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Bond Insurers' Capital Adequacy Is Sufficient To Handle Potential Credit Deterioration In Puerto Rico

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Standard & Poor's Ratings Services recently placed Puerto Rico's general obligation, infrastructure, appropriation, and revenue debt obligations on CreditWatch with negative implications (see Puerto Rico GO, Appropriation Debt Ratings On Watch Negative On Government Development Bank of Puerto Rico CreditWatch, Puerto Rico Infrastructure Financing Authority; Appropriations; Miscellaneous Tax, Puerto Rico Highways and Transportation Authority; Gas Tax, and Puerto Rico Aqueduct and Sewer Authority Revenue Bonds Placed on CreditWatch Negative, all published Jan. 24, 2014, on RatingsDirect). These actions, however, do not significantly affect our capital adequacy or financial strength ratings on Assured Guaranty Ltd.'s (AGL) insurance companies or National Public Finance Guarantee Corp. (National), despite investors' and capital-market concerns.

We view AGL's and National's capital as very strong. The companies have sufficient capital cushions to absorb higher theoretical losses from negative rating actions on Puerto Rico, while maintaining sufficient liquidity to pay possible losses through 2015. This assumes that the bond insurers will continue to experience refundings and normal amortization in their insured portfolios and limited new business production to replace the run-off of risk.

The higher level of municipal refundings in bond insurers' insured portfolios has led to accelerated growth of their capital and generally stronger capital adequacy. Although credit stress in the bond insurers' public finance exposure pressures capital adequacy, we believe the overall acceleration of capital generation will offset potential credit deterioration.

Our recent capital analysis of AGL and National incorporate the credit risk inherent in their respective Puerto Rico and Detroit insured risk exposures based on our views of ultimate loss and recoverability. These insurers maintain exceptional capital to cover expected losses in an extreme stress environment, and sufficient liquidity and capital resources to pay potential claims during the next two years.

AGL and National maintain net par insured exposure to Puerto Rico municipal debt obligations of $5.4 billion and $5.0 billion, respectively, as of Dec. 31, 2013. A one-category decline in our ratings to 'BB' from 'BBB' would reduce AGL and National's capital adequacy by approximately $65 million based on the lower credit quality of their insured Puerto Rico exposures. If credit fundamentals deteriorate to 'B' from 'BBB' the incremental increase in capital charges for each company would be approximately $115 million. Based on our year-end 2012 capital analysis incorporating theoretical losses of their total insured portfolios, AGL had a capital adequacy cushion of between $450 million and $500 million, whereas National maintained a capital cushion of between $350 million and $400 million.

Based on financial disclosures as of Sept. 30, 2013, we project National's gross par insured to decline by approximately 25% and its statutory capital (excluding any dividend payments) to increase by approximately 5% by Dec. 31, 2013, from the previous year end. For Assured, we project an approximate 10% decrease in total insured par and capital growth of approximately 3% as of Dec. 31, 2013, compared to the prior year end. Berkshire Hathaway Assurance Corp. does not have exposure to issuers that we placed on CreditWatch. Build America Mutual Assurance Co. does not maintain any Puerto Rico-related debt exposure in its insured portfolio.

In addition, although the Puerto Rico and Detroit exposures may be large relative to current statutory capital, any claim payments resulting from actual losses are made over time based on the payment schedule of the underlying issue with no acceleration. This allows the bond insurers to manage their liquidity and benefit from additional sources of claims-paying resources such as investment income and premiums from new business production.

At this time we do not expect to take any negative rating actions on the legacy bond insurers' U.S. public finance portfolios. However, we may need to revise our view if we believe the bond insurers' liquidity or capital is under stress.