Associated Press

S&P Downgrades ACA to Junk Status

21 minutes ago

NEW YORK (AP) — A major insurer of bonds was downgraded to "junk" status on Wednesday, a move that could potentially cost banks and local governments billions of dollars.

Credit rating agency Standard & Poor's slashed its credit rating for bond insurer ACA Financial Guaranty Corp. to a non-investment grade "CCC" from investment grade "A." S&P cited concerns about increasing claims from defaults on mortgage-backed bonds, and the risk that those claims could drain the bond insurers of needed capital.

The downgrade of ACA led S&P to cut ratings on nearly 3,000 municipal bonds, which could may spark a municipal borrowing crisis, according to Peter Schiff, chief executive of Euro Pacific Capital.

"Many municipalities get high credit ratings because their bonds are insured," said Schiff. "Higher borrowing costs for cities will force them charge higher property taxes, which will increase the strain on consumers. And some cities may be shut out of the credit markets."

The new strain on civic funding comes at the same time that plummeting home sales and values and rising mortgage defaults threaten to drain local coffers of property taxes. Many cities have been banking on higher property taxes, but now homes are being valued lower and this also reduces funds available to the cities, he said.

Many of the municipal bonds downgraded by S&P were cut below the underlying rating of the municipality. The reason, said Axel Merk, manager of the Merk Hard Currency fund, is because bonds can be linked to specific projects or future revenue streams.

"These bonds could be linked to property taxes or sales tax — anything," he said. "They are not necessarily backed by the full credit of the municipality."

The downgrade of ACA will essentially not allow it to continue insuring bonds, since most people will not buy insurance on bonds from a firm that does not have top-quality ratings.

Downgrades of bond insurers can also lead to losses at the companies who use them. Only minutes after S&P's downgrade of ACA, CIBC World Markets said insurance for $3.5 billion in securities it holds backed by subprime mortgages may no longer be viable.

"It is not known whether ACA will continue as a viable counterparty to CIBC," the Canadian firm said. CIBC said there is a "reasonably high probability" it will take a large charge for the period ending Jan. 31.

The S&P action on ACA comes amid reports investment banks, including Merrill Lynch & Co. and Bear Stearns Cos., were in talks to bail out the struggling bond insurer. Merrill Lynch and Bear Stearns were not immediately available to comment.

Bear Stearns declined to comment on any bailout speculation, directing calls to ACA itself. A Bear Stearns spokesman did add, though, that the investment bank was a small creditor of ACA and thus has little exposure to the bond insurer.

ACA and Merrill Lynch did not immediately return calls seeking comment.

As part of a mass review of the bond insurers, S&P also placed Financial Guaranty Insurance Co. on negative credit watch. FGIC currently carries a "AAA" rating. A negative watch means there is a one-in-two chance the rating could be downgraded in the next three months.

Ambac Financial Group Inc., MBIA Insurance Corp. and XL Capital Assurance Inc. were all placed on a negative outlook by S&P, though their ratings remained unchanged. A negative outlook means there is a one-in-three chance ratings will be cut in the next two years.

Shares of ACA were trading over-the-counter at 56 cents in afternoon trading. ACA shares had traded as high as $16.55 earlier in the year.

AP Business Writers Jeremy Herron, Leslie Wines and Joe Bel Bruno contributed to this report from New York.