Bonfire of the monolines

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It has become common among regulators and investors to think of the monoline bond insurers as having good and bad businesses. The problem, at least for project finance sponsors and lenders, is that none of them have decided which one infrastructure finance is. Even the monolines' management have yet to decide whether private standalone project deals count as structured finance, or should be part of public finance groups.

Regardless of where infrastructure staff sit, monoline activity in infrastructure finance has slowed to a crawl. They were removed from the £2.4 billion ($4.7 billion) debt financing for the Future Strategic Tanker Aircraft PFI project. Work has not ceased completely, as recent financings such as Belfast Gas Transmission and Depfa's EPIC III securitization from December show. The credit crunch has widened the spreads on all debt, and project finance debt, which is more illiquid than many assets, has followed this trend.

Compared to the monolines' core municipal and structured finance businesses, infrastructure is still a very small contributor to their bottom line. But it tends to make a disproportionate claim on monolines' capital, since most, though not all, project deals are enhanced from BBB-/Baa3 to AAA. In areas such as structured finance and municipal finance, monolines tend to have a higher proportion of their exposure in single-A and even triple-A credits.

How it happened

The monolines' difficulties largely come down to their involvement in structured finance and securitization. They have traditionally intervened at various points in the capital structure of structured deals, including mezzanine tranches, which typically refers to BBB credits, and single-A and AA tranches. They have also written credit default swap protection against super-senior AAA tranches. The securitizations have been both of primary products and of other securitizations, or CDO-squared.

The distress of the bond insurers comes from potential and actual claims against them as a result of distress in the underlying assets. The irrevocable and unconditional guarantee that they provide on bond insurance means that there is little room for wiggle. Monolines have been furiously bolstering their capital position to meet these claims and avoid further downgrades. Those, that is, that have not been downgraded so far as to make their survival moot.

Of almost equal importance is the credit default swap business that the monolines wrote against super senior tranches of securitizations. These CDS contracts differ a little from similar traded products, especially because the monolines do not have to post collateral against their obligations. But while this quality is more similar to insurance agreements than to derivatives, monolines have to mark the value of these positions to market. This tends not to flatter their financial results.

Of the eight monolines, two, FGIC and XL Capital Assurance, have been severely downgraded; two, Radian and CIFG, are relatively stable, but below AAA; the two largest, MBIA and Ambac, have been downgraded one notch by Fitch, and two, Assured Guaranty and FSA, have not been downgraded at all.

	Rating: S&P/Moody's/Fitch	**Change to project finance lines**
MBIA	AAA/Aaa/AA (Fitch unsolicited)	None Planned
Ambac	AAA/Aaa/AA	No structured power.

		Utilities and infra OK
Assured Guaranty	AAA/Aaa/AAA	Utilities/PFI/PPP
FSA	AAA/Aaa/AAA	None planned
XLCA	A-/A3/BB	No new business at all
FGIC	BB/Baa3/BBB	No new business at all
CIFG	A+/A1/A (Fitch unsolicited)	Plans to expand
Radian	AA/Aa3/AA-	None, though portfolio limited

Source: Agencies, Project Finance research

For FSA and Assured Guaranty, the upheavals offer them a chance to gain market share. Assured Guaranty, for one, is hiring in infrastructure FGIC and XLCA have stopped writing all new business, and FGIC has said it hopes to eventually separate its structured and public finance businesses, though its more immediate concern is satisfying the New York insurance regulator that it has sufficient capital to stay in business.

Ambac and MBIA between 1995 and 2000 operated a joint venture outside the US, and most of their project finance business was contained in this venture. They have the oldest and largest book of project finance business, which was divided between them during the 2000 divorce, and their failure would have the greatest effects on debt markets. Both have recently completed wrapped bank loans – Ambac on Babcock & Brown's Trans Bay Cable and MBIA on the Millau Viaduct.

Both have stressed that they want to spend the next few months conserving capital and MBIA says it may eventually split its business, though it stresses not only that it has no current plans to split, but also that it is open for project business.

What's left

Ambac had built a growing niche in US power deals, including the $819 million Plum Point refinancing and the $515 million Trans Bay Cable. Both projects featured heavy levels of government involvement, but the private power business was always considered a little far from the monolines' remit. XL Capital's involvement with the NRG Peaker portfolio, while innovative, closed months before the deal's sponsor entered bankruptcy protection. Ambac does intend, however, to continue to operate the overseas utilities sector, even when these utilities are privately owned, perhaps reflecting these industries' regulated returns.

For MBIA, Ambac, FSA and Assured Guaranty, however, the rewards available from writing policies on single-A credits come at a much proportionate smaller capital charge than those on BBB project finance. This capital charge is assigned by ratings agencies, whose voices have been dominant in the monolines' business strategy. But the agencies have not yet indicated any changes to the way in which they will treat infrastructure finance commitments, though several bankers and monolines contacted by *Project Finance* said that they thought a review might be underway.

The deals that have gone through so far have been done with unblemished bond insurers and on ratings above BBB. Belfast Gas Transmission, which closed a £119 million ($237 million) bond issue, wrapped by FSA, had an underlying rating of A1/A (Moody's/S&P). The 40-year bonds priced for a coupon of 2.207%, compared to 1.98% on the Ambac-wrapped Tameside bonds, which were due 2042 and closed in September 2007.

The comparison is not exact, since Tameside benefited from the late 2007 lull in credit market conditions, and prices of UK Gilts have edged up since September. But Tameside's underlying rating, at BBB, was much lower. Institutional investors might now look more to underlying ratings that they did during the go-go credit years, but a general risk aversion means that borrowers do not always see the benefit.

For Depfa's £666 million wrapped bond securitisation, EPIC III, it brought in Assured Guaranty to wrap the super senior tranche. Even with that protection the super senior tranche priced at 65bp over Libor, compared to the 30bp over Euribor of the nearest comparable, Dexia's WISE securitisation of wrapped bonds from 2006.

Neither deal is likely to spark imitators. The UK's Department for Enterprise, Trade and Investment provides a comfort letter to reassure bondholders about changes to an already generous regulatory regime. EPIC III's underlying assets are similarly highly regulated. The long-awaited Calyon and SMC securitization of Middle Eastern project loans, which would have used a different structure to EPIC III, has been shelved.

What's exposed

For buyers of wrapped loans and bonds, the effect of a downgrade to the guarantors is fairly straightforward – an increase in the amount of capital they need to set aside against this debt. For pension fund holders of wrapped bonds, downgrades will force them to hold them in different, and smaller, buckets for lower-rated debt. For the universe of money-market funds, structured investment vehicles and trading desks that cannot hold anything less than AAA, the wrapped debt would need to be sold at a loss.

For bank loans, the picture is a little more complicated, since they have a slightly greater degree of control over insured credits than bondholders. In particular, since wrapped bank loans are not all drawn down at closing, banks can inset provisions that halt draws if the loan insurer is downgraded. They can also force the monoline to cede control of the loan to lenders, though this intercreditor provision has not yet been widely tested.

For other providers of funding, the remedies may be even stiffer. The EIB is understood to have the right to accelerate debt in the event of the downgrade of a guarantor, though this usually has to be more than simply below AAA. But many wrapped bank deals simply have a step-up provision that increases pricing in the event of a monoline downgrade. For sponsors, the added debt service burden will be difficult to bear, especially given the high leverage that wrapped deals usually feature. For banks, the pricing increases can be so rewarding that they are in little hurry to remedy the situation, even if the downgrade does mean that the debt attracts a higher capital charge.

Other victims of the monoline downgrades include the holders auction rate bonds, which were used on at least one occasion to finance a stadium project – the New Meadowlands stadium – though they enjoy wider use in high-grade corporate debt and municipal finance than they do in private project finance. Interest rates on these bonds have reset to high levels as a result of the failure of issuers to roll over their debt.

The interest rates on auction rate securities are reset periodically through a Dutch auction, where buyers bid on quantity and interest rates, and the price is set at whatever rate allows the auction to clear. The investment banks that make markets in auction rate securities have typically supported these auctions, but because of their own balance sheet travails, and because of the decline in credit quality of many of the monolines, they have declined to do so.

Because the auctions failed, the rates rest to punitive levels, sometimes as high as 20%, to encourage a refinancing and compensate bondholders for the loss of liquidity. The high teens interest rates are understood to be outliers, and in many cases reset to lower levels in subsequent auctions. But the market depends for its efficient operations on deep-pocketed broker dealers, and auction rate bonds are not, in the circumstances, likely to extend their reach in private infrastructure deals.

What's the fix?

Ambac, which is feeling increasingly assertive following its 12 March recapitalisation, has formed a group to examine fixing the auction rate market. For infrastructure bondholders and lenders, options are more limited. An insurance policy with a monoline involves irrevocable commitments from both sides.

Replacing monolines is difficult. A mortally-wounded monoline will depend on continuing premium income from performing deals to finance claims against the distressed securitisation issues. While some of the premium on infrastructure deals might be paid upfront as part of closing costs, with monolines recognising that income over the life of the deal, much of the rest is due over the life of the debt.

Monolines resist having to accelerate debt unless at their discretion. In February, FSA and Ambac received £1.927 billion from the put option on the two Metronet London Underground PPP project companies. The proceeds followed

Metronet's default on its obligations, but the monolines are under no obligation to prepay the bonds. Depending on their circumstances, they may decide to keep up payments until the bonds' 29-year maturity.

Some deals allow a sponsor to call a policy after a set period, often ten years. Since as recently as ten years ago all infrastructure business was in the hands of the MBIA-Ambac joint venture, neither of which has been seriously downgraded, few deals will be able to refinance in this manner, and of those eligible, few will be distressed enough for this to be necessary.

If a sponsor or lender wishes to replace monoline it will need to repay the present value of all of the premiums that the monoline would have earned. This procedure is typically not economic, and holders of downgraded paper will often find it cheaper to take out a second wrap on the distressed paper. Several of the better-rated monolines say that they have received numerous enquiries from the holders of debt wrapped by downgraded competitors.

But there are few obstacles to monolines eventually consolidating their involvement in infastructure finance. New York State's insurance superintendent, Eric Dinallo, who has been an often forceful critic of monolines' involvement in securitization, and has raised the idea of splitting municipal and infrastructure business, has also stressed the monolines' useful role in "infrastructure finance". Pressed on the issue, Dinallo's spokesman, David Neustadt, says "there is no intention of discouraging monolines from project finance activities, whether in the US or overseas."

Project finance debt is still illiquid enough to make the monoline proposition – that a ratings and regulatory-led pricing model can beat the price offered in capital markets – a long-term possibility. Some of the sources of demand for wrapped paper will shrivel. The negative basis swap arbitrage, which provided an avid accounting-driven audience for wrapped index-linked UK PFI debt, has disappeared.

Banks may find better ways to manage credit risk and their funding requirements. Banco Espirito Santo closed a Eu1.1 billion mixed asset, cash collateralised loan obligation for BES' project finance portfolio in January. The bank, which structured the deal alongside ABN Amro, has not attempted to sell the securities that have been issued by the Lusitano Project Finance 1 vehicle. In the event that prices recover it may attempt to do so.

In the interim, the notes can be used as collateral against repo funding arrangements, because European Central Bank rules classify the notes as marketable assets. Banks have found unsecured lending to be very expensive, and raising unsecured debt against a portfolio of illiquid project finance loans is difficult. For now, though, the move allows BES, and any bank that cares to follow it, access to very cheap funding. Moreover, for now, neither of the main factors driving business to monolines have changed. Government interest in private infrastructure is still strong. And banks, under Basel II, will still get capital relief for wrapped debt under some approaches. With some monolines reporting strong demand for wraps on municipal credits, the flames show a little evidence of subsiding.