



How Bond Insurance Delivers Value for Investors:

In The Pandemic And Beyond

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Introduction

The Covid-19 pandemic spurred new demand for insured municipal bonds, and the strong interest appears poised to continue as investors team with states and local governments to help execute the largest wave of U.S. infrastructure investment in a generation. Amidst the uncertainty surrounding municipal fiscal stability and an increase in taxable debt issuance immediately following the outbreak, wrapped bonds offered investors stable ratings, increased liquidity and less volatility. Since then, the market has faced more prolonged volatility brought on by questions about the outlook for inflation, economic growth, and other factors like climate change. Insurance remains a valuable tool for investors and issuers to maintain reliable, affordable capital markets access and peace of mind.

Bond Insurance in the Pandemic: Value Preservation and Stable Ratings

The COVID-19 pandemic and the uncertainty it brought hit the municipal market with force in the spring of 2020. State and local governments increased spending and delayed income tax-filing deadlines to mitigate the pandemic's impact on residents — measures that constrained their own budgets. Investors, wary of the long-term impact to government revenues, pulled a record \$45 billion from muni funds.¹ Bond prices dropped while the yield on muni bonds rose sharply above the yield on comparable U.S. Treasuries due to a lack of liquidity in the market.²

In this unpredictable environment, investors and issuers seeking stability turned to bond insurance. Wrapped bond issuance has hovered around \$20 billion annually for the last decade, but that changed in 2020. The par amount insured that year totaled \$34.45 billion — the highest since 2009, and a penetration ratio of more than 7% of total issuance, according to data from The Bond Buyer and Refinitiv. The pace isn't slowing down even as Federal stimulus and vaccines have largely eased economic and credit concerns about state and local finance. For 2021, wrapped municipal bond issuance totaled \$37.2 billion, a penetration rate of 8.1%.³

The Advantages of Bond Insurance

Municipal bonds have an historically low rate of default, but like any investment they are not risk-free. Municipal bond insurance guarantees timely payment of interest and principal: An added level of protection that can be particularly valuable for individual investors who rely on their municipal bond holdings for cash flow to support their everyday expenses. Moreover, wrapped bonds come with the assurance that highly-seasoned professionals have conducted due diligence on the issuance and will continue to monitor economic, demographic, and political issues that could impact the issuer's ability to make payments. And while most investors hold their bonds to maturity, insured bonds offer better pricing transparency and protection against rating downgrades in the event an investor does choose to sell. This feature improves liquidity and offers investors peace of mind throughout the life of their bond.

1 <https://www.morningstar.com/articles/1030183/munis-in-the-year-of-covid>

2 <https://www.stlouisfed.org/on-the-economy/2021/january/pandemic-impact-municipal-bonds>

3 <https://thesource.refinitiv.com/thesource/getfile/index/09b53f8a-917d-4429-85c7-e962eed90162>

The economic uncertainty also prompted an uptick of investors choosing to purchase insurance protection for their uninsured holdings.

Several factors are at play in this comeback for bond insurance. For one, taxable debt has also increased over the few years, which has attracted more international investors to the municipal market. The muni bond market is vastly different from the corporate market and governments vary significantly from one another in terms of their level of disclosures and financial savviness. Given this diversity among tens of thousands of issuers, international investors often don't have the resources to conduct sufficient credit research and are therefore more attracted to the guarantee that comes with insured debt. In 2020, taxables totaled \$146.46 billion, the highest level in a decade.

Cost for issuers also played a role. Investor concerns about local government creditworthiness caused public officials – particularly those at universities facing revenue shortfalls due to a pause in on-campus learning – to look for ways to keep down borrowing costs. Wrapping their bonds with insurance provided an answer for many. Large, \$100-million bond sales that would have only been partially-wrapped pre-pandemic (if at all), were now being entirely insured. The economic uncertainty also prompted an uptick of investors choosing to purchase insurance protection for their uninsured holdings.

Amid this uncertainty over the future, insured municipal bonds have proven their worth. Data analyzed by Build America Mutual (BAM) shows that BAM-insured munis held their value better than equivalent bonds during the COVID-19 sell-off in late Spring 2020. In a study of more than 900 "pairs" of matched CUSIPs for bonds that were identical in every way except for the presence of a BAM insurance guaranty, credit spreads on uninsured bonds widened by an average of 10 basis points versus insured bonds during the six weeks following the initial spread of COVID in the U.S. This difference resulted in a 72% outperformance of the insured bonds. The results were even starker in the more volatile sectors like transportation and tourism-related categories, with spreads between insured bonds and uninsured bonds widening by an average of 50 basis points.

Insurance is a win-win in university housing bond sale

In 2021, the University of California at Davis broke ground on a long-planned renovation to one of its student housing complexes. Opened in the 1960s, the Orchard Park apartments were created to provide affordable housing and a sense of community for students and their families. The expansion and update of the complex is funded by proceeds from the May 2021 sale of \$277 million in tax-exempt bonds insured by Build America Mutual.⁴ The development is expected to offset approximately 25% of its annual energy consumption through a carport solar farm in the main parking lot. The bonds also carried the BAM GreenStar designation, which means that the structure and use of proceeds aligned with the International Capital Market Association's Green Bond Principles.

While the sale would have been successful without insurance, Nat Singer, partner and senior managing director at Swap Financial, who served as municipal advisor to the University, said at the time that "it was even more successful with insurance" because the wrap gave the Baa3-rated issuer a better rate than it would have achieved otherwise. "When we added the insurance, it served to expand the group of investors, giving the issuer even more pricing leverage," Singer said. "Ultimately, the cost of insurance was just a fraction of the incremental spread benefit we saw from upgrading a Baa3 credit to a AA credit."

4 <https://emma.msrb.org/P11501933-P11163168-P11578329.pdf>



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— Don Farrell, Head of Investor Relations, BAM

This performance in a volatile time is a big reason why investors and issuers continued to turn to bond insurance even after the municipal market stabilized. Don Farrell, BAM’s head of investor relations, said the insurer’s transparency in how it monitors and evaluates credits provided reassurance during the sell-off and continues to be a benefit. The company’s ready access to finance officers from insured issuers and BAM’s rigorous analysis of issuers — including stress testing — benefits bondholders. “Institutional investors who maybe hadn’t dealt with insured bonds since the 2008 financial crisis, once again saw the value of insurance and the ratings stability and liquidity it provides,” Farrell said. “Underwriters are striking that balance for issuers who want the savings of a lower coupon rate, and matching them with investors who are seeking the significant benefits of the wrap.”

The Early Recovery

The pace of the economic recovery slowed in mid-2021, largely thanks to the emergence of the Delta variant and the reimposition of lockdowns and other public health measures to stop the spread.⁵ Now, more than two years after the pandemic began, its long-term effects on the economy remain unclear. The dramatic rise of remote work, for example, has fiscal implications for the sales and business tax bases of cities that have yet to see their pre-pandemic daytime population rebound.⁶ Transportation-related credits in these large metro areas are also unlikely to see their rush-hour ridership fully rebound thanks to commuters staying home part- or full-time.⁷

BAM Chief Credit Officer Suzanne Finnegan notes that the environment has created a bifurcated recovery where some geographies or sectors bounced back quickly and others (particularly tourism and other user-tax-based credits) are farther behind. Public utilities have held up well and public schools are benefitting from the strong housing market. Pension plans have been buoyed by the surging stock market. On the other hand, the outlooks for higher education and public transit are murky as both sectors continue to adjust to a large portion of pre-pandemic users remaining remote.

The recovery from the Great Recession also produced a widening gap between certain credits. According to research at the time by PNC Bank, about 80% of issuers maintained or improved their credit profiles in the ensuing recovery, but a stubborn 20% continued to falter.⁸ The volatility of the pandemic in 2020 stressed that situation, particularly for lower-rated credits.⁹ In fact, it took more than a year for the spreads—the difference in muni yields versus comparable Treasuries—for high-yield munis to recover to pre-pandemic levels.¹⁰

Insurance can help retail investors manage against this gap. Whereas large issuers frequently release financial data and many now have annual investor days, bond insurance can be particularly helpful for holders of bonds from small, infrequent issuers. Because of their smaller capacity, these issuers tend to take longer to disclose financial information than large issuers and that information may not be at the level of detail investors expect. But a small issuer seeking insurance must provide in-depth details to the insurer as part of the evaluation process. “Whereas an offering statement might not have all the information investors are seeking, we have the ability to call them up and ask them to explain their financial plan,” said Farrell. “We get all that information before we make a credit decision. We’re putting in the same energy for a \$3 million issuance by a rural utility as we would on the New Jersey Turnpike.”

5 <https://www.brookings.edu/blog/up-front/2021/06/03/examining-the-uneven-and-hard-to-predict-labor-market-recovery/>

6 <https://rockinst.org/blog/covid-19-and-working-from-home-give-cities-a-chance-to-redefine-who-uses-downtowns/>

7 <https://www.bostonfed.org/publications/new-england-public-policy-center-regional-briefs/2021/the-covid-19-pandemics-impact-on-public-transportation-ridership-and-revenues-across-new-england.aspx>

8 <https://www.pnc.com/content/dam/pnc-com/pdf/corporateandinstitutional/MunicipalBond/Evolution-in-Thinking-PNC%25205-16-16.pdf>

9 <https://www.newyorklifeinvestments.com/insights/2020-municipal-markets-insights-mid-year-update>

10 <https://www.capitalgroup.com/institutional/insights/articles/high-yield-muni-bond-2021.html>



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— Suzanne Finnegan
Chief Credit Officer,
BAM

Given the uncertainty that remained throughout 2021 in some sectors, even large issuers and institutional investors have stuck with bond insurance in certain cases as a way to protect themselves against future volatility. Public higher education credits, for example, were under enormous financial pressure even before the pandemic thanks to declining enrollment and constrained state funding. The pandemic ushered in a new era of urgency with revenue losses related to suspending in-person operations. Although those losses were largely offset by Federal aid, colleges and universities are still adjusting financially to hybrid learning and remote work and more places are turning to bond insurance to keep access to the market affordable.

Inflation, Fiscal Stress, and Climate Change: Understanding the Risk Landscape

Looking ahead, bond insurance will continue to be a tool for investors and issuers seeking to mitigate potential risks in certain credit areas. There are a few reasons why the pandemic boost is expected to hold in the years to come.

In the more immediate term, it's expected that taxable debt will continue to play a meaningful role in the market. In addition, inflation and the Federal Reserve's plans to raise short-term interest rates will likely place a higher price tag on the cost of issuing debt in the coming year.¹¹ This means bond insurance could be financially beneficial to more issuers.

Looking further out, Federal stimulus spending that helped boost state and local government revenues through the pandemic will expire in 2026. Investors are wary about what that means. Research by the Federal Reserve of Kansas City has found that while direct monetary policy interventions quickly reduced liquidity risk in the municipal bond market and eased short-term credit risk concerns, “longer-term bonds saw considerable increases in their credit risk premia.”¹² This indicates that municipal market investors have “expectations of long-lasting recessionary impacts on state and local government budgets.”

Another long-term concern is climate change, which is increasingly being recognized as a financial risk for governments and therefore an emerging market for insurance. A recent report by the Federal Climate-Related Market Risk Subcommittee warned that climate change and extreme weather events add additional barriers of cost, time, uncertainty and risk to investments.¹³ It predicts that demand “will likely grow for public and open access to climate data, including for primary data collected by the government.” A BlackRock Investment Institute report even put a dollar figure to climate risk: It found that if significant climate action is not taken, in just 10 years more than 15% of the current S&P National Municipal Bond Index by market value will be issued by cities suffering likely yearly economic losses of 0.5% to 10% of GDP.¹⁴

Across all financial markets, investor demand for (and company disclosure of) information about climate change risks, impacts, and opportunities has grown dramatically.¹⁵ But within the municipal market, disclosures about climate-related risks still tend to be minimal, even among those that have recently experienced severe flooding and wildfires.¹⁶ As extreme weather events continue to become more frequent, more stakeholders are calling for better scrutiny of a government entity's climate risk. The recent Federal infrastructure bill also plays a role in this push, with initiatives that call for measuring climate risk and the impact of investments.¹⁷

11 <https://www.reuters.com/markets/us/feds-evans-may-need-more-restrictive-policy-2021-11-18/>

12 https://www.brookings.edu/wp-content/uploads/2021/05/Bi_Marsh_Muni_Bonds_-_20210702.pdf

13 <https://www.cftc.gov/sites/default/files/2020-09/9-9-20%2520Report%2520of%2520the%2520Subcommittee%2520on%2520Climate-Related%2520Market%2520Risk%2520-%2520Managing%2520Climate%2520Risk%2520in%2520the%2520U.S.%2520Financial%2520System%2520for%2520posting.pdf>

14 <https://www.blackrock.com/us/individual/literature/whitepaper/bii-physical-climate-risks-april-2019.pdf>

15 https://www.sec.gov/news/public-statement/lee-climate-change-disclosures%23_ftn2

16 <https://www.marketwatch.com/story/muni-bond-investors-need-straight-talk-about-climate-change-risk-11617001961>

17 <https://www.congress.gov/bill/117th-congress/house-bill/3684/text>

Insurance is one way to meet the demand for better climate-related disclosure and to mitigate risk. “We use a number of tools to evaluate the climate risk of an investment and even its potential social and economic vulnerability to climate change,” said Finnegan. “For a retail investor who may just be looking at the headlines, I think that helps a lot.” Beyond risk management, the BAM GreenStar designation helps investors identify high-quality infrastructure investments that help reduce water and air pollution and support sustainable development. Since launching the program in late 2018, BAM has provided a GreenStar Assessment on 300 transactions, totaling more than \$4 billion par value. The assessment is a transparent, third-party review of a bond issue’s purpose and includes ongoing surveillance and reporting on the construction status of the eligible project, so investors can have confidence that their funds are making a difference.

Conclusion

The uncertainty of the pandemic highlighted the value that bond insurance has for investors and issuers. Although the larger economy is recovering, uncertainty around what the new normal looks like remains. Factors such as remote work, climate change and the Federal stimulus all play a role in the immediate and long-term future for municipal finance and thus increasingly factor into any credit risk assessment. Wrapped bonds not only offer protection against future disruptions, they offer enhanced market access and liquidity in the event an investor chooses to sell before maturity.

About Build America Mutual

Build America Mutual (BAM) is a mutual bond insurance company operated for the benefit of its members — the cities, states, and other municipal entities that use BAM’s financial guaranty to lower their cost of borrowing — and the investors who hold their bonds. BAM only insures U.S. municipal bonds for issuers that provide essential public services, and has no exposure to transactions for U.S. territories like Puerto Rico, structured finance or international borrowers. BAM is the National League of Cities’ preferred provider of bond insurance for its members and through June 30, 2022, BAM has insured approximately \$112 billion of municipal securities for more than 5,000 municipal issuers nationwide. For investors, BAM guarantees timely payment of interest and principal, but does not guarantee market value of its insured bonds.

Learn more at <http://buildamerica.com/mission/>

