

Special Comment

Moody's Global Insurance

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Analyst Contacts:

New York 1.212.553.1653

Wallace Enman

Vice President/Senior Accounting Analyst

Stanislas Rouyer

Senior Vice President

Jack Dorer

Team Managing Director

Ted Collins

Group Managing Director

Interpreting Financial Guarantors' Mark-to-Market Losses

Summary Opinion

- In the past year, a number of financial guaranty insurers recorded significant mark-to-market losses relating to derivative contracts (principally credit default swaps ("CDS")) written to provide protection to investors in various types of structured financings. The magnitude of these charges has raised reasonable questions among some investors about the nature and degree of exposures at financial guarantors, as well as some confusion about how to interpret this information in the context of a guarantor's financial strength.
- For a variety of reasons, mark-to-market losses may not represent a true indicator of actual credit deterioration; however neither are they merely accounting "noise", particularly in the current environment.
- Losses recorded for CDS marks do not result in claim payments unless an actual event of default occurs on the reference obligation. In public disclosures, the guarantors have indicated they believe expected actual credit losses on their insured CDS portfolios will be materially lower than implied by estimated market values ascribed. This view is broadly consistent with the analysis performed by Moody's in our modeling of the guarantors' portfolios, as disclosed in our research.¹
- Large negative marks can, however, impact a guarantor's future business prospects, with structured finance or municipal clients choosing to avoid additional transactions with certain guarantors, or guarantors ceasing to write new business in the structured finance market.
- Significant mark-to-market losses may also cause investor appetite for a guarantor's debt or equity securities to diminish, inhibiting its ability to raise capital in a stress loss scenario.

¹ Refer to our Special Comment: *Moody's Financial Guaranty Update: Frequently Asked Questions*, January 2008, as well as guarantor-related press releases available on moodys.com.



Interpreting Financial Guarantor's Mark-to-Market Losses

- Comparing mark-to-market losses reported by the guarantors can be problematic, as companies may differ in valuation techniques and modeling assumptions used. Aside from the valuation problems inherent in marking a portfolio of contracts for which there is no active market, the guarantors may differ in their interpretation of both Statement of Financial Accounting Standards No. 157, *Fair Value Measurements* ("FAS 157") and of recent SEC guidance regarding marking illiquid securities in the current environment.
- Where the CDS are structured to avoid collateral posting or early termination, and are expected to be held until the maturity of the underlying reference security, losses would be realized by the guarantor only to the extent actual credit losses developed. This leads Moody's to place relatively greater emphasis in our analysis on assessing what portion of a mark-to-market loss may reflect actual losses estimated to be realized over the life of the security.
- Certain CDS contracts contain provisions stipulating that counterparties may request a market value termination of the CDS in the event of insolvency. Such terminations could result in significant cash payments being required. In such an extreme case, and assuming market values remained depressed, the guarantor would be forced to realize losses that might otherwise reverse over a longer time horizon.

Financial Guarantors' Involvement in the CDS Market

A credit default swap (CDS) can be viewed as protection, or insurance, against the default of an underlying credit instrument. Financial guarantors are significant participants in the CDS market, and have historically seen CDS execution as a natural extension of their traditional insurance business of providing "wraps" or "guarantees" on debt.

Under current accounting standards, CDS written by the guarantors are considered derivatives subject to Statement of Financial Accounting Standards No. 133 ("FAS 133") and are reported on the balance sheet at fair value, with changes in fair value (mark-to-market) recognized in earnings. (This is in contrast to financial guaranty policies, which account for the bulk of the industry's exposure, and are not generally subject to mark-to-market accounting.) Quoted market prices are the best evidence of fair value, but frequently the nature of the securities insured via CDS requires that the guarantors model their own estimates of fair value (mark-to-model).

The guarantors insure CDS contracts to scheduled maturity. In the absence of default, unrealized gains or losses arising over the life of CDS contracts will reverse over time (as CDS contracts expire with no value). Some of the more traditional risks associated with CDS — such as broader definitions of a "credit event," collateral posting requirements, and accelerated payment obligations — have largely been mitigated by the guarantors via modified International Swaps and Derivatives Association (ISDA) agreements, whose terms are structured to match many of those of a financial guaranty insurance contract.

Credit Market Dislocation Significantly Impacts Guarantors' Financials

The turmoil evident within credit markets over the past year, particularly in RMBS and related ABS CDO sectors, has caused significant credit spread widening in the credit-default swap market. Financial guarantors, through their exposure to CDS, have seen their GAAP results materially affected by the mark-to-market required on CDS structures under FAS 133. Some guarantors have reported unrealized pre-tax losses on their insured CDS books in excess of June 30, 2007 GAAP equity during the subsequent three quarters. The below table indicates the mark-to-market losses and impairment charges disclosed by guarantors during the second half of 2007 and first quarter of 2008 (for those companies who have reported 1q results):

Interpreting Financial Guarantor's Mark-to-Market Losses

Guarantor	6/30/2007 GAAP Equity	Cumulative Impairment Charge	Cumulative Mark- to-Market Loss (excl. Impairment)	3/31/2008 GAAP Equity
Ambac Financial Group	6.0	1.8	5.8	1.3
MBIA Inc.	6.8	1.0	6.3	2.1
FGIC	2.5	1.5	1.8	0.5
Radian Asset Assurance*	4.1	0.0	0.2	2.9
Security Capital Assurance	1.7	0.7	0.8	0.3
Assured Guaranty Corp	1.7	0.0	0.9	1.5
FSA	2.7	0.0	1.1	0.0
CIFG**	0.6	0.0	1.9	N/A

All amounts in \$billions

* Equity figures for Radian represent Radian Group Inc, which includes their mortgage insurance business.

Source: Company 10-Q and 10-K filings and press releases

** CIFG beginning equity as of 3/31/07. CIFG has not reported 1q '08 GAAP results as of the date of this report.

When providing protection via financial guaranty insurance contracts, guarantors record loss reserves on policies in-force based upon actual credit deterioration of an insured obligation. In their CDS business, however, the valuation of the credit enhancement that these companies provide is determined by market fluctuation, as well as by deterioration or improvement in a reference credit. The guarantors have typically structured these contracts in "pay as you go" form, which are similar to financial guaranty insurance policies with respect to the timing of interest and principal payments. Where the CDS are structured to avoid collateral posting or early termination, and are expected to be held until the maturity of the underlying reference security, losses would be realized by the guarantor only to the extent actual credit losses developed. This leads Moody's to place relatively greater emphasis in our analysis on assessing what portion of a mark-to-market loss may reflect actual losses estimated to be realized over the life of the security.

Mark-to-Market Losses May Not Diminish Claims-Paying Resources, but Can Reduce Financial Flexibility

The claims-paying resources of financial guarantors are not directly impacted by mark-to-market changes in the value of derivative contracts. Unrealized mark-to-market losses on credit derivatives are non-cash charges that may not represent a true indicator of credit losses within a CDS book. Yet, a large mark-to-market loss is not necessarily only noise either, as it conveys the fact that the market would require additional premium to insure the same exposures today.

Despite the fact that non-economic mark-to-market losses do not directly affect the guarantors' claims paying resources of the guarantors, the marks can significantly inhibit the financial flexibility of the industry in several ways:

- Large mark-to-market losses can serve to further dampen the capital market's appetite for guarantors' securities. In recent months, the industry's ability to obtain fresh capital at favorable terms has become more difficult, thereby affecting overall financial flexibility. A diminished share price, at least partially resulting from mark-to-market losses, caused one guarantor to postpone a public equity offering earlier this year.
- To the extent that they adversely affect customer perceptions of a company's financial strength, large negative marks can also impact guarantors' future business prospects. For example, some structured finance clients with large in-the-money exposure to the guarantors given mark-to-market movements may be reluctant to engage in additional transactions as long as their uncollateralized contingent counterparty risk to the guarantor remains high. Additionally, a guarantor may have difficulty writing new business if mark-to-market losses cause insureds, and potential investors in insured securities, to view the guarantor as less adequately capitalized than its competitors.

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- Substantial reductions in equity could result in a guarantor falling below minimum net worth financial covenants in its credit facilities, if mark-to-market losses are not explicitly excluded from such covenants. Violating financial covenants could inhibit financial flexibility by removing credit facilities as a source of capital for a guarantor or forcing the company to pay increased fees or interest on such facilities.

Strong financial flexibility not only allows a company to raise capital for additional growth or acquisitions, but also to meet unexpected financial demands whether those come from an unusually negative credit/market environment, earnings volatility, or other capital needs. Moody's believes that diminished capital market confidence that has resulted from continuing deterioration in the structured finance portfolios of guarantors, has limited access to capital and significantly strained the financial flexibility of the industry

Insolvency Provisions in CDS Contracts Can Trigger Termination at Market Value

Certain CDS allow early termination of the contract upon the insolvency of one of the parties, at the election of the non-defaulting party. While there could be differing views about what constitutes insolvency, Moody's believes that regulators — and regulatory action — could be expected to play a significant role in that determination. In any event, under insolvency, the balance due to the counterparty upon early termination is determined by marking the swap to market (i.e., determining the cost to replicate the swap in the current market), which could generate significant realized losses under current credit market conditions.

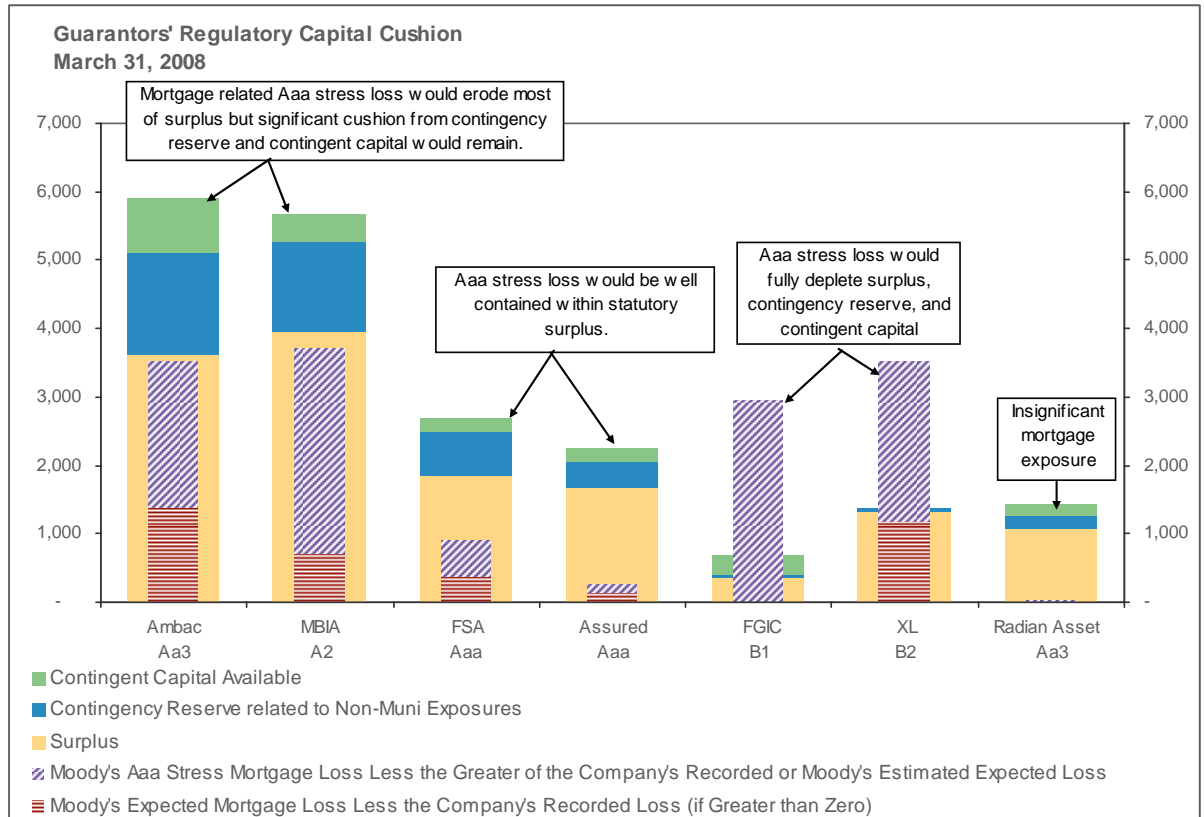
Moody's considers this risk as low for the majority of rated guarantors for two reasons. First, even guarantors that have meaningful exposure to mortgage risk typically maintain regulatory capital cushions well above minimum levels². Second, Moody's believes that a regulator would be reluctant to take preemptory action that might have the effect of worsening the financial condition of the insurer and reducing resources available for prospective claimants. Nevertheless, the presence of insolvency provisions in CDS contracts does represent another way in which mark-to-market valuations could have real consequences.

The below table compares the March 31, 2008 regulatory capital of each guarantor to Moody's stress case loss estimate for wraps of ABS CDO and RMBS securities. For illustration, regulatory resources, in this exhibit, include statutory surplus, contingency reserves related to non-municipal business, and contingent capital facilities available.

Contingency reserves are a statutory liability required to be recorded under state insurance regulations and statutory accounting principles. Companies are eligible to petition regulators in their state of domicile for a reduction if certain loss ratio thresholds are breached. For non-municipal business, the loss ratio threshold is 65%. The contingency reserves included in the table represent those reserves related to non-municipal guarantees only, under the assumption that regulators would not permit reduction of contingency reserves related to municipal guarantees as a result of excess losses on non-municipal business.

² For example, under New York State Insurance law, guarantors are required to maintain a minimum surplus to policyholders of \$65 million. Other states have lesser minimum surplus requirements.

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Notes:

- Estimated expected and stress losses as of June 20, 2008.
- Excludes CIFG, which has not yet filed 1st quarter 2008 or year-end 2007 financials for CIFG Guaranty. Moody's believes that CIFG's statutory loss reserve methodology may reflect a substantial conservative bias leading to sizable increases in reserves, which could cause the firm to breach regulatory capital requirements in the near future. (See Moody's press release on CIFG Guaranty dated May 20, 2008).

How Recent Market Turmoil Affects Financial Statements

Accounting for Derivative Instruments

Under current accounting guidance, financial guaranty insurance policies and CDS must be evaluated to determine if they qualify as derivatives for accounting purposes. Generally, these contracts are exempt from derivative (fair value) accounting if the following criteria are met³:

1. The guarantor's loss or obligation results strictly from the debtor's failure to pay when payment is due (i.e., not from a change in market price or the occurrence of other ISDA-defined credit events), and
2. The guaranteed party is exposed to risk of loss on the reference asset, as a precondition for payment, both at inception and throughout the term of the contract.⁴

Most CDS insured by the guarantors fail the exemption from derivative accounting and are reported on the balance sheet at fair value, with changes in fair value recognized in earnings. Conversely, most traditional financial guaranty insurance contracts are exempt from derivative accounting and are reported in accordance with Statement of Financial Accounting Standards No. 60 *Accounting and Reporting by Insurance Enterprises*, which states that the liability for unpaid claims on an individual contract shall be based on the insurer's best estimate of ultimate claim amount.

³ Refer to Statement of Financial Accounting Standard (SFAS) No.133 "Accounting for Derivative Instruments and Hedging Activities", as amended by SFAS No.149.

⁴ The Financial Accounting Standards Board (FASB) intended that a scope exception from fair value accounting rules be allowed for certain financial guarantee contracts (the "paragraph 10(d) exception"), similar to that allowed for traditional insurance contracts. Guarantees eligible for the scope exception are similar to insurance contracts in the sense that the guaranteed party (1) is exposed to loss on the referenced entity over the life of the contract and (2) incurs a loss/obligation upon the occurrence of an identifiable insured event (the debtor's failure to pay when payment is due).

Interpreting Financial Guarantor's Mark-to-Market Losses

The typical CDS issued by the guarantors does not qualify for exemption because of the counterparty's reluctance to commit to holding the guaranteed obligation (reference entity) throughout the term of the contract. For example, the collateral manager sponsoring a managed synthetic CDO has the option to trade the individual exposures in the CDO (within guidelines specified in the transaction documents).

The mark-to-market accounting of the CDS portfolio is in sharp contrast to the accounting treatment of what are broadly similar exposures assumed in a traditional insurance format. Financial guaranty insurance contracts are essentially off-balance sheet items, with claim liabilities recorded only when insurers estimate that an insured obligation may experience a default. On the other hand, changes in the mark to market of CDS exposures are recorded in the income statement as changes in the value of derivative instruments (CDS are treated under GAAP as trading instruments and, therefore, changes in value result in a charge to income.)

It is worth noting that the CDS business is not written directly by the insurance company subsidiaries of the guarantors. Rather, the swap contract is generally written by a 'transformer' subsidiary of the holding company, which is then insured by the insurance company. As such, statutory capital of the insurance entity is not affected by mark-to-market losses, absent actual credit impairment.

CDS Contract Valuation Methods are Complex, Varied

Companies use a range of methodologies for estimating the mark-to-market of their CDS exposures. The mark-to-market losses on CDS reported by the guarantors are not, in most cases, actual prices given the complex nature of their exposure and the lack of an observable market. Many CDS written by the guarantors are senior credit exposures to often illiquid subordinated risk tranches and, therefore, may not have third-party market valuation. Guarantors use varying methodologies to mark their portfolios, including applying index spreads to positions, marking CDS based upon quotes obtained on underlying referenced assets, or other 'mark-to-model' techniques. The unique composition of each guarantor's portfolio, as well as diversity in practice in marking methodologies employed hinders comparability of mark-to-market adjustments across the industry.

There can be a meaningful difference between the mark-to-market of a physical security and the mark-to-market on a CDS on that security. The CDS premium is typically a fraction of the credit spread associated with the physical security (the proportion of spread realized in guarantor pricing is generally greater for riskier reference obligations), and, therefore, changes in credit spreads affect the two differently. To the extent that spreads on underlying physical securities are an input to valuation, differences in assumptions in converting underlying spreads to CDS spreads may result in variations in recorded marks.

FAS 157 Provides Offset to CDS Marks

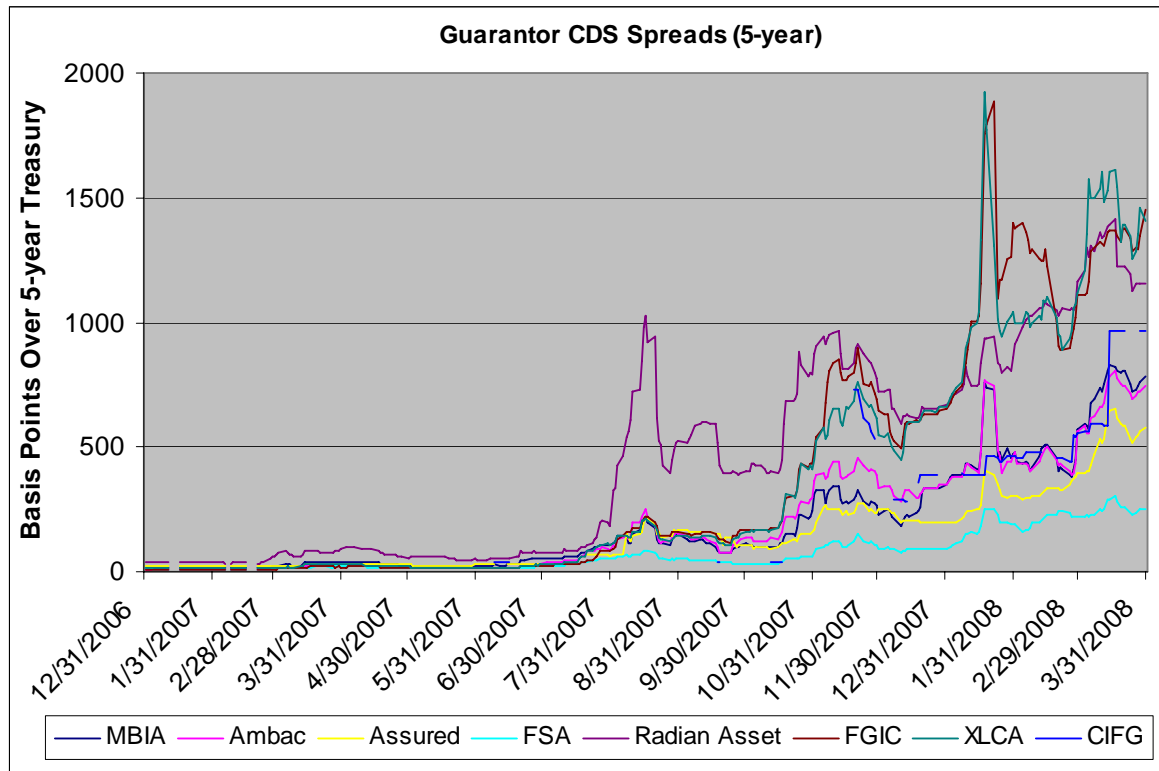
In the first quarter of 2008, FAS 157 became effective. FAS 157 sets forth a framework for measuring fair value and describes disclosures that will be required regarding fair value measurements. The standard states that "the reporting entity shall consider the effect of its credit risk (credit standing) on the fair value of the liability"⁵.

As credit spreads have increased on all the guarantors in the past year (See exhibit below), one would expect to see some offset to guarantors' marks-to-market to reflect a market valuation of their contingent liabilities. There is some degree of disparity in interpretation of the standard, however, as several guarantors' filings indicate that the effect of FAS 157 on their marks was not material, whereas others reported a net gain for the first quarter on CDS marks, despite the continuing deterioration of credit spreads on the underlying assets. Moody's notes that differences in valuation models, the relative weighting of agency ratings and credit spreads in determining the credit risk adjustment, and each company's interpretation of FAS 157 has and will result in diversity in practice in the application of the standard and significant differences in the resulting impact on CDS marks.

⁵ Refer to Statement of Financial Accounting Standard (SFAS) No.157 "Fair Value Measurements"

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The favorable impact of the adoption of FAS 157 on equity has not be seen as a credit positive or negative in our analysis, except to the extent that it creates more headroom under covenant restrictions. As mentioned above, Moody's believes that the claims-paying resources of the guarantors are not directly impacted by mark-to-market changes (up or down) in the value of CDS contracts. It would appear that FAS 133 and FAS 157 have, in some cases, managed to somewhat offset each other in causing marks on CDS to diverge from and converge closer to their actual economic value for certain financial guarantors.



SEC Guidance on Valuation Impacts Marks

On March 28, 2008, the Securities and Exchange Commission sent a letter to certain public companies that hold a significant amount of asset-backed securities or derivative assets and liabilities, regarding the application of FAS 157. The letter primarily addressed transparency and disclosure around valuations under the accounting standard, including requesting that companies provide more information regarding the assumptions used in determining unobservable inputs used in valuation, valuation techniques and models, and whether the reporting entity believes that the fair values determined in accordance with the standard diverge materially from the amounts anticipated to be realized upon settlement.

Also included in the letter was a passage which is receiving significant attention by financial statement preparers. The letter states that market prices must be considered even if the market is relatively illiquid in comparison with historic market volumes *"unless those prices are the result of a forced liquidation or distress sale."*

The italicized sentence does not differ significantly from the guidance already provided in FAS 157, which states that fair value is the price of an asset or liability *"in an orderly transaction between market participants"*, and *"an orderly transaction...is not a forced transaction (for example, a forced liquidation or distress sale)"*.

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Despite the fact that the letter doesn't seem to change the guidance already illustrated in the standard, some financial market participants have focused on the forced liquidation/distress sale passage as suggesting that values determined in accordance with previous marking methodologies, which use market spreads on illiquid reference credits, are no longer determinative, as the market turmoil and illiquidity seen in the structured finance market results in marks that represent distress sale prices. Guarantors who take this interpretation of the SEC's letter may report significantly lower cumulative mark-to-market losses than their peers who take a more conservative approach.

Investment Agreement Portfolio Accounting

Several of the guarantors provide investment agreements or guaranteed investment contracts (GICs) primarily to issuers of asset-backed and structured finance debt and to municipal issuers. Investment agreements used in structured financings provide a guaranteed investment return customized to meet expected cash flow requirements. The guarantors invest GIC proceeds in assets — typically highly rated ABS, MBS and municipal bonds — that are expected to generate a higher rate of return than is required to be paid on the liability. These investments are also primarily designated as available-for-sale under US GAAP (FAS 115).

Available for sale investments are carried at fair value, with fluctuation in values (net of tax) being recorded in other comprehensive income unless an "other than temporary impairment" ("OTTI") charge is recorded directly to income. Market declines in recent quarters have resulted in charges to other comprehensive income as guarantors have marked down their general insurance and investment agreement portfolios. Guarantors are responsible for monitoring the unrealized losses reported in AOCI and for recognizing those losses in the income statement when they become "other than temporary".

As market prices continue to remain significantly below cost for some securities, OTTI charges have begun to accelerate in the first quarter of 2008. The criteria for consideration of an OTTI charge under GAAP is not clearly defined in existing accounting literature, however reporting entities generally consider the degree to which a security's market value as well as the length of time the security has been underwater in determining whether an impairment charge is appropriate.

A key issue in evaluating the potential credit ramifications of a guarantors' investment agreement business is liquidity. To the extent that the business approximates a matched book, and the companies retain an adequate cash buffer, forced sales of below market securities in the investment agreement portfolio should be unnecessary. Realized losses in the investment agreement portfolio, whether from actual sales or OTTI charges, generally represent an economic loss to the guarantor and may result in additional ratings pressure.

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Author

Wallace Enman

Production Associate

David Heston

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