MOODY'S
INVESTORS SERVICE

INDUSTRY OUTLOOK

Financial Guaranty Insurance Industry

2009 Review and 2010 Outlook
Legacy Risks Hinder Recovery, Despite Encouraging Signs

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Summary Opinion

Our outlook for the financial guaranty industry is negative. Despite some encouraging signs, most notably the resilient demand for bond insurance in some segments of the market, we think it is too early to call a reemergence of the sector. There is still substantial uncertainty about guarantors' ultimate losses amid a sluggish economic recovery, and a changing longer-term competitive dynamics in the industry.[1]

2010 will be a pivotal year for the industry, as we expect visibility to improve on a variety of issues that will shape the future of the industry. The year will also be marked by continued corporate developments such as restructuring, and the possible debut of new entrants. The highlights of the report follow:

» The recovery of this sector is hindered by weakened market confidence following unprecedented stress to the industry and uncertainty about ultimate losses. The challenges facing several severely impaired guarantors will continue to be their inability to meet regulatory minimum capital requirements, constrained capital access, limited liquidity, and/or litigation risks. So far, regulators have demonstrated a willingness to work with guarantors to alleviate capital pressures, but they cannot be expected to show forbearance if severe deterioration persists.

» The skepticism about financial guarantors' business model is tempered, however, by the absence of competition, the current lack of alternative credit-enhancement solutions, and the persistent demand from some municipal issuers. Only one guarantor has been active in providing bond insurance since 2009. Insurer penetration in the U.S. public finance market was down to 8.6% last year, well below the historical peak of over 50% a few years back, reflecting both the lower supply and demand of bond insurance. Nevertheless, without credit enhancement, some municipalities were not able to issue debt on favorable terms. Currently, bond insurance appears to fill market needs, and there is unmet demand. For this reason, there may be opportunity for new entrants.

» There is a greater acceptance for guarantors with higher risk profiles than in the past, but there is also a lower perceived value of their insurance and thus narrower market opportunities. Should asset spreads normalize and competitive pressures increase, this can weaken guarantors' pricing power and profitability.

[1] Moody's Special Report, "Global Macro-Risk Scenarios 2010-2011 On the "Hook" for Some Time Yet", January 2010.

Recovery Hindered by Weakened Market Confidence and Uncertainty about Ultimate Losses

The financial guarantors have been facing unprecedented stress, primarily from their mortgage related exposures. Several guarantors saw their capital positions severely impaired. Some are unable or are struggling to meet regulatory capital requirements. At the same time, guarantors have engaged in a variety of loss-remediation strategies, including putting back loans that were deemed to have breached representations and warranties, and commuting collateralized debt obligations (CDOs) with counterparties. These efforts can bear fruit and lead to material loss reduction, but the overhang of guarantors' legacy books, in light of material uncertainty in ultimate claims, continues to hinder recovery.

Market Confidence Shaken by Mortgage Losses

Recent severe stress faced by guarantors also caused disruption in other sectors such as certain segments of the U.S. public finance market, weakening broad market confidence in the financial guaranty industry. Whether actively writing business or struggling to regain market presence, bond insurers are facing a more cautious marketplace.

Several guarantors saw their financial resources severely depleted as a result of claims, mostly from direct mortgage exposures and leveraged exposures through ABS CDOs, but also through stress in their insured asset-management businesses.

Today, existing guarantors are mainly in three different states of operations:

» Only Assured Guaranty (and its newly acquired subsidiary AGM, previously known as FSA), actively writes business today. Berkshire Hathaway Assurance Corporation (BHAC), a recent entrant, was active during 2008, opportunistically providing secondary market wraps, but essentially stopped writing new business during 2009.

» Ambac, MBIA, and CIFG are in a suspended state of operations.[2] To a large extent, their recoveries will depend on ultimate losses, which are potentially affected by the outcomes from loan put-back, commutation and/or litigation. Their overall liquidity positions are challenged by large claims, the liquidity drain of insured asset management businesses, and debt service at the holding company.

» Syncora and FGIC have been ordered by their regulator to suspend all claims payments until they can implement a capital-strengthening plan that generally involves the settlement of claims at a deep discount. They may face insolvency or receivership, depending on the outcome of restructuring and commutation, however, the firms, their counterparties, and their regulators are proactively working to develop plans that would avoid such outcomes.

[2] Having been taken over by its main counterparties in a restructuring, CIFG appears to be focusing on running off its remaining book.

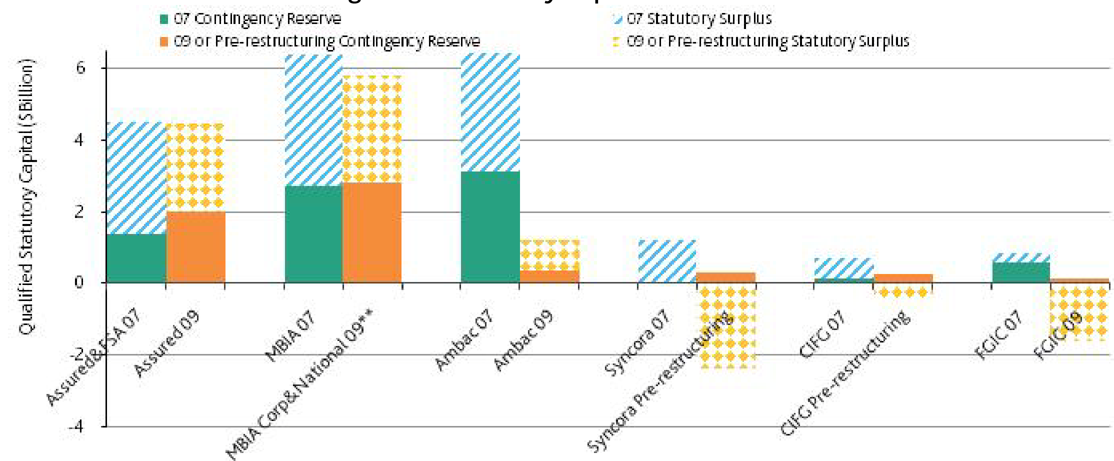
Some Struggled to Meet Regulatory Capital Requirements

For several guarantors, meeting regulatory minimum capital requirements has been the greatest challenge in 2009, and this will remain the case for some time. So far, insurance regulators have demonstrated a willingness to work with companies to alleviate capital pressures, including their approval for several guarantors to reclassify all of their contingency reserves as statutory surplus at once.

The qualified statutory capital (the sum of contingency reserve and statutory surplus) deteriorated significantly for several companies (Exhibit 1). Affected by severe credit deterioration and high operating leverage, Syncora, FGIC and CIFG reported significant negative statutory surplus, breaching regulatory capital requirements by a large margin. The New York State Insurance Department (NYSID), the regulator for Syncora and FGIC, ordered the two firms to suspend all claims payments. Both firms submitted plans to the regulator to restore policyholder surplus. CIFG completed a restructuring through a large-scale commutation with its major counterparties.

EXHIBIT 1

Several Guarantors Suffered Significant Statutory Capital Erosion*



Source: Moody's

** Pre-restructuring data are based on the companies' filings for the quarter prior to the date of restructuring. Data for 07 is as of Q4, except for CIFG; for 09 is as of Q3*

*** Among them, MBIA Corp.'s surplus and contingency reserve were $2.5 billion and $1.4 billion, respectively, as of Q3 2009.*

Loss Remediation through CDO Commutations and Loan Put-backs

Several guarantors reached a negotiated settlement, or commutated troubled exposures with counterparties under advantageous terms (sometimes under terms similar to a distressed exchange), thereby improving their capital profiles. The counterparties were typically paid cash as an exchange. In other cases, as with CIFG and Syncora, the firms engaged in master commutation agreements that were essentially corporate restructurings involving payments in both cash and equity participation to the counterparties. The motivation for the counterparties ranged from removing exposure to guarantors, reversing marks to market, to gaining control rights for the underlying reference transactions.

The payment suspension for Syncora and FIGC, however, highlighted both the severity of the problems and the difficulties in reaching negotiated settlements with counterparties outside of a formal regulatory process.[3]

Part of the preference for negotiated solutions outside of a formal regulatory receivership may be to avoid triggering credit default swap (CDS) contracts written by the guarantors (insured CDS) on CDOs. Regulatory receivership can trigger the termination of insured CDS. With current market values depressed, losses from insured CDS terminations could be substantially greater than expected losses, exacerbating a guarantor's financial problems. Regulators have therefore been cautious about taking over the companies to incur a regulatory receivership event. For both Syncora and FGIC, the suspension event was considered as a credit event by the International Swaps and Derivatives Association (ISDA), which triggered the market termination of the CDS referencing the guarantors' debt obligations (corporate CDS). The event, however, did not trigger the termination of insured CDS because it was not recognized as regulatory receivership or insolvency.[4]

We believe insurance regulators are likely to remain careful in their dealings with the weakest financial guarantors. Breaching minimum regulatory capital requirements may not necessarily result in an order to suspend claims, especially if a guarantor is perceived by its regulator as being able to recover on its own with or without some negotiated settlements. However, with both Syncora and FGIC forced to suspend claims payments, it appears that regulators may have little choice but to take formal actions, should a guarantor suffer severe and persistent capital shortfalls.

In an effort to reduce losses, some guarantors have engaged in loss-remediation strategies, such as putting back loans to lenders that were deemed in breach of representations and warranties to lenders and buying wrapped RMBS.[5] In addition, some guarantors have commuted risky exposures for less than their reserves, enhancing earnings.

Recent public disclosures indicated that several guarantors booked significant recoveries related to loan put-backs, totaling about $4 billion as of the third quarter of 2009. On average, this amounted to about 30% of their expected lifetime RMBS losses.[6] Should these claims mitigation strategies succeed, ultimate losses for the guarantors could be significantly lower than expected claims, a positive for their capital profiles.

To limit losses, several guarantors have also been buying (or tendering) wrapped RMBS at large discounts, thereby reducing actual payouts to third parties, and giving them some potential upside.[7] Such tactics, however, are limited by market opportunities and by guarantors' liquidity resources.

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3 The NYSID has shown a preference in the past, through strong encouragement to financial guarantors and their counterparties, for solutions not requiring formal regulatory intervention. Such solutions have included the transfer of municipal risks to another financial guarantor (as from FGIC to MBIA, and from CIFG to Assured Guaranty) and the comprehensive commutation of impaired exposures. FGIC had reinsured most of its municipal book, giving the insured municipal investors the right to present claims directly to National Public Finance Guarantee Corporation, a subsidiary of MBIA.

4 The termination of a corporate CDS does not directly affect a guarantor's claim paying resources. Upon a credit event, a CDS is terminated, and is settled between its protection buyers and protection sellers. Because companies typically do not sell protection on their own debt obligations, they are not affected by the termination costs.

5 Moody's Special Comment, "Monoline Insurers Push Back on Mortgage Claims", December 2009.

6 Thirty percent is the put-back credits as a percentage of the sum of total paid RMBS claims and RMBS loss reserves as of Q3 2009, and put-back credits.

7 As an example, if a guarantor buys a RMBS wrapped by itself, say at a depressed market price of 20 cents on a dollar, economically the guarantor is then no long exposed to potential claims from the RMBS because it essentially pays itself given a claim. However, the guarantor can have a gain if the ultimate loss of the RMBS is less than 80 cents. For example, if the ultimate loss is 60 cents, the guarantor receives 40 cents from owning the RMBS. This leads to a net gain of 20 cents, a 50% return on investment, for the guarantor as opposed to an insured loss of 60 cents.

Have We Reached the Bottom?

It is somewhat premature to consider the industry as having reached a recovery stage because of substantial remaining uncertainty about ultimate losses. The industry remains under stress because losses on residential mortgages continue to increase, and we still lack conclusive evidence of stabilization. Additional economic weaknesses, especially in areas negatively affecting mortgage performance such as unemployment and house price depreciation, would ensure further deterioration. Moody's also recently increased loss expectations on U.S. Prime Jumbo RMBS, Alt-A and subprime, reflecting the continued weakness in the residential mortgage market sector.[8] [9]

Other insured securitized sectors, most notably CMBS (especially CMBS resecuritizations given the leverage on leverage), have been showing signs of stress. They will likely become material loss contributors for MBIA and Syncora, which have substantial exposure to the sector.

The U.S. municipal market exhibited signs of weaker credit quality in 2009, as the recession trimmed tax collections and strained budgets for state and local governments. Moody's 2009 annual ratio of upgrades to downgrades was the lowest in at least 20 years.[10] The impact of recession on municipal issuers generally lags economic recovery, and the recovery of this recession will be sluggish in Moody's view. We expect continued fiscal strain for many issuers for the next 12-18 months, and downgrades to outpace upgrades in 2010. Nevertheless, we believe that most issuers will weather the recession with modest adverse impact, as they find ways to cut expenses, raise revenues and preserve capital.

Guarantors' high leverage means that relatively modest changes in loss estimates for impaired credits can have substantial effects on capital adequacy.

Rating Outlooks: Largely Developing or Negative

Although our outlook for the financial guaranty industry is negative, company specific considerations such as ultimate losses, capital and liquidity positions have led to ratings outlooks that are either developing or negative. We expect existing guarantors to continue facing an evolving environment in 2010, with some uncertainties abating. More visibility about ultimate losses, claim negotiations (including loan put-back, commutation and so on) or litigation settlements may lead us to re-position ratings.

The persistent large gap, between our expected and stress losses on RMBS-related exposures, suggests that a broad range of outcomes remain possible. Ultimate losses falling within our expected range could free up substantial required capital at a financially strong guarantor, improving their capital adequacy metrics.[11] By contrast, losses materially exceeding our expectations could exhaust the capital cushion at some firms or could magnify stress at others.

Guarantors' access to capital so far has been very limited because of rising losses, uncertainty regarding future business prospects, and the near-term inability to return to profitability. Only Assured repeatedly raised capital in 2009. Existing guarantors that are trying to re-establish a presence may find themselves competing for capital with new entrants without legacy books. The federal government has not shown any inclination to provide formal support to the sector. To ensure liquidity to pay claims, some guarantors have sold assets from investment books at a loss. At the same

[8] Moody's Resi Landscape, "U.S. Prime Jumbo RMBS Loss Projections Revised", December 18, 2009.

[9] Moody's Resi Landscape, "U.S. Subprime and Alt-A RMBS Loss Projections Revised", January 15, 2010.

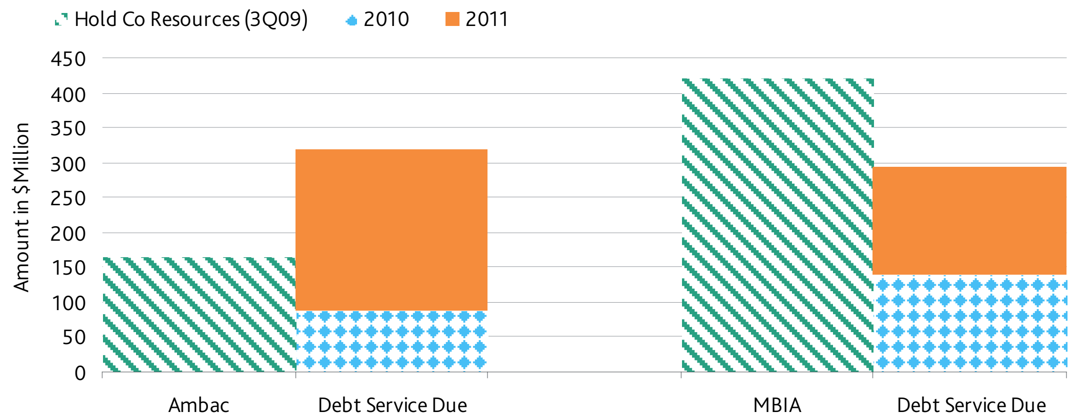
[10] Moody's Special Report, "U.S. Public Finance Fourth Quarter 2009 and Full Year Rating Revisions", January 2010.

[11] This is because for highly rated companies, we require a capitalization above expected loss.

time, their holding company resources are also limited, to the extent that they may run out of funds to service scheduled long-term debt obligations in the next couple of years. For example, Ambac and MBIA are two companies potentially facing holding company liquidity challenges (Exhibit 2).

EXHIBIT 2

Limited Hold Co Resources to Meet Debt Services*



Source: Moody's

* The debt service due includes scheduled principal and interest payments for long-term debt obligations of the holding companies

Market Opportunities Enhanced by Current Lack of Alternatives

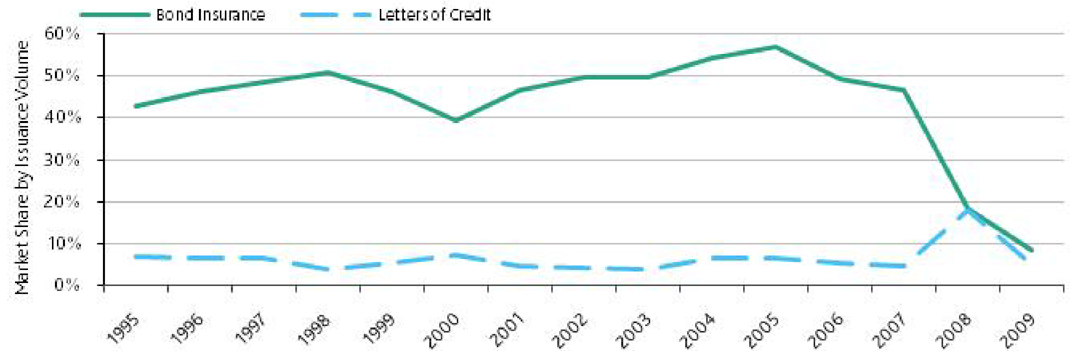
Despite the weaker market confidence, supply/demand dynamics are currently attractive for guarantors. This is largely driven by the lack of alternative credit-enhancement solutions and a drastic reduction in the supply of financial guaranty insurance relative to demand. Several guarantors have exited the market as a result of sizable troubled mortgage exposure. Few alternative credit enhancement solutions are available for both the public finance and asset finance market.

For public finance issuers, banks have generally reduced the availability of bank facilities including letters of credit (LOC). [12] Insurer penetration was down to 8.6% in the U.S. municipal market as of the end of 2009, well below historical levels (Exhibit 3). Assured (including its newly acquired subsidiary Assured Guaranty Municipal, formerly FSA) provided 98% of the volume. Some investors have reached or are approaching internal capacity limits for existing guarantors. State-sponsored structures such as bond banks were discussed in the marketplace, but the likelihood of such large programs emerging over the near-term is remote, given the complexities involved in setting up such programs.

[12] Moody's Special Report, "Reduced Availability of Bank Facilities May Have Credit Implications for Municipal Issuers with Moderate to Low Levels of Liquidity", May 2009.

EXHIBIT 3

Less Supply of Bond Insurance and LOC



Source: Moody's, Thomson Reuters, the Bond Buyers

The ABS market also lacks credit-enhancement solutions. While some traditional ABS sectors have performed largely as expected despite recent market dislocations, it has been challenging to find buyers for subordinated ABS risks, weakening the economics of such securitization. In prior years, significant amounts of junior ABS risks were funded by bank conduits and ABS CDOs, supporting the growth of the ABS market. With bank conduits volume down significantly and the collapse of the ABS CDO market, ABS issuers had to retain significant amounts of risk on their balance sheet, limiting their capacity to make more loans. Interim government programs such as TALF have helped, but ABS issuance remains well below historical levels. Given the relatively robust performance of some traditional ABS products, such as credit card and auto ABS, we would not be surprised to see guarantors' participation in these sectors pick up over time, as investors look for additional protection and dedicated transaction oversight. Market dynamics clearly have to evolve, however, in light of the on-going risk re-pricing in the structured markets and the bond insurance sector.

Demand from Smaller or Higher-Risk Municipal Issuers

While some smaller public finance issuers benefited from governmental stimulus and were able to borrow directly from banks in 2009, others have delayed issuing debt because of uneconomical costs. Having bond insurance from financially strong guarantors could help to improve their market access.

The American Recovery and Reinvestment Act of 2009 raised the bank qualified issuer size limit from $10 million to $30 million, allowing a broader range of municipal issuers to participate in the programs. It also encourages banks to buy more tax-exempt bonds, as it gives greater economic incentives for financial institutions to purchase tax-exempt securities.[13]

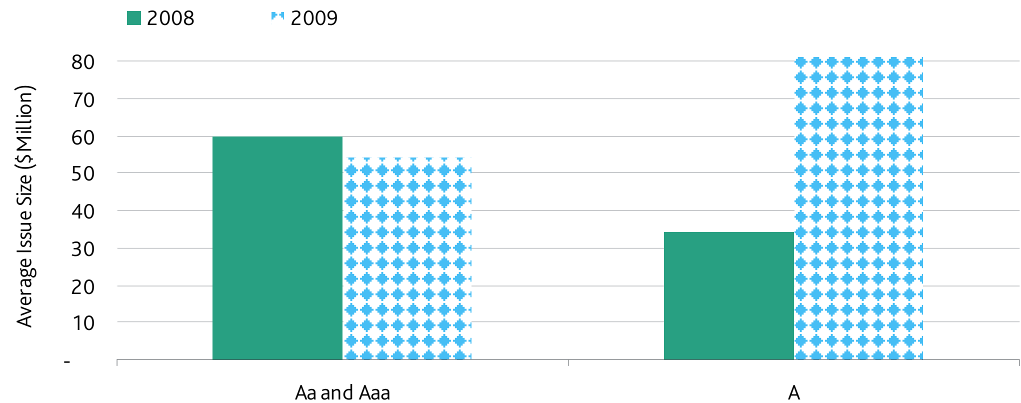
Other smaller-scale issuers, however, have delayed raising debt. Without credit enhancement, these issuers face considerably higher financing costs than they wish to pay. Funding costs for smaller or higher risk issuers such as hospitals and housing authorities have been formidably high, in part due to

[13] The stimulus act allows financial institutions to deduct 80% of the cost of buying and carrying tax-exempt bonds, to the extent that their tax-exempt holdings do not exceed 2% of their assets (the 2% de minimis rule). Banks can now deduct 80% of the cost of buying and carrying the tax-exempt bonds sold by issuers whose annual bond issuance is less than $30 million, up from the prior $10 million size limit.

the lack of credit-enhancement solutions. As shown in Exhibit 4, excluding direct borrowing from banks, the average size of single-A issues increased significantly from 2008 to 2009, while highly rated issues were not affected the same way. While large high-quality issuers have issued debt without credit enhancement, some smaller higher risk issuers had limited market access in 2009. This may have negatively affected smaller issuers' ability to fund capital projects, and bond insurance could have helped.

EXHIBIT 4

Smaller and Higher Risk Municipal Issuers Had Less Market Access in 2009



Source: Moody's, Thomson Reuters, the Bond Buyers

Demand from Municipal Retail Investors and Money Funds

While some large institutional investors are more inclined to buy unwrapped paper, core municipal investors such as retail investors and money market funds generally appear to place more value on bond insurance.

For many investors, the credit profile of municipal debt wrapped by a financially strong guarantor is enhanced as a result of the dual payer framework underpinning a financial guarantee policy. Additionally, some market participants believe that guarantors can add value through their underwriting and risk remediation, especially on smaller issuers (given the relatively high cost to benefit of in-house specialized skills). Some investors also value the enhanced liquidity for wrapped paper, owing to the credit homogenization of underlying issuers. These reasons support the continued demand for financially strong and stable guarantors.

Direct retail investors such as households are the biggest investor segment, owning about a third of U.S. municipal debt outstanding (Exhibit 5). Retail investors tend to be less sophisticated than institutional managers, and they lack the resources for in-depth credit analyses and surveillance. They are more likely to buy wrapped bonds, outsourcing those functions to bond insurers. However, here too, the stress faced by guarantors have led retail investors to become more circumspect.

EXHIBIT 5

U.S. Municipal Market Investors Profile

	($BILLION)			(%SHARE)		
	2007	2008	2009Q3	2007	2008	2009Q3
Households	$907	$960	$980	35%	36%	35%
Money Market Funds	$473	$495	$421	18%	18%	15%
Mutual Funds	$463	$467	$542	18%	17%	20%
Insurers	$413	$411	$444	16%	15%	16%
Commercial banks	$192	$216	$218	7%	8%	8%
Other	$171	$144	$169	7%	5%	6%
Sum	**$2,619**	**$2,692**	**$2,773**			

Source: Moody's, Federal Reserve Money Flow, the Bond Buyers

Money market funds, also a large segment of the overall U.S. municipal investor base, are more likely to use financially strong guarantors, in part because of regulatory requirements for investing in highly rated assets. U.S. money market funds are subject to Rule 2a-7, which institutes collateral eligibility requirements based on ratings. As of the end of third quarter 2009, about $421 billion municipal money market funds were outstanding, or 15% of the total municipal market (Exhibit 5). In addition to elevating the credit profile of invested assets, financially strong guarantors with a stable credit profile may also help a fund to mitigate forced selling should an underlying municipal debt breach investment guidelines after a downgrade.

Commercial banks' share in the U.S. municipal market held steady, at around 8%. While commercial banks' participation in the variable rate market declined, they invested more in smaller municipal issuers in 2009. The variable rate market was a large user of bond insurance in the past, but it suffered a substantial setback because the market turmoil led to less availability of credit and liquidity products for municipal issuers.[14] However, recent government stimulus acts provided more economic incentives for financial institutions (including commercial banks) to buy municipal debt, resulting in more investments from banks. Nevertheless, some commercial banks' investment-management departments may not have a sufficient operational infrastructure required to analyze the myriad of small municipal issuers. Bond insurers can offer value there.

Nascent U.S. Covered Bond Market Has Limited Effect on Guarantors

The U.S. covered bond market is at a conceptual stage, and current efforts appear to be primarily focused on mortgage and other structured finance sectors. The establishment of a sizable U.S. covered bond market could potentially change the market dynamics as it would introduce another source of credit enhancement, as well as bring in new investors and more liquidity to the municipal market. However, it may take some time for such a market to establish itself partly because of certain legislative and tax issues.

[14] Moody's Special Report, "The Municipal Variable Rate Market: 18 Months of Unprecedented Issuance Volatility", May 2009.

Several legislative drafts about U.S. covered bonds were proposed late last year.[15] Covered bonds are securities, generally backed by mortgage or consumer loans, or municipal debt. Covered bonds benefit from recourse to issuers in the event of a collateral shortfall, but they are protected from the bankruptcy of the issuers.

The U.S. mortgage market will likely be the first to test covered-bond structures. Given the unprecedented residential mortgage crisis in the U.S., covered bonds may be viewed as an alternative to securitization -- one that potentially is better aligned with structural incentives and has a stronger default protection. Covered bonds are prevalent in Europe, and their performance has been relatively resilient during the financial crisis.

An emerging U.S. covered mortgage market will have little initial effect on existing guarantors. Currently, most guarantors are uninterested or unable to insure additional mortgage-related risks given their recent loss experiences.

The inclusion, in current legislative drafts, of public sector debt as eligible assets could open up U.S. municipal issuers to new funding sources. However, it is unclear if and when a U.S. municipal covered bond market will materially develop, and to what extent it will weaken the demand for bond insurance. Currently, there is a lack of bond insurance supply relative to the demand for such insurance.

Moreover, several key differences between the financing mechanisms in the European and U.S. public finance markets may affect market dynamics. U.S. municipalities mainly fund through the public finance debt market leveraging a range of federal and state tax exemptions, while European municipalities typically borrow directly from banks on a taxable basis.[16] The potential complexity of creating U.S. municipal covered bonds that are also tax advantaged, however, could limit the relative attractiveness of covered bonds in the U.S.

Narrower Opportunities, but Some Receptivity to Existing and New Guarantors

With guarantors' financial strength generally weakened, the industry has evolved significantly across market opportunities, pricing, and receptivity. Despite the current low insurance penetration, it appears that bond insurance fills substantial market needs, and there is a greater acceptance of higher risk profiles and new entrants.

Narrower Opportunities and Lower Perceived Value

In general, financial guarantors are limited to transactions with higher perceived risk than their financial strength. The market generally sees value in bond insurance if a guarantor is perceived to be more creditworthy than the underlying securities that it wraps. As a guarantor' financial strength weakens, it will face narrower opportunities. A higher risk guarantor is therefore likely to have a weaker market penetration and less pricing power than a lower risk guarantor, all else being equal.

The market may assign widely different values to wrapped debt, depending on the financial strength of the guarantors. For severely impaired guarantors, the value may be very limited. Some investors are interested in assessing the stand-alone risk underlying a wrapped security, especially in light of the

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[15] See Moody's Weekly Credit Outlook, "U.S. Covered Bonds: Industry Gears Up to Propose Comprehensive Legislative Framework; Banks to Benefit", December 14, 2009.

[16] The nature of the European municipal market to a large extent limited guarantors' participation.

uncertainty in today's financial guaranty market. There appears to be a greater differentiation in the trading value of wrapped municipal bonds, based on the quality of the underlying risks. This differentiation is possibly driven by the combination of the lower perceived value of bond insurance and a greater appreciation of the underlying asset credit quality.

To enhance their value proposition, some guarantors are providing more disclosure than in the past. Market participants have applauded this effort, as it improves their ability to conduct independent research about the guarantors and to better price risks.

Greater Receptivity to Higher Risk Profiles and Potential New Entrants

Assured's ability to write substantial new business has illustrated the market's acceptance of a financially strong guarantor with a higher risk profile, albeit clearly the firm has also benefited from currently limited supply of bond insurance.

For similar reasons, there may be opportunity for new entrants. The barriers to entry, however, can be high. New entrants need to demonstrate track records, market receptivity and financial support. They are likely to face substantial scrutiny and some skepticism about their business readiness, stated strategy, and shareholders' long-term capital commitment. Nevertheless, new players may be welcomed by the market, because they are perceived as being part of the solution to the current high cost of financing in certain segments of the municipal market.

Given the poor performance of existing guarantors' mortgage-related exposures, all potential new bond insurers have proposed to focus exclusively on municipal finance. However, the fact that some leading bond insurers started as municipal-only insurers and then expanded into higher risk sectors, has somewhat weakened the credibility of such a stated strategy. The municipal-only business model, in itself, would not prevent companies from chasing higher risks for a greater return potential, should profitability prove insufficient in core markets.

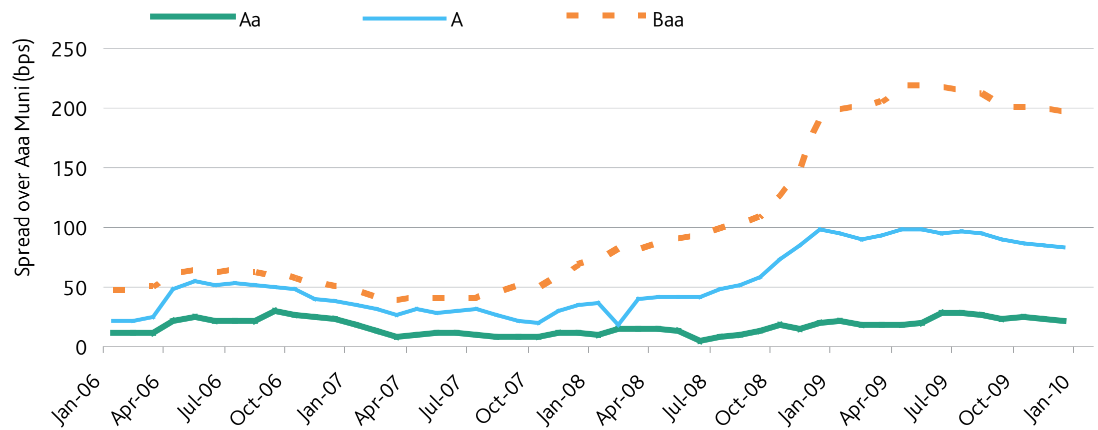
The emergence of guarantors that are not exposed to legacy risks could help fill the demand gap in the U.S. municipal market and could dramatically alter the competitive environment. Two firms, Municipal and Infrastructure Assurance Corporation (sponsored by Macquarie Bank and Citadel Investment Group) and the Bond Model Company (Sponsored by ButcherMark), are presently preparing for a potential 2010 market entry. In May 2009, the National League of Cities (NLC) proposed a new municipal bond insurer, though it does not seem to have gained momentum.[17]

Municipal credit spreads are at a multiple of historical levels, enhancing active guarantors' profitability (Exhibit 6). Although still fairly wide, spreads have tightened in recent months, and may narrow further as markets normalize or as credit-enhancement supply increases. We think the higher risk profile of guarantors and lower value of bond insurance will test more broadly the future profitability and strength of a municipal-only business model, should spreads normalize and competitive pressures increase over time.

[17] Moody's Weekly Credit Outlook, "New Bond Insurer May Shift U.S. Industry's Competitive Structure", May 2009.

EXHIBIT 6

U.S. Muncipal Spreads Widened Significantly but Tightened Recently



Source: Moody's Credit Trends

With such profound dislocation evident within the current market's structure, and given the remaining uncertainties, both about asset quality and the emerging competitive environment, it is challenging to predict the future landscape of the financial guaranty industry with confidence. What seems clear is that bond insurance fills substantial current market needs, and that 2010 will be a pivotal year for the sector, with visibility improving on many credit issues.

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