TESTIMONY
OF

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CONCERNING
THE STATE OF THE BOND INSURANCE INDUSTRY

BEFORE THE
SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE, AND GOVERNMENT SPONSORED ENTERPRISES

COMMITTEE ON FINANCIAL SERVICES

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Testimony Concerning

The State of the Bond Insurance Industry

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Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises
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Chairman Kanjorski, Ranking Member Pryce, and Members of the Subcommittee:

Thank you for inviting me to testify on behalf of the Securities and Exchange Commission about recent events in the financial markets and the implications arising from concerns about the credit-worthiness of certain bond insurers.

As a threshold matter, the Commission does not regulate these financial guarantors, known colloquially as monoline insurers; rather this is the domain of state insurance regulators. The Commission does, however, have specified regulatory authority over the credit rating agencies, or nationally recognized statistical rating organizations, that issue credit ratings to monoline insurers. There are also various ways that the securities markets and their participants, which the Commission does regulate, may be impacted by the declining creditworthiness of monoline insurers. Principal among these are certain systemically important securities firms (known as consolidated supervised entities or CSEs), municipal securities issuers and dealers, and municipal bond and money market funds, all of which engage with monoline insurers, either directly or indirectly, and may be affected by recent events.

While the monoline insurers are important market participants with potential impact through a number of different channels, the Commission staff has observed that most market actors are acutely aware of the potential issues and are taking steps to manage their exposures.

There is no question that, over the past year, the default of home purchasers with subprime credit on mortgage obligations has had a broad and significant impact. In addition to the difficulties that this has caused borrowers and others in their communities, the sharp rise in defaults has reverberated through the financial markets. Not surprisingly, a variety of securities that referenced pools of subprime mortgages were directly affected. Moreover, in a demonstration of the degree to which markets are linked, the indirect effects were much more broadly visible. As default levels on subprime mortgages exceeded expectations, market participants began to question the value of a variety of financial products. And as valuations came into doubt, liquidity in these products fell sharply, which further complicated the task of valuing particularly complex instruments. Derivatives referencing mortgages were not the only investments that experienced an unexpected decline in liquidity. A variety of other complex financial products that involved non-mortgage assets suffered diminished liquidity as well. As liquidity shrank with respect to structured products, market participants needing to raise funds sold less complex financial instruments such as equities and municipal securities, placing downward pressure on prices in those markets. Overall, these dynamics have significantly impacted a wide range of market participants, from individual investors to systemically important financial institutions.

Another area of concern on the part of many market participants is the financial and risk position of some of the bond insurers. These bond insurers began by insuring against defaults on bonds issued by municipalities. During the 1990s, some bond insurers migrated to insuring complex securities backed by home mortgages, including subprime instruments. In insuring such structured products, many of these bond insurers assumed that losses on mortgage-backed securities would stay within historical ranges. As the housing boom continued for many years, defaults were indeed low. However, during 2006, there was increasing evidence of the deterioration in home prices and related rise in mortgage default rates. As the deterioration has continued, market participants are questioning whether such bond insurers will in fact be able to pay on their bond guarantees and credit protection that they underwrote.

Commission Supervision of CSEs and Exposure to Monolines

The Commission supervises certain holding companies of securities firms, known as consolidated supervised entities (CSEs), on a consolidated basis. The focus of this prudential regime is the financial and operational condition of the holding company, and monitoring for risks that might place regulated entities within the group or the broader financial system at risk. At present, five internationally active securities firms are supervised under this regime: Bear Stearns, Goldman Sachs, Lehman Brothers, Merrill Lynch, and Morgan Stanley.

Each of the CSEs is of potentially systemic importance, trading a wide range of financial products, connected through counterparty relationships to other large institutions and providing services to a variety of market participants. The Commission's supervision of CSEs is primarily concerned with the risks that counterparties and market events potentially pose to the CSE firms specifically and, through the CSEs, to the financial system. This program's aim is to diminish the likelihood that weakness in the holding company itself or any unregulated affiliates would place a regulated entity, such as a bank or broker-dealer, or the broader financial system, at risk.

The Commission's CSE program supervises holding companies in a manner broadly consistent with the Federal Reserve's oversight of bank holding companies. CSEs are subject to a number of requirements under the program, including monthly computation of a capital adequacy measure consistent with the Basel II Standard, maintenance of substantial amounts of liquidity at the holding company, and documentation of a comprehensive system of internal controls which are subject to Commission inspection. Further, the holding company must provide the Commission on a regular basis with extensive information regarding its capital and risk exposures, including market and credit risk exposures.

Under the CSE program, in addition to adequate capital, liquidity and liquidity risk management are a critical focus of the Commission's review of broker-dealer holding companies. Liquidity is essential to the viability of all financial institutions. The ability of a firm to withstand market, credit, and other types of stress events is linked not just to the amount of capital the firm possesses, but also to the sufficiency of liquid assets to meet obligations as they arise.

Due to the importance of liquidity to the CSE firms, the Commission seeks to determine whether each CSE firm has adopted and follows funding procedures designed to ensure that the holding company has sufficient stand-alone liquidity and sufficient financial resources to meet its expected cash outflows in a stressed liquidity environment for a period of at least one year.

In addition to its focus on liquidity and liquidity risk management, Commission staff meets regularly with senior managers of critical control functions. Specifically, Commission staff meets frequently with senior risk managers focused on market and credit risk exposures, and meets often with senior financial controllers, senior treasury personnel, and senior internal audit personnel. Senior SEC personnel also meet periodically with senior management of the CSEs.

In the course of its constant contact with CSE firms, the Commission staff has discussed and reviewed the CSEs' current and potential exposures to monoline insurers. These exposures fall into three broad categories: credit risk, market risk, and liquidity risk.

In terms of credit risk, many CSE firms execute derivative trades with monolines, generating direct counterparty credit risk exposure. For instance, a CSE may purchase credit default swap protection from a monoline. In such transactions, should the credit underlying the credit default swap contract default, the monoline would be expected to make a protection payment to the CSE. CSE firms also bear indirect counterparty credit risk exposure to monolines through derivative transactions with municipalities that are "wrapped," or guaranteed, by monolines.

In terms of market risk, the CSE firms are exposed to the perceived creditworthiness of monolines through "wrapped" securities they may have in inventory. These include municipal securities, tender option bonds, auction rate securities, and some mortgage products. In addition, most of the CSE firms have trading and hedging positions linked to monolines' creditworthiness, e.g., credit default swaps referencing monoline debt.

Finally, the CSE firms also have implicit and explicit liquidity risk exposure to monolines through their activities as remarketing agents for certain products, such as auction-rate securities and tender option bonds. These programs fund longer-term obligations, such as municipal debt, with liabilities that have the characteristics of shorter-term paper. Often, monolines wrap the underlying longer-term obligations. Some of these programs are required to have liquidity backstops. Thus, a CSE may bear liquidity risk explicitly by acting as the liquidity provider for a particular program, e.g., for tender option bonds or variable rate demand notes. Even where that liquidity backstop is provided by a third party or where a backstop is not required, a CSE bears implicit liquidity risk when acting as the remarketing agent on a program, as it may decide to support the program and take securities on balance sheet out of client and franchise considerations.

Over the past six months, Commission staff has discussed these exposures to monolines with increasing frequency with CSE firm risk managers, treasurers, and business unit personnel. While the monolines are important market participants with impact through all the channels described above, the CSE firms are highly aware of and actively manage their exposures to the monoline sector. Although the exposures are undoubtedly in some instances material, based on the information available to us through our supervision of the firms, we believe that they have adequate capital and liquidity to deal with the consequences of the downgrade or even default of one or more monoline insurers.

The Commission staff is also in regular communication with other financial services supervisors, particularly the Federal Reserve Board, which directly oversees the holding companies of most of the systemically important commercial banks, the OCC, which oversees nationally charted commercial banks, and the UK's Financial Services Authority. Through a variety of formal and informal channels, the staff has worked with these other supervisors to understand the possible impact of downgrade or financial distress on individual institutions and on the broader financial system.

Municipal Securities Market

The municipal securities market is very significant, with $2.5 trillion of municipal securities outstanding and annual trading volume of $6.6 trillion. For this reason, the Commission staff is closely monitoring developments in the municipal securities markets related to the concerns about the credit-worthiness of the monoline insurers and the actual or potential ratings downgrades of bond insurers and associated ratings changes on insured municipal securities. Since an insured municipal security generally carries the higher of the rating of the insurer or the rating, if any, of the underlying source of repayment, downgrades and withdrawals of ratings on many bond issues result from downgrades of a bond insurer. In recent years, about half of all municipal securities offerings have been insured; insurance is also obtained in the secondary market. Although such downgrades will negatively affect the price of most bonds insured by companies that have been downgraded, the issuers and conduit borrowers with primary responsibility for repayment of these securities generally have investment-grade credit ratings or equivalent credit strength, mitigating the impact of downgrades of insurance providers.

Market participants have informed us that a few auctions of auction-rate securities in the municipal and corporate markets may have attracted too few bidders to establish a clearing rate as a result of turmoil in the credit markets, resulting in higher interest rates on those securities for a period of time. We understand that some municipal issuers and conduit borrowers have expressed an increased interest in converting their auction-rate bonds into variable-rate bonds backed by letters of credit or other types of credit enhancement or fixed rate bonds. However, heavy demand for such credit enhancement instruments and market concerns may have made them more difficult and time consuming to obtain.

We are also concerned about: the potential impact of downgrades of securities held by municipal money market and other funds; possible termination events of liquidity instruments; termination events or collateral posting events of swaps and other derivatives entered into by municipal issuers and conduit borrowers triggered by rating downgrades of either insurers or swap counterparties; and difficulties experienced by some state and local government investment pools. We are maintaining close contact with market participants to keep abreast of market volatility, pricing, and other issues.

The securities laws limit the extent of Commission regulatory authority over states and political subdivisions issuing municipal securities and conduit borrowers that are not public companies. Municipal securities are exempt from the registration and reporting provisions of the federal securities laws, and the Commission cannot specify line-item disclosure requirements or review disclosure documents in connection with offerings of municipal securities. Issuers and other participants in municipal securities offerings are, however, subject to the anti-fraud provisions of the federal securities laws, which prohibit materially misleading disclosures in connection with the offer, purchase, and sale of securities.

The disclosures made by private conduit borrowers with primary responsibility for repayment of many securities in the municipal market are often much less comprehensive than disclosures made by comparable entities in the corporate market. In fact, some conduit borrowers, in offerings backed by letters of credit, bond insurance, or other forms of credit enhancement, make no disclosures about themselves in their offering documents on the theory that the investors are looking solely to the credit enhancer for payment. Although the Commission has expressed the view that the presence of credit enhancements are generally not a substitute for material disclosure concerning the primary obligor on municipal bonds,[1] some offerings do not contain such disclosures.

As previously noted in Chairman Cox's letter to the bipartisan leadership of the House Financial Services Committee and Senate Banking Committee last summer, disclosure in the municipal securities market, particularly in the secondary market, is substantially less comprehensive and less readily available than disclosure by public reporting companies. Despite the size and importance of this market, it lacks a variety of the systemic protections found in many other sectors of the U.S. capital markets. The

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1 Securities Exchange Act Release No. 26985 (June 28, 1989), 54 FR 28799 (July 10, 1989).

recent problems of municipal bond insurers and the direct and indirect impact on municipal bond investors illustrate once again some of the shortcomings of the regulatory structure of this market.

Credit Rating Agencies

On September 29, 2006, President Bush signed into law the Credit Rating Agency Reform Act of 2006 (the "Rating Agency Act"), which permits credit rating agencies to apply to register with the Commission as nationally recognized statistical rating organizations ("NRSROs") and establishes a regulatory regime for those that become registered. Pursuant to the Act, the Commission issued final rules on NRSRO registration and oversight on June 18, 2007, all of which became effective either on that date or on June 26, 2007, the statutory deadline for issuing final rules. Since then, a total of nine credit rating agencies have voluntarily registered as NRSROs, including three that assign ratings to monoline insurers: Fitch Ratings ("Fitch"), Moody's Investors Service, Inc. ("Moody's"), and Standard & Poor's Ratings Services ("S&P").

Beginning in December 2007, Fitch, Moody's, and S&P have undertaken a number of ratings actions on monoline insurers. Each of the three has issued downgrades to the ratings of several monoline insurers and placed others on review for possible downgrade. Moody's and S&P have placed both MBIA Inc. and Ambac Financial Group Inc. on review for possible downgrade, while Fitch has downgraded Ambac from a triple-A to double-A rating and has added MBIA to its ratings watch negative list.

The ratings actions on monoline insurers have primarily been driven by the poor performance of the subprime residential mortgage-backed securities and collateral debt obligations for which monoline insurers have provided guarantees. As a result, the rating agencies now expect significantly higher levels of losses from those securities, which in turn would raise the potential amount of losses the monoline insurers would be obligated by their guarantees to pay if those losses should occur. As a result, the rating agencies have increased their estimates of the amount of capital required to support the insurers' guarantees and given closer scrutiny to the insurers' risk management and business models, resulting in extensive ratings actions.

The Rating Agency Act requires registered rating agencies to disclose their policies and procedures, including those regarding the ratings process and conflicts of interest. Last summer, using the new statutory authority that became effective in June 2007, the Commission staff began examinations of whether these credit rating agencies diverged from their stated methodologies and procedures for determining credit ratings in order to publish a higher rating. The staff's examinations are also focusing on whether the credit rating agencies followed their stated procedures for managing conflicts of interest inherent in the business of determining credit ratings for residential mortgage-backed securities. In this regard, these ongoing examinations will seek to determine whether the credit rating agencies' role in the process of bringing residential mortgage-backed securities to market impaired their ability to be impartial. I expect the findings from these examinations to result in a final report to follow in the early summer. The information gathered will better inform the Commission's oversight of the rating agencies, including their ratings of monoline insurers.

Mutual Funds

The Commission staff is closely monitoring developments with respect to bond insurers and their actual or potential effects on municipal money market funds, municipal bond funds, and other types of investments.

Bond Funds

The Commission regulates mutual funds and other investment companies under the Investment Company Act of 1940 and other federal securities laws. Investment companies of all types hold municipal bonds worth more than $850 billion, or 37% of the $2.5 trillion of municipal bonds outstanding. Mutual funds, including money market funds, hold 35% of all municipal bonds, and closed-end investment companies hold 2%. Funds that pursue a variety of investment strategies may hold municipal bonds. However, the vast majority of the municipal bonds that funds hold are in so-called municipal or tax-exempt funds, which are funds that seek to derive most or all of their income from municipal bonds that pay interest that is exempt from federal income tax. The Commission requires funds that call themselves tax-exempt to invest at least 80% of their assets in, or derive 80% of their income from, municipal bonds.

Only a small percentage of tax-exempt funds principally invest their assets in municipal bonds that carry insurance issued by the monolines. These funds generally have the word "insured" in their name and have an investment policy that requires at least 80% of their assets be invested in municipal bonds the payment of interest and principal on which is guaranteed by a AAA rated insurance company. The 36 municipal funds with "insured" in the name account for only 2.3% of all municipal bond mutual fund assets. Insured funds are more prominent among closed-end funds, representing about 28% of all closed-end municipal fund assets.

In total, insured funds hold less than 3% of the reported $1.6 trillion of insured municipal bonds outstanding. In addition, some so-called "non-insured funds," which are municipal bond funds that do not have "insured" in their name, may hold insured municipal bonds. Typically, a non-insured fund is deterred from holding insured municipals because they generally yield less than non-insured municipals with the same rating. However, a non-insured fund may be attracted to insured municipals to the extent they broaden the universe of available investments. For example, the presence of insurance may provide the credit support needed for a bond to be rated AAA or to meet other ratings criteria maintained by a fund.

Money Market Funds

Money market funds are subject to Rule 2a-7 under the Investment Company Act, which generally limits these funds to investing in a diversified portfolio of high quality, short-term dollar-denominated instruments. Fifteen percent (15%) of all money market fund assets belong to municipal or tax-exempt money market funds, which are funds that invest at least 80% of their assets in short-term municipal securities. Market observers have informed the staff that in 2007 up to 40% of municipal money market fund assets may have been "wrapped" or guaranteed by monoline insurers. These securities include variable rate demand notes and tender option bonds that have liquidity backstops provided by a CSE or other large financial institution. In addition to providing a source of cash to satisfy redemptions by fund shareholders, these liquidity features operate to shorten the municipal bonds' maturity and make them appropriate investments for a money market fund.

In most cases, the liquidity backstops require that the municipal bonds maintain certain ratings, which may be threatened by the ratings downgrades of the monolines. The Commission staff has been in regular contact with fund management companies, which are aware of these risks and have taken steps intended to protect municipal money market funds from the loss of these liquidity backstops. Fund managers have begun to examine the credit quality of the underlying municipal issuers and evaluate the risks of continuing to hold the instruments should they no longer be able to rely on bond insurance. Where the underlying credits are unsatisfactory, some fund managers are attempting to obtain alternative credit support or are selling the instruments. Where the underlying credits are satisfactory, fund managers are seeking amendments to the security's documentation that will preserve the liquidity feature in reliance on ratings issued to the municipal issuer without regard to the ratings issued to the monoline insurer. Fund managers report that they have been discussing their actions with fund boards of directors which are keenly interested in these developments. In the interest of the integrity of the municipal marketplace, we as regulators, and especially in our oversight function, must be careful not to trigger unnecessary sales of securities.

Losses by a money market fund, including a municipal money market fund, would be reflected by the fund re-pricing its securities below $1.00 ("breaking the buck"), an event that has happened only once since the development of money market funds in the 1970s. Based on its oversight of the industry, the Commission staff is presently unaware of any municipal money market fund currently threatened with breaking the buck as a result of recent downgrading and potential downgrading of monoline insurers.

Possible Effect on Funds of Monolines' Creditworthiness

Although it is difficult to predict the effect on municipal bond or money market funds of the declining creditworthiness of bond insurers, some projections can be made.

- A downgrade may require many insured funds to change their investment policy with respect to the ratings quality of portfolio holdings if those holdings are no longer guaranteed by an AAA-rated insurance company.

- Any overall decline in the value of municipal bonds or insured municipal bonds would be reflected in equivalent declines in the value of municipal bond fund shares.

- A more severe downgrade (e.g., from AAA to A) is likely to have a greater effect on the value of municipal bonds and funds than a less severe downgrade (e.g., from AAA to AA).

- A downgrade may present more price risk to an owner of a single municipal bond than to an owner of shares of a diversified municipal bond fund.

- With respect to municipal money market funds, if monoline ratings fall below A, many liquidity puts will terminate, the result of which will be to expose the funds to long-term, lower quality, illiquid debt which would result in lower prices.

- In the long term, the inability of bond insurers to maintain high credit ratings may restrict supply of high quality paper for municipal money market funds.

Thank you for the opportunity to testify before you today. I would be happy to answer any questions you might have.