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Credit Effects Of Swap Insurance In U.S. Public Finance

The risk of significant collateral postings or a termination payment under an interest rate swap is often a major impediment to hedging activities. However, many issuers, notably in the health care and transportation sectors, are able to mitigate these contingent liabilities and lower the overall cost of borrowing by purchasing swap insurance from an insurer that is rated 'AAA' by Standard & Poor's Ratings Services. Standard & Poor's Debt Derivative Profile (DDP) scores to date indicate that if not for swap insurance, many issuers would have been exposed to much greater levels of risk. Due to the traditional cost-benefit analysis of obtaining insurance, coupled with the growing comfort of issuers with debt derivative products, use of swap insurance by issuers is expected to grow significantly over time. Except in limited circumstances, insurers have tended not to enhance the dealer side of the swap.

Swap Insurance

Swap insurance polices are similar to bond financial guarantees in that policies guarantee payments to a beneficiary, in this case a swap dealer, for failure to pay by the insured, in this case the issuer. Also similar to bond insurance, issuers are required to reimburse insurers for any payments made to beneficiaries under swap policies and must live with insurer legal restrictions. Under regular swap insurance policies, the insurer will make regularly scheduled swap interest payments if the issuer fails to do so. The majority of policies issued by insurers to date have been regular swap insurance policies, as they present immaterial, incremental risk to insurers, since in most cases the insurer is also insuring regularly scheduled payments on the issuer's bonds. Swap and bond payments are typically on parity with one another. In addition to regular swap payment insurance, some issuers have purchased swap termination coverage through a policy endorsement for an additional premium. Termination coverage tends to become expensive, as this coverage does present incremental risk for the insurer over scheduled payments on bonds and swaps. Swap termination insurance provides further, although not complete, protection against termination exposure due to issuer and insurer credit events (rating downgrades). Under swap termination policies, insurers will make swap termination payments, up to a specified amount, to the extent that a termination event under the swap is triggered and the issuer has failed to make the termination payment, or in lieu of termination, failed to post collateral or secure a third-party enhancer.

Benefits

The benefits of swap insurance to an issuer are numerous, including significant, although not complete, mitigation of counterparty, collateral posting, and termination risks. Standard & Poor's DDP scores to date indicate that if not for regular swap insurance, many issuers--notably lower-rated health care issuers--would have been exposed to much greater levels of these risks. Of the approximate 210 issuers that have received a DDP score to date, about 15% have benefited from swap insurance through a lower overall DDP score as a result of scoring lower in the termination and collateral posting risk section of the DDP. The significance of swap insurance in the health care and transportation sectors is greater, with about 25% of issuers having benefited from insurance through lower DDP scores.

Regular swap insurance mitigates termination and collateral posting risk in several ways. In terms of collateral posting risk, the issuer is spared from having to post collateral under a credit support annex, due to the joint obligation of swap payments by both the issuer and the insurer. If the insurer has suffered significant ratings downgrades, collateral postings by the issuer are typically required, however. Furthermore, involuntary termination risk becomes more remote with regular swap insurance despite the fact that policies do not cover termination payments. This is because under insured swaps, the issuer's rating trigger for early termination becomes applicable only to the extent that the insurer has also suffered a significant ratings downgrade. The extremely low ratings volatility of 'AAA' rated monoline bond insurers combined with the overall stability of municipal ratings indicates that a termination event due to coincidental rating downgrades is an extremely remote possibility. In terms of counterparty risk mitigation, swap insurance can be beneficial to the issuer because insurers may require swap dealers to post collateral under credit support annexes, to the extent the counterparty suffers a credit event.

Risks

The primary risk under swap insurance policies is the credit risk of the insurer. If the insurer's credit deteriorates significantly, the issuer is likely to have to post collateral in order to maintain the hedge; otherwise, the swap may be subject to termination. Some issuers will purchase swap termination policies to mitigate this risk. However, the monoline bond insurer industry has had an extraordinary history of credit stability and presents a very low probability of an issuer experiencing this risk. A secondary risk of swap insurance includes the oversight and legal restrictions imposed by insurers under swap policies. Because the insurer is assuming the issuer's credit risk for the duration of the swap transaction--often 20 or more years--insurers maintain certain control rights under the insured swap and insert various legal provisions into an issuer's bond documents. For example, so long as the insurer has not suffered a credit event, insurers reserve the right to allow voluntary termination of swaps and sometimes place limitations on additional swaps. These restrictions may become problematic if the issuer needs to restructure the swap or enter into additional swaps for economic reasons. Insurers also typically require that a series of credit protection provisions be inserted directly into the schedule to the International Swaps and Derivatives Association (ISDA) agreement, including collateralization by the counterparty. These protections are typically positive for the issuer's credit quality, although they may impact the economics of the transaction. Also, in some cases the insurer has the right to direct the issuer to terminate the swap early if the issuer has experienced an event of default (as defined under ISDA swap documents). Standard & Poor's is not overly concerned about insurer-directed termination clauses due to an event of default since these risks are already reflected in the issuer's rating.

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