Box A: Financial Guaranty Insurers (Monolines)

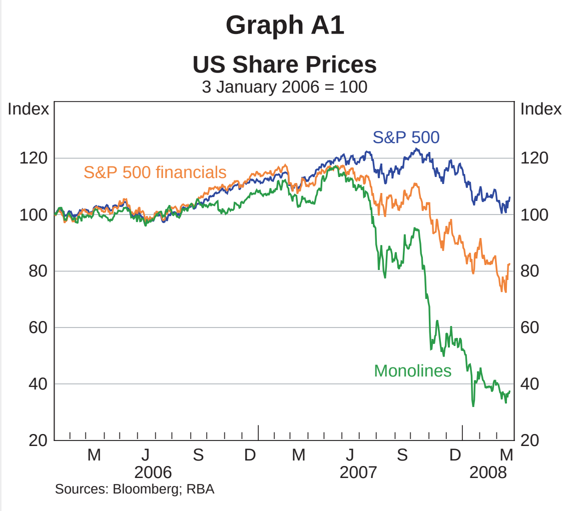
Financial guaranty insurers (FGIs), often called monolines, receive insurance payments from issuers of debt in return for guaranteeing that the holders of that debt receive full payment of interest and principal. The cornerstone of the FGI business model has been their high credit ratings – typically AAA – since this underpins the value of the insurance, or credit protection, provided to investors.

FGIs have existed since the early 1970s, initially focusing on the US municipal bond market. They are still an important source of credit enhancement in this market, insuring around 60 per cent of municipal debt obligations. Over the past decade, however, structured credit products, including securities backed by US sub-prime mortgages, have been an increasingly important source of business for the FGIs. The credit enhancement that they provide has played an important role in making securities based on sub-prime loans attractive to a broad range of investors. FGIs have insured around $US2½ trillion of total debt that is currently outstanding, with around $US1.9 trillion of this accounted for by the four major US FGIs, which dominate the global bond insurance industry. Of this, around 1½ per cent is accounted for by sub-prime mortgages and a further 2½ per cent by CDOs partially backed by sub-prime mortgages. (In Australia, FGIs have focused on insurance of corporate bonds, often referred to as credit wrapping.)

Another change over the past decade has been that much more of the insurance of structured finance exposures has been written in the form of credit default swaps (CDS), rather than standard insurance policies. This has made the FGIs' accounting profits more sensitive to market conditions. In particular, US accounting standards require that these CDS are marked-to-market at each balance date. In contrast, accounting standards only require the establishment of loss reserves for standard insurance policies if there is a material deterioration in the credit quality of the reference entity.

One feature of the global financial turmoil has been a marked increase in concerns about the creditworthiness of debt that has been insured by the FGIs even though actual defaults have, to date, been limited. Consequently, while FGIs' provisions have increased slightly, a more significant impact has been through considerable mark-to-market losses on the insurance provided through CDS, which has weakened the capital positions of some monolines. Reflecting this, the share prices of the monolines have declined sharply in recent months (Graph A1). While some monolines have been able to raise new capital to preserve their AAA ratings, others have suffered rating downgrades by at least one of the rating agencies and are finding it difficult to raise significant new capital. The US banks with the largest exposures to monolines have held discussions with the insurers (at the instigation of regulators), though a concrete proposal for a coordinated rescue effort has not emerged.

Internationally, the concern is that the downgrading of monolines has potentially widespread implications for credit markets and the financial sector more generally. Issuers who rely on monolines' credit enhancement to access credit markets will likely face higher funding costs, while investors holding insured debt will likely see the market value of their holdings decline in line with the deterioration in the value of the credit enhancement. A number of banks have already written down the value of credit protection, bought in the form of CDS, from the weakest monolines. Moreover, some investment funds may, depending on their investment mandates, need to sell downgraded bonds in distressed markets – a development that could exacerbate already unsettled debt markets.



In Australia, the effect on bond and other markets of any further downgrades to FGIs is likely to be less pronounced than in a number of other countries, though at least one bank has already announced higher provisions due to the downgrade of a US monoline. The relatively small effect on Australia reflects a number of factors.

First, credit-wrapped bonds account for only a relatively small share of the Australian corporate bond market. As at March 2008, there were $24 billion of credit-wrapped bonds outstanding, representing just under 7 per cent of all non-government bonds outstanding in the domestic market (Graph A2). Second, structured finance products in Australia rarely use credit wrapping as a form of credit enhancement, with only about one per cent of AAA-rated CDOs having been credit wrapped. Instruments such as RMBS and CDOs instead typically rely on subordination, over-collateralisation, lenders' mortage insurance and excess spread reserves for credit enhancement. Moreover, the Australian market is made up almost entirely of investment-grade corporates, with the 'pre-wrapping' average rating being BBB+. This suggests that any downgrades to FGIs would not result in a substantial deterioration in the underlying credit quality of domestic bonds.