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Before the
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Regarding:
The Municipal Bond Market and Bond Insurance

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I would like to thank Chairman Frank, Ranking Member Bachus and the other members of the House Financial Services Committee for allowing me to testify today.

My name is Eric Dinallo and I am New York State Insurance Superintendent.

Today's hearing is about conditions in the municipal bond market and the impact of the problems in the bond insurance industry on that market. Your other witnesses who are directly involved in the market are better able to provide you with detailed and accurate information about the current state of the municipal bond market. I believe that we can most contribute to today's discussion by telling you what we have been doing to help that market by working to stabilize the bond insurance companies.

Bond insurers, also known as financial guaranty insurers or monolines, currently insure about half of outstanding municipal bonds. The insurers, who generally have top triple-A credit ratings, promise to pay bondholders if the government or other entity that issued the bond is unable to pay. That insurance provides the municipal bond with a top triple-A rating, which the bond itself would not have without the insurance. Many states, municipalities and state and city authorities are willing to pay for this insurance because it increases the market for their bonds and lowers the net cost of borrowing. Many institutional investors and retail investors have a much larger allocation to invest in triple-A rated bonds. The lower financing cost more than makes up for the cost of the insurance, so the government issuer and the taxpayers who must repay the debt benefit from the insurance.

Investors also benefit. While in theory investors should independently analyze the creditworthiness of issuers before they invest, practically it is difficult to study each of the thousands of small state and local government entities that issue debt. By insuring thousands of issuers, the bond insurers take on the task of analysis and the risk of default for investors. Gathering and analyzing information about issuers has a real cost. By reducing those information costs, the insurers thus make investing in municipal bonds easier and less costly for investors.

The problems for the municipal bond market arose when the bond insurers' credit rating was threatened by deterioration in the subprime mortgage market. The bond insurers had also insured billions of dollars of subprime structured securities. If the bond insurers were downgraded, then the municipal bonds they insured would lose their triple-A rating and would either have their own generally lower rating or in some cases no rating at all.

In fact, while the two biggest bond insurers have preserved their top ratings with the two major credit rating agencies, some other bond insurers have been downgraded. While these downgrades and the threat of more had a serious impact on the municipal bond market, the general credit tightening put pressure on all debt securities. It is important to understand that even restoring some confidence in the bond insurers' credit ratings is not likely to resolve all of the current problems

There has been a general tightening in the credit markets and a flight to safety. In the auction rate market, investors now find that those securities are not as easy to exit as once believed. But investors are choosing to exit the market for auction rate bonds, regardless of the insurer, for liquidity reasons, so improving the standing of the bond insurers is not likely to change the current situation in this market. In the variable rate demand market, there is still demand for uninsured bonds or bonds not tied to weak bond insurers, but only time will tell how this market will react to the newly strengthened bond insurers.

Now, I would like to review what the New York State Insurance Department has done and is doing. We are the primary regulator of most of the companies in this industry. Wisconsin is the primary regulator for Ambac, but the company's headquarters is around the corner from our office in New York City. Maryland is the primary regulator for Assured Guaranty, but its main office is in mid-town Manhattan. And we license both Ambac and Assured to do business in New York.

As insurance regulators, it is our responsibility to protect policyholders and ensure a healthy, competitive market for insurance products. In the case of bond insurance, there are two main groups of policyholders. There are the municipal governments who bought insurance for the bonds they issued and by extension the investors who bought those bonds. Then there are the banks and investment banks who bought insurance for the structured securities, including mortgage-backed securities.

The best way to protect all the policyholders is to preserve the triple-A ratings of the bond insurers where that is possible. So we have been facilitating additions to the capital strength of the bond insurers, not for their own sake, but to protect first policyholders and second the markets and broader economy.

This has been an extraordinarily challenging endeavor. Every single bond insurer is in a different situation with different strengths and weaknesses. Each has a different group of investors and owners, who have different views. Each must deal with a different set of counterparties; that is banks, broker dealers and investment banks, each of which has a different level of exposure. And there are different potential outside investors with differing types of offers. The search for additional capital has been undertaken in a market for the securities of financial services companies in general and bond insurers in particular that has grown extraordinarily difficult.

Since mid-2007, as we saw the increasing problems in the subprime market and came to understand the impact on the bond insurers, we have been increasingly active and have, as of this date, made important progress, though there is more to be done.

Late last year, we developed a three-point plan for the industry. First, bring in new capital and capacity. Second, prepare to deal with any chronically distressed companies. Third, develop new regulations that would seek to prevent a repeat of this problem.

Our primary focus has been on point one. We have been working with all parties, the insurers, banks, financial advisors, private equity investors, rating agencies and federal officials, to support efforts to strengthen each individual bond insurer.

To date we have facilitated the addition of $7 billion of additional external capital into five different companies. That includes $2.5 billion for MBIA, $1.5 billion for Ambac and the $1 billion that Wilbur Ross committed to Assured Guaranty. In addition, we invited Berkshire Hathaway to open a new bond insurer in New York and licensed it in record time. Berkshire has made a public commitment to add $1 billion in capital to support its new insurance company. And we are working with the NAIC to help the company get licenses in all 50 states.

That additional capital provides three very important benefits. Capital strength is the most effective way to protect the credit rating of the bonds insured by those companies, both the municipal bonds and the structured securities. The entry of new, healthy guarantors ensures that, if some of the smaller bond insurers cannot be stabilized, healthy companies will be willing and able to take over at least their municipal bond portfolio. This additional capital and market depth should help the municipal bond market stabilize over time.

Better-capitalized insurers and new entrants will guarantee a competitive market for bond insurance for those municipal issuers that want to purchase it. Time and the market will determine the need for municipal bond insurance. Some governments have stated recently that they believe they no longer need bond insurance and have been issuing debt without it. That may mean that the demand for bond insurance shrinks. But we believe that a substantial number of municipal issuers, especially the smaller ones, will continue to need bond insurance. And, it is our job to ensure that it continues to be available for those who benefit from it.

Stabilizing the bond insurers should provide time for others to deal with the much bigger problems caused by the general subprime issue, hopefully with less pain to the economy as a whole. The condition of the bond insurers became a focus of the broader markets because, if they lost their top credit ratings, it would have had a broad impact on other financial institutions and thus on the economy. Preserving the insurers' ratings was absolutely necessary to avoid worse problems, but it is obviously not sufficient to solving the much larger issues caused by subprime mortgages and other financial market problems. We certainly hope the federal government, other regulators and the financial community will make good use of the time provided by the efforts and capital provided so far.

As for point two of our three point plan, we have been studying what steps could be necessary if one of the bond insurers is unable to find the capital it needs to maintain its ratings and stabilize its business. Of course, we hope such steps will not be necessary.

Finally, point three, we are working on rewriting the regulations for bond insurance to prevent companies from taking on inappropriate risk in the future, while not discouraging

the financial creativity that is essential to maintaining our position as the world financial capital.

Because any legislative proposal will be complex and could have a substantial impact not only on the bond insurers, but also on the public and structured finance market generally, we are proceeding carefully. We are consulting with the full range of interested parties, including the bond insurers and their industry organization, the three major credit rating agencies, issuers and underwriters of guaranteed instruments, and other government officials. We have begun these meetings and have an aggressive schedule in the next few weeks to gain input in this effort.

We do not yet have a final product, but I can present some of the broad ideas and concepts we are carefully considering. In general, we believe it is important that new regulations improve transparency so that risk can be accurately evaluated.

There is nothing inherently wrong with securitization. Properly used, it can be a valuable tool for raising capital and spreading and therefore reducing risk. But we must understand the risk of moral hazard and other agency problems when there are large-scale transfers of risk.

Clearly, there must be a way to ensure that the risks that are securitized are accurately reported through each stage of the process so that underwriters, credit rating agencies, bond insurers and investors all understand the actual risk and make decisions on that basis.

For example, there are securities known as CDO squareds. A collateralized debt obligation groups a large number of mortgages, credit card or auto or student loan receivables and sells bonds supported by the stream of income from those thousands of debts. These asset-backed securities are sold in tranches ranked by predictions of their likelihood of default. Tranches with the first right to the payments from the underlying mortgages or loans are the highest quality and have the highest ratings; those with the last rights to payments have the lowest ratings. The more secure tranches receive a higher credit rating, but a lower interest rate. The less secure receive a lower credit rating and a higher rate.

The CDO **squared** bonds are made up of middle or mezzanine tranches of the **CDO** asset-backed securities and are also sold in tranches. A CDO squared groups these tranches together on the theory that the risk that all of them will default is small and so by pooling a large amount of these riskier loans into a small tranche, that tranche can be highly rated. At this point there have been **two** levels of tranching, and it becomes much more difficult to accurately determine the risk of these securities.

We are considering whether bond insurers should be prohibited from guaranteeing CDO squareds.

We want to ensure that the municipal bond market will not be affected by problems in the structured securities market in future, or vice versa for that matter. These are two very different markets with different types of risk and different payment streams. So it is not clear that it makes sense to combine them. We are considering whether a bond insurer should at some point in the future have to select one type of business to conduct, either public finance or structured, but not both. Once the company made that decision, for the market it would no longer serve, it would continue to service its current clients, but would not take on any new business. So this would not "split" the companies with all the potential issues raised by that approach. But it would have the same end result of having companies serving only one or the other market.

Other possibilities are to limit the amount of structured business that a bond insurer could do or to increase the amount of surplus and capital that a bond insurer must hold for its structured exposure. In general, in regulating insurance we are moving towards risk-based requirements for capital. So it will be important to study what that means when applied to this type of insurance.

The primary goal of insurance regulation is to ensure that the insurer maintains an adequate level of solvency and is able to honor policyholders' claims. The business model for the financial guaranty insurance companies, however, requires that they hold levels of capital that will allow them to maintain the triple-A rating necessary to write new business.

It has become clear that the loss of the triple-A rating essentially cripples the company's ability to do business as a going concern and puts the insurer in a "run-off' mode. This can lead to a downward ratings spiral that can destroy the market value of the insurance policies that issuers have purchased. We are now considering whether the sustainability of the business model should be the regulatory standard going forward. While we will continue to regard claims paying ability as the benchmark, our goal for the future, for all insurers, is to do higher level risk-based examinations.

Financial guaranty insurance is a complicated business, which is largely based on modeling and underwriting of complex capital market instruments. Total reliance on the rating agencies is not prudent. Rather an independent analysis by regulators of risk positions taken by bond insurers is more appropriate. It would also require greater transparency between the bond insurers and their regulator, by which I mean more information and oversight regarding the nature of the risks being insured.

We are looking at ways to improve reporting requirements, so we will better understand what the bond insurers we regulate are doing and can discuss this with them before problems arise.

We welcome any suggestions about how to improve our regulations.

I welcome your questions.