The Ultimate Power Play

Financial Mess

For several weeks Eric Dinallo, the New York State Insurance Department Superintendent has been spear-heading an effort to help the bond insurers maintain a "AAA"-rated claims paying ability. To this end, he has organized a consortium of banks and compelled them to cough-up approximately $15 billion to shore up the balance sheets of the financial guarantors. To date it appears that his mission is failing, but why? For one, the banks would prefer to see a Federal Government rescue plan rather than shouldering the financial burden. In addition, the confidence and liquidity in the financial system has vanished. Just as a thirsty man in the desert finds that the "oasis" is a mirage, the regulators will soon find that Wall Street's capital appears to have also evaporated.

Two Minute Warning

The urgency to fix the bond insurers is intensifying as the failed Municipal Adjustable Rate Securities Market (ARS) has caught the Government's attention. These failed auctions are igniting concerns that even the safer areas of the credit markets could crumble. As structured product of all flavors is unraveling regulators can ill afford to have the crisis spread to the money market funds. With Moody's and S&P threatening to knock the claims paying ability of MBIA and AMBAC below "AAA" they need to make something happen now. Should the downgrades occur before a plan is implemented then Wall Street could be caught under an avalanche of write-downs. Pick your acronyms : CDO's, CLO's, CBO's etc, all have a short term floating rate component that is used to fund the longer-dated maturities of their structure. If the "AAA" rating is pulled, then the access to credit can vanish and lead to forced sales by the holders of the riskiest tranche of the structured security. The stakes are high as these forced sales could trigger another $200 billion of losses within the banking community.

Now with the rescue plan seemingly stuck in neutral, New York Governor Elliott Spitzer and Dinallo have devised a plan that could break the log- jam. In their testimony to Congress on Thursday, they gave the insurance industry only a few more days to raise the needed capital or face other remedies. Specifically, they are contemplating a plan that separates the business structure of the insurers into two parts: a healthy municipal bond guarantee business and the taxable operations. By removing the "good" and keeping it separate and distinct from the "bad" and the "ugly", the claims paying ability of the municipal component can be maintained at "AAA". There seems to be precedence for this proposal as regulators in the late 1980's devised a "good bank/bad bank" system due to exposure to bad real estate loans. The troubled assets were sliced out of the entire bank and worked off while the good bank continued to operate.

Carrot and the Stick

While Dinallo and Spitzer talk about the concept of splitting an insurance company into two parts as a solution it smells more like a threat to the banking community. Think about it: if Wall Street does not "fork over" approximately $15 billion so that AMBAC and MBIA retain their "AAA" status then the Insurance Company's portfolio may be split in two. Should this occur the guaranty covering the municipal assets is a solid "AAA" but an avalanche of toxic waste would fall below a "AAA" rating touching off huge losses to the "street". It seems like Dinallo and Spitzer are holding the stick but the carrot is nowhere to be found.

Bottom line for Municipal Investors

While the street finds itself between a rock and a hard, or harder place the tax-exempt mess may become untangled. No matter what course of action the street chooses, municipal bond prices and their credit quality should be the beneficiaries. Said another way: Don't fight the regulators!

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