



ARE MUNICIPAL BONDS STILL SAFE?

Insured municipal bonds have been scrutinized over the past few months as the companies who guarantee their principal and interest payments were caught up in the subprime mortgage crises. While the situation is unsettling, an important distinction should be made – the problems are with the insurance companies and not with the underlying municipal bonds they insure.

Municipal bond insurance was first available in 1971, giving municipal bond issuers the option of having their debt insured. This guarantee of the principal and interest payments allows bonds to be issued with a AAA credit rating and the lowest possible interest rate. Eight municipal bond insurers now exist, and some have branched out into insuring mortgage backed securities.

A vicious cycle has been created between insurers, debt securities, and rating agencies. Standard & Poors, Moody's and other firms whose job it is to rate the credit worthiness of bonds have been downgrading mortgage backed debt. Downgrades require the firms who insure those securities to hold more capital in the event of possible default. As debt downgrades pile up and capital at the insurance companies becomes scarce, the credit ratings of the insurers have been put on watch. If the insurers are downgraded, the creditworthiness of the bonds they guarantee falls, the insurers must reserve more capital, and the cycle builds on itself.

In the worst case scenario several bond insurance companies go bankrupt, leaving the holders of insured bonds without an explicit guarantee of principal and interest payments. However, the loss of insurance has no impact on the bond issuer's ability to pay off the debt. The market value of the bond will decline if the guarantee is lost, but no loss is realized as long as the bond issuer itself does not go bankrupt and bond owners hold the investments to maturity.

It should also be noted, if one insurance company goes bankrupt, bond issuers can seek insurance from other firms. Warren Buffet recently formed a company to compete against the likes of Ambac and MBIA, giving the marketplace another healthy option.

Perhaps the ultimate answer to our question, "are municipal bonds still safe?", lies in one basic statistic. The rate of default amongst insured municipal bonds is less than 1%. Thus, our concern is muted for bonds in the portfolios we manage, even in the worst case scenario.

We will continue to monitor the situation.