

CSFI

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The monoline dilemma: A round-table discussion on the future of the monoline insurance business. With Shirley Beglinger, Iain Barbour (MBIA), Henrietta Podd (RBC), Georg Grodzki (LGIM), and John Grout (ACT) held on Wednesday, April 23, 2008 at Innholders' Hall, 30 College Street, London EC4R 2RH, from 12:30-2:15pm

Monolines had such a smooth first two decades of life, helping small US municipal authorities lower their borrowing costs by selling them a AAA credit rating, that people paid them little attention – too little in retrospect. The first speaker said the current troubles began when, along with everyone else in the credit market, they fell prey to “mission creep” and moved into structured credit such as subprime ABS and collateralised debt. The same model applied – the monoline issued a long-term insurance policy guaranteeing AAA status in exchange for an annual premium. AAA-rated themselves, monolines did their own research and were seen as having deep knowledge. Given that, the big question is how they failed to see problems with subprime and CDOs, of which ratings agencies had warned back in 2006. This turn leads to another question: are there other areas – credit cards, auto loans – that might yet prove the next shoe to drop?

The second speaker outlined the position of one monoline that guaranteed \$679bn of credit risk, of which two-thirds was public finance and a third structured credit. Within that, subprime made up just 3% or \$25bn and CDOs \$30bn – a “small contained sum”. The issue with subprime was not its direct impact but the consequential liquidity problem. The company had experienced significant losses and had warned mark-to-market exposure would increase. It was important to stress that even if it lost its AAA rating, it could not be forced to put up capital or crystallise its losses. It was well capitalised and had a guaranteed income stream of £1bn a year from premiums.

The third speaker said the investment industry was so dependent on credit ratings they were embedded in the system. Monolines played a major role in Europe by guaranteeing AAA ratings for debt in PFI projects. Of an estimated £40bn, £15bn had gone into the bond market of which less than 3% was issued without a monoline wrapper. There is £15-16bn of regulated utility debt in the UK and a further €10-15bn of Euro area debt. Compared with a BBB- rating a PFI debt might otherwise receive, the wrapper increased the investor base and reduced the borrowing cost – a prime concern for public authorities. There is a dilemma: monolines played a very valuable role but it may be necessary to find other ways to encourage investors into the PFI/utility infrastructure area without the comfort of a monoline wrapper.

The third speaker took a harsh tone – investors are disillusioned and are tempted to call an end to the monoline era. He could not see a situation where he would be prepared to “leave yield on the table” in exchange for a wrapper. He said he was cynical about monolines despite their efforts to keep investors informed; he did not believe the major players could

perform the function they promised. It was not enjoyable to say but it was the prudent course. His firm was hiring more analysts to do that job itself. He said it was a buyer's market in which there was a sober realism not to allow credit markets to get carried away again. If he was sceptical about monolines, he was not sceptical about the concept of credit insurance, which predated them. The second speaker said monolines would make significant investment in resources to restore confidence in the business, which still offered value-added to sectors such as PFI.

The final speaker laughed at the idea that investors would prevent another credit bubble – these cycles will always continue. He said it was important not to overlook the benefits of monolines, which can oil the wheels and enable more business to be done. It would not be disastrous if monolines disappeared but it would lead to a repricing of risk. He said municipal authorities were already starting to resent the lower ratings they were being given in the absence of a wrapper. He said new players, such as Warren Buffett's Berkshire Hathaway, would come into the market, the market would grow and wheels start turning again.

Looking forward, the second speaker said that in the eyes of independent observers monolines were on a stable platform - although there were significant issues to deal with. There is a long way to go and with more "bumps in the night" likely, they will look to ratings agencies to react calmly to new news. This sparked questions over whether governments or banks had put pressure on ratings agencies not to down grade monolines from AAA. Is the AAA real or artificial? Strikingly, four members of the panel said they had heard stories of such pressure. The second speaker reassured the roundtable it had been recently won AAA from Moody's and S&P...albeit with a negative outlook.