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## Detailed Results Of Subprime Stress Test Of Financial Guarantors

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# Detailed Results Of Subprime Stress Test Of Financial Guarantors

Standard & Poor's Ratings Services, continuing its series of stress tests of the monoline financial guarantors with respect to their domestic nonprime mortgage exposure, today announced several rating actions (see "S&P Takes Additional Bond Insurer Rating Actions," published Feb. 25).

For this review, we developed a set of net cumulative loss assumptions by asset type and vintage that we believe will likely turn out to be no less than, and perhaps higher than, the ultimate loss levels experienced. As such, save for the possibility of materially adverse asset class performance beyond our current expectations, we view this stress test as one that will retain its relevance over time.

Nevertheless, given the unprecedented level of mortgage market deterioration that has occurred, we remain circumspect about assigning stable outlooks to insurers even if they have sufficient capital when measured against our projected stress case losses. Accordingly, we will still assign negative outlooks to those firms with significant exposure to domestic nonprime mortgages and/or meaningful lower credit quality exposures. The assignment of a negative outlook may also reflect our assessment with regard to the comprehensiveness and degree of completion of projected capitalization strengthening efforts underway.

The financial strength ratings of Assured Guaranty Corp. (AAA/Stable), Financial Security Assurance Inc. (AAA/Stable), and Radian Asset Assurance (AA/Stable) were not reviewed in conjunction with this latest stress test. These companies do not have material amounts of direct nonprime mortgage or ABS CDO exposure and therefore, in our view, are not at risk to have significant losses from these sectors. We also did not review the 'CCC' financial strength rating of ACA Financial Guaranty Corp. because the company is in negotiations to modify its obligations to its counterparties. ACA's rating remains on CreditWatch with developing implications, reflecting the dual possibilities that a favorable result of the negotiations could improve the company's credit standing, while a negative outcome could leave the company with significant liquidity and capital shortfalls.

## Rating Actions

- The 'AA' financial strength rating of Financial Guaranty Insurance Co. has been lowered to 'A' and remains on CreditWatch with developing implications.
- The 'AAA' financial strength ratings of XL Capital Assurance Inc. and XL Financial Assurance Ltd. have been lowered to 'A-' and remain on CreditWatch with negative implications.
- The 'AAA' financial strength rating of MBIA Insurance Corp. has been affirmed and has been removed from CreditWatch. The outlook is now negative.
- The 'AAA' financial strength rating of Ambac Assurance Corp. has been affirmed and remains on CreditWatch with negative implications.
- The 'AAA' financial strength ratings of CIFG Guaranty, CIFG Europe, and CIFG Assurance North America Inc. have been affirmed and continue to have negative outlooks.

## Capital Resources And Financial Flexibility

While varying by guarantor, the industry has a number of options available for raising capital. At-risk companies are in various stages of planning with respect to some or all of these options. These options include excess-of-loss type reinsurance, traditional quota share reinsurance, raising additional debt or hybrid debt, issuing preferred stock through existing contingent capital trusts, raising additional equity, or common stock dividend curtailment. The industry also has a powerful capital-raising tool at its disposal that is not directly reliant on third parties. Reducing future business and/or focusing business initiatives on activities with lower risk (and thus, lower capital charges) can free up hundreds of millions of dollars as an added capital cushion. (The Standard & Poor's capital adequacy model and the associated capital cushion are sensitive to assumptions about future business volume.) Finally, the annuity-like earnings characteristics of the industry have the potential to help replenish statutory capital. We expect that earned premiums will remain substantial relative to previous years even as companies experience a curtailment in near-term business due to unearned premium reserve amortization, as well as earnings from existing annual payment business. Likewise, we expect investment income to be a stable revenue element.

A summary of our analytic approach and the assumptions used to test the ability of the financial guarantors to withstand mortgage market stress follows.

## Capital Adequacy Stress Test

We tested the capital adequacy of the various primary bond insurers against a scenario that applies stressful default assumptions to various RMBS-related transactions that the companies have insured. The insured direct RMBS transactions (direct RMBS) and tranches of uninsured RMBS transactions (tranching RMBS) are components of the collateral backing insured CDOs. We based the default rates for these transactions on stressful cumulative net loss assumptions supplied by our Structured Finance department that vary by asset type and vintage. We have included the Alt-A, subprime, closed-end second, home equity line of credit (HELOC), and net interest margin (NIM) asset types with 2005, 2006, and 2007 vintages in this analysis. Table 1 shows the cumulative net loss assumptions for each of the asset classes by vintage.

These loss assumptions are the same as those used for our Jan. 17, 2008, review of the bond insurers except that we have increased the 2006 and 2007 Alt-A loss expectations. We changed the 2006 assumption to 5.5% from 3.5% and increased the 2007 assumption to 9.0% from 3.5%. These levels are higher than those currently published by our structured finance department; however, they were established to add a higher level of stress in evaluating the bond insurers' capital adequacy consistent with the goals of this review.

To stress the direct RMBS component of the bond insurers' total exposure, we developed rating-sensitive loss assumptions for individual insured transactions in each asset class. We also converted the various asset-type loss assumptions to probability distributions of outcomes using internal data of projected losses for individual transactions. Each of the theoretic outcomes were compared with typical credit enhancement levels for such transactions to determine if the transactions defaulted or not, and if so, what the losses would be. Factoring in the probability of each possible outcome produces an analysis that defines the expected losses at each rating level for transactions in the various asset classes and vintages. Table 2 shows the results of this analysis.

We computed the expected loss on each transaction based on the original par value and original rating of the

transaction. Next, we adjusted the accumulated results to reflect the reality that the bond insurers' underwriting and risk remediation processes result in better overall loss rates. We effected this adjustment by reducing expected losses by a modest amount. Finally, we converted the calculated results to a present value by discounting the losses at 5% per year over a five-year period, assuming an equal payout in each period and adjusting for taxes. Table 6 shows the results of this analysis.

For CDOs, we computed rating-sensitive tranche loss assumptions using the same methodology described for computing rating-sensitive loss assumptions on direct RMBS transactions. To reflect the comparatively poorer performance of CDOs versus RMBS transactions, we increased the loss assumptions in table 1 (except for the 2006 and 2007 Alt-A asset classes discussed above) by 10%. (Table 3 shows the results of this analysis.) For each insured CDO, we computed incremental collateral pool losses on all the asset types with 2005-2007 vintages based on the same methodology as described for computing losses on RMBS transactions. In this case, however, there was no adjustment for better underwriting and the present value methodology was changed to reflect different payment patterns. We removed the better underwriting adjustment since the collateral of the wrapped CDOs is not insured, and therefore does not benefit from the insurers' underwriting and risk remediation expertise. We changed the period for the present value adjustment to 10 years, reflecting the structural features of the CDOs, which often require interest only until the final maturity.

For the portion of the CDO collateral that was made up of tranches of other ABS CDOs, we determined incremental loss assumptions based on the typical asset composition of such CDOs. We added additional capital charges to ABS CDOs that are likely to be subject to the negative effects of event-of-default triggers. (Table 4 shows these loss assumptions.) We handled possible losses on CDO squared transactions on a case-by-case basis. Incremental losses were then aggregated to determine the collateral pool impairment.

We then compared the collateral impairment to the subordination supporting the tranche that the bond insurer had insured. In the vast majority of cases, bond insurers have insured a "super senior" tranche, meaning that the subordination supporting the insurer's insured tranche is at least 1.3x the level required to achieve a 'AAA' rating. The "subordination impairment ratio" (the ratio of collateral impairment divided by available subordination) shows how much of the available subordination would be lost to theoretic incremental losses.

Subordination impairment ratios above 1.0 signify that theoretic incremental losses would exceed the available subordination. Ratios below 1.0 signify that theoretic incremental losses would be less than the available subordination in the CDO. In this case, the insurer would not incur a loss. Four categories of CDO impairment ratios under 1.0 were defined and incremental capital charges were assigned. (See table 5 for the incremental capital charges assigned and table 7 for the results of this analysis.) The theoretic capital charges varied depending on whether the CDO was "high grade" or "mezzanine." A high-grade CDO has collateral originally rated in the 'A', 'AA', or 'AAA' rating categories. A mezzanine CDO has collateral originally rated largely in the 'BBB' category.

The sum of the incremental theoretic losses on RMBS and CDOs defines the additional stress test losses. We then compared these losses to the capital cushion an insurer has in excess of the minimum amount necessary to maintain its current rating (see table 8). The capital cushion is the amount of additional losses the insurer could incur and still pass Standard & Poor's capital adequacy test. It is calculated using the margin of safety from capital adequacy results as of Dec. 31, 2007, adjusted for subsequent capital raising activity in 2008 by solving for the amount of additional theoretic loss that would bring the margin of safety down to the minimum. The margin of safety is computed as the ending capital plus theoretic losses incurred, divided by the theoretic losses incurred. For 'AAA'

rated insurers, the minimum is 1.25x. For 'AA' and 'A' rated insurers, the minimums are 1.0x and 0.8x, respectively.

For those insurers whose theoretic losses exceed their updated capital cushions, any rating action taken will reflect Standard & Poor's assessment of the comprehensiveness and degree of completion of projected capitalization-strengthening efforts.

## **Company-Specific Comments**

### **Ambac Assurance Corp.**

The 'AAA' financial strength and financial enhancement ratings of Ambac Assurance Corp. and the 'AA' rating of Anchorage Finance Sub-Trusts I-IV and Dutch Harbor Finance Sub-Trusts I-IV (committed capital facilities supported by, and for the benefit of, Ambac) and holding company Ambac Financial Group Inc. were affirmed and remain on CreditWatch with negative implications. The rating affirmation reflects our assessment of the scope of Ambac's capital-raising plans and the company's ability to implement those plans. It has been reported that Ambac plans to raise at least \$2 billion in new capital through a rights offering to existing shareholders. Success of this offering would more than cover the approximate \$400 million current shortfall of capital cushion versus projected losses. In our view, the current \$400 million shortfall is a relatively modest number relative to the size of the company's capital position. Should Ambac not execute its current capital plan, other actions, such as reinsurance transactions, could eliminate the shortfall, at least in part.

We left the ratings on CreditWatch with negative implications to reflect uncertainty surrounding the risk profile and capitalization plans for the reported new corporate structure being contemplated by the holding company.

### **CIFG Financial Guaranty**

The 'AAA' financial strength rating of CIFG was affirmed; the outlook remains negative. To support CIFG's claims-paying resources, Banque Federale des Banques Populaires (BFBP) and Caisse Nationale des Caisses d'Epargne (CNCE) contributed a total of \$1.5 billion in capital resources to CIFG Holding. The contribution was in the form of equity of \$1.3 billion and soft capital of \$200 million. BFBP and CNCE also acquired 99.99% of CIFG Holding from Natixis S.A. In our opinion, the owner's capital contribution resulted in the company satisfactorily addressing concerns relating to its capital adequacy.

CIFG's outlook was changed to negative from stable in June 2007 for reasons unconnected to its subprime exposure. Rather, we looked at the effectiveness and processes of the company's board, appropriate succession planning, and the degree of long-term support to be provided by its parent Natixis S.A. The assignment of the negative outlook also reflected our views relating to CIFG's below-average earnings and return on earnings. Nevertheless, we consider the \$1.5 billion capital contribution to be an important statement by CNCE and BFBP about their near-term commitment to the financial guaranty industry and CIFG.

### **Financial Guaranty Insurance Co.**

The ratings on Financial Guaranty Insurance Corp. (FGIC), FGIC Corp., and Grand Central Capital Trust I-VI (a committed capital facility supported by, and for the benefit of, FGIC) were lowered and remain on CreditWatch with developing implications. The downgrade reflects our current assessment of potential losses, which is higher than previous estimates. In our view, FGIC's capital cushion is inadequate to absorb those losses, resulting in a shortfall of about \$2.2 billion. We understand that the company's capital plan does not expect to raise capital adequate to offset this shortfall. In addition, we believe that there is meaningful execution risk with respect to the

elements of the capital plan.

Management is in the early stages of working toward establishing a new company and, in general, splitting its municipal and structured finance business between the new company and FGIC. The CreditWatch also reflects the uncertainty surrounding the risk profile of each company, the capitalization of each company, and the viability of those companies in the marketplace.

### **MBIA Insurance Corp.**

The ratings on MBIA Insurance Corp., MBIA Inc., and North Castle Custodial Trusts I-VIII (a committed capital facility supported by, and for the benefit of, MBIA) were affirmed and removed from CreditWatch Negative; the outlook was changed to negative. In our view, MBIA's success in accessing \$2.6 billion of additional claims-paying resources is a strong statement of management's ability to address the concerns relating to the capital adequacy of the company. It is also a strong statement by investors of their understanding of MBIA's franchise value and business practices. To further improve the company's claims-paying resources, management is pursuing alternatives to reshaping the insured portfolio through reinsurance transactions. We believe management is likely to succeed in implementing their reinsurance strategy. However, the reversion back to a negative outlook is warranted in light of the absolute size of stress scenario losses relative to the adjusted capital cushion, as well as the uncertainty surrounding a possible reconfiguration of the company. In our view, several factors--the viability of the resulting corporate structure, investor acceptance, the effect on the company's franchise value, and the potential for disadvantaging any group of policyholders with regard to the availability of claims-paying resources--will require further assessment.

### **XL Capital Assurance Inc./XL Financial Assurance Ltd.**

The ratings on XLCA, XLFA, XL Capital Assurance (UK) Ltd., and Twin Reefs Pass-Through Trust (a committed capital facility supported by, and for the benefit of, XLFA) were lowered to 'A-' and placed on CreditWatch with negative implications. The downgrade reflects our assessment that the company's evolving capital plan has meaningful execution and timing risk. In our opinion, the company's ability to access additional capital resources is uncertain. Based on each of the companies' current claims-paying resources and projected theoretical losses generated by Standard & Poor's capital adequacy model, each of the companies' margin of safety falls in the 'A' category. The CreditWatch Negative designation reflects the potential that the capital plan will not be successful.

**Table 1**

<b>Asset Class Cumulative Net Loss Assumptions (%)</b>					
<b>Vintage</b>	<b>Alt-A</b>	<b>Subprime</b>	<b>Closed-end second</b>	<b>HELOC</b>	<b>NIM</b>
2005	2.75	8.50	17.25	10.35	8.50
2006	5.50	18.80	40.00	15.75	18.80
2007	9.00	17.40	40.00	13.00	17.40

**Table 2**

<b>Direct RMBS Transaction Loss Assumptions (%)</b>						
<b>Vintage/Original Rating</b>	<b>Alt-A</b>	<b>Subprime</b>	<b>Closed-end second</b>	<b>HELOC</b>	<b>NIM</b>	
<b>2005</b>						
AAA	0.00	0.00	0.06	0.04	0.00	
AA	0.05	0.13	1.49	1.13	0.13	
A	0.38	0.80	3.75	2.98	0.80	

**Table 2**

<b>Direct RMBS Transaction Loss Assumptions (%) (cont.)</b>					
BBB	0.96	2.19	6.58	5.03	2.19
BB and lower	N/A	N/A	N/A	N/A	20.00
<b>2006</b>					
AAA	0.03	0.59	17.40	0.69	0.59
AA	1.24	5.34	26.12	4.78	5.34
A	2.47	8.86	29.91	7.91	8.86
BBB	3.41	11.66	32.82	10.40	11.66
BB and lower	N/A	N/A	N/A	N/A	20.00
<b>2007</b>					
AAA	1.78	0.08	16.18	0.36	0.08
AA	4.80	2.45	24.95	3.34	2.45
A	6.10	5.45	28.91	5.92	5.45
BBB	7.01	8.56	32.05	8.07	8.56
BB and lower	N/A	N/A	N/A	N/A	20.00

N/A-not applicable.

**Table 3**

<b>Tranched RMBS Tranche Loss Assumptions (%)</b>				
<b>Vintage/Original Rating</b>	<b>Alt-A</b>	<b>Subprime</b>	<b>Closed-end second</b>	<b>HELOC</b>
<b>2005</b>				
AAA	0.00	0.00	0.23	0.13
AA	3.03	2.50	15.29	18.29
A	31.60	22.22	45.47	57.71
BBB	66.23	45.86	64.99	74.49
BB and lower	90.51	60.34	75.00	76.10
<b>2006</b>				
AAA	0.03	1.38	22.58	1.38
AA	29.41	50.22	86.11	56.32
A	77.53	82.25	96.01	86.24
BBB	90.91	88.70	96.57	93.91
BB and lower	96.64	92.19	97.41	96.86
<b>2007</b>				
AAA	1.78	0.25	21.47	0.85
AA	79.42	27.82	84.86	49.55
A	94.08	68.09	94.49	84.35
BBB	96.76	79.70	95.91	92.43
BB and lower	98.52	85.72	96.92	96.34

NIM transactions were not tranched.

Table 4

ABS CDO Collateral Loss Assumptions (%)		
Wrapped CDO Type/Year of Origination	No event-of-default risk	Event-of-default risk
<b>High-grade CDO</b>		
2005	30.25	40.25
2006	59.40	69.40
2007	56.10	66.10
<b>Mezzanine CDO</b>		
2005	72.60	77.60
2006	82.50	87.50
2007	89.10	94.10

These loss assumptions apply to ABS CDO collateral within wrapped CDOs.

Table 5

Incremental Losses/Capital Charges On CDOs (%)		
Impairment ratio	High-grade CDOs	Mezzanine CDOs
> 1.00	Greater of calculated loss or 10.0	Greater of calculated loss or 20.0
> 0.75 < 1.00	4.0	13.6
> 0.50 < 0.75	2.2	7.0
> 0.25 < 0.50	0.6	2.0
> 0.00 < 0.25	0.4	1.4

Capital charges applied to notional value of insured CDOs.

Table 6

RMBS Exposure Information And Stress Test Results					
(Mil. \$)	Ambac	CIFG	FGIC	MBIA	XLCA
<b>Original net par written</b>					
CES	15,017.5	603.3	13,295.2	14,126.7	2,456.7
HELOCs	34,521.9	1,619.5	32,344.7	27,181.7	6,617.6
NIMs	346.1	N/A	148.0	N/A	N/A
Alt-A	15,076.8	124.5	5,537.5	4,317.0	3,046.4
Subprime	48,754.7	3,509.6	23,135.8	32,163.0	5,085.8
Total	113,717.1	5,856.8	74,461.3	77,788.4	17,206.5
<b>Current par outstanding at Sept. 30, 2007</b>					
CES	5,653.6	525.4	9,006.8	11,082.5	2,101.6
HELOCs	12,483.3	810.9	10,055.4	10,153.5	3,356.9
NIMs	27.5	N/A	18.7	N/A	N/A
Alt-A	7,789.5	89.3	2,025.5	4,118.9	2,128.5
Subprime	8,774.1	1,922.6	7,870.2	4,319.4	1,182.6
Total	34,728.0	3,348.2	28,976.5	29,674.2	8,769.5
<b>Vintage based on original par written</b>					
2004 and prior	66.9	34.0	51.4	57.2	31.8
2005	11.3	25.8	22.9	12.4	13.9
2006	12.3	29.9	19.2	14.7	32.2

Table 6

<b>RMBS Exposure Information And Stress Test Results(cont.)</b>					
2007	9.5	10.3	6.5	15.7	22.1
<b>Rating distribution based on original par written</b>					
AAA	10.2	51.8	10.3	16.1	42.7
AA	5.2	5.6	6.0	1.3	7.9
A	37.8	10.2	12.9	15.4	7.4
BBB	46.7	32.4	70.8	67.2	42.0
BB and lower	0.2	0.0	0.0	0.0	0.0
<b>Total projected losses by asset class</b>					
CES	1,580.4	141.7	2,761.1	3,511.9	468.3
HELOCs	1,013.2	85.8	740.6	857.2	362.9
NIMs	7.0	N/A	2.3	N/A	N/A
Alt-A	67.9	N/A	N/A	15.3	6.3
Subprime	215.7	1.2	129.9	2.6	18.5
Total	2,884.2	228.7	3,633.9	4,387.0	856.0
Present value of losses	2,497.5	198.1	3,146.6	3,798.7	741.3
After-tax net RMBS losses	1,623.4	194.9	2,674.6	2,469.2	741.3

N/A-not applicable.

Table 7

<b>CDO Exposure Information And Stress Test Results</b>					
<b>(Mil. \$)</b>	<b>Ambac</b>	<b>CIFG</b>	<b>FGIC</b>	<b>MBIA</b>	<b>XLCA</b>
<b>CDO net par insured with RMBS exposure as of Sept. 30, 2007</b>					
High-grade CDOs	28,683.9	2,716.1	7,508.3	25,101.0	16,595.3
Mezzanine CDOs	510.0	6,677.5	3,425.4	3,679.5	281.5
Secondary market	N/A	N/A	N/A	1,623.0	N/A
Total	29,193.9	9,393.6	10,933.7	30,403.4	16,876.8
<b>CDO net par by impairment ratio</b>					
Impairment ratios > 1.0	19,159.3	6,618.3	9,272.2	18,307.6	14,828.7
Impairment ratios > 0.75 < 1.0	1,933.0	574.8	109.5	2,158.3	14.8
Impairment ratios > 0.50 < 0.75	2,792.3	718.5	552.1	3,497.4	648.6
Impairment ratios > 0.25 < 0.50	5,309.3	923.7	0.0	1,498.6	301.1
Impairment ratios > 0.0 < 0.25	0.0	558.3	1,000.0	3,318.5	1,083.7
Secondary market	N/A	N/A	N/A	1,623.0	N/A
Total	29,193.9	9,393.6	10,933.7	30,403.4	16,876.8
<b>Theoretic loss and incremental capital charges</b>					
Impairment ratios > 1.0	4,434.6	2,161.4	3,133.7	4,531.4	2,484.2
Impairment ratios > 0.75 < 1.0	77.3	52.3	14.9	99.1	2.0
Impairment ratios > 0.50 < 0.75	61.4	50.3	38.6	147.2	14.3
Impairment ratios > 0.25 < 0.50	31.9	10.5	N/A	14.3	4.8
Impairment ratios > 0.0 < 0.25	0.0	5.0	4.0	19.4	4.9
Secondary market	N/A	N/A	N/A	284.4	N/A
Total	4,605.2	2,279.5	3,191.2	5,095.8	2,510.2

**Table 7**

<b>CDO Exposure Information And Stress Test Results(cont.)</b>					
Present value of losses	3,684.2	1,823.6	2,553.0	4,076.6	2,008.2
After-tax net CDO losses	2,394.7	1,794.4	2,170.0	2,649.8	2,008.2

**Table 8**

<b>Summary of Losses And Capital Position</b>					
<b>(Mil. \$)</b>	<b>Ambac</b>	<b>CIFG</b>	<b>FGIC</b>	<b>MBIA</b>	<b>XLCA</b>
After-tax net RMBS losses	1,623.4	194.9	2,674.6	2,469.2	741.3
After-tax net CDO losses	2,394.7	1,794.4	2,170.0	2,649.8	2,008.2
Total after-tax losses	4,018.1	1,989.4	4,844.6	5,119.0	2,749.5
Adjusted capital cushion at Dec. 31, 2007	3,600-3,650	2,250-2,300	2,650-2,700	5,500-5,550	950-1,000

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