

## *National Federation of Municipal Analysts*

### *White Paper on Disclosure for Financial Guarantors*

*Draft of: December 10, 2007; Comment deadline: March 10, 2008*



The National Federation of Municipal Analysts (the "NFMA") was chartered in 1983. It is a not-for-profit association with the goals of promoting professionalism in municipal credit analysis and furthering the skill level of its members through educational programs and industry communication, providing an informed perspective in the formulation of legal and regulatory matters relating to the municipal finance industry, and facilitating the flow of information between investors and issuing entities. NFMA membership includes approximately 1,000 members, primarily research analysts, who evaluate credit and other risks of municipal securities. These individuals represent, among others, mutual funds, insurance companies, broker/dealers, bond insurers, and rating agencies.

One of the main initiatives of the NFMA is to promote timely and thorough disclosure of the financial and operating information needed to assess the credit quality and risk of a municipal debt issue. The NFMA's efforts have ranged from global disclosure-related issues to more detailed, sector-specific work. For further information on the NFMA's continuing work in the area of disclosure, please see the "Disclosure Guidelines" and "Position Statements" on the NFMA's web site at [www.nfma.org](http://www.nfma.org).

The following discussion takes the form of a "White Paper" rather than a "Recommended Best Practice in Disclosure". In order to develop our Recommended Best Practices in Disclosure, diverse groups of NFMA analysts work with non-analyst professionals in each sector to develop "best practices" guidelines for certain municipal bond market sectors. The same process was followed to produce this White Paper, the purpose of which is to more broadly describe information needed to help analysts most effectively do their jobs. The NFMA believes that the best practice in disclosure will always be the one that provides a steady flow of timely information from borrowers to the entire market.

Following is the White Paper on Disclosure for Financial Guarantors. It is important to note that the NFMA's disclosure efforts are a continuing process. This White Paper and the Recommended Best Practices papers are not static documents, and will be revisited and changed as market conditions warrant. We encourage interested parties to submit comments at any time to [lgood@nfma.org](mailto:lgood@nfma.org) so that they can be considered in the development of future versions of this White Paper.

*The recommendations in this White Paper are not intended to apply equally to all financial guarantors. To the extent the financial guaranty companies adopt recommendations of this White Paper; we encourage them to indicate when a specific item requested in the White Paper is not applicable to that company.*

## **INTRODUCTION:**

The NFMA Financial Guaranty Disclosure subcommittee was formed to produce a White Paper to identify those issues of concern to analysts regarding financial guarantor disclosure. There are currently nine primary market municipal bond insurers and five active reinsurers. This White Paper will focus on disclosure by the primary market insurers. Bond insurance penetration rates have risen over the last several years; in 2006 approximately 50 percent of new issue U.S. municipal bonds were insured. In addition, the financial guarantors have diversified considerably over recent years to the point where US public finance exposure is less than 50 percent of all par insured. Due to these increasing penetration levels, disclosure by the bond insurers has become even more important to the municipal bond market.

There are three overriding themes of this White Paper:

- Transparency of financial data disclosed,
- Improved and equal access to information, and
- Consistency in format.

Within the framework of these three themes, the subcommittee will delineate the disclosed and desired balance sheet and income statement information, operating statistics, and risk profile.

### **A) THEMES**

#### **1. Transparency**

Because of well established Statutory and GAAP accounting principles, disclosure of financial guaranty companies' financial results is fairly straightforward and transparent. Despite this transparency, there are significant areas of weakness which remain unresolved among industry participants. The weakness is driven mainly by the complex evolution of financial guaranty corporate structure and the expanding global influence on the market. The two areas of most importance discussed in this White Paper with respect to disclosure transparency among insurers are consolidation of financial reports and non-US GAAP reporting. Transparency in risk profile will also be addressed.

#### **2. Improved Access to Information**

There appear to be discrepancies in both the provision of disclosure information and the thoroughness of that information. The most detailed disclosure is provided to the rating agencies. Less disclosure is provided to bondholders and to other parties, such as asset managers, who act as their proxies. The differentiation of disclosure is problematic from more than one standpoint.

First, it is bondholders who ultimately bear all of the credit, liquidity, regulatory or headline news risks related to a particular bond issue.

Second, bondholders desire access to information now only available to rating agencies. Rating agencies receive line item detail on all insured transactions. While this goes beyond the scope of publicly available information, it is relevant when there are either concerns relating to credit quality for insured obligations or new products being insured that are not disclosed to

bondholders. Examples of this include recent disclosure of ABS collateral by vintage and type of security, after-the-fact disclosure that certain airline equipment trust certificates have been insured, and subordination levels for CDO obligations. While rating agencies typically receive this information on all deals in advance, insured bondholders are only able to see this information once problems have become evident. This subcommittee believes summary level information regarding asset type, security, vintage, and subordination is relevant and recommends that this information be developed for presentation on an ongoing basis rather than on an ad hoc and after-the-fact basis.

### **3. Format Consistency**

Consistency in format is another theme that filters through to a number of aspects of financial guarantor disclosure. Many insurers, especially via their Quarterly Supplements, have made good strides in providing additional information to investors. However, there is a fair amount of inconsistency in format and content among the insurers. For example, some insurers provide only information on par outstanding while others with more municipal exposure refer to total debt service exposure. In addition to inconsistent format, the bond insurers' definition of terms is not identical and can make comparison of data difficult. The attached Appendix A, "Scorecard on Quarterly Operating Supplements" details each insurer's disclosure breakdown and illustrates the differences in disclosure format of material items. The chart in Appendix A was difficult to prepare based on the different definition of terms by the guarantors. A standard glossary of terms would be beneficial for the investor community's analysis. At this point, comparisons are difficult and sometimes impossible without numerous additional calculations and/or information from sources outside the Quarterly Supplements.

## **B) SPECIFIC DISCLOSURE SEGMENTS**

### **1. Risk Profile**

More specific disclosure is warranted with regard to the insured portfolios of each financial guarantor. Specifically, the subcommittee recommends enhanced disclosure regarding the largest insured transactions, structured transactions, and watch list credits. Because a loss in one large exposure could be significant to the profitability and overall operations of an insurer, more thorough and consistent disclosure of each insurer's largest transactions-- by type and by rating - - would be preferred. Specifically, the lower of either the internal rating or rating agency rating should be provided for each transaction.

The subcommittee also recommends financial guarantors provide more detailed disclosure of their largest structured transactions, including CUSIPs. If full disclosure cannot be provided because of confidentiality agreements, a general narrative/categorical description should be provided, *e.g.*, \$10 million sub-prime credit card, pool equivalent rating Aa2, amortization and reserve details, etc. In addition to describing the form of collateral, further discussion of the transaction's lien status, subordination, trigger points, covenants and the like would also be desirable.

"Watch lists" have different meanings at different companies; sometimes credits are placed on the list for reasons which do not materially affect the credits' debt servicing ability, *e.g.* amendments, waivers and consents. The subcommittee's recommendation is for a "true" watch

list of weak credits, with specifically defined ratings in a 3-tiered schema, specifically, 1) transactions warranting case-based reserves, 2) sub-investment grade exposures, and 3) the less easily defined “watch list credits”.

“True” watch list credits above a certain threshold (expressed as a certain percent of claims-paying resources), should be disclosed on a quarterly basis, along with a narrative on any material credit developments. In addition, exposure should be expressed both on a net and gross basis and any facultative and/or treaty reinsurers should be identified along with dollar amounts and any material reinsurance terms, *e.g.*, retrocession or termination event triggers. Finally, disclosure documents should also include statements concerning the insurer’s policy regarding the use and insurance of derivatives as well as the insurer’s foreign currency policy.

## **2. Operating Results**

Operating results show important trends in business activity, lines of business, pricing, and market position.

Appendix A shows, by line item, the categories of non-financial data that are needed to compare and analyze participants in the financial guaranty industry.

Lines of business are generally divided among public finance and structured business, and further divided between domestic and foreign segments.

Business activity includes both principal and premium written as units of measure. In addition, practitioners need a metric that shows the degree to which the financial guaranty company uses reinsurance.

There are selected financial ratios which are in common use in the financial guaranty industry. Quarterly Supplements reports need to clearly identify whether the information is based on statutory or GAAP accounting. An accurate comparison of financial results among different financial guaranty companies is impossible without this type of information.

## **3. Income Statement and Balance Sheet**

Consolidation of financial data for credit/rating analysis is inconsistent with consolidation of financial data for corporate and shareholder reporting. As the financial guaranty business has become global, separate business units have been established to provide access for companies to write business outside of the United States. In many instances capital support and re-insurance among separate business units provide capital, reserves and operating support for the rated enterprise. Traditional financial reports that show financial results consolidated at the parent company level do not reveal the extent of capital and resources distinctly available to support debt service at the level of the triple A –or other high rated, claims- paying subsidiary. Holders of insured bonds are interested in a single consolidated financial report which shows the sum of capital and reserves that are available and segregated for support of the triple A or other high rating. This alternative form of consolidation is referred to in this report as “economic consolidation”. This is in contrast to consolidation at the enterprise level which is the practice among companies at this time.

Reporting on the basis of economic consolidation would describe financial results based on economic principles rather than on enterprise principles stipulated by law and accounting practice. Analysts tracking the claims-paying ability of monoline financial guaranty companies are confronted with a mix of statutory, GAAP, domestic and non-domestic accounting. In addition, they are required to interpret non-consolidated results of separate enterprises to determine the actual resources available to pay claims.

Potential implications of inadequate reporting of financial guaranty operations include a “spread penalty” attributable to weak market liquidity, limited institutional following, high uncertainty relating to reported results, and incomparability among peers. The NFMA proposes that adequate and timely reporting of financial results, consolidated on an economic basis, is a requirement for proper analysis of the financial guaranty industry. Economic accounting of a monoline financial guaranty company needs to include a single set of financial reports showing results of operations and a balance sheet including the assets, liabilities, capital, and operations of all companies that directly contribute to the company’s triple-A credit rating. Also preferably included in this information would be details of specific case reserves and identification of which transactions the reserves are associated. Companies which are multiline by nature that include monoline financial guaranty as a business unit are encouraged to produce discrete financial reports showing the financial condition and results of operations for the monoline business. Reinsurance, P&C business, surety business, PMI business and other related insurance enterprises are forms of insurance which do not directly support the triple-A claims-paying rating. Holders of insured bonds desire to obtain reports which reflect, on a consolidated basis, the exclusive operations of the monoline financial guaranty enterprise. Because economic reporting is neither a statutory nor accounting form of report, it could take the form of a report included in the operating supplement produced quarterly.

The subcommittee recognizes that not all reporting is GAAP compliant. The economic reports may include non-GAAP information so long and the basis for the accounting report is clearly stated.

Companies that do not report in the US are subject to both alternative accounting standards and currency translation gains and losses. This situation results in additional difficulties when an analyst attempts to analyze these financial statements. In the absence of market-driven sanctions, there is no legal or regulatory requirement for foreign corporations to report their financial results on a basis consistent with U.S. GAAP or statutory requirements. Failure to produce consolidated financial statements in U.S. dollar denomination is not acceptable disclosure to U.S.-based investors. Because all companies require statutory accounting but only a few require GAAP accounting, it is reasonable to consolidate economic operations according to statutory accounting principles.

Some holders of guaranteed bonds have relied upon the credit rating of the financial guaranty company instead of the underlying obligor. To own these bonds and rely on the guaranty rating, bondholders must have ongoing access to a single set of financial reports that fairly reflect the financial position of the bond guarantor. Because current financial and regulatory practices do not address the important aspects of economic consolidation and domestic reporting, the

subcommittee deems it important to bring these disclosure matters to light and to embed them in the criteria for evaluation of financial guaranty company reporting practices.

### **C) SCORECARD ON QUARTERLY OPERATING SUPPLEMENTS**

In Appendix A we show all nine financial guarantors insurers on the X-axis, and specific reporting items on the Y-axis. We used either the financial guarantor's 9/30/06 or 12/31/06 Quarterly Operating Supplement to compile this data, along with any special disclosure sections on the company websites.

The Scorecard assesses disclosure in three general areas of interest to the analyst:

- 1) "Risk Profile", i.e. describe your insured portfolio;
- 2) "Operating Results for the Quarter", i.e. what type of transactions did you do and what kind of returns are you getting?; and
- 3) "Balance Sheet Numbers and Ratios", i.e. what are your claims-paying resources and how do they stack up to the risk you are incurring?

Because we are dealing with nine different insurers, with varying business strategies and at different stages in their business lives, it is difficult to draw any overall conclusions from this Scorecard. Younger insurers with pristine portfolios and low leverage ratios may face fewer questions on their book of business than older insurers who have gone through a number of credit cycles, so some variation is understandable. The general trend, over time, has been toward more disclosure. For example, two of the older insurers - MBIA and AMBAC - have over time led the way in providing more tables in response to demands from the analytical community. ACA has just recently begun to publish a Quarterly Operating Supplement. However, in many areas there remains a good deal of variation in the quality and quantity of such disclosure.

In Section 1, "Risk Profile", all of the insurers provided some level of detail on their insured book, showing composition by sector and sub sector, and top exposures. Most insurers identify their top municipal exposures by name, but many structured transactions are difficult to identify. In the below investment grade and "closely monitored" transactions list, there was a great deal of variability in disclosure – some give specific names but others aggregate such exposure by sector and sub sector. None give detail on defaulted bonds. Reinsurer data is particularly light. While ACA does not provide a list of its below investment grade credits, it does give individual transaction detail on its website, with a "term sheet" on most of its transactions.

In Section 2, "Operating Results for the Quarter", most insurers give aggregate numbers of premium and par written. However, information regarding sector, rating and other information of business written during the quarter is light and variable. It is therefore difficult for the analyst to discern any shifts in markets positions and business strategy. All of the insurers provide most of the premium, expense and earnings numbers in a similar format.

In Section 3, “Balance Sheet Numbers and Ratios”, the level of disclosure is particularly light. Many analysts would like to replicate rating agency models, adding variation and sensitivity analysis elements as needed. But the lack of capital charge, credit quality and diversification ratios makes this very difficult. The Capital Ratio and Total Capital Ratio are provided by some but not all insurers.

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## Appendix A: Scorecard on Quarterly Operating Supplements

Reporting Item	Rationale/Description	Notable Findings	Assured (AGC)	Ambac	CIFG	FGIC	FSA	MBIA	SCA: XLCA/XLFA	RADIAN	ACA
		Most also have investor presentations on their websites, with varying levels of detail.	Quarterly Operating Supplement 9/30/06	Quarterly Operating Supplement 9/30/06	Quarterly Operating Supplement 9/30/06	Quarterly Operating Supplement 9/30/06	Quarterly Operating Supplement 12/31/2006	Quarterly Operating Supplement 12/31/2006	Quarterly Operating Supplement 3/31/2007	12/31/2006 + Selected Stat. Supplement 12/31/06	Quarterly Operating Supplement 12/31/2006
<b>1) RISK PROFILE</b>											
<b>Largest Credits</b>	Want to understand largest exposures, and measure concentration of risk	Detail and numbers vary; not totally applicable to some younger insurers as their book of business is smaller.	Shows rating and par but not full detail for international and structured.	Shows rating and par but not full detail for international and structured.	Shows rating and par but not full detail for international and structured.	Shows par but no rating; doesn't have full detail for structured..	Ratings on ABS only; par shown for public finance and ABS.	Shows rating, country and par for public finance and structured.	XLCA: Shows par but no ratings. SCA: Top 25 Public Finance, Top 10 Structured Servicer.	Shows par and ratings, but lacks full detail for structured.	No
	US Public Finance		10	25	15	50	50	25	10	25	10
	Structured		US only, 10	25	15	15	25	25	10	25	No
	International		10	25	included above	No	No	No	No	No	No
	Healthcare		10	10	No	No	No	No	No	10	No
<b>Breakdown of all credits</b>											
	To gauge overall mix of business.										
	By Sector (e.g. Asset backed, US Public Finance, etc.)		Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
	Subsector (e.g. transport)		Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
	Average Rating		Yes	Yes	Yes	Yes, shows breakdown within sectors also	Yes	Yes	Yes	Yes	Yes
	State		Top 10	Top 10	Top 10	Top 10	Top13	Top 10	Top 10	Top 10	No
	Country		Top 5	Top 5	Top 8	No	No	Top 10	All	No	No
<b>Largest below investment grade exposure</b>	It is also important to understand how "below investment grade" defined - whether by the rating agencies (may lag) or by the FG itself.	Some of the younger insurers may not have BIG exposure, but if they don't report it's difficult to say. It is odd that ACA doesn't report this, given their niche.	Table by sector shows average rating.	Aggregates net par by sector & subsector.	No	Aggregates net par by sector & subsector.	No	Shows % of BIG insured par outstanding.	No	Shows par outstanding by sector.	No
	By Rating		No	No	No	No	No	No	No	No	No
	Sector		Yes	Yes	No	Yes	No	No	No	Yes	No
	Top specific names		Yes, 10. Shows rating for each transaction. Not all structured is fully detailed and identifiable.	No	No	No	No	Yes, 10. Shows rating for each transaction. Not all structured is easily detailed and identifiable.	No	No	No
	Shows "closely monitored credits" (internally determined)		Yes, categorizes by risk and aggregates exposure.	No	No	No	No	No	No	No	No
<b>Transactions in default</b>	Should give details on gross vs. net exposure on specific credit, debt service amortization, claims actually paid, etc.		Shows net par of those credits where claims being paid, but no details on names.	No	No	No	No	No	No	No	No
<b>Derivative Exposure</b>											
			No	No	No	No	No	No	No	No	No
<b>CDO Exposure Details</b>		Often difficult to identify specific asset-backed securities given the brief descriptions.	Yes, shows net par, weighting, amortization, asset type.	No	Yes, breaks down to cash flow or synthetic; investment grade or not, shows one average underlying rating of all CDOs.	No	Yes, to the extent they are included in the Top 25 ABS exposure; internal ratings given.	Yes, to the extent they are included in the Top 25 ABS exposure; internal ratings given.	SCA: Yes, ratings distribution and year of issue details.	Yes, rating and underlying assets.	Yes, collateral type, transaction type, avg. rating, equity levels, maturity, etc.



Reporting Item	Rationale/Description	Notable Findings	Assured (AGC)	Ambac	CIFG	FGIC	FSA	MBIA	SCA: XLCA/XLFA	RADIAN	ACA
<b>Over the past 3 months:</b>	To understand earnings picture.										
Premium Earned			Yes	Yes	Yes	Yes	Yes	Yes	SCA: Yes	Yes	Yes
Net Investment Income			Yes	Yes	Yes	Yes	Yes	Yes	SCA: Yes	Yes	Yes
Gross Underwriting Expense Ratio			Yes	Yes	Yes	Yes	No	Yes	SCA: Yes	Yes	No
Loss & Loss Expense Incurred			Yes	Yes	Yes	Yes	Yes	Yes	SCA: Yes	Yes	Yes
Net Income			Yes	Yes	Yes	Yes	Yes	Yes	SCA: Yes	Yes	Yes
<b>3) BALANCE SHEET NUMBERS AND RATIOS</b>											
<b>Claims Paying Resources and Aggregate Exposure</b>	To understand claims paying resources vs. exposure										
Total Policyholder's surplus & contingency reserve			Yes	Yes	Yes	Yes	Yes	Yes	SCA: Yes	Yes	Yes
Unearned Premium Reserve			Yes	Yes	Yes	Yes	Yes	Yes	SCA: Yes	Yes	Yes
Capital Support agreements			Yes	No	Yes	Yes	Yes	Yes	SCA: Yes	Yes	No
PV of future installment premiums			Yes	Yes	Yes	Yes	Yes	Yes	SCA: Yes	Yes	Yes
Total debt service (P and I) Insured (a.k.a. "financial guarantees in force")			Yes	Yes	Yes (in "Net Exposure Amortization" table)	Yes	Yes	Yes	SCA: Yes	Yes	No
<b>Risk Measures</b>	To get a quantitative measure of their risk exposure.										
Hard Capital Ratio (a.k.a. Capital Ratio)	Net p and I outstanding / qualified statutory capital		Yes	Yes	No	Yes	Yes	Yes	No	Yes	No
Total Capital Ratio (a.k.a. Financial Resources Ratio)	Net p and I outstanding / total claims paying resources		Yes	Yes	No	No	Yes	Yes	No	Yes	No