TRIPLE~A RATED

INSURED MUNICIPAL BONDS

Guaranteed payment

of interest and principal on

insured bonds.

CONTENTS

Introduction
1

Municipal Bonds: The Basics
3

What Is Municipal Bond Insurance?
4

What Value Does Bond Insurance Add?
4

Does Bond Insurance Protect Market Value?
6

How Are Issues Selected for Insurance?
6

Why Are Bond Insurers Rated Triple-A?
7

How Much Does Bond Insurance Cost?
9

Should You Buy Insured Municipal Bonds?
9

Glossary
11

All information and opinions contained in this publication were produced by The Bond Market Association from our membership and other sources believed by the Association to be accurate and reliable. By providing this general information, The Bond Market Association makes neither a recommendation as to the appropriateness of investing in fixed-income securities nor is it providing any specific investment advice for any particular investor. Due to rapidly changing market conditions and the complexity of investment decisions, supplemental information and sources may be required to make informed investment decisions.

INTRODUCTION

Municipal bonds historically have been an exceptionally safe and tax-favored investment. And they're even more attractive when they're insured — that is, when scheduled interest and principal payments are guaranteed by Triple-A rated municipal bond insurers.

Municipal bond insurance protects investors primarily in two ways. Occasionally, cities or states that issue debt securities get into financial difficulty. When that happens, they may not be able to pay interest and principal on their debt as scheduled. Even if an issuer does not default, the rating agencies may lower the ratings on an issuer's securities if its financial condition deteriorates, causing the market value of its securities to decline.

Investors in bonds insured by Triple-A rated municipal bond insurers are insulated from these risks because they can depend on the insurer, whose claims-paying ability is rated Triple-A, to make timely payment of scheduled principal and interest.

The strong demand for insured issues (almost half of all new issues are insured) is due to investors' desire for secure investments. In addition, when an issuer faces financial difficulties, history has shown that its insured bonds have more liquidity and price protection than its uninsured bonds. Issuers often prefer to offer their bonds with the highest ratings in order to lower borrowing costs.

Today's municipal bonds are insured by "monoline" insurers. This means that the insurer is in one insurance business only, the insurance of investment-grade debt securities, and is not exposed to risks from any other lines of business, as are property and casualty and life insurers. Moreover, the four leading bond insurers have a Triple-A rating from each nationally recognized rating agency.

In recent years, when many financial institutions experienced difficulties, bond insurers posted record performance. They added considerably to their claims-paying ability and to the strength of their Triple-A ratings. In general, they have been successful because they guarantee only bonds that meet their high-quality standards, and bond insurers limit their own investments to the most conservative, liquid securities.

This booklet explains how bond insurance works, how bond insurers select the issues they guarantee, and how they maintain Triple-A claims-paying ratings.

MUNICIPAL BONDS: THE BASICS

Municipal securities are the debt obligations of states, their political subdivisions (such as counties and cities) and certain agencies and authorities. More than 50,000 state and local government units issue securities to raise money for public purposes such as water and sewer systems, schools, highways, housing, hospitals and other public facilities.

Individual ownership of municipal bonds, purchased directly or through mutual funds and unit investment trusts, has grown from $137 billion in 1980 to $1.4 trillion at the end of the third quarter of 2003, according to the Federal Reserve.

Under present federal income tax law, the interest income from tax-exempt municipal bonds is exempt from federal income taxes.*

In most states, interest income received from securities issued by governmental units within the state is also exempt from state and local income taxes. Moreover, interest income from securities issued by U.S. territories and possessions — Puerto Rico, the U.S. Virgin Islands, Guam, American Samoa and the Northern Mariana Islands — is exempt from federal, state and local income taxes in all 50 states.

** If you are subject to the alternative minimum tax (AMT), you must include interest income from certain municipal securities in calculating the tax.*

WHAT IS MUNICIPAL BOND INSURANCE?

The insurance policies written by municipal bond insurers guarantee that interest and principal will be paid as scheduled, should the issuer default. Each guarantee is unconditional and irrevocable and covers 100% of interest and principal for the full term of the issue. A bond may be insured in the primary or secondary market.

While many investors are aware of the protection municipal bond insurance offers against default and downgrade, they may not realize it also shields them from other risks as well. These may include, for example, natural disasters (earthquakes, floods, tornadoes, etc.) and environmental hazards.

If an insured bond defaults, the insurer would immediately step in and make the scheduled payments. As an investor, you would not experience any interruption in the timely payment of income.

WHAT VALUE DOES BOND INSURANCE ADD?

Insurance adds several value-enhancing features to municipal bonds:

Safety. With insurance, an investor has a backup source of payment to rely on if the primary payer, the issuer, cannot meet its obligations.

Quality. Insured bonds automatically receive the highest rating available, Triple-A, based on the Triple-A claims-paying ability of the insurer.

Ratings strength. Municipal bond insurers are highly regulated by state insurance departments and closely monitored by the major rating agencies,

which historically have reaffirmed their Triple-A ratings at least once a year.

Liquidity. Large volumes of Triple-A rated, 100%-insured securities are traded every day in the secondary market. Investors who wish to sell their insured bonds before maturity usually find a ready market for such highly rated securities.

Yield. In most cases, Triple-A insured municipals offer slightly higher yields than Triple-A uninsured securities.

Opportunity for even higher earnings. There are certain types of municipals — for example, revenue bonds and structured issues — that pay higher yields than conventional general obligation bonds. However, many investors are unfamiliar with such securities. By guaranteeing timely payment of interest and principal, insurers enable investors to purchase them with confidence.

Preselection of issuers and issues. Before an insurer agrees to guarantee a municipal security, its underwriters rigorously analyze the issuer and the specific issue.

Surveillance. The performance of every insured issue is monitored to final maturity by the insurer that provided the insurance. Surveillance teams make on-site visits to issuers and require a variety of financial reports, which are carefully analyzed for any sign of credit deterioration.

DOES BOND INSURANCE PROTECT MARKET VALUE?

Insured bonds historically have retained more of their market value than comparable uninsured bonds in difficult economic times. In particular, bonds of issuers that have been downgraded or have experienced fiscal problems perform better if insured.

However, the presence of an insurance policy alone does not guarantee a municipal bond's price in the secondary market. As with any other security, the actual bid price is determined by the market at the time of resale. Bonds sold prior to maturity may be worth more or less than their original cost.

HOW ARE ISSUES SELECTED FOR INSURANCE?

Bond insurance companies select the issues they guarantee with care. To begin with, they work only with issuers that have stable, investment-grade credit profiles. And, most important, they primarily insure only bonds that are of investment-grade quality even without insurance. ("Investment-grade" refers to those issues that would be rated Baa/BBB or higher by Moody's Investors Service, Standard & Poor's, Fitch Ratings or other rating agencies.)

Having limited themselves to insuring investment-grade bonds, insurers then go through a very thorough underwriting (i.e., risk assessment) process. They each have a sizable staff devoted to municipals — including credit analysts, attorneys and economists — who review each bond issue in great detail. Some of the factors they examine are the following: the issuer's tax base, regional economy, financial

condition, existing debt, expected future borrowing and spending requirements.

The goal of this analysis is to make sure the securities meet the insurers' rigorous internal standards. One such standard is what is known as "zero-loss" underwriting. This means confirming that the issuer is so strong — or is providing such ironclad protections in the bond issue — that the insurer believes it will sustain *no* losses. Zero-loss underwriting in the municipal bond industry contrasts with the actuarial approach used by multiline insurers, which assumes a certain level of losses will be sustained.

There are other hurdles a bond issue must surmount before being insured. Each municipal bond insurer has a senior credit committee that sets underwriting policy and has responsibility to see that all of the appropriate criteria and conditions are met.

WHY ARE BOND INSURERS RATED TRIPLE-A?

For a municipal bond insurance company, a Triple-A rating reflects a particular kind of financial strength — the ability to pay claims. Rating agencies continually evaluate bond insurers' claims-paying ability through detailed analyses of financial resources, operations and exposures, and they publish regular reports on each insurer.

Among the key indicators the rating agencies look at very carefully before they assign a Triple-A rating are the following: the quality of the insured portfolio, capital adequacy, financial performance, operating efficiency, risk management, liquidity of assets, reinsurance, ownership and the skill and experience of management.

The agencies also require insurers to comply with capital adequacy requirements and a variety of other standards for their insured bond portfolios. Finally, they subject each insurer's portfolio to what is called a "depression analysis." This exercise is designed to show how well the company would withstand the economic stresses of a simulated four- or five-year worldwide depression and continue to meet all its obligations as a going concern.

A strong contributor to the strength of bond insurers' Triple-A ratings is government regulation. State insurance departments (particularly those of the States of New York and California) exercise rigorous oversight of the municipal bond insurance industry.

Finally, bond insurers cannot be required to advance payment of interest and principal ahead of schedule in a default situation. The insurer is obligated to make payments only as originally scheduled. This preserves its capital and protects the bond insurance industry against a "run" on its capital.

HOW MUCH DOES BOND INSURANCE COST?

For the investor, there are no direct charges. The premium is paid by the issuer of the bonds or the investment banks and securities dealers that sell them. However, in exchange for the extra security of guaranteed payment and a Triple-A rating, investors earn less income than if the bond was not insured.

SHOULD YOU BUY INSURED MUNICIPAL BONDS?

Before considering insured municipal bonds, you must decide whether municipal bonds in general are an appropriate investment for you. (Another booklet in this series, *An Investor's Guide to Municipal Bonds*, provides detailed information to help you make this important investment decision.) Briefly, municipals probably belong in your portfolio if you want tax-exempt income.

Once you choose to invest in municipals, you should then discuss with your broker, financial planner or other investment advisor the merits of insured versus uninsured bonds. Most brokerage firms deal in insured municipals.

To recap, if you decide to buy insured municipal bonds, you will receive the following primary benefits:

Unconditional guarantee of the insurer. First and foremost, when you purchase an insured municipal bond, you are assured of receiving full and timely payment of scheduled interest and principal for the life of the bond issue.

Highest safety. Because of insurance, your bonds carry the highest rating awarded by the leading rat-

ing agencies, for instance "AAA" rating from S & P and Fitch or "Aaa" from Moody's.

Liquidity. Triple-A insured bonds have historically enjoyed broad market acceptance. Investors who want to sell their bonds before maturity usually find a ready market.

Attractive yield. In most cases, Triple-A insured securities offer slightly higher yields than uninsured Triple-A bonds.

GLOSSARY

Bond:
An interest-bearing promise to pay a specified sum of money — the principal amount — due on a specific date.

Default risk:
Possibility that a bond issuer will fail to pay principal or interest when due.

Downgrade risk:
Possibility that a bond's rating will be lowered because the issuer's financial condition, or the financial condition of a party to the financial transaction, deteriorates.

General obligation bond:
A bond secured by the pledge of the issuer's full faith, credit and, usually, taxing power.

Investment-grade:
Bonds considered suitable for preservation of invested capital by the rating agencies and rated Baa or BBB or above.

Issuer:
A state, political subdivision, agency or authority that borrows money through the sale of bonds or notes.

Liquidity:
A measure of the ease with which a security can be sold in the secondary market.

Maturity:
The date when the principal amount of a security becomes due and payable.

Monoline bond insurer:
A Triple-A rated company that guarantees that all

interest and principal payments on a bond will be paid as scheduled and that participates in no other line of insurance business.

Principal:
The face amount of a bond that must be repaid at maturity, as separate from interest.

Ratings:
Designations used by investors' services to give relative indications of ability to repay principal and interest on a timely basis.

Revenue bond:
A bond payable solely from net or gross nontax revenues derived from tolls, charges or rents paid by users of the facility constructed with the proceeds of the bond issue.

Secondary market:
Ongoing market for bonds previously offered or sold in the primary market.

Triple-A claims-paying rating:
Designation for insurers offering superior security on both an absolute and a relative basis. Such insurers have been judged to possess the highest safety and have the capacity to meet policyholder obligations.

Yield:
Percentage rate of return earned on a security.

This booklet was prepared jointly by The Bond Market Association and The Association of Financial Guaranty Insurors.

NEW YORK
WASHINGTON
LONDON
646.637.9200
www.bondmarkets.com

Copyright 1997–2004. All reproduction and other rights reserved.