Box 4

"MONOLINE" FINANCIAL GUARANTORS: THE BUSINESS MODEL AND LINKAGES WITH FINANCIAL INSTITUTIONS AND CAPITAL MARKETS

One of the sectors worst affected by the turbulent credit market environment after the summer of 2007 is the financial guarantor sector (also referred to as "bond insurers" or "monolines"). Large credit spread increases, coupled with rating downgrades on structured credit products against the default of which the financial guarantors had sold protection, caused large mark-to-market losses for most financial guarantors, which weakened their capital positions. The capital shortfalls led to a questioning of the ratings of the financial guarantors (often AAA-rated), and guarantors that were not able to raise new capital were downgraded by rating agencies. The rating downgrades of some financial guarantors led to rating downgrades and value losses for the securities that they had insured. These developments rippled through parts of the financial system and capital markets through both direct and indirect channels. This box describes the financial guarantor business model and how the problems in the sector spread to other parts of the financial system and to capital markets (more recent developments and the outlook for financial guarantors is discussed in Section 1.3).

The defining characteristic of financial guarantors is their involvement in one insurance business only, the insurance against default of investment-grade debt securities (hence the label "monoline insurer"). In bond insurance the financial guarantors typically guarantee to provide continuity of payments (principal and interest) should the bond issuer default. In structured credit product insurance, the financial guarantor provides a "wrap" for the issue and/or protection for individual holders mainly via credit default swaps (CDSs).

The financial guarantors' business model is reliant on the guarantors' own high credit ratings (often AAA), which they achieve by only insuring high-grade securities which were deemed unlikely to default *en masse*. Financial guarantors usually enhance the credit rating of securities issues to AAA (or in some cases AA or A) by substituting their credit risk for the risk of the instruments they insure, thereby ensuring lower-cost placements for bond and structured credit product issuers and better liquidity for investors. It is the issuing company or public entity that issues a bond or structured credit product that arranges the insurance and pays the insurance premium to the financial guarantor.

The first financial guarantors were established in the early 1970s and only insured municipal bonds (debt obligations issued by states, cities, counties and other governmental entities) in the United States. Since then the sector has grown to include about a dozen companies and has remained domiciled in the United States (with subsidiaries in Europe and elsewhere), although most now also insure securities issued outside the United States. The value of securities insured by financial guarantors at the end of 2006 was about USD 2.4 trillion (par value). Although insuring municipal bonds remains the main business of most financial guarantors, with USD 1.4 trillion (par value) insured at the end of 2006 (about half of all US municipal bonds carry a financial guarantor guarantee), many have increasingly been providing protection on structured credit products such as asset-backed securities (ABSs) and collateralised debt obligations (CDOs), with an insured par value of USD 612 billion in the United States and USD 212 billion internationally (see Figure). However, since 2004 ABSs have accounted for more than half of all new business.

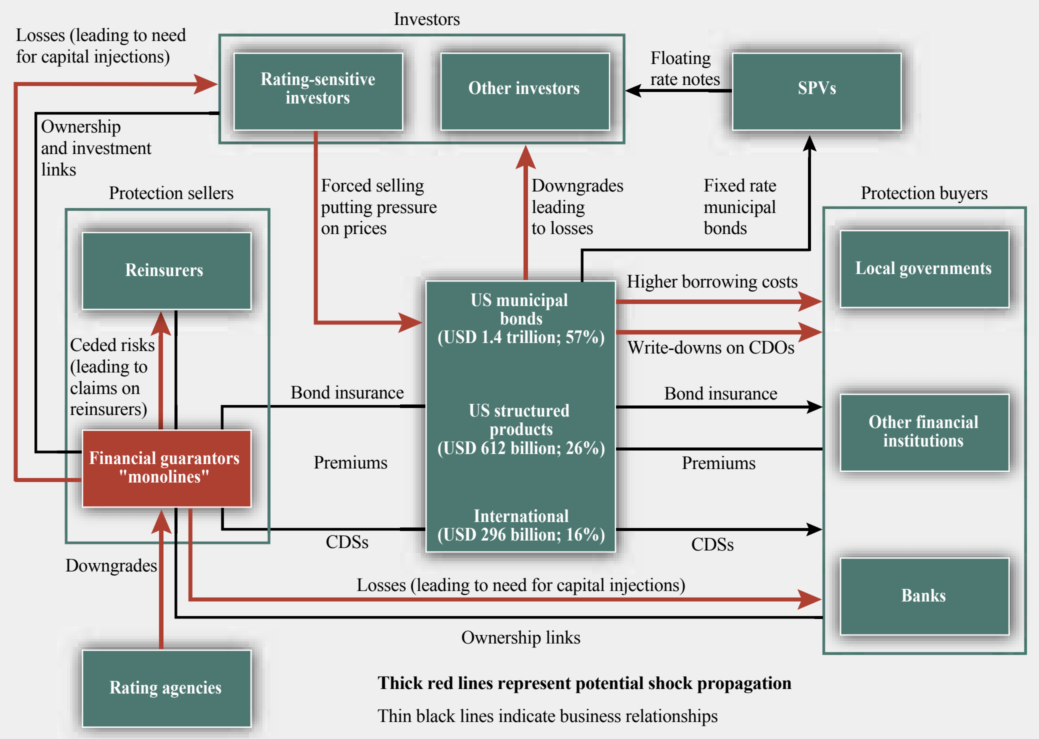
The large losses recorded by most financial guarantors in recent quarters were caused by exposures to CDSs that reference underlying obligations on credit products affected by the market turmoil. This was due to the fact that financial guarantor contracts, including those executed via CDSs, have to be marked to market, with the unrealised gains and losses being recorded through the income statement.

There are several propagation channels through which the problems faced by financial guarantors have and could spread further through the financial system and affect financial institutions and capital markets in the euro area (see Figure below).

i) Securities issuers, such as banks, that have bought credit protection from financial guarantors on, for example, CDOs they have arranged have had to face write-downs since these "hedges" lost value when the ratings were downgraded. These rating downgrades and the fact that most financial guarantors have stopped writing insurance on structured finance products have led to higher borrowing costs on structured credit products for protection buyers such as banks. The same problems have affected municipal bond issuers and have already caused municipal bond auction failures and funding difficulties for municipal bond programmes.

ii) Investors, and in particular rating-sensitive investors such as banks, insurers and municipal-bond mutual funds, can be adversely affected by losses and rating downgrades of financial guarantors if they are holding securities whose rating is sensitive to the insurance (or "wrap")

Linkages to financial guarantors in the financial system



provided by a financial guarantor. These investors face mark-to-market losses and an increase in regulatory capital charges because the lower-rated securities will attract a higher capital requirement. To the extent that investors, due to regulatory requirements, are only allowed to hold high-rated securities, securities downgrades can also cause forced selling by such investors, putting further pressure on the prices of municipal bonds, structured credit products and other securities insured by financial guarantors. In addition, banks that sponsor funds that have invested in securities insured by guarantors might also face reputation risks if the funds were to experience large losses.

iii) Losses by financial guarantors and their need to restore capital bases have also affected, and could further affect, some euro area banks and other companies that own financial guarantors and have provided capital injections. Most prominently, Dexia owns Financial Security Assurance (FSA) and Caisse d'Epargne and Banque Populaire together own CIFG after taking it over from their jointly owned investment bank Natixis by injecting USD 1.5 billion in capital.

iv) Euro area reinsurance companies could face losses if they have reinsured the business of financial guarantors. Thus far, however, such losses have been limited.

To sum up, the main concern from a euro area financial stability viewpoint regarding the financial guarantors' problems are risks of losses for euro area banks and insurers/reinsurers (to the extent that they have exposures – both direct and indirect – to the financial guarantors and securities guaranteed by them) and of further possible knock-on effects in the broader bond and structured credit markets.