

**Preliminary Business Plan**



**NATIONAL LEAGUE OF CITIES'  
ISSUERS MUTUAL BOND ASSURANCE COMPANY**

**May 1, 2009**

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## **Introduction**

This is a proposal of the National League of Cities (NLC) to return stability to the municipal bond market through the creation of the “Issuers Mutual Bond Assurance Company,” which will be owned by state and local governments as well as state and local government agency municipal bond issuers. This new company will endeavor to replace the 15 commercial municipal bond insurers that were downgraded in 2008 and 2009.

This initiative will make a significant contribution to the nation’s economic recovery. The municipal bond market holds over \$2.3 trillion of the country’s wealth. Insured bonds comprise about 1/3<sup>rd</sup> of this market, with insured issues accounting for about 50% of new issues in recent years. Throughout 2008 and 2009, the market was devastated by the downgrades of every single municipal bond insurance company. These downgrades brought on the utter collapse of the Auction Rate Securities market and the disruption of the Variable Rate Demand Note (VRDN) market. These events, in turn, cost state and local government bond issuers billions of dollars in added interest payments. Furthermore, because of the continuing absence of any triple-A insurance, many small or infrequent municipal bond issuers no longer have access to the market or, if so, only at rates that are significantly higher than they are accustomed to paying.

The economic crisis has put state and local governments across the country under great financial stress. This stress imperils essential governmental services that people rely on and governments’ abilities to pay for them. Everything possible must be done to alleviate this stress by reducing the cost burdens of state and local governments. This initiative of the National League of Cities speaks directly to this issue.

The Issuers Mutual Bond Assurance Company (“Issuers Mutual” or the “Company”) brings an entirely new concept to the municipal bond insurance market.

Bond buyers should have great confidence in -- and therefore accept lower interest rates on -- bonds insured by Issuers Mutual because it is owned by the very entities that are insured. It is a peer-owned, self-assistance enterprise that must succeed in order to achieve the goals of its state and local government owners: reducing their borrowing costs. It brings a new – mission-driven, public-benefit corporate culture to the municipal bond insurance industry; one that is based on providing great service to bondholders and issuers, rather than profits to its shareholders. Furthermore, the structure of a mutual insurance company avoids the thorny and contentious issue of cross-collateralization that has vexed many inter-state efforts at governmental self-help in the bond market.

NLC will present this preliminary business plan to the U.S. Treasury from which it will request a \$5 billion interest-free loan to capitalize Issuers Mutual, plus a small amount of funding for start-up working capital<sup>1</sup>. The request will be for \$3 billion of cash upfront and \$2 billion of call capital. The Pro Forma GAAP Cash Flow Projections that accompany this document envision such a \$3 billion initial contribution in the form of a Surplus Note<sup>2</sup> from the U.S. Treasury in Year One, with an additional \$1 billion in Year Seven. The final \$1 billion is not actually needed unless greater market penetration is achieved.

## **Background**

In 2008 the National League of Cities (NLC) and the National Association of Counties (NACo) became alarmed at the collapse of the municipal bond insurance industry which included downgrades in the credit ratings of all 15 companies in the market. Furthermore, the flight to quality in all financial markets that ensued from the general economic decline made it either impossible or prohibitively expensive for small issuers with A or triple-B credits to access the market.

In the Autumn of 2008, NLC in cooperation with NACo, formed a Blue Ribbon Commission on Municipal Credit Enhancement to investigate market conditions and make recommendations for improvement. The Commission found that the continuing pressure to increase earnings forced the traditional municipal bond insurers to diversify into insuring more profitable but much riskier securities, such as Collateralized Mortgage Obligations (CMOs), which led to their downfall.

The Commission concluded that there was a need for a new municipal bond credit enhancement mechanism that was mutually owned by the issuers whose bonds it insured -- that would be freed from the ominous and persistent drive for ever greater profits.

In the Spring of 2009, NLC resolved to create such a mutually owned municipal bond insurer to meet the needs of its constituents and other market participants. This document presents the preliminary business plan for such an enterprise, the working name of which is the Issuers Mutual Bond Assurance Company.

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<sup>1</sup> It should also be noted that although this initiative is structured as a mutual insurance company, it need not necessarily be so. The purpose of this initiative is to provide credit enhancement. This could be accomplished through other structures such as a bank or a federally chartered institution. Comment is invited on alternative structures that could accomplish the same ends.

<sup>2</sup> There are no shares in a mutual insurance company. Investments are made in the form of Surplus Notes.

The sole purpose of a business corporation is to earn a return on the equity contributed by its investors. The purpose of a mutual enterprise is twofold: primarily, to provide benefits for its members and, secondarily, to allow them to share premium income that exceeds the amount of funds required to pay claims by growing the enterprise and ensuring that it has long-term capital adequacy. Therefore, Issuers Mutual will operate on principles significantly unlike those of commercial municipal bond insurers.

The members of Issuers Mutual will be united voluntarily to meet their common economic needs. This organization will succeed where others have failed because it will:

1. limit its offerings to only those products that its members use
2. develop member loyalty
3. provide financial incentives to members to participate
4. have an open line of communication with members
5. educate its members about and require the adoption of recommended financial management practices
6. limit administrative and overhead costs
7. be governed by an independent board of industry experts from the public and private sectors elected by the members
8. be treated as a tax-exempt, risk-sharing organization because it is performing the essential government function of lowering the cost of governmental financings
9. be accountable to its members and the bond-buying public
10. be transparent in its operations

Mutuals are successful, stable and policyholder-focused company structures that have been used since insurance began centuries ago. They provide a distinct perspective and contributions to the insurance marketplace that for the first time ever will be applied to municipal bond insurance to respond to the severely reduced availability of such insurance.

## **Operating Principles**

Issuers Mutual will be a unique enterprise. This organization will exist solely to reduce the cost of borrowing for its issuers/members. It will do so by attracting the lowest possible interest rates on bonds which it insures by offering bond purchasers the highest quality, well capitalized financial guaranties that are provided – not by commercial interests – but by the insureds themselves through Issuers Mutual.

The goal of Issuers Mutual will be to lower the cost of borrowing for those state and local governments as well as state and local government agencies that purchase bond insurance from

the Company. It will accomplish this goal by demonstrating to bond purchasers the value not only of its strong capital base; but, more importantly, of its unique corporate culture and mutual ownership structure, which mandate it to adhere to its fundamental principles and not be beguiled into riskier lines of business by the allure of false profits.

It will return the initial capital furnished by the U.S. Treasury and provide a modest return on investment to those state and local governments and their agencies that purchase its insurance. The six principles for forming this new, publically owned municipal bond insurance company under the aegis of the National League of Cities are:

**Mission Driven.** The overriding objective of forming a municipal bond insurance company owned by local governments is to serve the public by reducing the cost of borrowing. This principle has to be crystal clear at the onset to all potential stakeholders. This is especially true of: bond buyers, local government bond issuers, staff, the rating agencies, the regulators, and the public.

**Reduce Borrowing Costs to Borrowers.** Issuers Mutual serves the public by lowering the borrowing costs of local governments, which translates directly into lower taxes and lower fees for water, sewer, and other essential government services.

**Provide a Reasonable Return to Members.** Fifteen shareholder-owned municipal bond insurers have failed because of the intense pressure to produce 15-25% annual returns for their shareholders. Issuers Mutual's goal, however, will be to produce a modest return to the municipal bond issuers that purchase their bond insurance from, and are, therefore, members of, Issuers Mutual and to support the company's growth by building capital.

**Limited Classes of Business.** Issuers Mutual will only insure general obligation (GO) and revenue bonds for essential municipal services, or short-term municipal notes and municipal leases related to essential municipal services. It is possible to insure some Variable Rate Demand Notes (VRDNs), but only where there are ceilings on the interest rates that are a fixed number: they cannot be linked to any indexes. These ceiling rates, then, must also be the ones used in the underwriting to determine if the issuer can afford the debt. In the main, however, long-term, fixed-rate general obligation bonds and essential service revenue bonds as well as short-term municipal notes and leases must be the core business.

**Simple and Fair Premium Structure.** Issuers Mutual will be rated triple-A. Historically, triple-A insured bonds have traded at a discount to bonds with natural triple-As. Because of its unique and highly favorable ownership structure and strong capital base, Issuers Mutual intends to narrow that spread and trade very close to natural triple-As. The premiums on municipal bond insurance traditionally result in win/win situations for insurers and insureds. There is always a

spread between the rate at which an issuer's bond will sell and a lower rate that it will sell for, if insured. Municipal bond premiums result in a division of this spread, such that the insurer receives a good premium and that the issuer/insured saves money on interest rate payments.

Issuers Mutual, freed from having to be aggressive in seeking high profits on its premiums, will charge moderate, affordable premiums. Premiums will be officially set by Issuers Mutual's Board of Directors.

**Limited Membership.** Membership in Issuers Mutual will be limited to local governments, local government agencies, states, and state agencies that purchase municipal bond insurance from the Company. Members will be entitled to vote for directors of the Company at its annual meeting.

### **Tax-Exempt Status of the Company**

Issuers Mutual will, upon organization, apply to the U.S. Treasury for a ruling that its income is exempt from federal income taxation.

All of the Members of the Company will be local governments, local government agencies, states, or state agencies, all of whose income is exempt from federal income taxation under Section 115 of the Internal Revenue Code. Furthermore, the Members' participation in the company is in furtherance of the valid public purpose of reducing their borrowing costs, thereby protecting their financial security.

In addition, upon dissolution of the Company, all of its property and funds will inure directly to the benefit of its Members.

NLC has sponsored the creation of NLC Mutual, which is a company that is owned by local government general liability and workers' compensation intergovernmental risk pools that, in turn, are owned by local governments themselves. The Internal Revenue Service has issued a letter ruling acknowledging the tax-exempt status of this company. Because of the similarities, the Company believes that its income will not be includable as income for tax purposes under Section 115 of the Internal Revenue Code.

### **The Business**

The business of Issuers Mutual will be to insure the bonds of local governments, local government agencies, states, and state agencies that are either general obligations of the issuer or revenue bonds issued to fund capital projects related to essential government services performed

by the issuer. It will also provide liquidity for issuers of Variable Rate Demand Notes (VRDNs). Issuers Mutual will also insure municipal notes of local governments and state and local government agencies for cash-flow financing purposes and municipal leases for equipment used in providing essential government services.

Essential government services include, but are not limited to: water, wastewater, solid waste and other municipal utilities; schools and higher educational facilities; public housing; government-owned medical and health care facilities; roads, bridges, and other transportation facilities as well as ports and airports. Issuers Mutual will not insure private-activity bonds or bonds issued by not-for-profit corporations.

Issuers Mutual will only insure those bonds that have received either a rating, or shadow rating<sup>3</sup>, of investment grade from at least one of the major international credit rating agencies. Investment grade ratings are those that are rated triple-B or better.

## **The Market**

In 2007, some \$429 billion of municipal bonds were issued in the United States. In 2008, even with the severe economic downturn, \$391 billion were issued. As of the end of the first quarter of 2009, issuance is running slightly ahead of 2008 levels. So, for round numbers, this document assumes that approximately \$400 billion of municipal bonds will be issued in 2009. For conservatism's sake, the market has only been estimated to grow at an annual rate of 2%.

In addition, in order to show a more realistic representation of the traditional market, this document has used statistics published by the Securities Industry and Financial Markets Association (SIFMA) in April of 2008 to portray a snapshot of a relatively stable market for use as an example, and in formulating estimates.

At that time, the percentage of bonds issued by their respective credit ratings were as follows:

<u>Issuer's Rating</u>	<u>Distribution Percentage</u>
AAA	3%
AA	23%
A	55%
BBB	19%

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<sup>3</sup> A "shadow rating" is an unpublished rating.

Bonds with ratings below triple-A comprise 97% of the market. These, theoretically, could all use the Company's bond insurance. However, at least for the top tier of double-A rated bonds, this will depend on what rate investors will pay for a double-A issuer's bonds versus what they will pay for the same bond insured by the Company. If the spread between the two bonds is positive, they might buy insurance; but if not, certainly not. Thus, if bonds insured by Issuers Mutual trade at spreads more favorable than double-A uninsured bonds, then 97%, or nearly all, of the municipal market will be available to the Company as a market as well. The goal of Issuers Mutual will be to trade as closely as possible to true triple-As. But, even if bonds insured by Issuers Mutual trade in the double-A range, then at least 75% of the market will constitute the Company's gross possible market.

Of the \$91.19 billion of bonds issued in the first quarter of 2009, the following amounts were issued for the following purposes:

<u>Purpose</u>	<u>Amount (billions)</u>	<u>Percentage</u>
General Purpose	\$28.75	31.5%
Education	\$23.17	25.4%
Utilities	\$ 9.45	10.4%
Health Care	\$ 8.15	8.9%
Transportation	\$ 5.27	5.8%
Other	\$16.40	18.0%

Issuers Mutual should be able to insure virtually all of the General Purpose Bonds, Utility Bonds and Transportation Bonds totaling about \$43.5 billion, or 47.7% of the market. The Company should also be able to insure Education Bonds issued for public institutions. A conservative estimate of the public-sector share of the Education Bond market would be about 75%. Health care institutions that are owned by governments or government agencies would also be eligible. This might comprise 50% of that market segment. Finally, no more than 10% of the "Other" category of bonds should be included in Issuers Mutual's potential market. All in all, the potential market by segment suggests that approximately 75% of the total market will be eligible for Issuers Mutual insurance. No private-activity bonds or bonds issued by not-for-profit corporations will be insured.

These market statistics cannot be summed or otherwise combined: they are apples and oranges. But even if they could, they suggest a market today of in the \$250 - \$300 billion range for Issuers Mutual.

For the sake of conservatism, this document has assumed a Year One market penetration of \$20 billion, which is about 5% of the market. This share rises to 25% in Year Five and remains there. It should be noted that all 15 of the commercial insurers enjoyed a 50% market share. So, although Issuers Mutual will, at least initially, be the only triple-A company in the business, its market share, in Year Five, is only projected to be 50% of the 50% of the market that was previously being insured.

This may well be a conservative market estimate. As noted, today there are no triple-A insurers. There may never be. But even if there are, Issuers Mutual may take a disproportionate share of the market.

First, Issuers Mutual will be well capitalized with its \$5 billion from the U.S. Treasury. Second, Issuers Mutual will, by its charter, limit itself to GOs and essential service revenue bonds, a highly conservative approach. Third, Issuers Mutual's capitalization ratio is not expected to exceed 100:1 and will limit itself to 125:1. These are very conservative positions which should result in the Company's bonds trading at very favorable rates. This may attract issuers who never before insured their bonds. These factors may push the Company's market penetration far beyond the 50% level which the commercial insurers had achieved before the financial crisis.

## **Marketing**

There are three segments of Issuers Mutual's market: those who issue bonds, those who facilitate the sale of bonds, and, those who buy bonds. The Company will mount an aggressive marketing campaign in all three segments.

**Issuers.** The major thrust of the Company's marketing to issuers will be through the many associations that represent government officials who manage bond-issuing agencies engaged in providing various essential services. These begin with the National Governors Association; the National League of Cities; the U.S. Conference of Mayors; the National Association of Counties; the Government Finance Officers Association; the International City/County Management Association; the National Association of State Treasurers; the National Association of State Auditors, Comptrollers, and Treasurers; and others. The Company will rank these organizations in order of importance and relevance; and its marketing representatives will attend, and make presentations at, if possible, appropriate meetings of these organizations. The Company will also develop strategic information on the size, credit quality and bond-issuing frequency of government agencies and will target the most likely bond purchasers for its marketing efforts.

**Facilitators.** Facilitators include bond underwriters, financial advisors, bond lawyers, and rating agencies. Some of these groups have national events. The National Association of Bond Lawyers has annual meetings. The rating agencies also sponsor regional and national

conferences which are not only attended by issuers but by financial advisors and bond underwriters as well. The Company will take advantage of as many of these national, public events to reach as many market participants as is possible. But it will also schedule trips for its marketing representatives to major cities where clusters of financial advisors, bond lawyers, rating agencies, and bond underwriters maintain places of business. Individual presentations and other contacts will be made through these means.

**Bond Buyers.** The bond-buying market can be divided into three elements: large tax-exempt municipal bond funds, financial institutions, and the general public. The Company regards bond buyers, represented by the major tax-exempt municipal bond funds and by the major institutional brokerage houses that sell bonds to the public, as an extremely important segment of the market and will strive to establish and maintain strong relationships at the highest levels with these firms. This is where the Company's dedication to its Operating Principles and its financial strength must be demonstrated to an often skeptical audience. Bond buyers and brokers must not only be made aware of the existence of Issuers Mutual bond insurance; but they must be convinced that it is a superior product offering outstanding protection against default, such that they are willing to pay a premium for bonds insured by it. This price premium will translate directly into lower borrowing costs for issuers which is the *raison d'être* for the Company. A cadre of senior marketing representatives will regularly call on the major tax-exempt municipal bond funds and brokerage houses.

In addition, the Company will compile data on the municipal bond buying appetites of major financial institutions, such as commercial banks and property and casualty insurance companies, and will make direct calls on them.

Finally, as the Company's marketing representatives visit cities to call upon issuers, facilitators, and financial institutions, they will also make calls and presentations to the local offices of the major brokerage houses that sell bonds to the public.

## **Governance**

**Board of Directors.** The Company and its affairs will be managed by a board of directors. Article XII of the New York State Insurance Law requires a minimum of thirteen directors, two of whom must be residents of the State.

The initial slate of directors will be selected by the National League of Cities in consultation with the U.S. Treasury. Subsequent thereto, the then-sitting directors will nominate new directors who shall be elected by the Members.

In order to assure continuity and smooth governance, it is proposed that there be fifteen directors who shall serve for five-year terms. Initially, three of the directors will be elected for one-year terms; three will be elected for two-year terms, three for three-year terms, and so on. Directors shall not serve more than two consecutive terms.

It is proposed that one of the directors be a representative of the NLC. The other directors should come from disciplines and sectors of the financial market where their expertise will be of great value in guiding the affairs of the Company. There should be representatives of issuers, although to avoid even the smallest appearance of political influence in the underwriting process, issuer representatives will not serve on the Underwriting Committee and will recuse themselves from any decisions where they have had direct involvement. There should also be representatives of the brokerage houses and major municipal bond funds that purchase bonds insured by the Company. Finally, there should be other experts from law, finance, ethics, business, and academia who can materially contribute to the management capacity of the board.

**Management.** The board of directors will elect the president and chief executive officer of the Company. Other officers will be appointed by the chief executive officer.

In view of the critical importance of sound underwriting, there shall be an Executive Vice President of Underwriting. The underwriting staff shall report to this officer.

In addition, since the Company must have the strongest possible relationships with both bond issuers and bond purchasers, there shall be an Executive Vice President for External Affairs. This person shall be responsible for building solid relations with the bond buying community as well as the local governments that purchase the Company's insurance for their bonds. The Marketing Department shall report to the Executive Vice President for External Affairs. This officer shall also be responsible for the Company's relations with the international credit rating agencies and, with the assistance of the General Counsel, be responsible for relations with state and federal regulators. The Executive Vice President for External Affairs shall also manage the Company's relationships with states and the federal government.

There shall also be an Executive Vice President for Operations who shall be the chief operating officer. This officer shall be responsible for the conduct of the Company's day-to-day affairs and for its activities in the following specific areas: legal, human resources, reinsurance, information technology, investments, accounting, and administration.

Candidates chosen for the above positions shall have qualifications and expertise suitable to their positions.

Compensation levels are expected to be fair and must be competitive; but, since the initial capital is coming from the American taxpayers, compensation levels will be in accord with U.S.

Treasury guidelines for executives of all financial services companies receiving federal assistance under the Troubled Asset Relief Program (TARP).

## **Premiums and Pricing**

Issuers Mutual will charge fair premiums designed to reduce issuers borrowing costs. Premiums must, however, be set at rates sufficient to maintain capital adequacy. Issuers Mutual's goal is to achieve a ratio of outstanding insured bonds to Surplus of not more than 125:1 in order to maintain investor confidence in its ability to pay claims. Premiums, therefore, must be set at rates sufficient to achieve this goal.

The premium used in the Pro Forma GAAP Cash Flow Projections is equal to seventy basis points (0.7%) of principal and interest on a 25-year bond at a 4% interest rate. On a \$1 million bond, this equals \$11,202, which is 1.1% of par.

The True Interest Cost (T.I.C.)<sup>4</sup> to the issuer can be calculated using 4% as a base interest rate (as per the rate paradigm in the accompanying Pro Forma GAAP Cash Flow Projections). After deducting the bond insurance premium from the \$1,000,000 bond, the issuer would have net proceeds of \$988,798. The annual payment on a \$1,000,000 bond at 4% for 25 years is equal to the annual payment on a 25-year bond of \$988,798 at 4.11%. So, bond issuers will enjoy substantial savings.

## **Underwriting**

**Procedure.** The underwriting process is composed of four phases. First, the issuer's most up-to-date financial statements, a description of management structure, and its history will be reviewed based on information supplied by the issuer. Second, this information will then be reviewed against any and all of the published credit ratings of the issuer. Third, an underwriting report will be written detailing the findings of such research. Fourth, the underwriting report will be submitted to the Underwriting Committee of the board of directors of the Company for

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<sup>4</sup> T.I.C. is a truth-in-lending term that accounts for upfront charges, like points on a mortgage, or insurance premiums on a municipal bond. For example, a home buyer might purchase a home and get a \$300,000 mortgage at 5% but has to pay two points (2%, or \$6,000) to the bank. In such case, the homeowner is actually borrowing \$306,000. The payments on a \$300,000 at 5% are \$1,610 a month; but on a \$306,000 loan they would be \$1,643. Since the homeowner never sees the \$6,000 that goes to the bank, paying \$1,643 on a \$306,000 loan is the same as paying 5.17% on a \$300,000 loan. The 5.17% is the T.I.C. Banks sometimes refer to this as the Annual Percentage Rate (APR).

approval. Only those credits that are approved by the Underwriting Committee will be insured by the Company.

**Avoidance of Political Influence.** It is of critical importance to note that the Company, because it is owned by its insureds, will take all steps necessary to avoid even the slightest appearance of political influence on the underwriting process. No representative, or former representative, of any issuer shall sit on the Underwriting Committee. All contacts between any persons representing issuers will be documented by the underwriting staff (and by the members of the Underwriting Committee themselves) and noted in the final underwriting report. Finally, to demonstrate absolute freedom from political interference, the final underwriting report for each issuer whose bonds are insured by Issuers Mutual will be posted, as part of the Company's transparency program on its website. (See below.)

**General Obligation Bonds.** General obligation bonds are backed by the full faith and credit of the issuing jurisdiction. They are issued by general units of government: states, cities, towns, townships, villages, school districts, and counties. The full taxing power of the jurisdictions is pledged to repay the principal and interest on such bonds.

As such, sound underwriting of GOs begins with an analysis of the demographic and economic condition of the community that the issuing government serves. Is the population growing or shrinking? What are the per capita income and the median household income? Who are the major employers? To what extent does the jurisdiction rely on one or two major employers? This phase of the analysis asks the question whether the financial condition of the community is strengthening or weakening?

The next phase of the analysis concerns the fiscal strength of the government issuing the bonds. What taxes does it have the power to levy? If a property tax, what is the appraised valuation for the jurisdiction? Is it growing or shrinking? If a sales or excise tax, what is the tax base? Is it growing or shrinking? What are the tax rates being charged? Are there any provisions in the jurisdiction's charter, the state law or the state constitution that limit the rates that can be charged for such taxes? Where are the jurisdiction's rates in comparison to such limits? How do the tax rates charged by the jurisdiction compare to those of adjacent, comparable jurisdictions? What are the collection rates for such taxes? What are the historical trends for such taxes?

The third phase of the analysis deals with the efficacy of the government itself. How much GO debt is already outstanding? How much general or special revenue bond debt of any agencies of the jurisdiction is outstanding? As far as the revenue bonds are concerned, to what extent do the revenues pledged to such bonds exceed the annual payments on such bonds? As far as general obligation debt is concerned, how much are the annual debt service payments and what are the amortization schedules for all of the debt? What percentage of the jurisdiction's budget constitutes debt service payments? What is the recent history of the jurisdiction's budget levels?

How much of the jurisdiction's budget is for: police, fire protection, education, water, sewers, and solid waste disposal? How do the per capita amounts paid for such essential services compare to the per capita amounts paid for the same services by comparable jurisdictions? What part of the jurisdiction's budget is for non-essential services?

The fourth and final phase of the analysis is subjective. The biographies of the senior elected officials are reviewed along with the resumes of key career management professionals.

Competent management, fiscal responsibility and a positive economic outlook are the key factors for approval of an application to insure a jurisdiction's general obligation bond.

**Revenue Bonds.** There are two types of revenue bonds: general revenue bonds and special revenue bonds. General revenue bonds are those where all of the revenues of all of the enterprises of a government are pledged to the repayment of its debt. Special revenue bonds are those where only the revenue from a specific governmental activity or facility is pledged to the repayment of the debt. A good example to differentiate these types of revenue bonds would be a general revenue bond issued by a state transportation agency (with responsibility for ports, toll roads, toll bridges, and airports) where all of the revenues from all such activities were collected and pledged to the repayment of a general revenue bond of the agency versus a special revenue bond of the transportation agency of another state with comparable jurisdiction, but that issues a special revenue bond to, say, repair a specific bridge, where the tolls from that bridge – and no other funds – were pledged to the repayment of that bond.

General revenue bonds are analyzed by assaying the general financial health of the issuing agency. From what sources does the agency derive its revenues? How much from each source? What are the historical trends in collections? How much general revenue debt does the agency have? Does the agency have any special revenue bond debt? If so, to what extent do the net revenues from the facility exceed the annual debt service payments on it? What part of the agency's budget constitutes debt service payments? By how much do the agency's revenues exceed its operating expenses and debt service payments? How do the agency's expenditures compare to those of comparable agencies? Will the instant bond be senior, or subordinate, to any other debt? What happens when there are either budget surpluses or deficits, both legally and operationally? Is the parent jurisdiction in any way morally obligated to make up any debt service payments upon which the agency defaults? The analysis concludes with a review of the qualifications, experience, and operating history of the agency's management.

The analysis of a special revenue bond is a narrow exercise that focuses on the reliability and size of the revenue stream pledged to the bond. The analysis begins with a history of the facility being financed and its importance vis-à-vis its ability to generate income, e.g., the only bridge over a river for 50 miles. Next is an analysis of the cost of the improvement as well as a review of its operation and maintenance. Are the projected expenses for maintenance of the facility

adequate? Operation and maintenance costs plus the special revenue bond annual debt service should make up the total budget for the facility. To what extent do existing and projected revenues exceed budgeted expenses? Based on historical trends in revenue collection for the facility, how reliable is the projected revenue stream? This analysis concludes with a review of the facility's management's experience and qualifications.

The volume, strength and reliability of the income streams are pledged to the repayment of revenue bonds and are the key factors for approval of an application to insure a jurisdiction's revenue bond.

**Monitoring and Surveillance.** The underwriting process is just the beginning of the Company's relationship with its insureds.

Each year, insureds will be asked to furnish the Company with their most recent audited financial statements. Insureds will also be asked to furnish a summary of any changes in senior management or other internal or external events that might have a significant effect on its operations. If appropriate, the underwriting staff will contact representatives of such insureds to obtain further information. Then, and if necessary in the opinion of management, a report will be prepared for the board of directors containing management's recommendations as appropriate. If the board of directors so directs, management will initiate high level contacts with any insured experiencing any difficulty which might affect future payments and will work closely with such local officials to assure a successful outcome.

Underwriting, in addition to monitoring and surveillance, for Issuers Mutual will be done under the direction of the Executive Vice President for Underwriting who will hire a staff of municipal analysts to assist.

## **Risk**

**Risk of the Enterprise.** "Risk of the Enterprise" means that the Company is not able to conduct its business either at the onset, or at some time in the future. This could come about under a variety of unlikely scenarios.

First, the federal government could create a competing company that charges premiums so low that the Issuers Mutual could not possibly compete. This will be most unlikely if the U.S. Treasury invests \$5.0 billion in Issuers Mutual, as planned. But it is possible that the Congress might enact legislation creating such a company, notwithstanding the investment by the Treasury. In such case, the Company would cease operations, place its extant book of business into run-off and return any unneeded Surplus to the Treasury. The balance of Treasury's

investment would be repaid over time, less run-off expenses, as the underlying insured bonds matured.

Another unlikely scenario would be if the remaining commercial municipal bond insurers (and potential new market entrants) reduced their premiums to the point where Issuers Mutual could not compete. This is most unlikely for two reasons. First, in order to raise capital, commercial insurers will have to offer private equity investors returns in the 15-20% range. This will put extreme pressure on the premium rates they would have to charge. Issuers Mutual has no such pressure. In addition, Issuers Mutual's investment earnings compound at tax free rates, a luxury which commercial insurers cannot enjoy. But, even if commercial insurers effectively pushed Issuers Mutual out of the market, it would then simply cease operations, put its book into run-off and return its capital to the Treasury and then to its Members.

A third scenario would be if interest rate spreads collapsed to the point where municipal bond insurance, itself, was no longer a viable option for issuers. In such case, Issuers Mutual's board would certainly wait an appropriate time until it was certain that this market change was permanent, and then put the Company's book into run-off and pay out unneeded Surplus to the Treasury and its Members, as above.

A fourth scenario might be where the rating agencies devised a unitary rating system that had the effect of collapsing the spreads as in the third example above. In such case, Issuers Mutual would cease operations and wind up its affairs as described above.

Finally, there is always *force majeure*. If some great, unforeseen event renders municipal bond insurance unviable as an enterprise, then Issuers Mutual would cease operations and wind up its affairs, again, as described above.

**Risk of Loss.** "Risk of Loss" is the risk of losing money by making bond payments on behalf of defaulting or delinquent issuers.

The Company is designed to withstand losses at many times the historical loss rates of municipal bonds. First, the Company uses Moody's historical loss rates for municipal bonds which, at 0.2% of par, are significantly higher than Standard & Poor's estimate of 0.07% of par. Second, the Moody's estimate is for *all* municipal bonds. Issuers Mutual will limit its classes of business to only general obligation bonds and revenue bonds for essential governmental services. It will not venture into the dicey waters of private-activity bonds, non-profit institution bonds, or non-essential government service bonds. Thus, Issuers Mutual can expect to suffer far fewer losses than the general municipal bond market as a whole.

Finally, and most importantly, is the degree to which the premiums charged by Issuers Mutual exceed expected losses. Issuers Mutual is charging an average premium of 1.1% of par.

Now, the Moody's loss estimate is 0.2% of par which in this example, of a \$1 million bond, is \$2,000. Thus, to cover a projected loss of \$2,000, Issuers Mutual will receive about \$11,000 in premium, which is more than 550% of the Moody's default rate.

It should also be noted that the Pro Forma GAAP Cash Flow Projections that accompany this document write off all losses in the year of bond issuance, a position that is more conservative than the Financial Accounting Standards Board's (FASB) procedures, more conservative than the National Association of Insurance Commissioners' (NAIC) Statutory Accounting Procedures (SAP), and even more conservative than the accounting requirements of the State of New York, which are the strictest.

There are two other factors that mitigate Issuers Mutual's risk that are worth mentioning. The first relates to famed investor Warren Buffet's aside in the section of his annual report dealing with the Berkshire Hathaway Assurance Corporation, a municipal bond insurance company that entered the market with a triple-A rating in early 2008 and was downgraded to double-A in April of 2009. Mr. Buffet speculated that local government officials might be more willing to default on their bonds that carried commercial municipal bond insurance, because, after all, they had paid a large premium; and, since the insurance company would then be paying the bondholders, no one would be hurt. Municipal bond insurance has been around since 1971. There is no evidence, whatsoever, to support Mr. Buffet's conjecture. But, nonetheless, even if it were true, the most cynical local government officials must have pause in defaulting on a bond insured by Issuers Mutual, since they and, their peers, own Issuers Mutual. Thus, peer pressure is a small, but noteworthy, mitigator of risk of loss to Issuers Mutual.

The last note is about recoveries. Of the very few issuers who default on their bonds, more than 90% of General Obligation bonds and over 70% of general revenue bonds resume payment after the issuers straighten out whatever problem caused the default. These recoveries are the subject of elaborate modeling scenarios which the rating agencies use to assess "stress" on municipal bond insurers. They have not been made a part of this business plan because Issuers Mutual has taken the unusually conservative approach of writing off – totally, without any recoveries – all defaults in the year of bond issuance.

So, there will be losses for Issuers Mutual. But they will be manageable; and they are well provided for in the accompanying financial projections.

**Risk to the United States Treasury.** The risk of loss to the U.S. Treasury is exceedingly remote. First, as is clear from the above subsection, the pro forma premium to be charged exceeds Moody's historical default rate for all bonds by 550%. This, alone, should assure the Treasury that their investment is safe.

In addition, the Pro Forma GAAP Cash Flow Projections in Appendix A indicate that the \$3.0 billion of Surplus, 100% of which the Treasury will have contributed in Year One and the

additional \$1.0 billion of call capital which they will have contributed in Year Seven, has blossomed by Year Ten into a Surplus of \$8.8 billion. So, again, there will be ample funds available to repay the Treasury for its initial capital contribution.

## **Assumptions for Pro Forma Cash Flow Projections**

**Bond Market Volume.** SIFMA reports \$391 billion of bond issuance in 2008. Issuance so far in 2009 looks pretty much the same. So, for round numbers, \$400 billion of issuance is estimated in 2009, rising 2% per year, thereafter.

**Market Share.** The estimated market share for Issuers Mutual is: 10%, 20%, 30%, 40%, and 50% of the insured market (50% of the total market, close to the SIFMA historical average, ex 2008) in the first five years, respectively.

**Gross Written Premium.** This is the total premium which is paid upfront at closing. It is 1.12% of par.

**Earned Premium.** Premium is earned annually by a specific ratio applied to the Gross Written Premium. The formula for the ratio is: “the number of years remaining on the bond (in any given year) divided by the total number of bond years (1 + 2 + 3 + 4 + .....23 = 321)”. In the first year of our average bond, there are 23 years remaining; so the earned premium ratio for year #1 is 23/321, or .0717. In year #2, the ratio is 22/321, or .0685, and so on.

**Investment Return.** Investments are at an assumed rate of 5%. Because all losses are written off, in this pro forma, in the year the bond is insured, there is no provision for shorter-term investments. A half-year convention is observed for the investment of all current income.

**Operating Expenses.** These are roughly estimated at 30 staff at an average annual cost of \$150,000 each, plus another \$2.5 million for premises, IT, legal, regulatory, accounting, etc., or \$7 million in Year One. This sum increases at a rate of 5%. This is a very conservative estimate since it is most unlikely that 30 staff will be needed for several years.

**Losses.** Moody’s estimates losses on ALL municipal bonds at 0.2%. Standard and Poor’s estimates such losses at 0.07%. Although Issuers Mutual is not insuring ALL municipal bonds, just GOs and essential service revenue bonds, the larger Moody’s loss estimate has been used here, for conservatism sake. In addition, all losses are written off in the same year the bond is insured. This method of dealing with losses is more conservative than Financial Accounting

Standard Board Ruling #163, Statutory Accounting Procedure #60, and the New York Insurance Superintendent’s rules which are the strictest in the country.

**Representation of Liability.** Most municipal bond insurers represent outstanding liability by showing the arithmetic sum of all future insured bond payments against current capital and surplus. This can be confusing. The first number is not a present value, while the second, necessarily, is. So, you have apples and oranges. Furthermore, none of this takes into account the unearned premium reserve, which can surely be applied to future bond payments. Suffice it to say, that Issuers Mutual represents Liability as “outstanding par value divided by surplus”. Again, there is no use of unearned premium reserve.

### Summary of Pro Forma GAAP Cash Flow Projections

Below is a summary of the highlights of the Pro Forma GAAP Cash Flow Projections for Issuers Mutual in Appendix A. The numbers represent key indicators over the first five years of operation as well as the sum of the first ten years of operation in the last column.

Year	(Billions)					Total 10 years
	1	2	3	4	5	
Bonds Insured	\$20	40.8	62.4	84.9	108.2	891
Losses	\$0.04	0.08	0.13	0.17	0.22	1.78
Surplus*	\$3.12	3.26	3.42	3.64	3.95	8.81
Capitalization Ratio	6.4x	18.5x	35.5x	55.7x	77.4x	91x

\* Surplus shows \$3 billion contributed by Treasury in Year One and another \$1 billion in Year Seven, as is required to maintain a 100:1 capitalization ratio. In this scenario, the final \$1 billion of call capital from the Treasury is not needed. (Issuers Mutual has prepared an additional scenario showing a more aggressive market penetration where all \$5 billion is required to maintain a 125:1 capitalization ratio.

Most important for bond purchasers is the Surplus and the Capitalization Ratio. These numbers indicate an extremely strong financial position even after having paid off almost \$1.8 billion of losses.

Commercial municipal bond insurance companies have traditionally enjoyed Capitalization Ratios for the general obligation and essential service revenue bond segments of their portfolios in the 200x range. Issuers Mutual's 10-year Capitalization Ratios reflect its extremely conservative approach to the business which is designed to instill confidence in the minds of bond buyers which will be reflected in lower interest rate payments for state and local governments and their agencies that buy Issuers Mutual's bond insurance.

## **Investments**

**Limited Classes of Investments.** The vast majority of the funds held by Issuers Mutual will be invested in long-term securities of federal government agencies or other long-term, fixed-rate securities that are rated triple-A.

**Short-term Investments.** A minimal amount of funds will be invested for short-terms to provide necessary working capital.

**Liquidity.** The Company will obtain a liquidity facility from a major bank to pay for losses and delinquencies and to assist in the management of its cash flow. This facility is not shown on the accompanying Pro Forma GAAP Cash Flow Projections because they reflect the most conservative scenario where all losses are deemed to occur in the year of bond issuance and are written off totally in that year.

## **Reinsurance**

It would be prudent, albeit not absolutely necessary, for Issuers Mutual to seek some reinsurance<sup>5</sup>.

Although Issuers Mutual's target market will be for smaller, less frequent issuers who are experiencing difficulty accessing the market, it would nonetheless be advisable for the Company

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<sup>5</sup> Rooted in a centuries-old, colorful history, the reinsurance industry retains much arcane terminology. The relevant taxonomy of reinsurance is as follows. There are two basic types of reinsurance: treaty reinsurance which covers a multiplicity of similar risks, and facultative reinsurance which covers only a single risk. These categories are further subdivided into two generic subcategories: quota-share reinsurance which is (and would otherwise be called) pro rata insurance, and excess-of-loss, or just "excess", which is exactly what it says: it covers losses in excess of a certain dollar amount (similar to the deductible on a homeowners' or automobile policy). To complicate matters even further, there is also quota-share excess insurance on both a treaty and facultative basis. Finally, in reinsurance argot an insurer with a risk that it wants to reduce "cedes" the risk to the reinsurer and pays the reinsurer part of the premium it has received from the customer.

to be able to underwrite risks of larger, more well-known issuers as well. Risks of one issuer, however, are limited by the New York State Insurance Law to 10% of Surplus. In this regard, without reinsurance, Issuers Mutual will be limited to \$300 million of risk from any one issuer. This is not enough to play a meaningful role in the market for larger cities, counties, and agencies some of which have billions of dollars of outstanding bonds. This situation will change over time. By Year Ten, even after the repayment of the Surplus Note to the Treasury, Issuers Mutual will have well over \$8 billion of Surplus and will be able to underwrite over \$800 million of risk from one issuer.

Until its Surplus builds to levels sufficient to do meaningful underwriting in this segment of the market, it will be prudent for Issuers Mutual to negotiate a quota-share reinsurance treaty for readily identified larger issuers such that the Company will be able to assume the risks of a single issuer up to \$500 million as determined by the Company's board. In order to accommodate single large issues, Issuers Mutual may cede facultative reinsurance (if it is available) on either a quota-share or excess of loss basis.

The market for financial guaranty reinsurance has largely collapsed along with the primary market. There are no remaining monoline<sup>6</sup> commercial municipal bond insurers with a triple-A rating; but there are others with lesser investment-grade ratings. There are also multi-line insurance companies to whom Issuers Mutual might cede reinsurance.

In terms of capital adequacy, the rating agencies do not give 100% credit for reinsurance ceded to anything less than a triple-A rated monoline. Less than 100% credit is given for monolines with double-A, or below, ratings and for all multi-lines regardless of rating. (The credit reduces commensurately with the rating.) This, however, should not pose a problem for Issuers Mutual because of its strong capitalization ratios.

Nonetheless, when negotiating its treaties, Issuers Mutual will need to balance price against capital adequacy considerations.

Finally, if reinsurance is unavailable at a reasonable price in the commercial market, Issuers Mutual will work with the U.S. Treasury to increase its ability to serve large issuers by devising either reinsurance or synthetic reinsurance to accommodate these legitimate needs.

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<sup>6</sup> Monoline insurers are those limited by law to the business of financial guaranty insurance. Multi-lines are property and casualty insurers who sell traditional insurance in those fields.

## **Benefits to Issuers**

Issuers who purchase municipal bond insurance from Issuers Mutual will enjoy substantial interest savings. For example, if an issuer's bonds sell at 100 basis points (bp) above those of Issuers Mutual, they will enjoy a savings of the spread (100 bp) less the cost of insurance (11 bp) for an annual savings of 89 bp, which is \$8,900 per million dollars of par. So, on a \$10 million bond, the issuer will save \$89,000 per year in interest rate costs.

In addition, Members of Issuers Mutual will be entitled to a pro rata share of the Surplus of the Company after all losses are paid (or adequately reserved for), all trade creditors are paid, and after all payments are made to the U.S. Treasury on the Surplus Notes which were purchased to provide the initial capital for the Company. Thus, with a Year Ten Surplus of \$8.81 billion, after repaying the \$4 billion contributed by the U.S. Treasury, the Members of Issuers Mutual will be entitled to a pro rata share of the \$4.81 billion remaining.

It should be noted that under New York Law, mutual insurance companies may only make distribution of excess Surplus to their members with the permission of the New York State Superintendent of Insurance. At its discretion, the Board may elect to apply to the New York State Superintendent of Insurance for permission to make distributions of Surplus, not needed for continuing operations, both to the U.S. Treasury and to Members of the Company.

## **Credit Rating**

This business plan for Issuers Mutual has been prepared in accord with the published criteria of the three major credit rating agencies. It is expected that the Company will receive a triple-A rating from all three. However, in the event that one or more of the rating agencies concludes that it will not issue a triple-A rating for any monoline financial guaranty insurer regardless of capitalization or any other consideration, then the Company will seek whatever the highest credit rating is that such rating agency will issue.

There are many factors which the rating agencies consider when evaluating bond insurance companies. One of the most important of these is the Capitalization Ratio which expresses the ratio of par exposure to GAAP Surplus. Issuers Mutual will strive to maintain a Capitalization Ratio below 100:1, but in no event will it exceed 125:1. These are very conservative ratios.

## **Regulation**

As an insurance company, Issuers Mutual will be subject to regulation by the commissioners of insurance in all 50 states. This is not as onerous as it seems because there is close coordination among the regulators through the National Association of Insurance Commissioners (NAIC).

The regulator in the state where an insurance company is domiciled is the lead regulator. New York State was the pioneer in regulating the municipal bond insurance industry, issuing the first comprehensive set of regulations for the business in 1986. Since then, New York has continued its lead role and is regarded by the financial services industry, as a whole, as the strictest of all the state regulators.

Issuers Mutual has chosen New York as its domicile precisely for this reason. In order to maintain the pristine reputation it needs for success, the Company must subject itself to the most severe tests of the regulators. The Company does not foresee any difficulty in complying with the insurance law and regulations of New York State, or of any other state.

## **Transparency and Accountability**

**Transparency.** The funds that the National League of Cities is requesting from the U.S. Treasury will come ultimately from the U.S. taxpayers. Lending \$3 billion to Issuers Mutual, as start-up capital, will probably be one of the wisest investments that can be made with these funds. Counting only the over \$890 billion of bonds insured by Issuers Mutual over the first ten years of operations, as shown in the accompanying Pro Forma GAAP Cash Flow Projections, and using 100 bp as an average spread, the Company will save the American people over \$7 billion per year.

But saying that an investment in Issuers Mutual is wise is not the same thing as proving it. Issuers Mutual owes it to the American people to demonstrate that its funds have been wisely invested.

Therefore, Issuers Mutual will take the unusual step of adopting a policy of complete disclosure and will manifest this commitment by publishing its affairs on the Internet.

In this regard, Issuers Mutual will every month list each bond it insures on its website along with the premium charged and the estimated savings to the issuer over the lifetime of the bond. The Company will also publish the amounts of its Surplus and of its Unearned Premium Reserve. For the sake of complete clarity, it will provide this latter data in three formats, according to: Generally Accepted Accounting Principles, Statutory Accounting Procedures, and the regulations of the New York State Superintendent of Insurance.

**Accountability.** Issuers Mutual must be accountable to five important stakeholder groups: its Members/issuers, bond buyers, the regulators, the rating agencies, and the U.S. Treasury.

The Company must be accountable to its issuers, who must know and be able to quantify and demonstrate to their own constituents that they are achieving real savings by insuring their bonds with Issuers Mutual.

The Company must be accountable to bond buyers, who must be able to conclude that the Issuers Mutual insurance on the bonds they purchase provides true assurance that they will, indeed, be paid in the event of any delinquency or default by the issuer. They must know that the Company has more than adequate funds and the determination to make such payments.

The Company must be accountable to federal and state regulators, who must be assured that the Company is hewing the business plan that they approved, that estimated Surplus is sufficient to cover projected losses, and that such funds are being invested in accord with their requirements.

The rating agencies, too, must be assured that the business plans upon which their ratings are based are, in fact, being carried out; that actual capital is both adequate and in accord with estimates; and that the Company remains true to the classes of businesses to which it has limited itself.

Finally, having received its initial capital from the U.S. Treasury, the Company must be accountable and provide proof that Treasury's investment, and faith, in Issuers Mutual is well placed; and that the Company both provides substantial savings to the citizens/constituents of the government agencies whose bonds it insures and also that it ultimately will repay the \$4 billion of funds advanced to it by the Treasury.

The primary means of achieving accountability will be through the policies of complete transparency as described in the preceding section of this document. In addition, the Company, through the offices of the Executive Vice President for External Affairs, will maintain continuing personal contacts with each of these important stakeholder groups.

Only by being completely accountable to all of these five important constituencies, will Issuers Mutual be able to fulfill its unique and singular mission of reducing the cost of state and local government borrowing.

## **Appendix A: Pro Forma GAAP Cash Flow Projections**



Operations	\$7.00	\$7.35	\$7.72	\$8.10	\$8.51	\$8.93	\$9.38	\$9.85	\$10.34	\$10.86	
Losses	\$40.00	\$81.60	\$124.85	\$169.79	\$216.49	\$220.82	\$225.23	\$229.74	\$234.33	\$239.02	\$1,781.86
Total Expenses	\$47.00	\$88.95	\$132.57	\$177.90	\$224.99	\$229.75	\$234.61	\$239.59	\$244.67	\$249.88	
Net Operating Income	\$123.80	\$131.69	\$164.33	\$222.54	\$307.19	\$444.51	\$635.27	\$779.79	\$927.03	\$1,077.22	
End Surplus	\$3,123.80	\$3,255.49	\$3,419.82	\$3,642.36	\$3,949.55	\$4,394.07	\$6,029.34	\$6,809.13	\$7,736.16	\$8,813.38	
End Unearned Premium Reserve	\$207.99	\$616.93	\$1,220.12	\$2,011.20	\$2,984.20	\$3,903.87	\$4,772.78	\$5,593.55	\$6,368.84	\$7,101.38	
Bond Amortization Ratios											
Principal = \$1	1.0000	0.9764	0.9485	0.9195	0.8892	0.8577	0.8249	0.7908	0.7552	0.7182	
Rate = 4.11%	0.0411	0.0401	0.0390	0.0378	0.0365	0.0353	0.0339	0.0325	0.0310	0.0295	
Term = 23 years	0.0236	0.0279	0.0291	0.0303	0.0315	0.0328	0.0341	0.0355	0.0370	0.0385	
Payment = \$68,044											
Annual Outstanding Bonds Insured	\$20,000	\$19,529	\$18,970	\$18,389	\$17,784	\$17,154	\$16,498	\$15,815	\$15,105	\$14,365	
		\$40,800	\$39,838	\$38,700	\$37,514	\$36,279	\$34,994	\$33,656	\$32,264	\$30,813	
			\$62,424	\$60,953	\$59,210	\$57,396	\$55,508	\$53,541	\$51,494	\$49,363	
				\$84,897	\$82,896	\$80,526	\$78,059	\$75,490	\$72,816	\$70,032	
					\$108,243	\$105,692	\$102,671	\$99,525	\$96,250	\$92,841	
						\$110,408	\$107,806	\$104,724	\$101,516	\$98,175	
							\$112,616	\$109,962	\$106,818	\$103,546	
								\$114,869	\$112,161	\$108,955	
									\$117,166	\$114,404	
										\$119,509	
Total Outstanding Bonds Insured	\$20,000	\$60,329	\$121,233	\$202,938	\$305,647	\$407,456	\$508,152	\$607,583	\$705,590	\$802,004	
Capitalization Ratio	6.40	18.53	35.45	55.72	77.39	92.73	84.28	89.23	91.21	91.00	