
Chapter 9: The role of insurance in asset-backed securities

Mahesh K Kotecha
Capital Markets Assurance Corporation

One of the key reasons behind the rapid expansion of the asset-backed securities market in the US is the widespread availability and investor acceptance of third-party credit enhancement. With credit enhancement in place, asset-backed securities (ABS) have become safe, liquid and high-yielding investments. For industrial, financial and other service sector companies capable of originating and servicing securitisable assets, ABS are likely to become as important a corporate finance alternative as equities, bonds and bank loans.

Since 1985, \$107.5bn of ABS have been issued in the US public markets, and financial guarantee insurance companies have credit-enhanced 4.8% of this total. In 1989, a total of \$26bn in ABS were issued in the US public markets. A year later, new issuance volume reached \$46bn¹ and 1991's total may exceed \$50bn.

In addition, the volume of US ABS placed privately since 1988 is estimated by CapMAC at \$12.6bn, of which about 30% has been credit-enhanced by financial guarantee insurance companies. In the short-term sector, there are now around 60 asset-backed commercial paper programmes with an aggregate value of approximately \$50bn in commitments. Financial guarantee insurers provide credit enhancement for about 10% of this market².

Non-US ABS markets and non-US insurers

The international market for ABS holds considerable potential. By the end of 1990, the ABS market backed by non-US assets, including issues backed by pools of residential mortgages, was equivalent to \$28bn, of which about 5% have been enhanced by financial guarantee insurers². This does not include the several billion dollars' worth of issues backed by US assets which have been sold to non-US investors.

Market analysts expect international activity, including a nascent market in Japan, to reach \$100bn by the mid-1990s. As in the US, the growth will be spurred by "seller/servicers", ie, those financial institutions and corporations which can originate and service securitisable consumer and corporate receivables, and which need to restructure their balance sheets, improve profitability ratios and/or diversify sources of funds.

It is important to note that the term "financial guarantee" is used here only as defined below (see "Financial guarantee insurance defined"), as distinct from the broader use of the term in Europe, where financial guarantees also include "credit insurance", whereby an insurance company may indemnify merchants extending credit against loss or damage resulting from non-payment of debts owed to them.

Some non-US property and casualty insurers with top ratings have been important in providing financial guarantees both in the US and abroad. The largest non-US multiline insurers are in Japan, Germany, the UK, France, Italy, Switzerland, and Scandinavia. While a number of them have acted as reinsurers or insurers for ABS, they have done so very cautiously and in small amounts.

Non-US companies that have reinsured US asset-backed securities include Winterthur Swiss Insurance Company, Royal Reinsurance Company, International Credit Insurance Corporation, Stockholm Reinsurance Company Limited, Svenska Kredit, Skandia International Insurance, Trygg Hansa Insurance Company, Aachen Reinsurance Company, Pohjola Insurance Company, Dai-Tokyo Fire & Marine Insurance, Nippon Fire & Insurance, Hanover Reinsurance Company, Zurich Insurance and Tokio Marine & Fire Insurance Company.

The European property and casualty insurers are also an important source of insurance and reinsurance in the non-US ABS markets: for example Sun Alliance, Pohjola, Eagle Star, Trygg Hansa and others have been active primary insurers in the UK sterling mortgage-backed securities market. Similarly, French insurance companies such as Union des Assurances de Paris, Axa du Midi, Groupe des Assurances Nationales and Assurances Générales de France have been active in the burgeoning French ABS market.

Credit enhancement alternatives

The spectacular growth of the US ABS market since 1985 reflects investors' acceptance of the safety and liquidity of credit-enhanced securities, which provide yields slightly higher than comparable non-asset-backed (or "natural") triple-A rated securities. For seller/servicers, some of whom could have difficulty raising capital on acceptable terms from conventional sources, ABS often provide a cost-effective alternative, particularly after taking into account the cost of capital associated with on-balance sheet funding of assets.

Credit enhancement plays a central role in each transaction, by helping to create top-rated securities acceptable to safety-conscious investors. Credit enhancement techniques have taken various forms, including structures such as senior/subordination and cash collateral accounts, or third-party support from bank letters of credit or financial guarantee insurance.

Letters of credit

The oldest and most popular form of credit enhancement is a bank letter of credit (LOC), available from top-rated international banks. Letters of credit have generally been provided on a "partial" basis, ie, a coverage of credit losses on the underlying asset pool which is less than 100% but still sufficient for the security to attain a triple-A status.

The popularity of this form of enhancement is waning for two key reasons. First, bank rating downgrades have accelerated. In 1970, there were 40 banks rated triple-A by Standard & Poor's and Moody's Investors Service. In mid-1990 there were 12. As of September 1991, only six international banks have retained their triple-A ratings from both agencies.

Second, banks with triple-A ratings have recently encountered another hurdle. The capital adequacy guidelines of the Basle Accords require banks to increase their risk-adjusted capital ratios, causing them to re-examine the risk/return trade-offs for all lines of business, including letters of credit for ABS.

As a result, letters of credit have become more expensive, less helpful and less available. This is one reason why the market has increased its reliance on three other credit enhancement techniques.

Senior subordination

Senior subordination, which involves overcollateralisation, is a form of credit enhancement internal to the transaction. While commonly referred to as a credit enhancement technique, senior subordination is in reality a form of "investor segmentation", in which the transaction's credit risk is split between different classes of investor with different risk appetites.

In its basic form, a senior/subordinated structure has two parts:

- an "A" or senior tranche, which represents the majority of the asset pool. The "A" piece, usually rated triple-A or sometimes double-A, is sold to investors seeking to limit credit and duration risk;
- a "B", or subordinated tranche, which is junior in payment priority to the "A" tranche and is designed to bear losses on the entire pool. It usually (but not always) has a longer maturity, a more uncertain

duration and a lower credit rating. Consequently, "B" tranche investors are paid a market premium for the extra risk.

Subordinated structures may also be credit-enhanced with cash reserves against first losses, letters of credit, and partial or 100% surety bonds issued by a financial guarantee insurer.

Senior/subordinated structures can limit the need for third-party credit enhancement, premiums for which are replaced in effect by a higher return paid on the "B" tranche. One potential problem with senior/subordinated deals is finding investors willing to take the junior tranche on terms which are attractive to the issuer. Investor appetite for this type of paper is clearly dependent on market conditions prevailing at the time.

Cash collateral accounts

A technique of recent vintage is the cash collateral account (CCA). While the LOC business remains largely the domain of triple-A rated institutions, lower rated lenders may still provide third-party credit enhancement by offering loans to fund cash collateral accounts. Developed initially to support ABS backed by credit card receivables, these accounts provide a reserve of cash, which is designed to bear the credit and liquidity risks of a transaction.

In practice, a loan is made to a special purpose entity (such as a corporation, a trust or a limited partnership, sometimes called a special purpose vehicle or SPV) issuing the securities. As long as the bank has a short-term A-1/P-1 rating, the vehicle company then redeposits the loan back with the lending bank. As in an LOC, the bank receives a fee, which is the difference between the interest rate paid by the SPV on the loan and the interest rate paid to the SPV on the deposit. While both rates are often set with reference to Libor, the fee usually ends up being a fixed spread of 3/4 to 1%.

At the time of writing, the technique is relatively new but is gaining primarily at the expense of the LOCs. It remains to be seen whether the technique becomes widely accepted in light of the restrictions it imposes on the lender of the funds for the cash collateral account. The lender must:

- have or develop the expertise to assess the creditworthiness of the borrower, the collateral, and the ABS structure. As the identity of the lender is not always disclosed, the investors are being asked to assume that the lender has this expertise;
- be willing to balloon the institution's balance sheet by making the loan, and thus restrict its ability to deploy its capital more profitably elsewhere; and

- be willing to assume a funding risk in the event its rating drops below A-1/P-1 and the SPV moves its cash deposit to another institution. In this event, the issuer may have to pay a higher rate on the loan if the loan conditions permit the lender to pass along a part or all of its higher funding costs.

This may explain why, to date, loans for cash collateral accounts have not for the most part been provided by banks rated lower than triple-A but by the same banks that already provide letters of credit for ABS.

Financial guarantee insurance defined

A financial guarantee (sometimes also referred to as "bond insurance" or a "surety bond") is used in ABS to enhance a security to the triple-A level, based on the financial guarantee company's triple-A rating. The guarantee is designed to ensure that investors will receive timely payments of principal and interest, regardless of whether the underlying collateral assets are able to support such payments.

The financial guarantee law of New York state, where most insurers of this type of coverage are domiciled, defines a financial guarantee narrowly, as "a surety bond, insurance policy, or ... an indemnity contract ... under which loss is payable upon proof of occurrence of financial loss, to an insured claimant, obligee, or indemnitee ... as a result of a failure of an obligor to perform under a payment obligation as a result of a default or an insolvency".

Under this law, financial guarantee companies are permitted to underwrite only credit risk, not market risk (or the risk of changes in prices of collateral assets). However, financial guarantee insurers may enhance transactions where the market risk is in fact remote but where the credit risk is related to the market value of the underlying collateral. An example is the so-called market value collateralised bond obligation or CBO. Such securities are backed by a pledge of a pool of corporate bonds whose market value must be maintained, if necessary, through a pledge of additional collateral at a significant multiple of the principal amount of the guaranteed securities.

Financial guarantees are used to support principal and interest payments for a wide range of obligations. Financial guarantee companies have partially or fully-insured financings backed by cash flows or market values of assets domiciled not only in the United States but also in the United Kingdom, France, Australia and New Zealand. Insured transactions involve such collateral assets as first mortgages, home equity loans or second mortgages, major bank and private label credit card balances, auto loans, boat loans, recreational vehicle loans, manufactured housing loans, timeshare vacation

apartment loans, perpetual floating rate notes, high yield bonds, senior loans to highly leveraged companies, commercial real estate leases and municipal leases.

The benefits of financial guarantee insurance

Market participants increasingly value the benefits of triple-A financial guarantee insurance. First, the investor can be confident that the transaction structure is inherently safe and will remain so. Insurers not only impose stringent conditions at the outset but also continue to monitor the credit of the transaction and quality of the asset pools. This is because the insurers put their own triple-A rating and their capital on the line with each transaction.

Second, the investor also benefits from the oversight of the rating agencies on both the transaction and the financial guarantee company. Each guaranteed transaction must in general be reviewed, approved and deemed investment grade in its own right by the rating agencies before a financial guarantee can be issued.

Third, financial guarantee insurance enables the underwriter to simplify distribution of ABS to investors, thereby improving the economics of the transaction. ABS which do not include third-party credit enhancement often require the investor to have a more thorough understanding of the underlying transaction structure, and the specific collateral backing the issue.

Investors have developed a high level of confidence in financial guarantee insurance due, in part, to the industry's unusual performance record. Unlike LOC banks, no financial guarantee company has suffered a rating downgrade in the 20-year history of the industry; nor has any issue supported by a financial guarantee ever been downgraded. Furthermore, no investor in any insured security has missed a single timely payment of principal or interest.

Financial guarantee insurers

There are nine US-based providers of financial guarantee insurance or reinsurance, specialising solely in this form of coverage. As a practical matter, this has evolved into a triple-A only market and, therefore, all financial guarantee insurers are rated triple-A by at least one or more of the major credit rating agencies.

Four of the nine mainly insure the domestic borrowings of US municipalities, states and other non-Federal government entities. They are:

- AMBAC Indemnity Corporation (AMBAC);
- Capital Guaranty Insurance Company (Capital Guaranty);

- Financial Guaranty Insurance Company (FGIC); and
- Municipal Bond Investors Assurance Corporation (MBIA).

Two focus on guaranteeing ABS. They are:

- Capital Markets Assurance Corporation (CapMAC); and
- Financial Security Assurance Inc (FSA).

One, Connie Lee Insurance Company (Connie Lee), is a quasi-governmental reinsurer focusing on the college and teaching hospital debt market. It is also permitted to write direct insurance.

There are also two major reinsurers, each with a small direct insurance capacity. They are:

- Capital Reinsurance Company (Cap Re), and
- Enhance Reinsurance Company (Enhance Re).

These franchises, however, are shifting. FGIC and MBIA have begun insuring ABS issues, while FSA has dedicated some of its capacity to municipal financial guarantee activity.

It is noteworthy that the US financial guarantee insurers are sometimes referred to as "monoline" insurance companies because they engage in only one line of business, namely, financial guarantee insurance. Monoline insurance companies are often contrasted with "multiline" insurance companies which engage in a variety of other lines of business, including but not limited to life insurance, annuities, accident and health insurance, fire insurance, miscellaneous property insurance, personal injury or property damage liability insurance, fidelity insurance, residual value insurance, etc. As already noted, regulatory restrictions do not permit multilines licensed in New York and certain other states to provide financial guarantee insurance, except through separately capitalised subsidiaries authorised only to provide financial guarantees.

With the emergence of an international ABS market, financial guarantee insurance companies have become active internationally. FSA, FGIC, CapMAC and Cap Re have opened overseas offices. MBIA, which has a cross-shareholding arrangement with Crédit Local de France, has recently been authorised to write insurance in France.

There are currently no non-US based monoline financial guarantee insurers. This reflects not only the infancy of formal credit ratings in the international markets but also the more recent and relatively slower development of the asset-backed securities market in Europe and Japan. Another factor may be the lack of a clear regulatory framework for financial guarantee insurance outside the US. However, many European and Japanese property and casualty companies do provide insurance and reinsurance for ABS.

Regulatory controls on financial guarantee insurers

Regulatory oversight on financial guarantee insurers has fostered investor confidence and facilitated an expanding role for financial guarantee insurance in the ABS market.

US financial guarantee insurance companies are regulated by state insurance authorities. A number of states, including New York, Florida and California, currently have, or are considering adopting, specific insurance laws to regulate financial guarantee companies: for example, in 1989 New York enacted a comprehensive law governing financing guarantee insurers domiciled or licensed to do business in that state.

The New York statute establishes:

- single risk limits applicable to all obligations tailored to the various types of obligations guaranteed, to ensure that no single risk is disproportionate to the capital of the insurer;
- aggregate risk limitations, also tailored to the various types of obligations guaranteed, to ensure that the aggregate book of business of the insurer is not disproportionate to its capital;
- contingency reserve requirements, to ensure that the insurer sets aside reserves with respect to each obligation guaranteed and, effectively, increases its capital base over time; and
- case basis loss reserves, ie, reserves against actual defaults on guaranteed transactions, and unearned premium reserves to protect the insurer against losses.

Insurance regulations in effect dictate the amount of capital an insurer must maintain to support its book of business. The capital required takes into account the different features of the various types of insured transactions and is based on pre-determined leverage ratios for individual categories.

In addition, each financial guarantee company must also comply with the insurance regulations of all states in which it is licensed to do business. From state to state, regulations restrict such operations as investments of capital and surplus funds, and dividend payments.

Financial guarantee insurance companies are also reviewed on an ongoing basis by the credit rating agencies. In assigning triple-A ratings, the rating agencies must be satisfied that the financial guarantee company would have sufficient capital to meet its insured obligations on a timely basis, under a variety of economic and financial scenarios, called "stress tests", including a simulation of the Great Depression.

The agencies periodically review the company's business plan, underwriting standards and procedures, diversification of insured portfolio risks, monitoring procedures, exposure limits and capital adequacy. Analysts from the rating agencies also review each company's financial performance, including the market performance of its investment portfolio.

Furthermore, the agencies must satisfy themselves that each guaranteed transaction meets investment grade standards *before* a financial guarantee is provided. Rating agencies assess the adequacy of a financial guarantee insurer's capital by assigning a "capital charge" for each transaction (for a definition, see section below on "Premiums for financial guarantee insurance").

Each of the financial guarantee insurance companies, regardless of its ownership structure, is also subject to an annual audit by an independent certified public accounting firm.

The process of undertaking a financial guarantee

An ABS issuer, a seller of assets, banker or broker (the "client") seeking a financial guarantee typically initiates the process with an inquiry to a potential provider of the coverage.

The insurer screens the inquiry to determine whether the proposed ABS transaction meets its own business strategy, underwriting standards, reinsurance capacity, risk diversification objectives and return targets.

If a proposed transaction surmounts this initial hurdle, the insurer then indicates interest, and may specify its premium and structural requirements. The client of the insurer would then accept the terms or continue to seek an alternative form or source of credit enhancement.

Next, the insurer carries out its "due diligence" on the transaction, to enable it to reach its risk underwriting decisions. This investigation involves three basic steps:

- (1) the legal risks of the ABS are assessed, to ensure that cash flows to investors would be unimpeded by bankruptcy of the seller/servicer;

- (2) the seller/servicer is assessed, not only to determine its general creditworthiness, but also to satisfy the insurer regarding the seller's ongoing ability to originate and service the assets being pooled in the transaction; and
- (3) the insurer assesses cash flow risks by simulating several "worst case" scenarios, to evaluate their impact on the structure of the ABS in question. The simulations are typically carried out through appropriate quantitative models to test the structure's response to high levels of unemployment, rising interest rates and other adverse circumstances.

The object of the exercise is to create a balanced structure meeting the needs of the seller/servicer and investors, assuring the investor and the insurer that the credit risks are mitigated.

For innovative transactions, the underwriting process may need to be tailored to the unique risks of the transaction and involve a research and development phase. If a new asset type is involved, the process would require considerable research on its quality and performance under economic adversity. Recently, a "debtor in possession," or "DIP" financing, market has developed in the United States, entailing prolonged investigation of legal risks and bankruptcy court approvals prior to execution of each transaction.

At the conclusion of the underwriting process, the client receives an underwriting commitment subject to conditions deemed appropriate by the insurer. If the commitment and its terms are accepted by the client, detailed negotiations of the transaction structure and documents follow until the ABS is priced, sold and closed.

Insurers typically structure transactions to ensure that they will incur no losses. Their *modus operandi*, as well as their specific transaction requirements, are also geared to this end. They generally require that the expected loss on the underlying collateral is covered several-fold, through first loss protection, which may take the form of overcollateralisation, spread accounts, refundable or non-refundable cash deposits, or third-party recourse.

To maintain their high portfolio asset quality, financial guarantee insurers make certain that each ABS meets the rating agencies' investment grade standards in advance of issuing a surety bond. This contrasts with banks issuing letters of credit, who generally do not have this requirement, and are consequently in a position to bear part or all of the first loss.

The insurers' due diligence does not end here, however: insurers carry out additional research to ascertain that (i) the quality of the underlying assets is good, (ii) the legal structure gives sound protection against subsequent challenge, (iii) the transaction allows the insurer to monitor the structure's performance with vigilance, (iv) there is extensive regulatory oversight from

the insurance regulators and the rating agencies, (v) the seller/servicer has a material stake in the event of a loss to provide it with a strong incentive to ensure the ongoing integrity of the structure and (vi) that reinsurance is arranged, whenever appropriate, to diversify the insurer's risks.

The length of time between a financial guarantee company's receipt of an initial enquiry and its making an underwriting commitment can range from several days to weeks or months. Routine transactions can be closed in several weeks — although the process can be accelerated if necessary — with two to three months being the norm. For the unusual transaction, including one involving assets outside the United States, the process can take several months or longer.

Exposure management and risk monitoring

To protect their capital and the investor purchasing guaranteed securities, all financial guarantee insurers are committed to ongoing monitoring and surveillance, both on a transaction basis and on an overall portfolio basis. After a transaction is closed, each company follows detailed procedures to monitor the performance of the collateral, the servicer and other related parties. The procedures include on-site visits, audits, regular telephone contact and written reports.

Most financial guarantee companies have designated individual departments responsible for monitoring and surveillance. The unit may also be responsible for ensuring that the legal documents are complete and safely stored, that all monitoring requirements are documented, analysed and met, and that audits are conducted and reviewed as required. Each transaction is reviewed formally at least on an annual basis, with more frequent reviews based on need. The monitoring unit draws on the company's systems and staff to identify problems and correct them before they result in losses for the company.

In addition to transaction monitoring, each financial guarantee company evaluates and monitors portfolio risks: for example, CapMAC maintains a comprehensive database that permits it to analyse total portfolio exposure according to product types, issuers, geographic concentration, trustees, transaction structure, maturities and a variety of other factors. With an exposure management and monitoring unit alert to economic and financial developments that could affect individual transactions and the overall portfolio, senior management has the ability to anticipate and correct problems to protect the company and the investors.

Differing types of financial insurance guarantees

While the basic type of financial guarantee covers all financial obligations of the issuer to the investor, it can have many forms and variants. The simplest

form is the most common: it covers full payment of the principal and interest due to the investor from an ABS. In such transactions, investors need look no further than to the insurer for payments. While the prospectus for an ABS may, subject to the applicable laws and regulations, disclose the general nature of the collateral and structure, it need not do so in great detail because the investor is taking the insurer's risk.

Another form is the "principal only" guarantee, which does not cover the interest payments of an ABS. While several transactions have been mooted with this structure, few have been completed.

Some insurers, CapMAC for example, have guaranteed the credit risk of counterparties in derivative products such as interest rate or foreign currency swaps. In these transactions, the guarantor simply steps into the shoes of the counterparty should the latter fail to perform its swap obligations.

CapMAC is the only financial guarantee insurance company to date that provides "partial guarantees", ie, a coverage of credit losses on the underlying asset pool which is less than 100% but still sufficient for the security to attain a triple-A rating. This type of guarantee competes directly with other forms of credit enhancement, including letters of credit, cash collateral accounts and senior subordination.

Some financial guarantee insurers have also provided full guarantees for the subordinated tranches of securities whose credit risks are similar to those incurred in providing a partial guarantee on the entire pool. Market participants have occasionally shown a preference for such full enhancement, especially when market conditions make it difficult to sell unenhanced subordinated tranches.

Several insurers have followed the example of secondary market guarantee programmes instituted for municipal bonds by providing guarantees of secondary market tranches of certain types of corporate obligations: for example, the first mortgage bonds of investor-owned utilities. Such programmes are offered by FSA, FGIC, MBIA and CapMAC. Recently, CapMAC has also become the first insurer to guarantee blocks of outstanding ABS issues in the secondary market.

Premiums for financial insurance guarantees

Financial guarantee insurers' premiums are determined in response to two factors: return on equity for the transaction and market competition. The insurers use either upfront premiums (the norm in municipal guarantees) or ongoing premiums (the norm in ABS transactions) or a combination of the two. With routine transactions in the ABS market, upfront fees may be waived, but with complex transactions they may be significant. Fees range from under 10 or 15 basis points per annum for swap counterparty guarantees

to over one percentage point for complex financing programmes for lower quality seller/servicers with high quality assets but low credit ratings. Most transaction premiums fall somewhere in between. The frequency of premium payment usually mirrors the payment frequency for the underlying assets, although this need not be the case.

The capital that the financial guarantee company must “ earmark ” for each transaction, the “ capital charge ”, is a function both of rating agency guidelines and applicable state insurance regulations on leverage (see “ Regulatory controls on insurers ”). Capital which must be reserved is the higher of the amounts required pursuant to guidelines of the rating agencies on the one hand and the insurance regulators on the other. Given the applicable “ capital charge ”, the financial guarantee company determines the minimum premium consistent with its target return on capital.

The maximum premium that a financial guarantee insurer can charge depends on the value it adds, including its speed of execution, expertise, trading levels, etc. This upper limit is determined by the cost, terms and availability of alternative forms of credit enhancement and, indeed, any alternative cost of funds for the issuer.

Given the value added, the capital charge, and its target return on capital, the insurer is able to set the premium. In theory, the minimum acceptable premium for a given risk is the same for all financial guarantee insurers. In practice, of course, the actual premiums may vary among insurers based on their differing perceptions of these factors.

The role of reinsurers

Reinsurance is used extensively by financial guarantee insurance companies for three essential reasons:

- to diversify transaction and portfolio risks;
- to increase underwriting capacity; and
- to increase profitability ratios.

Reinsurance improves profitability ratios because the risks retained are reduced more than the premiums earned. The financial guarantee company originating the transaction keeps a “ ceding ” commission to cover a portion of its originating and monitoring expenses.

A reinsurer takes a negotiated portion of the risk, typically on a pro-rata basis (as opposed to on an excess basis). This can be done on a transaction-by-transaction, ie, “ facultative ”, basis. It can also be done on a “ treaty ” basis for a

class of eligible transactions, which are then automatically reinsured by insurers which are a party to the treaty.

Market spreads and credit enhancement

Yields on ABS generally exceed those on unenhanced ("natural") triple-A corporate debt with similar maturity and credit characteristics. There are a number of reasons for these wider yield spreads *versus* benchmark US Treasuries. First, the paper issued by natural triple-A companies is scarce. The ratio of enhanced (LOC-backed and guaranteed) new issue ABS to non-asset-backed triple-A paper in 1990 was almost 7 to one. Second, ABS cash flow characteristics, including scheduled and unscheduled principal payments and repayments, are generally less predictable than those of straight corporate debt.

Spreads can also differ between similar financings supported by different types of credit enhancement, but such differences are not overwhelming. Where they exist, the differences can reflect investor concerns on the perceived credit quality of a specific transaction, including the collateral type, the seller/servicer, the structure and perhaps the credit enhancement technique. To the extent that spreads differ among comparable issues backed by different financial guarantee companies, they may reflect perceptions about the company's capital adequacy, portfolio risk, parent support and product expertise. However, it is not easy to isolate the spread impact attributable to any one factor, including the credit enhancement technique or provider.

Financial guarantee companies are generally not as well known or as large as some international banks that provide credit enhancement. To improve spreads on issues they insure, financial guarantee providers need further to educate investors about an industry with an unparalleled track record of financial reliability. Investors must be made more aware of their triple-A credit quality, stringent underwriting procedures, vigilant regulatory supervision and a long record of success.

Conclusion

Financial guarantee insurance is an advantageous and expanding credit enhancement technique widely accepted by investors. It continues to be economical for many types of transactions in a burgeoning ABS market. Therefore, issuers, investors, brokers, bankers and other interested market participants will benefit from a better understanding of how financial guarantee insurance can benefit them.

The availability and attractiveness of each credit enhancement alternative can vary not only with collateral type, structures and market innovations but over time. One type of credit enhancement may be economical

Role of Insurance

and available at a particular time but not at another and may be suitable for one type of transaction but not for another. Therefore, it is best to consider each credit enhancement technique on a case-by-case basis.

Notes

1. Source: Dean Witter Reynolds Inc
2. Source: Standard & Poor's Corp