BOND INSURANCE

Bond Insurance is a commitment by an insurance company to make the scheduled principal and interest payments on a bond should the obligor of the bond is unable to do so.

How does it work?

When a company or a public entity decides to issue a bond, it pays the bond insurer to guarantee its bonds. Entities with a lesser credit rating than the monocline company can get their bonds insured so that they can have the same rating as the insurance company itself (mostly AAA). So, relatively poor-quality debt becomes investment-quality debt because the insurance company will pay the interest and principal if the borrower defaults.

This makes the bonds safer and investors should, in theory, require lower interest payments to lend the money.

Bond insurers essentially lend their rating to less creditworthy borrowers; just as some students can only borrow money if parents act as guarantors.

Who uses bond insurance?

The market development in the US in the 1970s as municipal borrowers, such as small towns or regions, realised that they could borrow money from big investors if they were guaranteed by bond insurers with triple-A credit ratings, the best possible.

In recent years, bond insurers have developed business around guaranteeing payments on structured or securitised bonds. Some have also entered the derivatives market.

What is problem now?

Bond insurer agree to pay principal and interest when due in a timely manner in the event of a default. Many bond insurers have provided such guarantees on billions of securities, including collateralized debt obligations (CDOs) that are partly exposed to subprime mortgages. The problem is that tidal waves of mortgage defaults are sweeping the US, creating so many losses that many bond insurers are getting swamped.

The risks of defaults in the structures and securitised bond markets have proved to be higher than in the municipal bond market. Some of the assets behind the complex bonds were mortgages, including risky US subprime mortgages. The soaring rates of delinquencies on these mortgages means payments to the bond have stopped.

Losses on these bonds, some of which are called collateralized debt obligations have been higher than expected, and the bond insurers have to find extra capital to be sure they can meet their obligations. Without the extra capital, they could lose their triple-A ratings, and no longer be able to insure as many bonds.

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