Undue Alarm: Municipal Bond Investments by P/C Insurers

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People Are Asking: How Safe Are P/C Insurer Investments in State and Local Government Bonds?

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The questions arise from the following concerns/observations:

- Many states' and localities' tax revenues plunged from the "Great Recession"
- At the same time, they face higher spending
  - Many state and local pension funds, previously poorly funded, are in even worse shape now, due to low interest rates and the volatile and weak performance of other investments (mainly stocks)
  - "Safety net" spending is soaring in the aftermath of the recession
- Lately, as concerns about the safety of these bonds have risen, their prices have fallen
  - Some analysts have predicted, and the media have amplified, "hundreds of billions of dollars' worth of defaults"

Two Types of Municipal Bonds With Different Characteristics

General Obligation Bonds
Special Revenue Bonds

Munis: General Obligation (GO) vs. Special Revenue Bonds

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- General Obligation (GO) bonds
  - States, cities, and other political subdivisions borrow by issuing GO bonds
  - "Are secured by the full faith and credit of the issuer, meaning that the borrower is committing to raise taxes and other revenues sufficient to cover the amount owed"
    - But timely payment of principal and interest might be affected by revenue shortfalls, expense surprises, or both
- Special Revenue bonds
  - "Are secured by a defined stream of revenues," such as from a toll road, revenue from operating a hospital, etc
  - Are not affected directly by the fiscal fortunes of the states and other political units in which the revenue-generator operates

Source: https://self-evident.org/?p=877.

Municipal Bonds Are a Small Part of P/C Insurer Investments

Muni Bond Exposure is Limited

Most of the P/C Insurance Industry's Investment Portfolio is in Bonds*

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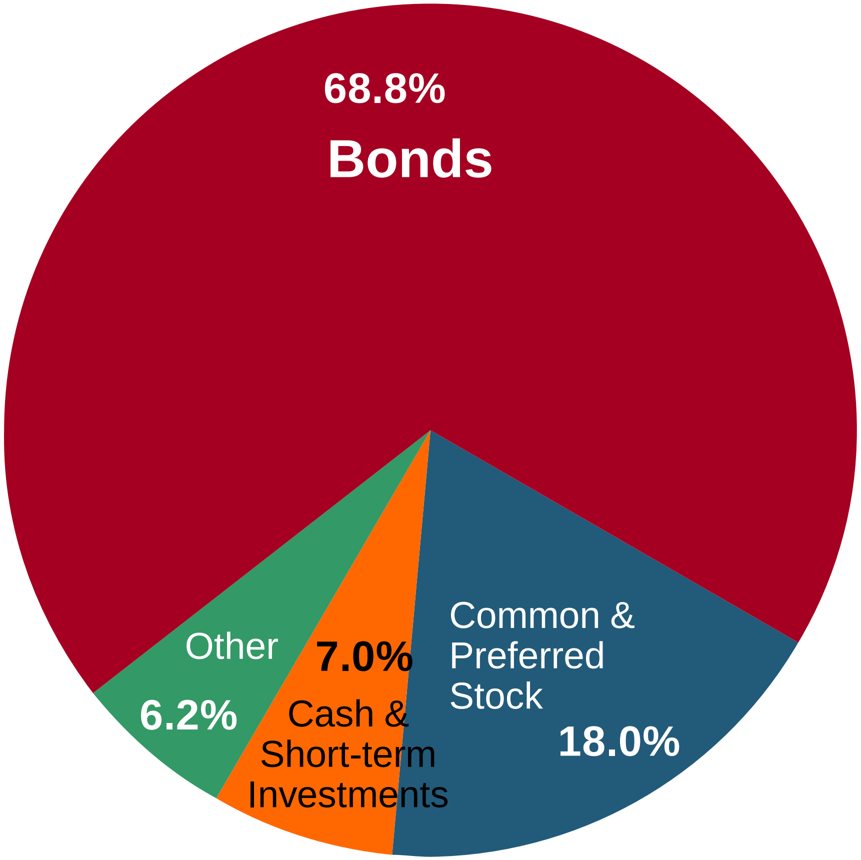
Portfolio Facts as of 12/31/2009

- Invested assets totaled $1.26 trillion
- Generally, insurers invest conservatively, with over 2/3 of invested assets in bonds
- Only 18% of invested assets were in common or preferred stock

As of December 31, 2009



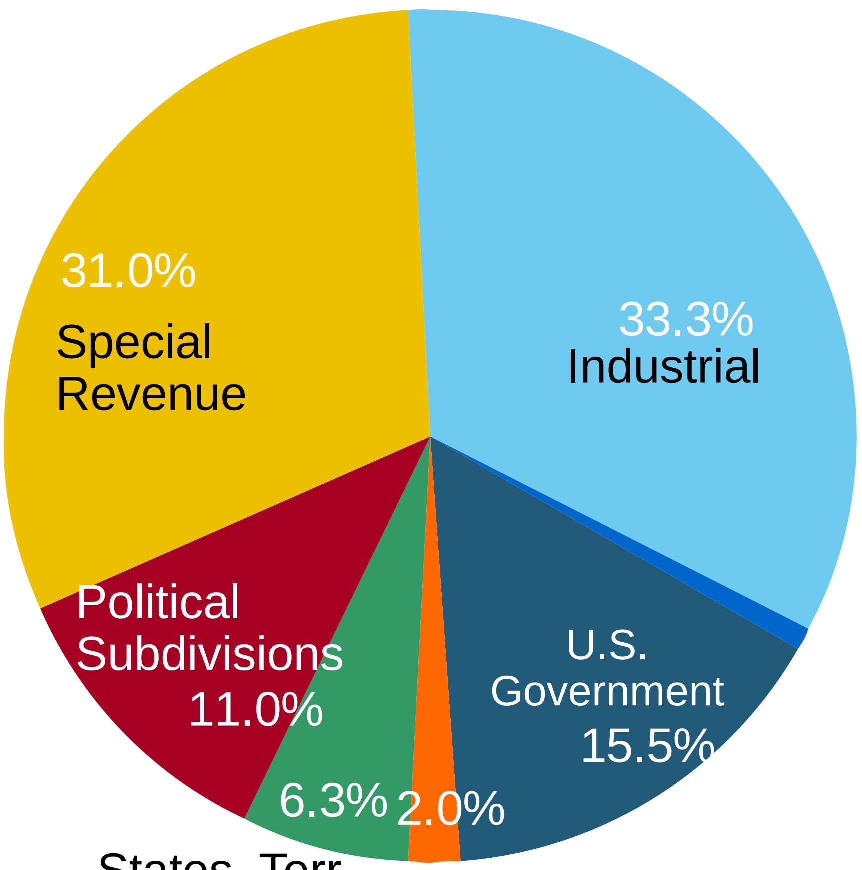
*Net admitted assets.

Sources: NAIC; Insurance Information Institute research.

About Half of the P/C Insurance Industry's Bond Investments Are in Municipal Bonds

Bond Investment Facts as of 12/31/09

- Investments in "Political Subdivision [of states]" bonds were $102.5 billion
- Investments in "States, Territories, & Possessions" bonds were $58.9 billion
- Investments in "Special Revenue" bonds were $288.2 billion
- All state, local and special revenue bonds totaled 48.2% of bonds, about 35.7% of total invested assets



Sources: NAIC, via SNL Financial; Insurance Information Institute research.

Municipal Bonds Rarely Default

Munis Have Historically Been Very Safe Investments

Virtually All of the non-Revenue-Based State and Local Government Bonds Are Top Rated

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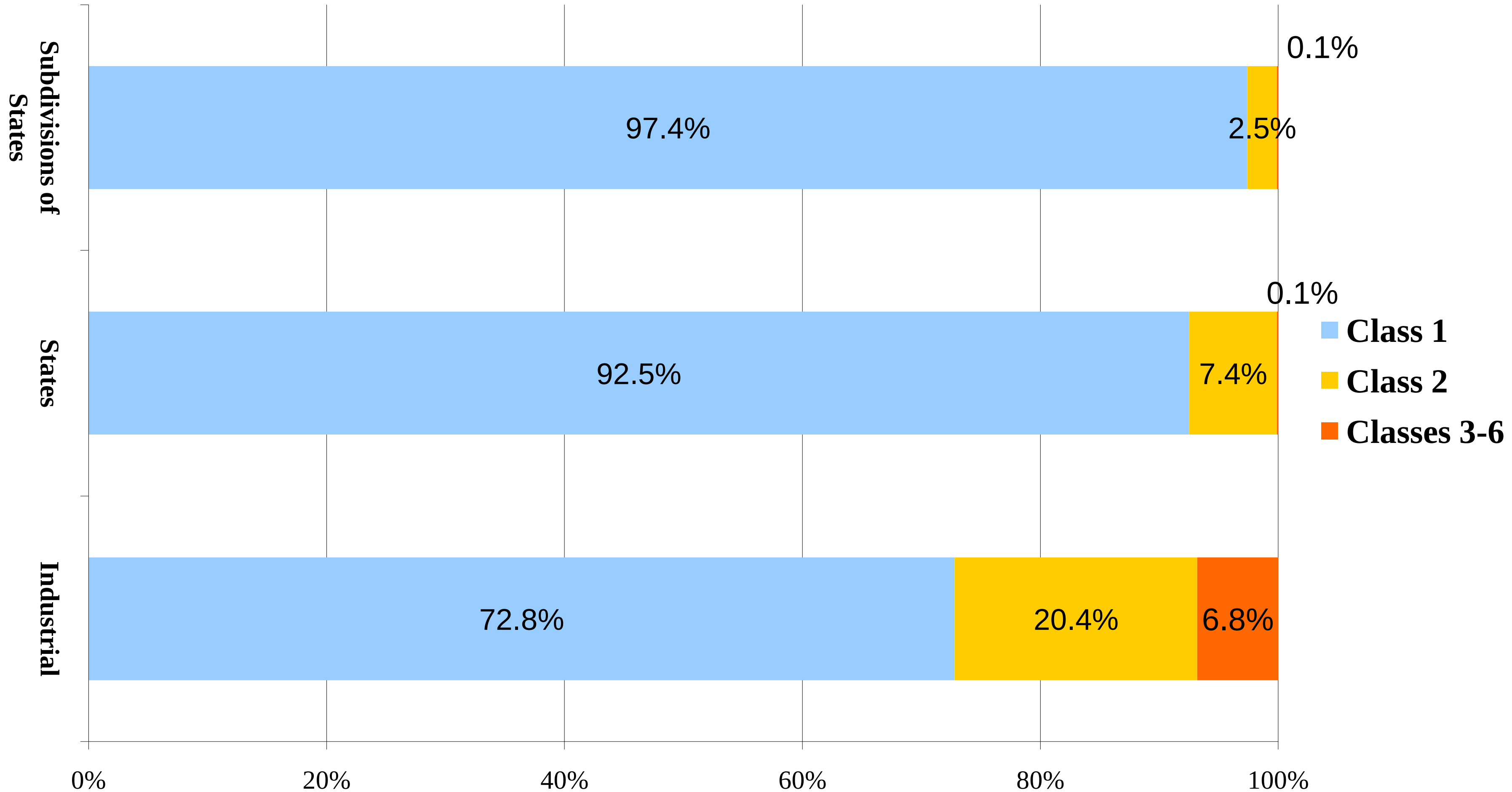
- The National Association of Insurance Commissioners (NAIC) has its own Securities Valuation Office (SVO)
  - For regulating bond risk, it's these ratings, not those by the better-known ratings agencies, that are used
- The NAIC's SVO rated virtually every one (over 97%) of the "Political Subdivision" bonds in its safest category
- The SVO rated nearly all (over 92%) of the bonds issued by "States, Territories, & Possessions" in its safest category

Sources: NAIC, via SNL Financial; Insurance Information Institute research.

When P/C Insurers Invest in Higher Risk Bonds, It's Corporates, Not Munis



The NAIC's Securities Valuation Office puts bonds into one of 6 classes: class 1 has the lowest expected impairments; successively higher numbered classes imply increasing impairment likelihood.

Data are as of year-end 2009.

Sources: SNL Financial; Insurance Information Institute.

Some Analysts Believe That at Least Partial Default On Some of These Bonds Is Possible

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- Defaults on muni bonds are extremely rare—much rarer than defaults on corporate bonds.
  - Moody’s research found that, since 1970 “the average 5-year historical cumulative default rate for investment-grade municipal debt is 0.03%, compared to 0.97% for corporate issuers.”
  - “Municipals had lower average cumulative default rates than … corporates…by rating symbol.
    - For example, … in the single-A rating category to which the majority of municipal ratings are assigned, average cumulative default rates are much lower for municipals than for corporates with the same single-A symbol.”

Source: “U.S. Municipal Bond Defaults and Recoveries, 1970-2009,” Special Comment, Moody’s Investors Service, February 2010.

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Recently, Municipal Bond Prices Have Fallen Sharply

Falling Muni Bond Prices Can Have Different Impacts on Different Insurers

Yes, the Muni Bond Index Fell In The Last Two Months of 2010…

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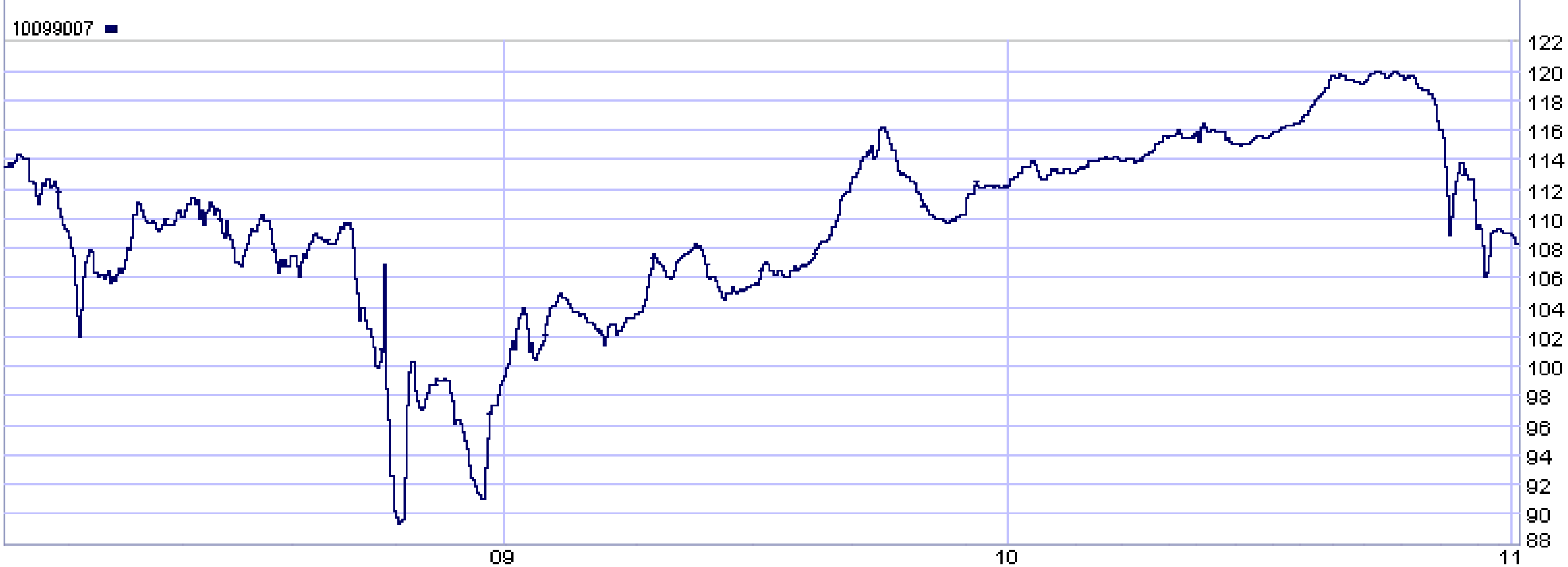
Date	Open	High	Low	Close	Time Frame
1/08/08	113.469	113.469	113.469	113.469	1/07/08 to 1/06/11



Bond prices fluctuate. The October-to-December 2010 drop in the Bond Buyer Muni Bond index , 11.6% at its greatest point, brought the index back to its level in the first half of 2009. The 3-year chart, above, puts these changes in perspective

Source:" http://online.wsj.com/mdc/public/npage/2_3051.html?rnd=5334&sid=441268&page=us accessed 1/6/2011.

How Are P/C Insurers Affected by Lower Market Prices of Municipal Bonds?

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- If an insurer owns these bonds and carries them on the balance sheet at market value, this drop constitutes an unrealized capital loss, which shows up as a drop in surplus. If the drop is large enough, it could threaten the insurer’s solvency
- However, most muni bonds are held to maturity and therefore carried at “amortized cost”—which means that market price fluctuations don’t affect the balance sheet and don’t affect the insurer’s surplus

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***Thank you for your time
and your attention!***