Special Comment

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Rating Triggers in the Financial Guaranty Industry

2004 Update

Introduction

Moody's has completed an update of its study of rating triggers within the financial guaranty industry. Based on current rating levels, this year's survey revealed neither the addition nor the elimination of any material[1] rating triggers.

The term "rating trigger" refers to any clause in a contract or agreement that allows one party to take protective action against the deteriorating creditworthiness of the other party once a pre-determined rating threshold is breached. The impact that a particular rating trigger can have on the credit analysis of a guarantor depends upon the type of the trigger, the number of notches off of the current rating level, and the significance of the particular contract or agreement to the financial health of the guarantor. In our view, the rating triggers embedded in the contracts of *primary* financial guaranty companies are largely "non-material" because the action required by the trigger would not likely have any meaningful impact on the ability of the guarantor to conduct business. For the monoline financial guaranty *reinsurers*, however, virtually all of their reinsurance contracts continue to give the primaries certain protective rights if a reinsurer is downgraded. We consider these triggers to be material in that, while the existence of the trigger does not impact the current rating level, it could have an impact if the company's ratings were at lower levels.

1. *A "material" trigger is one that would have further ratings impact (additional notches of downgrading) if the company's ratings were at lower levels. Material triggers do not impact the rating levels that exist today.*

Summary Findings

Primary Financial Guaranty Companies

For the primary guarantors, typical rating triggers can call for remedies such as pricing increases, the posting of collateral, or the termination of an agreement. Moody's believes, however, that if these rating triggers were tripped in the event of a primary company's downgrade below a certain threshold, the impact that they would have on the guarantor's overall financial strength would be modest. In other words, if such rating triggers were activated, it is not likely that the guarantor would experience much if any additional rating stress beyond the original cause of the downgrade.

A brief summary of primary guarantor related triggers and the impact that they have in our analysis is described below.

Swaps and Derivatives

Some guarantors enter into swaps and other derivatives for the purpose of managing interest rate and currency risks. These transactions are typically executed through Master ISDA (International Swaps and Derivatives Association) agreements which allow for the netting of all amounts due to and owed by a particular counterparty. Master ISDA agreements with counterparties typically require collateralization when net mark-to-market exposure exceeds a certain threshold amounts. The level of this threshold often varies with the rating of the guarantor such that, if a guarantor is downgraded, the amount of the threshold will decrease. Therefore, these rating triggers will have an impact on the amount of collateral that a guarantor would potentially have to post under the terms of its Master ISDA agreements. It should be noted, however, that such triggers, which have become standard in many ISDA agreements, are bilateral--meaning that the guarantor's counterparty is subject to the same collateral-posting requirements and rating thresholds as is the guarantor itself. Furthermore, the guarantors strive to balance-out trades under each of their Master ISDA agreements to avoid overexposure to any one counterparty. As a result, the potential to post meaningful levels of collateral is small in most cases, making these triggers non-material to the guarantor's rating. Some swap agreements also contain termination clauses should the guarantor be downgraded below a certain level, although such clauses would generally only be triggered with a significant downgrade of the guarantor (e.g., between five and eight rating notches.)

Certain guarantors provide termination payment coverage on interest rate swaps used in conjunction with an issuer's municipal securities. A municipality may be obligated to make a termination payment to a swap counterparty if the guarantor providing coverage for principal and interest of the municipal security is downgraded multiple notches and the municipality is in default. Under the swap termination coverage, the coverage of the wrap is extended to cover a swap termination payment. Because this trigger requires multi-notch downgrades of the guarantor, typically has to be in conjunction with a default of the municipality, and usually is caped at a modest level, it is deemed to be non-material.

The guarantors also enter into credit default swaps, typically executed through Master ISDA agreements, as an extension of their credit enhancement business. The guarantors have for the most part avoided entering collateral support agreements (CSAs) with their swap counterparties, however, some transactions contain CSAs with triggers that require or increase collateralization levels at certain specified rating levels. Moody's believes that the writing of substantial volume of credit default swaps with rating triggers embedded in their related CSAs could magnify the effect of reference asset deterioration and/or rating downgrades. If such collateral support agreements were to become more commonplace, they could potentially expose a guarantor to significant liquidity stress.

Municipal GICs

Many of the primary guarantors also offer guaranteed investment contracts, or "GICs" to their municipal clientele through subsidiary companies. Municipal bond issuers use these investment contracts to invest the proceeds of bond issues until such time as the money is needed for its intended purpose, and the guarantor provides an insurance policy for the GIC which guarantees its performance. To protect these public funds from credit deterioration of the guarantor, most muni-GICs include rating triggers requiring the guarantor to post collateral to secure certain GIC liabilities. However, these triggers are not viewed as being material from a rating perspective. Most transactions require a significant downgrade before such triggers are actuated (generally at least four rating notches), lessening the likelihood that the guarantor will need to take action. If the trigger were tripped due to a multiple notch downgrade of the guarantor, GIC assets can be posted as collateral for the majority of any collateral requirements. A collateral margin amount of 3-5% may also be required for some transactions, although the guarantor's line of credit and equity in its GIC subsidiary would be available to post this margin. The guarantor would also typically have the option of returning funds at par.

Soft Capital Facilities

The guarantors maintain a variety of soft capital facilities which are designed to provide additional claims-paying support beyond hard "paid-in" capital that forms the core of its claims-paying resources. Most of these facilities contain rating trigger clauses which would allow the provider of the facility to increase pricing by a specific amount in the event of a one-notch downgrade, although the amount of the pricing increase is usually quite modest. Since this rating trigger has only a minor pricing impact if tripped, we believe that it is not material to the guarantor's rating assessment.

Liquidity Lines

Many of the primaries have established lines of credit with banks for general corporate purposes. Currently, most facilities are only 1-year in duration, raising the question of whether they would be renewed if a guarantor were to experience significant financial stress. In any event, this form of trigger is viewed by Moody's as being non-material. The main purpose of bank facilities is to give the guarantors access to emergency liquidity to pay unexpected insurance claims. However, the industry's exposure to liquidity risk is relatively modest given the low historical frequency and severity of insured defaults, coupled with the nature of the insurance contract, which protects against the acceleration of principal payments. Furthermore, the guarantors do not issue short-term debt, lessening the need for significant amounts of back-up liquidity. Should liquidity lines become unavailable, insurance claim payments could be funded by the cash flow generated from the company's operations, which is significant. In addition, the guarantors have large, high quality investment portfolios allowing them to either sell or repo marketable securities to meet short-term liquidity needs.

The primary guarantors, of course, are also exposed to another form of rating trigger that is not embedded in any documentation, but is instead imposed by the market itself - If a financial guarantor were to lose its existing rating, while not directly impacting the company's current insured portfolio or claims-paying ability, it would likely affect the firm's competitive position and business prospects going forward. As a result, if a primary guarantor were to be downgraded, it may well be that the additional negative impact on the firm's future franchise value from the downgrade itself could cause Moody's to downgrade the company by an extra rating notch. Having said this, the importance of the rating to a guarantor's business franchise provides a strong incentive for the company to maintain a strong credit posture, which is one of the reasons we have seen few downgrades in this sector. Therefore, although the ratings on financial guarantors are likely to be quite stable as a group, the guarantors may be more vulnerable to a two-notch downgrade than some other companies. We do not, however, believe that financial guarantors are more vulnerable to downward rating spirals than other companies as they do not have significant financial obligations that increase as their ratings decline, and operating expenses are relatively low and can be scaled back if new business originations decline.

Financial Guaranty Reinsurance Companies

For the monoline financial guaranty reinsurers, Moody's ratings incorporate considerations of the rating triggers embedded in virtually all of their reinsurance contracts with the primary guarantors. These rating triggers are generally based on a downgrade of the credit rating of the reinsurers and/or on a reduction of the reinsurance benefits to the financial guarantor as evaluated by the rating agencies. Financial guarantors have substantial counterparty risk exposure to the reinsurers and have used these triggers as a tool to get more flexibility in managing this exposure. Generally, upon a trigger event, the financial guarantor has the option to terminate its reinsurance contracts on a cutoff (exposure and unearned premium returned to primary) or a runoff (no additional exposure) basis, or to increase ceding commissions.

While these triggers are material in the sense that they can lead to negative changes in a reinsurer's business franchise, they would not under most circumstances present a direct threat to the claims-paying ability of the reinsurer. From a financial point of view, a cutoff termination may, in fact, improve the claims paying ability of a reinsurer by eliminating its exposure to losses from the recalled portfolio and, at least initially, result in greater capital resources for the remaining portfolio. In a few cases, however, a cut-off termination would allow a primary financial guarantor to pick and choose the exposures it wanted to take back, resulting in the potential for adverse selection against the reinsurer. In a runoff termination, the reinsurer would retain its existing insured portfolio and would continue to earn reinsurance premiums on that portfolio, although it may have to pay higher ceding commissions which would affect the reinsurer's profitability and rate of capital growth. Nevertheless, if some of these triggers were tripped, the reinsurer's future business prospects could potentially be called into question, especially if it meant the end of a business relationship with one or more of the financial guarantors. In this instance, the reinsurer would likely consider a wide range of strategic options from runoff to a dramatic change of the business model, both of which would have potential negative rating implications for the reinsurer and would need to be evaluated on a case-by-case basis.

Reinsurance treaties are generally negotiated annually and have evolved over time. As a result, despite their small client base, reinsurers have exposure to a wide range of rating triggers through multiple reinsurance agreements with each primary. This leads us to believe that if some of the triggers were tripped, negotiated solutions on the overall exposure to a financial guarantor's portfolio are more likely to take place than a strict application of each treaty's specific trigger. Additionally, because financial guarantors are substantial users of reinsurance, they would have to evaluate the financial consequences of reassuming their exposure from a reinsurer, both from a capital adequacy and single-risk perspective. Given the possible damage to their overall risk profile and the uncertainty around the ability to substitute a new reinsurer, financial guarantors may not choose to exercise their option to call back the business in all cases. More broadly, financial guarantors would have to evaluate the benefits of their reinsurance relationship using criteria that go beyond the actual rating of the reinsurer and rating agencies' assessment of the reinsurance benefits. Monoline reinsurers continue to be well-capitalized companies offering a dedicated and committed source of reinsurance, which provides significant value to the primary guarantors.

In addition to the triggers embedded in reinsurance contracts, a couple of the reinsurers rated by Moody's are also exposed to rating triggers in liquidity lines and swap agreements, with terms similar to those described for the primary companies. We do not view these triggers as having a material impact on the financial health of these firms.

Related Research

Special Comment:

The Unintended Consequences of Rating Triggers, December 2001, #72804

Moody's 2003 Review and 2004 Outlook for the U.S. Financial Guaranty Industry, December 2003, #80778

Rating Methodology:

Moody's Rating Methodology for Financial Guaranty Insurance Companies, December 2003, #80806

To access any of these reports, click on the entry above. Note that these references are current as of the date of publication of this report and that more recent reports may be available. All research may not be available to all clients.

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