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Build America Mutual Assurance Co.

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Build America Mutual Assurance Co.

Rationale

Financial Strength Rating
Local Currency
AA/Stable/--

Business Risk Profile

- Strong competitive position driven by proven investor acceptance of BAM financial guarantees and growing share of insured par
- Satisfactory management with extensive background in the U.S. public finance market and financial guarantee industry
- Low insurance industry and country risk assessment (IICRA)

Financial Risk Profile

- Capital adequacy ratio greater than 1x
- Investment portfolio presents low risk to the financial risk profile
- No largest obligor violations
- Strong prospective operating performance
- Financial flexibility neutral to the rating

Other Factors

- Strong enterprise risk management (ERM)
- Strong prospective liquidity with operating cash-flow improving as business volume increases

Outlook

The outlook is stable, reflecting Standard & Poor's Ratings Services' view that Build America Mutual Assurance Co.'s (BAM) competitive position will remain strong and supportive of the rating. We expect BAM's risk-adjusted pricing (RAP) ratio and operating performance to improve. The outlook also considers a steady increase in BAM's business volume and continued market acceptance by fixed-income investors.

Downside scenario

We may lower our rating if BAM's operating performance has a significant negative effect on its capital adequacy. We may also lower our rating if demand for financial guarantees offered by BAM declines as shown by a meaningfully lower amount of par insured, or if the municipal RAP does not improve to more than 4.0% with an expected rise in interest rates.

Upside scenario

We are unlikely to raise our rating in the next two years. Any upgrade would depend on a significant improvement in BAM's operating performance on an absolute basis and relative to peers'.

Expectations

- Capital adequacy ratio greater than 1.0x
- A 20% increase in par insured in 2015
- RAP ratio greater than 4.0%
- Combined ratio less than 100% by 2016

Company Description

BAM is a N.Y.-domiciled financial guarantee insurance company only insuring issuers in the U.S. public-finance market. The company is structured as a mutual company owned by the issuers it insures. With the issuance of each policy, in addition to a risk premium, issuers are assessed a members' contribution.

Business Risk Profile

The score for the company's adjusted competitive position is '3' and the industry risk is '2', leading to a business risk profile score of '2'.

Insurance industry and country risk: Operating in stable markets

We believe BAM faces low industry and country risk. Our view of BAM's very low country risk stems from the potentially higher-income nature of the markets in which BAM operates and their relatively effective and stable political institutions, sophisticated financial systems, and strong payment culture (especially in the U.S.). We believe BAM's financial guarantee operations are exposed to low industry risks because of high barriers to entry and moderate product risk. The U.S. financial guarantee market's growth prospects and overall institutional framework further support the low industry risk assessment.

Competitive position: Strong despite short history

We have lowered BAM's competitive position score to strong from very strong. We view BAM's competitive position as being no stronger than that of its peers. Although BAM has limited operating history, the acceptance of the company's insured wrap by market participants is shown by its number of municipal issues and insured par since inception. In 2014, BAM insured approximately 40% of total insured U.S. public finance-insured par and was spread across approximately 700 deals.

As of Dec. 31, 2014, the composition of the insured portfolio was geographically well diversified with 22% of insured exposure from issuers in California, 20% in Texas, 15% in Pennsylvania, 10% in New York, and 7% in Illinois. With the exception of exposure to issuers in Illinois, all the figures are two-to-three percentage points lower than those as of year-end 2013. The company does not have any exposure to Puerto Rico. Approximately 72% of the net par exposure was general obligation bonds and principally small school districts. The average credit quality of the insured portfolio was 'A'.

Table 1

Build America Mutual Insured Portfolio Statistics			
	--Year ended Dec. 31--		
($ 000s)	**2014 % of net par**	**2014**	**2013**
Public finance			
G.O.	72.1	8,925,279	3,580,399
Utility	13.1	1,615,256	671,929
Tax-backed	9.9	1,222,009	192,435
Hospitals	0.0	0	0
Transportation	2.1	257,830	154,950
Colleges & universities	2.5	311,670	73,565
Investor-owned utilities	0.0	0	0
Housing	0.0	0	0
Special revenue	0.0	0	0
Other	0.2	30,455	30,455
Total	100.0	12,362,499	4,703,733

In 2014, BAM's RAP suffered as a result of tight credit spreads in the U.S. public finance market, which resulted in a RAP of 2.31%. BAM's RAP calculation includes members' contributions as we view these as a form of premiums. There was a slight rise in pricing during May and early June as interest rates rose slightly. With an expected rise in interest rates late in 2015 and 2016, and the consequent widening of credit spreads, we expect the company's municipal RAP index to improve to more than 4.0%.

Management and governance: Well-supported strategic plan

We view BAM's management and governance as satisfactory based on the extensive background of senior management in the U.S. public-finance market and financial guarantee industry and its well-developed strategic plan. The plan ensures liquidity of BAM's insured paper and provides market participants significant transparency of the insured portfolio. The legal, credit surveillance, accounting, and actuary teams complement the company's underwriting process as they ensure that BAM's risk-taking is acceptable from various legal, operational, and contingent risks that may develop under the long maturity profile of the credit insured portfolio.

We have not identified any governance deficiencies in our assessment.

Financial Risk Profile

The company's final capital adequacy score is '1' and the operating performance score is '3', leading to a financial risk profile score of '2'.

Capital and earnings: Extremely strong

BAM's capital adequacy ratio is in excess of 1.0x. The capital adequacy ratio expresses the relationship between losses the capital adequacy model generates and capital remaining at the end of a theoretical economic depression. The analysis includes a liquidation of the collateralized trust accounts securing the first-loss reinsurance obligations of HG Re Ltd. (HG Re), a Bermuda-based reinsurance company dedicated solely to supporting BAM's claims-paying resources.

Table 2

Build America Mutual Capital Statistics*		
	--Year ended Dec. 31--	
(Mil. $)	**2014**	**2013**
Portfolio risk		
Municipal insurance weighted average capital charge (% of average annual debt service)	11.77	11.82
Model capital inputs ($ 000s)		
Statutory capital	453,522	470,123
Letters/lines of credit	0	0
Contingent capital	0	0
Excess of loss reinsurance	0	0
Unearned premiums	6,477	2,997
Loss reserves	0	0
Supplemental and Regulation 114 Trust balances	119,962	105,388
Capital adequacy		
Margin of safety (x)	>1.00	>1.00
Reliance on soft capital (%)	0	0

*U.S. statutory basis.

Although HG Re is an unrated reinsurer, investment resources used to support BAM are ring-fenced in regulatory trusts that are used to collateralize the reinsurer's claims-paying obligations. As per the reinsurance agreement with HG Re, 60% of premiums (net of appropriate ceding commissions) will be diverted directly into a Regulation 114 collateral trust account, collateralizing HG Re's 15% of par-loss reinsurance obligation. At minimum, all assets equal to the unearned premium reserve and loss reserves ceded and $400 million of HG Re's capital will be segregated in the Regulation 114 and supplemental trusts.

As of Dec. 31, 2014, BAM had no largest obligors test violations.

Investment risk modifier: Neutral to the financial risk profile

BAM's investment portfolio is of high quality and liquid, and presents low risk to the financial risk profile. As of Dec. 31, 2014, BAM's investment portfolio was $458 million and was composed of 57% corporate fixed-income investments, 28% U.S. treasury and agency securities, 4% municipal bonds, and the balance short-term investments and cash. The average credit quality of fixed-income investments was 'AA-' with corporate bond exposure focused on industrials and highly rated financial institution debt obligations. Given the current yield environment, BAM has maintained a conservative duration of 2.4 years, which allows for sufficient liquidity and positions the company to withstand the negative effects of a volatile and higher-interest-rate environment.

Operating performance: Strong

Our evaluation of a bond insurer's operating performance considers the demonstration of superior and stable operating performance supporting a company's ability to generate capital internally, attract external capital, and reward stockholders with appropriate returns. As a mutual company, BAM's owners are focused on a stable, low-cost source of financial guarantee support rather than a high return on investment. In addition, because a component of the cost of insuring a financial guarantee policy is members' contribution, BAM is effectively issuing equity with the issuance of each policy. However, weak operating performance will present a drain on capital, which could affect capital adequacy.

Table 3

Build America Mutual Operating Performance*		
	--Year ended Dec. 31--	
(%)	**2014**	**2013**
Operating ROE	N.M.	N.M.
Municipal risk-adjusted pricing ratio	2.3	3.2
Statutory combined ratio	188.2	161.0
Statutory loss ratio	0.0	0.0
Statutory expense ratio	188.2	161.0
Statutory return on revenue	N.M.	N.M.
Insured portfolio speculative grade exposure	0.0	0.0

*U.S. statutory basis. N.M.-Not meaningful.

We believe that as the company's business volume increases, its operating performance and profitability will improve. If the company maintains the prudent underwriting strategy it has exhibited since inception, it should experience minimal losses, in our view.

Our expectations of BAM's operating performance are supported by market acceptance of the company's financial guarantees as seen by the company's strong market share of the total insured U.S. public-finance market and strong trading value of BAM-insured bonds compared to uninsured bonds of the same issuer. The company's increase in insured secondary-market transactions should help operating results as these transactions have historically had stronger economics than primary insured transactions.

Table 4

Build America Mutual Financial Statistics*		
	--Year ended Dec. 31--	
($ 000s)	**2014**	**2013**
Total assets	475,719	486,529
Cash & invested assets	473,026	483,666
Net premiums earned	159	24
Losses & LAE	0	0
Underwriting expense	37,380	33,230
Investment inc. including gains/(losses)	5,424	3,903
Net income	(31,796)	(29,303)

*U.S. statutory basis.

Financial flexibility: Neutral to the financial risk profile

As a mutual insurer, BAM has limited access to the capital markets. This limitation is offset by the members' capital contributions that BAM collects with each policy issuance.

BAM's surplus notes are owned by HG Holdings Ltd. and HG Re. Payments on the surplus notes would not be approved by the New York Department of Financial Services if BAM's capital were not sufficient.

Other Assessments

Enterprise risk management: Supported by strong experienced management team

BAM's ERM framework is strong, in our view, with continued enhancements to address the changing risk dynamics of the U.S. public finance market. Governance and structural limits define the risk categories and underlying risk exposures, which BAM continues to monitor closely for validation as it ramps up. The company runs stress and scenario tests, including an assessment of potentially correlated revenue streams and sensitivities to a variety of concerns, at least quarterly. We view the well-established management team with more than 25 years in the municipal bond insurance industry as a strong factor in our ERM assessment. Our view of BAM's ERM reflects a positive assessment of its risk management culture, risk controls, and strategic risk management. These positive assessments are partially offset by our neutral views of emerging risk management and risk models.

Liquidity

We view BAM's liquidity profile as strong based on the lack of any credit-sensitive liabilities or collateral-posting requirements. We expect the company's operating cash-flow generation and underwriting cash-flow ratio to improve with the growth in business volume and the low credit-loss profile of the insured portfolio.

Accounting Considerations

We view BAM's accounting policies as generally consistent with industry standards and neutral to the ratings. BAM files financial statements under statutory accounting principles and publishes an operating supplement each quarter.

Related Criteria And Research

- Group Rating Methodology, Nov. 19, 2013
- Enterprise Risk Management, May 7, 2013
- Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers, Nov. 13, 2012
- Bond Insurance Rating Methodology And Assumptions, Aug. 25, 2011
- Use Of CreditWatch And Outlooks, Sept. 14, 2009
- Hybrid Capital Handbook: September 2008 Edition, Sept. 15, 2008

Ratings Detail (As Of June 29, 2015)	
Build America Mutual Assurance Company	
Financial Strength Rating	
Local Currency	AA/Stable/--
Counterparty Credit Rating	
Local Currency	AA/Stable/--
Financial Enhancement Rating	
Local Currency	AA/Stable/--
Holding Company	None
Domicile	New York

*Unless otherwise noted, all ratings in this report are global scale ratings. Standard & Poor's credit ratings on the global scale are comparable across countries. Standard & Poor's credit ratings on a national scale are relative to obligors or obligations within that specific country. Issue and debt ratings could include debt guaranteed by another entity, and rated debt that an entity guarantees.