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For Bond Insurers, The Future Depends On Investor Confidence

Primary Credit Analyst:
Robert E Green, New York (1) 212-438-2013; robert_green@standardandpoors.com

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There is little doubt that this is a time of upheaval in the bond insurance industry. With the global structured finance market largely dormant, most bond insurers are focusing on the U.S. public finance market. Even so, Standard & Poor's Ratings Services' outlook for the industry is generally negative because investors in insured bonds, or "wrapped paper," and in debt and equity have apparently lost confidence in insurers in general, especially amid ongoing credit deterioration globally. Market acceptance is uncertain for companies that have been downgraded in a market that came to expect 'AAA' ratings. In addition, we believe competition from new or alternative sources may increase.

Bond insurers were once a haven of ratings stability, and as many as eight primary financial guarantors were rated 'AAA'. Today, only Berkshire Hathaway Assurance Corp. (BHAC) and Assured Guaranty Corp. have retained their 'AAA' financial strength ratings and stable outlooks. (BHAC does not employ a traditional bond insurance business model; rather, we rate it based on a guarantee from affiliate Columbia Insurance Co.) Financial Security Assurance Inc. also has retained its 'AAA' financial strength rating, but it is on CreditWatch with negative implications because the company has become a non-core unit of parent company Dexia S.A. and is being sold to Assured Guaranty Ltd.

At the opposite end of the rating spectrum is a group of companies that is severely impaired with speculative-grade ratings and for which run-off seems a likely outcome: CIFG GUARANTY, Financial Guaranty Insurance Co., and Syncora Guarantee Inc. These companies suffered capital deterioration to varying degrees caused by losses and credit uncertainties surrounding their subprime portfolio and collateralized debt obligations (CDOs) of asset-backed security (ABS) insured portfolio.

In between these two groups are the MBIA operating units and Ambac Assurance Corp. These companies are moderately impaired, rated investment grade, currently not writing new business, and in various stages of restructuring. MBIA Inc., the group holding company, recently announced that it has reorganized its operations, creating separate municipal and structured finance units. MBIA Insurance Corp. of Illinois, the new public finance unit, now has a financial strength rating of 'AA-' and is on CreditWatch with developing implications. MBIA Insurance Corp., the newly designated structured and international unit, is rated 'BBB+/Negative'. Ambac Assurance, rated 'A/Negative', has announced that it is also restructuring its operating units along municipal and structured lines.

Growing Wariness Among Investors And Policyholders

Investors may no longer have the confidence to do business with firms in what had been a largely 'AAA' rated industry. MBIA's restructuring resulted in a lower rating on its structured finance unit than on the public finance unit. As a result, policyholders who may feel they have been disadvantaged in the restructuring may be less willing to do business with them in the future. Even public finance policyholders may be wary about the restructuring. It is uncertain whether there will be legal challenges, but this is another possibility.

Another factor potentially giving investors pause may be the commutation strategies of many companies that settled some CDO claims with the counterparty on a discounted basis. This loss-mitigation technique is in sharp contrast to the financial guaranty insurance policy standard, and market expectation, of payment in full on defaulted principal and interest as it comes due.

A Broader Range Of Rivals

Given how difficult it has become to issue debt in the public finance market for all but the most creditworthy issuers, as well as the generally negative sentiment surrounding the bond insurance industry, new competition could come from the public sector. Members of the National League of Cities have proposed creating a mutually owned, nonprofit, bond insurance-type company to insure state and local government debt. This entity could represent serious competition within the tax-backed sectors. However, the prospective company is seeking federal funding, which at this point is uncertain. A federal guarantee program for public finance issuers is also being considered. Although both of these entities are only in the early discussion stages and their ultimate establishment is uncertain, they do underscore the industry's changing competitive dynamics.

Wider credit spreads and pent-up issuance demand in the public finance market, especially from smaller 'A' and 'BBB' rated companies, have created an attractive market opportunity for the private sector. The Macquarie Group Ltd. and Citadel Investment Group are lead investors in the Municipal Infrastructure and Assurance Corp. (MIAC; unrated). MIAC received regulatory approval in October 2008 to write financial guarantee business, and published reports indicate that it is in discussions with rating agencies to obtain a rating. If MIAC actually begins writing insurance, it will, all else being equal, have the advantage of not having been associated with mortgage-related losses and lowered ratings.

Letter-of-credit (LOC) providers have also emerged as a formidable enhancement substitute, almost equaling the bond insurance volume of about $72 billion in 2008. However, LOC penetration in 2009 is less certain because some banks may be at their capacity limits.

Looking ahead, some uncertainty surrounds what is likely to be greater regulatory involvement in the industry. We believe regulators have played key, behind-the-scenes roles in several highly visible reorganizations, commutations, and reinsurance transactions. Regulators have made clear their desire for highly rated and municipally focused bond insurers. It is possible that tensions between management and regulators could emerge at some point regarding strategic matters.

Financial Flexibility Is Diminished

Because the full extent of structured finance losses will not be known for some time and business prospects are uncertain, most bond insurers' financial flexibility has been seriously damaged. Just as prospective policyholders have generally lost confidence in the industry, so, too, have public and private capital sources. Although some companies were able to raise capital in 2008, the cost of doing so became prohibitively expensive, and ultimately, capital became unavailable for most.

Financial flexibility has also been diminished by disruption in the reinsurance market for bond insurance. With the exception of Assured Guaranty Re Ltd. ('AA/Stable'), we downgraded the four other monoline reinsurers recently. Multiline reinsurers that provide capacity for the bond insurers have seen demand for financial guaranty reinsurance ebb and flow historically, but recent events may result in many multilines exiting this market.

To facilitate raising capital in connection with MBIA's restructuring, a new intermediate holding company has been established between ultimate holding company MBIA Inc. and MBIA of Illinois with an objective of "ring-fencing" the public finance unit from the risks of the structured finance business. Management believes prospective investors in wrapped paper and in debt and equity will view this more formal separation as positive. However, because details of the composition of the board of directors and other governance matters are still developing, it is uncertain how effective this structure will be in supporting capital raising. If successful, this ring-fenced structure could raise questions about the ability of MBIA of Illinois to upstream dividends to service the debt of ultimate parent MBIA Inc.

As with other financial institutions, capital assistance from the federal government is high on most insurers' wish lists. We expect discussions with the Treasury Department to continue.

Credit Deterioration Could Continue

Continued losses in domestic subprime mortgages and related CDOs of ABS exposures cannot be ruled out. Since late 2007, we have periodically increased our loss estimates across all subprime mortgage sectors after seeing evidence of progressively worsening foreclosures, longer expected durations of peak foreclosure periods, and greater home price depreciation (see table).

History Of Cumulative Net Loss Estimates

	Vintage	December 2007 (%)	March 2008 (%)	June 2008 (%)	September 2008 (%)	December 2008 (%)
Alt-A	2005	2.75	2.75	2.75	3.75	4.15
Alt-A	2006	3.50	5.50	5.50	10.90	10.90
Alt-A	2007	3.50	9.00	7.50	13.35	13.35
Subprime	2005	5.75	8.50	8.50	10.50	10.50
Subprime	2006	15.50	18.80	18.80	23.00	23.00
Subprime	2007	17.00	17.40	22.60	23.00	23.00
Closed-end seconds	2005	17.25	17.25	18.51	20.58	20.58
Closed-end seconds	2006	40.00	40.00	44.28	42.74	42.74
Closed-end seconds	2007	40.00	40.00	57.10	59.03	59.03
HELOCs	2005	10.35	10.35	10.35	6.93	6.93
HELOCs	2006	15.75	15.75	15.75	22.62	22.62
HELOCs	2007	13.00	13.00	13.00	37.89	37.89

For example, in December 2007, our loss assumptions for 2007 vintage home equity lines of credit (HELOCs) and closed-end seconds were 13.0% and 40.0%, respectively. Our loss assumptions for the same vintage and sectors are now 37.9% and 59.0%. With the bond insurers' establishment of their initial reserves in the third and fourth quarters of 2007, each subsequent quarter likewise generally showed further increases in losses. It is not possible to say whether current reserves are adequate. Moreover, as the global credit crisis broadens, deterioration in other asset classes is possible.

In conclusion, bond insurers are facing big problems on many fronts. The companies that are not materially impaired are in various stages of reinventing their business models. Assuming they can avoid material losses, their success will depend largely on regaining investor trust.