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FROM THE COVER

Subprime turmoil clouds muni bond market

BY RENEE MCGAW / DENVER BUSINESS JOURNAL

Colorado's municipalities, water and school districts may have nothing to do with subprime mortgages.

But their bond insurers' exposure to the subprime mess could raise their borrowing costs, forcing taxpayers to foot a bigger portion of the bill for public bond-funded projects, industry experts say.

In December, Standard & Poor's lowered its outlook on some of the nation's biggest municipal bond insurers, including Ambac Assurance Corp., MBIA Insurance Corp. and XL Capital Assurance Inc.

Financial Guaranty Insurance Co. was placed on Credit Watch with negative implications, and ACA Financial Guaranty Corp. — the worst-hit — had its credit rating slashed to CCC, junk status, from a previous A rating.

Bond insurers pay up if borrowers default. By buying insurance from top-rated bond insurers, cities, nonprofits, hospital districts and others whose credit isn't as stellar can get a better credit rating on their bonds. For instance, an issuer whose own credit rating might be A- can use insurance to boost its bonds' rating to AAA. Carrying the higher rating lets the borrower pay a lower interest rate on bonds.

But many insurers guarantee other things, including mortgage-backed securities that have suffered losses this year, as homeowners have defaulted on their mortgages. In order to keep their AAA rating, some insurers will have to raise capital, which could make insurance premiums more expensive. Even if the insurers don't raise their premiums, their insurance won't be worth as much if their credit isn't perceived to be as strong.

"Clearly, it could impact the cost of borrowing for municipal issuers," said Cary Kennedy, Colorado's state treasurer. "We're encouraged that none of the four major insurers have been downgraded yet. I think there are still good products in the market to provide insurance for municipal borrowers at reasonable prices, but certainly the actions that the agencies have taken have had an effect.

"My understanding is that costs are about 20 to 30 basis points higher because of the actions that have been taken, and premiums are higher.

"There will be a substantial impact if any of

Ratings on some recent insured bond issues, and the ratings they would have carried without insurance:

Bonds	Rating	Rating without insurance
Colorado Springs airport system revenue refunding bonds series 2007A	AAA	A-
University of Colorado Hospital Authority refunding revenue bonds series 2007A	AAA	BBB+
Parker sales & use tax revenue bonds series 2006	AAA	A+

the four major insurers lose their AAA rating," Kennedy said. "I think at that point, many municipal issuers will consider issuing their bonds just using their underlying rating."

That wouldn't be a problem for the state of Colorado, which borrows little compared with other states, and whose bonds typically carry a high underlying rating of AA-, Kennedy said.

But it could hurt some smaller issuers.

Dan O'Connell, a director at RBC Dain Rauscher, in December handled a \$30 million bond deal for the Moffat County School District, in northwest Colorado.

"In that instance, they had the state intercept rating, which is AA-, but we did decide to purchase bond insurance from FSA [Financial Security Assurance Inc.]" to bring the rating up to AAA, O'Connell said. "It still made economic sense, although the margins are getting smaller and smaller as far as how much sense it makes."

FSA, the only major insurer whose rating outlook wasn't downgraded, "has behaved as you might expect in the marketplace," said Terry Casey, a managing director at RBC Dain Rauscher who has handled bond deals for the Douglas County School District. "They have concluded that since they don't have those problems, they can charge more for their insurance premium, which is a perfectly rational business response on their part."

Higher premiums won't have much effect on Douglas County School District bonds, because the district carries an underlying Moody's rating of AA2, a strong enough rating that it doesn't need bond insurance, Casey said.

"But the vast majority, candidly, of school districts in the state, assuming that they're issuing any significant amount of debt at one time — \$5 million or more — this does have some pretty significant implications for them," Casey

said. "It's hard to figure right now exactly what the fallout's going to be, because there haven't been any big deals done ... Our concern is that the shakeout probably isn't over yet, in terms of the AAA-rated insurers. None of them have been downgraded yet."

Ultimately, taxpayers may be hurt, some say.

"If you are in a school district, for example, that might be BBB+ ... and they were going to acquire insurance to benefit from the AAA, the mill levy would have to be adjusted to sell that municipal instrument just on its own credit, rather than on the insurer's credit," said Wayne Nielsen, president of W.G. Nielsen & Co., a Denver-based investment bank. "So it could impact the mill levy that gets assessed to the average homeowner."

"The big names aren't going to be hurt," said Russell Caldwell, senior vice president for public finance at D.A. Davidson & Co. in Denver. "Fort Collins, Greeley, Boulder, Loveland, Longmont, Denver, Thornton, Colorado Springs — all the way down to Pueblo, they're all A+, AA credit. But if you're being served by a medium-size town, or a water district, there could be some direct economic effect on you as a taxpayer."

Caldwell said he doubted that any major projects would be delayed because of the turmoil. Municipalities that already have issued bonds aren't affected, although those that bought the bonds may be, as the existing bond's credit rating would drop along with that of its insurer.

"It's the future issues that will be affected," Caldwell said. "What we have seen in some states — Florida and a few others, but not yet in Colorado — that were ready to come to market with a big \$100 million project and they've decided not to use the insurance ... They're waiting to see how this sorts out and who's going to maintain their AAA rating."