

Ambac

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Ambac holdco/opco flip in CDS signals receivership bets are on the rise

The CDS market is signaling increased fears that Ambac operating company Ambac Assurance will enter receivership within the year as fear of a municipal bond crisis spreads.

The cost of short-term credit default swaps written on Ambac's holding company Ambac Financial widened significantly in February relative to the price of protection on Ambac Assurance. Investors repriced the differential between the credits on growing expectations that the opco will enter receivership this year, according to two CDS traders and three analysts.

Previously, investors believed that state regulators might order American Assurance to stop paying out insurance claims but would balk at placing the company in receivership. Under that scenario, the holdco would survive on dividends from the opco until at least 2011 that would be cut off immediately in a receivership scenario.

The bankruptcy filing in February of Las Vegas Monorail Corporation (LVMC) and the prospect of proliferating municipal defaults forced fund managers to revisit those assumptions.

Two investors who said that they placed a low probability on receivership in November indicated in interviews this week that they believe the chance of receivership has increased. Both sources cited fear of a municipal default epidemic and the opacity of Ambac's finances as contributing factors.

"The logic is that the holdco wouldn't survive a receivership at the opco," said a buysider.

If the Wisconsin Insurance Commission forced Ambac Assurance to stop paying policies but kept the insurer out of receivership, it would trigger failure to pay on the CDS referencing the opco without causing an immediate credit event for the holdco. However, receivership at the opco would likely force Ambac Financial into bankruptcy, triggering its CDS as well.

CDS referencing both Ambac entities enjoyed a brief rally in November following the announcement of a surprisingly high statutory capital surplus. But as municipal and sovereign debt fears rose and Reuters reported in February that the monoline itself had hired workout specialist Blackstone Group, the credit lost its luster.

One-year holdco contracts traded roughly six points inside CDS on the opco in January at 37.5 and 43.5, respectively, according to dealers and a buyside trader. That differential tightened to two points by early February and to less than one point on 1 March when both contracts were quoted in the mid to low 50s.

Five-year contracts on the companies followed a similar trajectory, starting the year four points apart before ratcheting in to trade virtually on top of each other around 65, the sources said.

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The Chapter 11 bankruptcy filing of the LVMC last month, and Ambac's exposure to the credit, reminded investors that the US has its own version of a sovereign crisis brewing in the municipal market, noted the first analyst.

Ambac disclosed wraps on USD 47bn par value of tax-exempt securities as its largest selected exposure to the asset class as of September 2009. The next largest groupings are insurance written on USD 37bn of structured finance instruments and USD 35bn written on subprime RMBS bonds, respectively, according to data on Ambac's website. The company is slated to release full 2009 earnings on 16 March.

Currently the MCDX index of municipal bond CDS is trading 50bps wide to the corporate CDX IG, noted a second analyst. The MCDX moved wider in November of last year after trading tighter for much of the summer and fall, he added.

The LVMC filed for Chapter 11 protection in the district of Nevada last month with roughly USD 648m in municipal bond debt outstanding. Ambac wrapped the debtor's USD 451m 5.625% first tier notes due 1 January 2032, which are secured by LVMC revenue. Ambac claims its total exposure to the LVMC debt is USD 1.16bn, according to court documents

The filing will eventually crystallize losses that had previously sat in a reserve on the company's balance sheet, as previously reported.

Heading into Ambac's release of 2009 earnings on 16 March, investors have re-upped their trades on the credit and paid particular attention to the holdco/opco interplay, noted the two CDS traders.

Investors have also put on new curve trades including both credits, selling protection at the two-year part of the curve while buying at five, as a sort of survivor option play that profits regardless of whether a credit event occurs, noted the third analyst.

Ambac Financial generated positive net cash flow of USD 41m over the first nine months of 2009, according to SEC filings. With USD 165m of cash, short term investments, and bonds on hand, the company has liquidity to pay interest expense until at least 2011, as previously reported.

Ambac, which had USD 165m in liquidity at the end of 3Q09, expects to pay USD 2.5bn in claims in the next five quarters, offset by investment income of USD 921m and premium payments of USD 475m. The USD 1bn shortfall is expected to be closed with, among other things, loan put-back proceeds and a USD 400m tax refund from a recently changed tax law regarding NOL carry backs, according to company statements.

Ambac did not return calls and Blackstone declined to comment.

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Media Enquiries:

Hannah Bagshawe
Global Head of Public Relations
Tel: +1 646 378 3194
hannah.bagshawe@debtwire.com