MUNICIPAL BOND INSURANCE AFTER THE FINANCIAL CRISIS
Can It Help Reduce Borrowing Costs for Local Governments?

The municipal bond insurance business receives little attention from fiscal policy analysts, but it has had major effects on taxpayers, government officials, and bond investors. At the industry's peak, before the Great Recession, industry players received over $1.5 billion in premium revenue annually from state and local governments. Additionally, when a city faces insolvency, municipal bond insurers play an active role in bankruptcy litigation, sometimes impeding progress toward a final settlement.

Although the industry shrank markedly between 2007 and 2012, it has enjoyed a rebound in recent years. Municipal bond issuers, their financial advisors, and investment bankers continue to grapple with the question of whether purchasing municipal bond insurance is worthwhile. In "Municipal Bond Insurance after the Financial Crisis: Can It Help Reduce Borrowing Costs for Local Governments?," Kenneth A. Kriz and Marc D. Joffe explore the existing evidence on municipal bond insurance and advise issuers to be extremely cautious in purchasing municipal bond insurance.

BENEFITS AND COSTS OF BOND INSURANCE IN TODAY'S MARKET

Bond insurers market their product to municipal issuers as a way to reduce financing costs. The bond insurance market underwent extreme structural change after the financial crisis of 2008–2009 and associated economic recession.

This study uses a comprehensive measure of interest costs that takes into account financial costs of issuance. Using a dataset of California bond issues, the study finds that borrowers do not realize a statistically significant interest-cost reduction from the use of municipal bond insurance.

RESULTS

Generally, bond insurance is not a good deal for local governments:

- If the insurer's credit rating is lower, the cost of borrowing increases.

For more information, contact
Marc Morris, 703-993-9887, mmorris@mercatus.gmu.edu
Mercatus Center at George Mason University
3434 Washington Boulevard, 4th Floor, Arlington, VA 22201

- Local governments cannot conclude with scientific certainty that bond insurance has any effect on interest rates.
- In addition, the loss of time for staff members in preparing bond insurance applications and providing information to bond insurers is likely to be non-negligible.

CONCLUSIONS

Issuers should be very cautious about using municipal bond insurance, at least in the current market environment. If financial advisors or underwriters recommend the purchase of bond insurance, government finance officers should ask these service providers to explain why they believe the use of insurance would be beneficial for the issue at hand.