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Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises

"The State of the Bond Insurance Industry"
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Chairman Kanjorski, Ranking Member Pryce and members of the Subcommittee, I thank you for the opportunity to address the Subcommittee and share my perspectives on the Bond Insurance industry. I will explain how the bond insurance industry grew beyond its original roots to its current troubled state, share my views on current attempts to bail out some of the existing insurers, and propose solutions to address the potential for systemic risk due to a failure of some or all of these institutions. As a preliminary matter, I begin with an introduction to my firm, Pershing Square Capital Management, L.P.

Introduction to Pershing Square

Pershing Square is an SEC-registered investment adviser that manages $6 billion of capital.

We are value investors with large stakes in North American companies like Target, Barnes & Noble, Borders, and Sears.

The success of our investments and our funds is highly dependent on the strength of the U.S. economy and consumer.

We are concerned about recent deterioration in the housing market, worldwide equity and credit markets, and the weakness of the U.S. consumer.

I am here today to talk about our only short position, a short investment in MBIA Inc. and Ambac Financial Group, Inc., the owners or, in terms of their legal structure, the holding companies for the two largest bond insurers.

It is important to distinguish between the holding companies, which are the owners of the bond insurers, and the bond insurers themselves, which are operating companies that guarantee bonds for a fee, pay claims to policyholders, and are the focus of today's hearings.

Background on the Bond Insurance Industry

The bond insurance industry began in the 1970s. The insurers were structured as private associations, and for the first 25 years primarily insured municipal bonds.

The holding companies for some of the insurers went public in the late 1980s and early 1990s. Senior management received restricted stock and options in the holding companies. The interests of policyholders and management teams, compensated based on holding company stock prices, began to diverge over time.

New entrants increased the competitiveness of the business. In response, holding company executives seeking higher profits began to take greater risks with insurance company capital.

Over the last 10 years, risk-taking accelerated, ultimately leading to the guarantees of highly complex structured products like collateralized debt obligations (CDOs) of residential mortgage backed securities (RMBS) backed by subprime mortgages, or translating into English, trusts which owned slices of subprime residential mortgages.

Who is Responsible for the Bond Insurance Industry's Problems?

The poor decisions of holding company executives are the primary cause for the bond insurers' problems, but the rating agencies also share responsibility.

The rating agencies encouraged the bond insurers to diversify into structured finance risks and gave them additional rating credit for doing so. The rating agencies understated the risks of the new strategy while earning much higher fees for rating these structures.

The rating agencies' profits soared along with the growth in structured finance issuance.

Insurance regulators relied on the rating agencies and management teams to assess the risk of these new structures.

The rating agencies were paid by the issuers of these securities and helped in structuring these exotic instruments to meet the ratings agencies' insufficient standards for Triple A ratings. The rating agencies only received their full fees if they approved the Triple A ratings for these transactions.

The combination of aggressive risk taking by management, poor judgment by conflicted rating agencies, and over-reliance by regulatory authorities on rating agency judgment led to the current situation.

Regulatory Response and the Proposed Bank-Led Bailout of the Bond Insurers

The impending losses from CDOs and other mortgage securities will likely overwhelm the capital of the bond insurers, leaving insufficient funds to pay claims to all policyholders.

The New York Insurance Department under Superintendent Eric Dinallo has been working proactively to mitigate the situation. While Superintendent Dinallo has only been in office for a year, the seeds for the insurers' demise were planted years beforehand.

The New York Insurance Department has sought to bring in new providers of capital like Berkshire Hathaway to replace the loss of insurance capacity from existing players. Other well-capitalized players are considering entering the business.

Superintendent Dinallo has also been working on a bailout of existing insurers. While we are supportive of the industry raising additional capital, we believe the current approach to saving existing industry participants will fall short. Moreover, by allowing investment banks that are bond insurer counterparties to artificially prop up ailing insurers, this approach creates even greater risk for the global capital markets.

The insurance regulators have approached the major banking institutions who are the biggest policyholders of the insurers seeking an infusion of capital or credit lines for the insurers.

Given current credit market conditions, one wouldn't expect investment banks to be interested in investing in or lending to new speculative ventures. The banks are, however, interested in preserving the bond insurers' Triple A credit ratings.

Why? Because if the insurers are downgraded, banks will be forced to write down their exposure to the insurers and take losses estimated by respected industry analysts to be as much as $35 to $70 billion.

Banks are trying to take advantage of the lower regulatory capital and rating agency standards for the insurers where magically one dollar of capital in an insurer is deemed to be worth about eight dollars of capital in a bank. If offered the choice, what bank wouldn't invest a billion to avoid eight billion of writedowns?

The problem is that the math doesn't work. The amount of losses doesn't change whether the losses are borne by the banks or the insurers. The maintenance of the bond insurers' Triple A rating with credit lines or capital that is insufficient to pay all of the ultimate claims is simply an artificial loss-deferral exercise. Eventually, losses will come home to roost when the bond insurers ultimately fail.

The banks which did business with the bond insurers made billions of dollars creating CDOs and structured finance securities while hedging the exposures they could not sell with the bond insurers. It seemed too good to be true and it was.

Recently, Warren Buffett summarized the situation: "It's poetic justice in that the people that brewed this toxic Kool Aid found themselves drinking a lot of it in the end."

The banks' coordinated attempts to prop up the bond insurers' overstated Triple A ratings will only continue the fiction. Delaying inevitable writedowns only reduces market transparency and encourages the continuation of risky behavior.

The Potential for Systemic Risk Created by Downgrades of Insured Municipal Bonds

Unfortunately the downgrade of the bond insurers affects constituencies who are not to blame for the problem. I am sensitive to this concern.

The biggest worry is what will happen to the approximately $1.6 trillion of insured municipal bonds which are likely to be downgraded to their underlying ratings, if the bond insurers lose their Triple A ratings.

There is a risk that municipal money market funds and other fiduciaries will be forced to dump these bonds if they are downgraded below Double A.

While the rating agencies overstated the ratings for CDOs and structured finance securities, they have systematically underrated municipal issuers. Taking the opportunity to correct this problem now may actually form the basis for mitigating risk from a bond insurer downgrade.

What Can be Done to Address the Potential for Systemic Risk?

The substantial majority of municipal issues would be Double or Triple A, if rated on the same scale as corporate bonds are rated by the rating agencies.

A Triple B municipal general obligation bond has one fourth the probability of default as a Triple A corporate bond. The rating agencies know this, but they still rate municipal bonds on a tougher scale.

The systematic underrating of municipal bonds created the opportunity for bond insurers to charge insurance premiums to Double A or lower-rated municipalities.

While the bond insurance industry estimates that it has saved issuers billions of dollars over the years, in reality, about $30 billion or so has been spent on municipal bond insurance by taxpayers that would have been unnecessary if these bonds were rated on the same basis as corporate bonds.

The good news is that this practice can be stopped immediately. Rating agencies can be required to grade municipal bonds on the same scale as corporate bonds. According to press reports, Connecticut Attorney General Richard Blumenthal has recently subpoenaed the rating agencies about this practice.

Federal regulators can also take steps to address this issues. For instance, the SEC regulation that requires money market funds to sell securities that have been downgraded below Double A can be clarified to provide that the corporate rating scale should be used to determine the credit ratings for this test. A similar strategy can address the situation of other fiduciaries, such as public pension fund managers, that may have ratings-based triggers in their investment mandates. The potential for systemic risk can be mitigated if the SEC and pension boards act quickly along these lines.

A migration of ratings to the corporate scale will lead to a wholesale upgrading of municipal bond issues, avoid the forced sale of these securities, and reduce the cost of municipal borrowings in the future as investors are better educated about municipal default probability. It will also reduce the need for bond insurance in many instances.

Risk Created by Downgrades of Structured Finance and CDO Securities

Unlike municipal bonds, structured finance issues have been overrated by the rating agencies.

We believe that it is unlikely that the bond insurers will have adequate capital to meet their claims to policyholders on these and other exposures.

The insurers have some capital which will help reduce total losses to policyholders.

Some banks may still lose billions of dollars. The biggest losers will be those that made the most money from issuing CDOs and residential mortgage-backed securities in recent years.

What Should be Done about Downgrades and Losses

Most banks are still sufficiently well capitalized to absorb these losses, although some may have to raise additional capital for these and other exposures.

Banks must recognize their losses and be as transparent as possible to increase market confidence.

If the banks need additional capital or potentially a bailout, it would be much more efficient and transparent to the market to recapitalize or bail out a bank directly than through the indirect method of propping up ailing bond insurers.

If banks put capital in a bond insurer, they are exposing themselves to the risks of other exposures about which they know little.

Moreover, by allowing banks to reinsure their own risks by investing in a bond insurer, systemic risk is increased rather than reduced.

The Bond Insurers Should Retain as Much Capital as Possible

The bond insurers should retain as much capital as possible to meet claims to policyholders. The problem is that holding company executives are trying to take out as much money as possible from the insurers through dividends and otherwise to prop up their stock prices and pay stockholder dividends.

For example, last year MBIA took out $1 billion in special dividends from its insurance subsidiary which it used to buy back stock from shareholders and members of management. $660 million of stock was bought from shareholders and $70 million of stock was bought from insiders at prices four to five times today's stock price. In addition, about $170 million was spent on shareholder dividends. The balance of the funds was used for holding company executives' salaries and other expenses.

MBIA's holding company would have taken out more insurance company dividends if the New York Insurance Department hadn't stopped them this past summer.

The problem is that while the insurance regulators can stop special dividends, they cannot stop ordinary dividends when the insurers have "policyholders' surplus" unless regulators take direct legal action.

Policyholders' surplus is based largely on holding company executives' estimates of future losses. Since the task of determining capital reserves is a self-graded exam, one would not expect executives to give their company a failing grade that will lead to the elimination of policyholders' surplus and dividend capacity. Indeed, despite billions of dollars of recent writedowns, these executives predicted just a few short months ago that they'd suffer no meaningful losses.

We believe that holding executives have and continue to substantially underestimate losses, thereby overstating statutory surplus. As a result, without proactive measures by regulators, holding companies can continue to deplete their insurance subsidiaries' capital through dividends.

The problem is not whether regulators are sufficiently empowered to address this situation. State laws provide insurance commissioners with enormous power and discretion. We urge regulators to exercise their safety and soundness powers now. Anything less will jeopardize the policyholders they are mandated to protect.

MBIA recently announced that it expected to take $540 million in ordinary dividends from its insurance subsidiary beginning in April of 2008. This is a big problem for MBIA policyholders.

It is critically important that independent assessments of the bond insurers' exposures are used to determine capital adequacy.

The Treasury, Comptroller of the Currency, and the Federal Reserve can be very helpful in this regard by working with the state regulators to assess the bond insurers' exposures and capital adequacy.

If the bond insurers' capital is found to be deficient, then the state regulators can seize control of the insurance subsidiaries from the holding companies and work to preserve as much capital as possible to meet policyholder claims.

Summary Thoughts

It is important to hold those responsible accountable for their actions.

Holding company executives that caused the insurers to take on risky new lines of business are principally responsible for the problem.

These same executives continue to control the insurance subsidiaries and have announced their intention to continue to withdraw capital from these regulated subsidiaries.

This practice has to stop in order to protect policyholders.

State regulators, in coordination with their federal counterparts, should assess the complicated exposures of the bond insurers to determine their capital adequacy.

State regulators should continue to encourage well-capitalized entrants to provide insurance for municipalities who need bond insurance to raise funds cost effectively.

All bonds including municipal bonds should be rated on a single, standard scale that is based on their probability of default.

If the same standard that is used for corporate issuers is applied to municipal issuers, nearly all municipal bonds will have upgraded ratings leading to reduced borrowing costs for all municipalities and the reduced need for bond insurance.

Banks should mark their losses to market. If, as a result, banks need additional capital or bailouts, they should raise such funds directly, not through the backdoor propping up of the bond insurers to which they have exposure.

While it would be ideal if no one were to lose money, the nature of the investment business is caveat emptor. One of the great things about this country is that while we make mistakes, we are generally good about admitting them, doing the best we can, and moving forward. That, in my view, is the path to progress.

I welcome any questions you may have.