).