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Global Financial Guaranty Insurance Industry Outlook

Summary Opinion

Table 1: Moody;s Rated Financial Guarantors ($Mil.)T

Company	Sector	Moody's IFSR [1]	IFRS Rating Outlook [1]	Net Par Outstanding at 3Q2006	% Industry NPO
MBIA	Primary	Aaa	Stable	$590,450	27.1%
Ambac	Primary	Aaa	Stable	$513,438	23.6%
Financial Security Assurance	Primary	Aaa	Stable	$365,322	16.8%
FGIC	Primary	Aaa	Stable	$239,693	11.0%
XLCA/XLFA	Primary	Aaa	Stable	$110,779	5.1%
Radian Asset Assurance	Hybrid	Aa3	Stable	$95,979	4.4%
CIFG	Primary	Aaa	Stable	$64,461	3.0%
Assured Guaranty Corp.	Primary	Aa1	Positive	$62,285	2.9%
Assured Guaranty Re	Reinsurer	Aa2	Stable	$59,294	2.7%
Channel Re [2]	Reinsurer	Aaa	Stable	$32,575	1.5%
RAM Reinsurance Company	Reinsurer	Aa3	Stable	$30,325	1.4%
BluePoint Re Limited	Reinsurer	Aa3	Stable	$14,207	0.7%
			Industry Total	$2,178,808	

Source: Moody's, Company Data
[1] Ratings as of December 7, 2006a
[2] Channel Re NPO as of June 30, 2006

Moody's outlook for the global financial guaranty insurance industry is stable, which reflects the view that, over the next 12 to 18 months, the number of rating actions is likely to be modest and driven more by specific characteristics of individual firms than by industry-wide conditions. While the capital adequacy of the financial guaranty industry remains strong and underpins our stable outlook, a number of factors continue to create a challenging operating environment for the industry as a whole.

Tight credit spreads, a record supply of capital seeking returns, the maturity of the U.S. public finance market and financial guaranty alternatives (including credit default swaps, derivative products companies and senior/sub structures), have all combined to test the industry's underwriting discipline as all of these growth-minded firms look to notch top-line growth with adequate returns on invested capital. Moody's notes that some of the newer entrants to the industry operate without the benefit of strong embedded earnings to mitigate the effect of cyclical downturns in pric-

ing. This could put additional pressure on these companies to write new business at less favorable terms. The established companies face issues of their own given the greater efforts required to redeploy capital in their core business.

Looking beyond today's challenging operating environment, emerging structural trends affecting the world's financial markets are likely to provide substantial opportunities for the guarantors over the medium to long term. These opportunities are expected to arise from increased financial disintermediation globally, growing institutional demand for low-risk securities and the pending implementation of Basel II.

The financial guaranty industry is changing with the overall financial markets, having embraced change throughout its history, evolving from an industry that exclusively focused on U.S. municipal securities to one that has significant involvement in the structured finance markets and a growing presence outside the United States. As new asset classes emerge, Moody's expects the financial guarantors to remain at the forefront, wrapping transactions that meet the low-risk underwriting philosophy that has defined the sector, and where their insurance is valued by both issuers and investors.

Financial Guaranty Insurance Industry Profile

STRENGTHS/OPPORTUNITIES

- High quality and well-diversified insured portfolios
- Srong risk-adjusted capitalization
- Stable and predictable earnings streams
- Highly transparent risks and business strategies
- Limited liquidity risk through policy contract language that precludes acceleration of principal payments on insured obligations

WEAKNESSES/CHALLENGES

- Mature market, with an increasingly competitive underwriting environment
- Sensitivity of insured portfolios to credit cycle with some large single risk exposures
- Tight credit spreads have adversely affected demand for product
- Alternative forms of execution (e.g. credit default swaps, senior/sub structures) remain a threat to industry
- Limited pool of financial guaranty reinsurers

Key Rating Drivers

MAINTAINING A STABLE OR UPWARD RATING PROFILE COULD RESULT FROM:

- Strong market acceptance and demonstrated franchise value
- Maintenance of hard and total capital ratios at levels above Moody's expectations
- Consistent, profitable growth and capital formation
- Controlling costs, maintaining underwriting discipline, and effectively managing portfolio risk

DOWNWARD PRESSURE ON A COMPANY'S RATING COULD RESULT FROM:

- Failure to maintain hard and total capital ratios at levels consistent with Moody's expectations
- Erosion of profit margins from inadequately priced business
- Sudden, adverse changes in the legal, tax or regulatory environment
- Aggressive financial leverage at holding company
- Significant growth in non-financial guaranty businesses
- For guarantors with corporate parents, a downgrade of the parent company debt rating beyond certain thresholds

Recent Developments and Trends

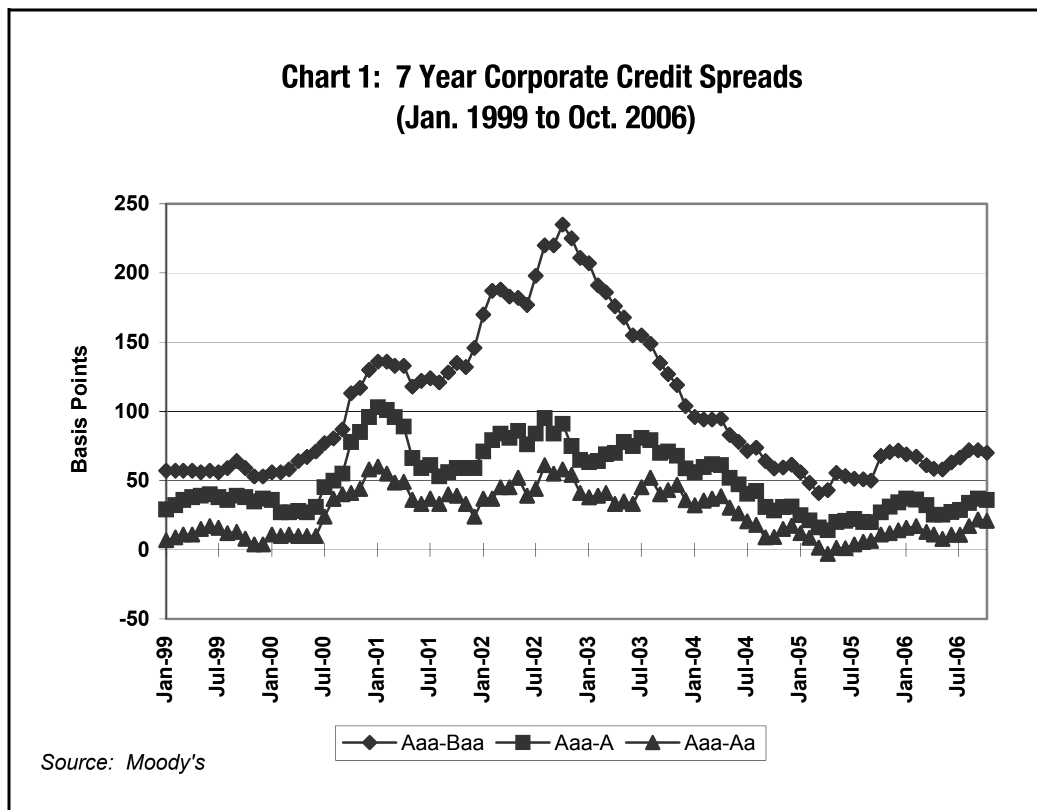
AGGREGATE PREMIUMS REBOUND, BUT REMAIN BELOW RECORD ACHIEVED IN 2003

Following a 10%+ slide in adjusted gross premiums (AGP) during 2004, the primary financial guarantors reversed the downward trend, posting approximately an 8% rise in AGP during 2005. With approximately $3.5 billion in AGP written through the first nine months of 2006, Moody's projects that full year 2006 AGP will be roughly flat compared to 2005 and still below the record level of AGP achieved during 2003. Tight credit spreads and intense competition among the guarantors created a challenging operating environment that shows no signs of abating any time soon.

TIGHT CORPORATE CREDIT SPREADS FRUSTRATE STRUCTURED FINANCE PRODUCTION

Generally speaking, credit spreads represent the range within which a financial guaranty premium can be priced by a guarantor. From the perspective of the debt issuer (the buyer of the guaranty), the credit spread represents the upper limit on potential debt service savings that can be achieved by purchasing insurance - assuming the issuer in question trades flat to average spread levels.

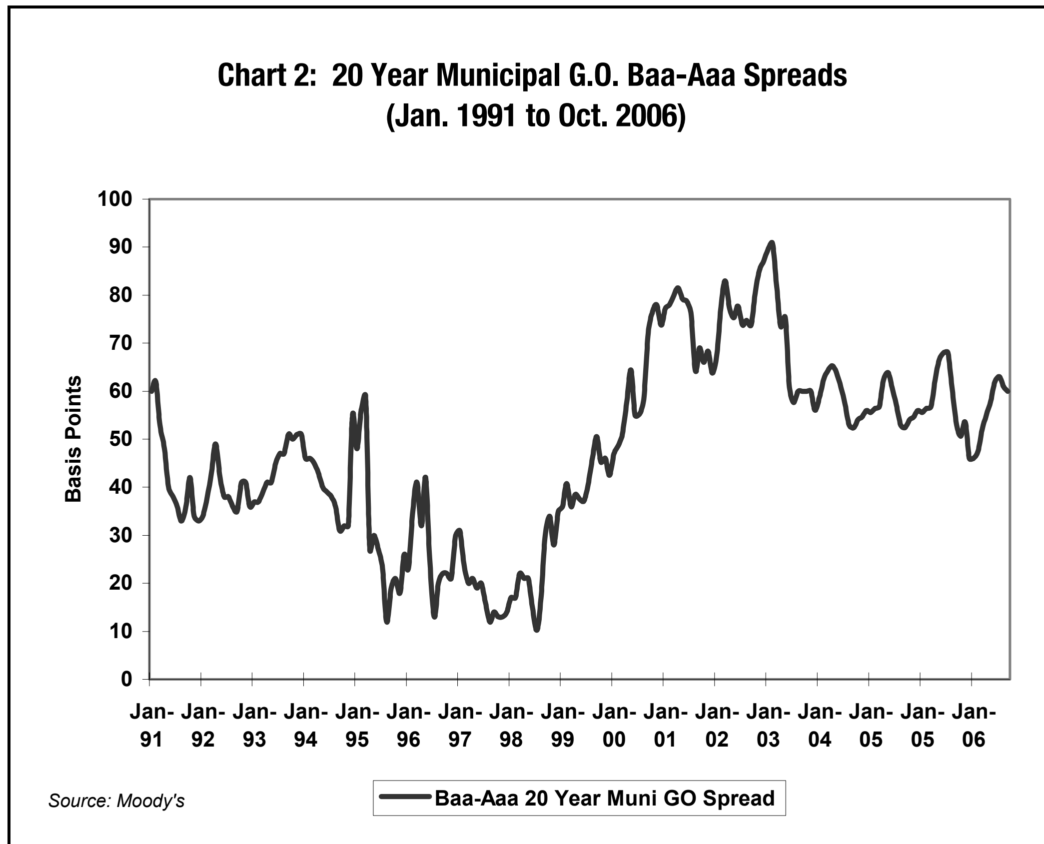
Beginning in mid-2002, corporate credit spreads began to tighten, reflecting a combination of enthusiasm over the rebounding economy and exceptionally low interest rates, ultimately reaching lows not seen in over five years by early 2005. The impact of tight spreads has adversely affected structured finance penetration rates and pricing. While credit spreads have rebounded from the lows, they remain at levels that continue to impact premium levels and production volumes. The corporate credit spreads shown in Chart 1 provide an indication of the recent tightness in asset-backed security (ABS) sectors relative to strong pricing conditions in the 2001-2002 timeframe.



MUNICIPAL SPREADS HOLDING ON; COMPETITION DECREASES MARGINS

Like spreads in the corporate bond sector, municipal spreads have also been in a downward trend, but remain at levels much higher than those observed through most of the 1990s. Consequently, the U.S. municipal sector continues to provide moderately favorable underwriting conditions – though sluggish issuance volume and the potential for reduced penetration rates may result in less opportunity for guarantors to use the municipal market as an offset to flat structured finance insured volume and erratic opportunities in international markets. Price competition for municipal deals is intense due to the desire by both the established players and newer entrants to add high quality municipal issu-

ers to their insured portfolios. The result in some cases has been a decrease in the portion of the credit spread captured by the guarantors through premiums.



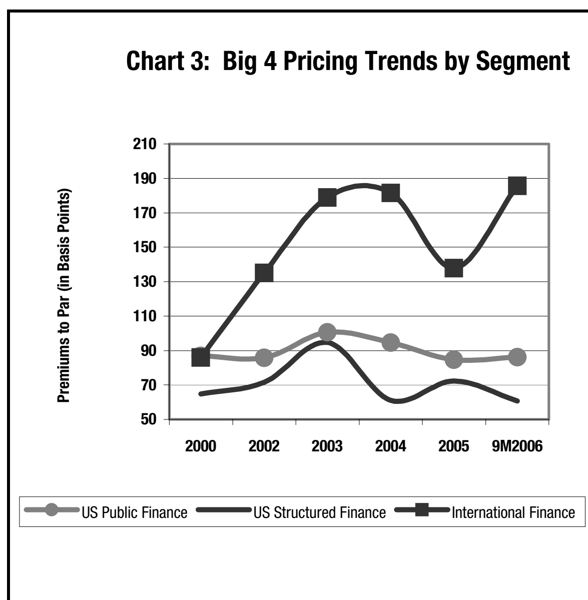
AGGREGATE INDUSTRY PRICING TREND LIFTED BY INTERNATIONAL SEGMENT; U.S. PRICING CONTINUES DOWNWARD SLIDE

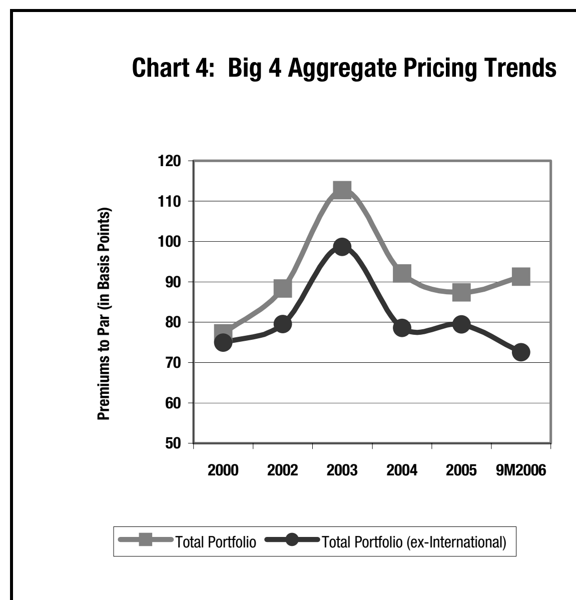
One way to get a high-level quantitative view into pricing trends is to compare adjusted gross premiums (which represent upfront premiums written plus the present value of future installment premiums) to gross par written, resulting in a price per unit of exposure. While this is a non-risk adjusted measure, it does provide a ballpark estimate of pricing trends in the industry.

Using the four largest industry players - Ambac, MBIA, FSA and FGIC (which collectively represent approximately 85% of primary industry gross par written) in this pricing trend model, we see that pricing during the past seven years peaked during 2003, declined sharply in 2004 and has since remained relatively stable on an aggregate basis, buoyed by strong pricing in the international segment. Taking international finance production out of the equation, we see a continued slide in pricing trends, from 99 basis points in 2003 to about 73 basis points currently, with recent weakness in both the U.S. public finance and U.S. structured finance sectors. To be sure, some of the decline in the U.S. structured finance sector could be explained by the proliferation of high excess "super-senior" risks being written by the guarantors. However, the pronounced slide in premiums to par for U.S. risks leads us to believe that there is more at work here – with increased competition among the primary guarantors the likely culprit. Moody's notes that the conclusions reached through this framework are largely consistent with the aforementioned credit spread trend data depicted above, with better pricing coinciding with wider credit spreads.

Table 2: "Big 4" Pricing Trends ($ Mil.) - Ambac, MBIA, FSA and FGIC	2000	2001	2002	2003	2004	2005	9M2006
Total U.S. Public Finance Gross Par Written	$96,398	$147,167	$189,321	$195,251	$184,003	$223,675	$113,179
Total U.S. Structured Finance Gross Par Written	$113,624	$163,385	$148,333	$104,464	$166,861	$163,165	$129,587
Total International Finance Gross Par Written	$54,133	$57,499	$64,329	$63,698	$52,768	$60,660	$48,260
Total Gross Par Written	$264,155	$368,051	$401,983	$363,413	$403,632	$447,500	$291,026
Total U.S. Public Finance Adj. Gross Premiums	$838	$1,185	$1,623	$1,966	$1,739	$1,894	$975
Total U.S. Structured Finance Adj. Gross Premiums	$736	$986	$1,061	$991	$1,018	$1,180	$785
Total International Finance Adj. Gross Premiums	$465	$743	$868	$1,139	$958	$836	$896
Total Adjusted Gross Premiums	$2,039	$2,914	$3,552	$4,096	$3,715	$3,910	$2,656
Total Premium to Par (in bps):							
U.S. Public Finance	86.9	80.5	85.7	100.7	94.5	84.7	86.1
U.S. Structured Finance	64.8	60.4	71.5	94.8	61.0	72.3	60.6
International Finance	86.0	129.3	135.0	178.8	181.5	137.8	185.7
Total Portfolio	77.2	79.2	88.4	112.7	92.0	87.4	91.3
Total Portfolio (ex-International)	74.9	69.9	79.5	98.6	78.6	79.5	72.5

Source: Company Data, Moody's





NEWER ENTRANTS MAKE PRESENCE FELT

The growth of the financial guaranty industry during the past five years and the success of the established guarantors have brought about increased competition, both from within the industry and from alternative credit enhancement products and vehicles. Highly competitive bidding has been indicated as a concern among the guarantors many times during the past couple of years. The degree of competition is exacerbating the weak conditions brought about by tight credit spreads.

Firms such as FGIC, XL Capital Assurance (XLCA) and Assured Guaranty Corp. (AGC) have had some success in joining Ambac, MBIA and FSA on the underwriting rotations of major ABS issuers. XLCA, in particular, continues to expand its footprint, broadening its acceptance across a range of market sectors. CIFG has been active as well, growing its NPO by 51% during the first nine months of 2006. AGC's primary gross par written during 9M2006 grew by 220% over the prior year period. AGC's new production continues to be concentrated in structured finance although the company has also been gaining traction in the international markets. Also in the mix is Radian Asset Assurance (Radian), which has been executing a strategy of writing primary insurance for niche and lower credit quality transactions and providing reinsurance for the primary companies. However, given Radian's strategy of focusing on transactions where Aaa credit enhancement is not necessarily required, the company has generally avoided competing directly against the Aaa-rated primary guarantors.

Derivative product companies (DPCs) with Aaa-rated operating platforms, such as Primus Guaranty Ltd. (Primus) and Athilon Capital Corporation, have the potential to create additional competition for the guarantors in the structured finance space. As of September 30, 2006, Primus had approximately $15.4 billion of net notional amounts outstanding (analogous to NPO). While these companies primarily compete with commercial and investment banks in the single-name credit default swap (CDS) arena, Moody's believes that they could increasingly have overlapping activities with financial guarantors in the future (e.g. CDS on structured finance bonds).

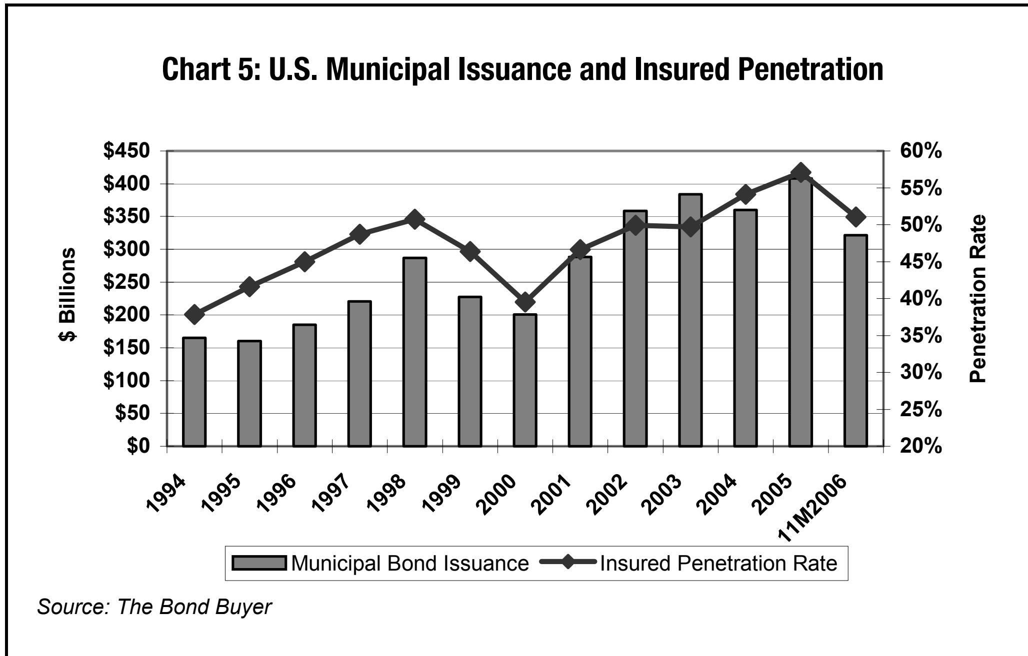
RAM HOLDINGS AND SECURITY CAPITAL ASSURANCE COMPLETE IPOs

Both RAM Holdings Ltd. and Security Capital Assurance Ltd (SCA) made their stock market debuts during 2006 through initial public offerings. The $141 million RAM IPO was largely for the benefit of selling shareholders (including MBIA, Transatlantic Reinsurance Company and a host of private equity investors), with approximately $17 million being added to the company's capital base. The $481 million SCA IPO raised approximately $341 million in net proceeds for the company ($200 million of which was downstreamed to its wholly-owned operating subsidiaries, XLCA and XL Financial Assurance Ltd, (XLFA) to support business growth) with the remainder going to selling shareholder, XL Insurance (Bermuda) Ltd, a wholly-owned subsidiary of XL Capital Ltd, which continues to maintain a 63% economic stake in the company.

U.S. Public Finance

MUNICIPAL MARKET REBOUNDS IN 2005 TO RECORD LEVEL; 2006 VOLUME SLUGGISH WITH LOWER PENETRATION RATE

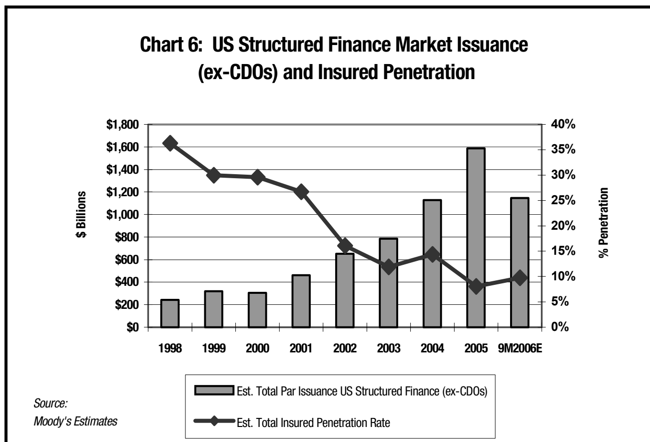
Following the decline in U.S. public finance new issuance volume in 2004, the municipal market rebounded strongly to record levels in 2005, with approximately $408 billion in new issuance (2004: $360 billion), accompanied by a record high insured penetration rate of more than 57% (2004: 54%). For the first eleven months of 2006, public finance new issuance volume approximated $321 billion, a 14.7% decrease relative to 11M2005, and the lowest volume during the first eleven months since 2001. In addition, insured penetration for 11M2006 was 51%, down significantly compared to 2005, but still above the long-term historical average.

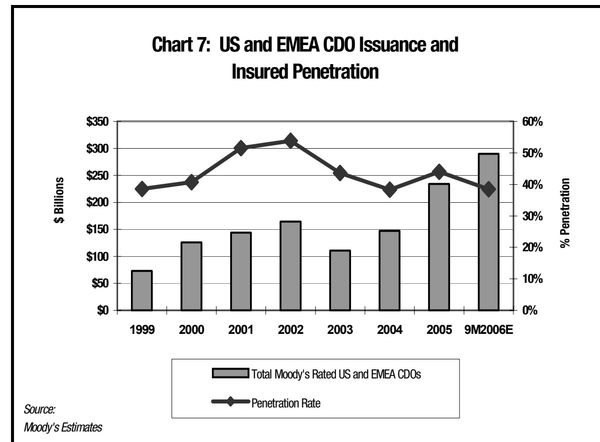


U.S. Structured Finance

LOW PENETRATION RATES IN ABS SECTOR RESULT IN FAILURE TO RIDE ISSUANCE BOOM; CDOs PROVIDE LONE BRIGHT SPOT

US ABS production during 2006 should eclipse the amount of par written during 2005, largely due to the continued explosion in CDO issuance volume, which has largely offset continued weakness in other ABS sectors - which despite strong secular growth, particularly in mortgage-related sectors, has exhibited a pronounced decline in insured penetration rates. In addition to the aforementioned tight credit spread environment, Moody's believes that the decline in non-CDO ABS penetration has also been a result of greater investor comfort with traditional ABS sectors, such as credit cards, autos, equipment leases and mortgage-related products, resulting in the widespread acceptance of senior-subordinated structures and over-collateralization as a means of credit enhancement.





EMERGING ASSET CLASSES PROVIDE OPPORTUNITIES

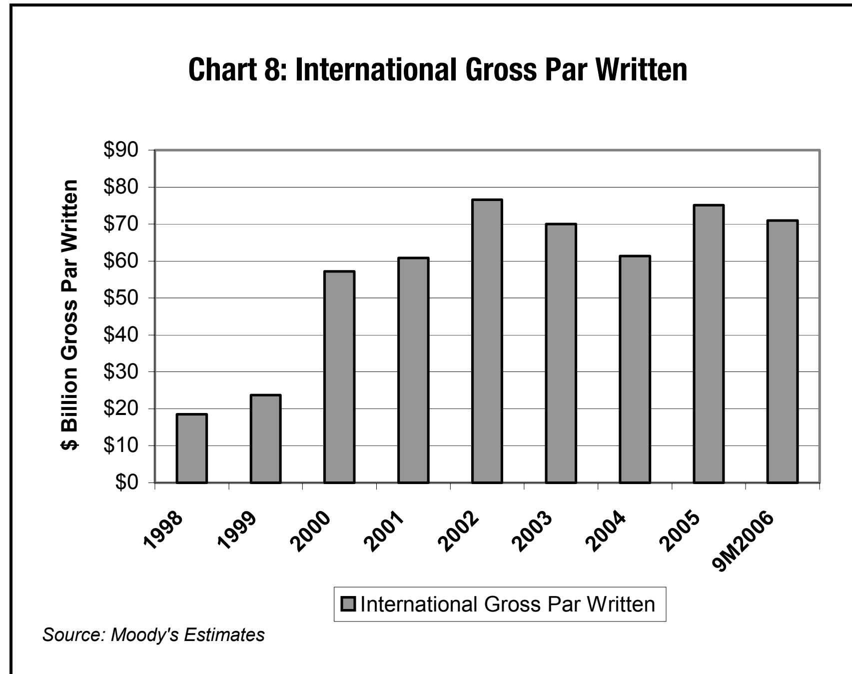
The guarantors continue to find opportunities in wrapping new asset classes. Here, the financial guaranty industry has a proven track record – as exemplified by the expansion beyond municipal underwriting into structured finance transactions. Recent new products include guarantees of principal protection plans and Regulation XXX securitizations of closed blocks of life insurance policies. In general, the guarantors have approached these new products in a prudent fashion, ensuring that transactions meet a broad underwriting philosophy consistent with their traditional business model of underwriting to an investment grade standard with a low probability of default and low loss severity given default.

Moody's generally views each of these opportunities favorably as it allows firms to continue to grow while diversifying their overall portfolio. However, Moody's notes that new products often carry risks that go beyond pure credit risk – such as market and interest rate risk and fraud risk – which may be difficult to analyze and manage. Our main concerns relate to the potential for the guarantors to take on liquidity risk or catastrophic risks that would be inconsistent with their business model and financial profile.

International Finance

INTERNATIONAL MARKET PICKS UP; WILL GROWTH PROMISES FINALLY BE REALIZED?

The international financial guaranty sector has long been viewed as the next great growth engine for the industry. However, business volumes can be volatile – reflecting the impact of large transactions on overall business written. With approximately $71 billion in international gross par written for the first nine months of 2006, the guarantors are on pace to break the record $77 billion in production volume achieved during 2002. A significant challenge faced by the guarantors in the international segment relates to tight credit spreads for structured finance business, which constitutes the majority of international business opportunities. As a result, the guarantors are relying more on infrastructure and whole business securitization transactions for volume, which are inherently more unpredictable than traditional flow business. In addition, Moody's notes that several guarantors, including FGIC, XLCA, AGC and CIFG have increased their international presence in the past couple of years, leading to increased competition in the non-U.S. market. Going forward, Moody's believes international markets remain a significant growth opportunity for the industry, particularly given the continued trend toward financial disintermediation in non-U.S. jurisdictions, as well as the pending implementation of Basel II.



Cyclical and Structural Factors Shape Competitive Environment

In Moody's opinion, the operating environment for the financial guarantors remains challenging – as it has for the past couple of years. Tight credit spreads, rising interest rates, increased competition - both from within the industry and from financial guaranty alternatives - all serve as headwinds to be faced by the industry. Some of these challenges are cyclical in nature, while others are more structural.

NEGATIVE FACTORS

Cyclical

- Tight credit spreads
- New entrants and increasing maturity of smaller players
- Capital levels at an all-time high
- Rising interest rates can lower issuance volume

Structural

- Mature U.S. market
- Financial guaranty alternatives (Credit default swaps, DPCs, senior-subordinated structures)

POSITIVE FACTORS

Cyclical

- Potential for increased perception of credit risk, leading to wider credit spreads and greater demand for credit enhancement
- Industry will adjust supply of capital (e.g. buybacks, consolidation)
- Rising interest rates generally lead to wider credit spreads and better returns on invested assets

Structural

- Global financial disintermediation
- Financial innovation (new asset classes)
- Basel II recognition of financial guaranty insurance for capital relief

POTENTIAL TACTICAL AND STRATEGIC RESPONSES

Moody's anticipates that the financial guarantors will utilize both tactical and strategic actions to navigate their way through the difficult current market environment - some of which are more radical than others.

Lower Premium Rates

Growing the top line in a mature market often requires taking business from competitors. One way to do this is to offer your product at a lower cost. While such a strategy could potentially achieve its goal of increasing new business production, it carries significant attendant risks. In Moody's opinion, this strategy can lead to a race to the bottom – with adverse implications on risk-adjusted returns for the entire industry.

Take More Risk

By writing more low investment grade and non-investment grade deals, guarantors can boost premium levels. However, Moody's notes that this strategy would require a delicate balancing act. First, Moody's believes that a key tenet of the guarantors' strategy that supports the industry's high ratings is underwriting to an investment grade standard, with high quality, low-risk portfolios. A marked increase in non-investment grade exposure would create negative ratings pressure. Second, if we were to enter an adverse credit cycle with significant and broad-based downward credit migration, a company with a portfolio exhibiting lower overall credit quality would be more vulnerable to failing Moody's capital adequacy tests, potentially placing the company's ratings (and potentially the franchise) at risk. To date, portfolio credit quality among the guarantors has remained relatively stable, but Moody's continues to closely monitor the credit quality ratio results of our portfolio risk model for signs of increased risk appetites among the guarantors.

Capital Management Activity

One cost of success for the established guarantors in the current competitive environment is the limited level of opportunity to deploy the capital generated over the past few years. If we assume that industry hard capital above 1.4x Moody's portfolio risk model test is deemed to be "excess capital", the industry had nearly $4.3 billion of excess capital at year-end 2005. To the extent profitability measures are adversely affected by such marginally deployed capital, a rational response is to reduce capital through share repurchases and/or increased common share dividends. In Moody's opinion, share repurchases or extraordinary dividends are preferable to significant increases in quarterly dividend payments, since once quarterly payouts are raised, companies often lack the willpower to reduce them (usually until a real capital crisis occurs), resulting in what effectively become higher fixed charges that must be serviced. During 2005, both Ambac and MBIA engaged in significant share repurchase activity.

Consolidation

If there are too many guarantors chasing too few business opportunities, another remedy available is to reduce the amount of competition through consolidation. While cost savings could be considerable given the scalability of the financial guaranty model, in Moody's opinion, it would take a "fire-sale" price to make the execution risk of an acquisition worthwhile for the best-positioned players. On the other hand, the merger of two newer entrants to the market could create a company better able to compete with the more established franchises.

Focus on New Markets and Products

Non-U.S. markets, despite the erratic business production figures over the past few years, continue to be attractive for third party credit enhancement. The aforementioned global trend toward financial disintermediation and privatization efforts, particularly in Europe, continue to fuel demand for financial guaranty product. Likewise, other opportunities exist in new ABS products that are constantly being developed – such as Regulation XXX securitizations – though, as mentioned before, these products may carry attendant risks.

Enter Extension of Core or Non-Core Businesses

In an effort to grow and diversify revenues, several guarantors have pursued targeted diversification strategies by investing in a small number of non-core ventures and by developing significant asset management operations. This has included insuring and/or sponsoring programs involving GICs, funding conduits, swap brokerage and third-party asset management. For some companies, these activities have become a notable part of their business operations, introducing distinct forms of financial, operational and reputational risks to the core franchise. If unchecked, the growth in prominence of such non-core activities could potentially lead to negative rating pressure, particularly if these activities begin to have a material impact on a guarantor's overall risk tolerance, strategic focus or credit profile.

At current levels, the diversification activities of the guarantors are not generating undue risk in our opinion, and do not present a threat to their ratings. This reflects our view that the bulk of today's non-financial guaranty activities have franchise and risk attributes, and/or are of a relative size, that leaves the guarantors' overall business model and credit profile largely intact. However, history has demonstrated that certain diversification activities can prove distracting to management, and more importantly, can be costly from both a financial and reputational standpoint. For this reason, any significant change to the guarantors' inherently narrow business model of assuming high quality credit risk would likely alter our view of the key rating drivers going forward, and could place negative pressure on existing ratings.

Increase Financial Leverage

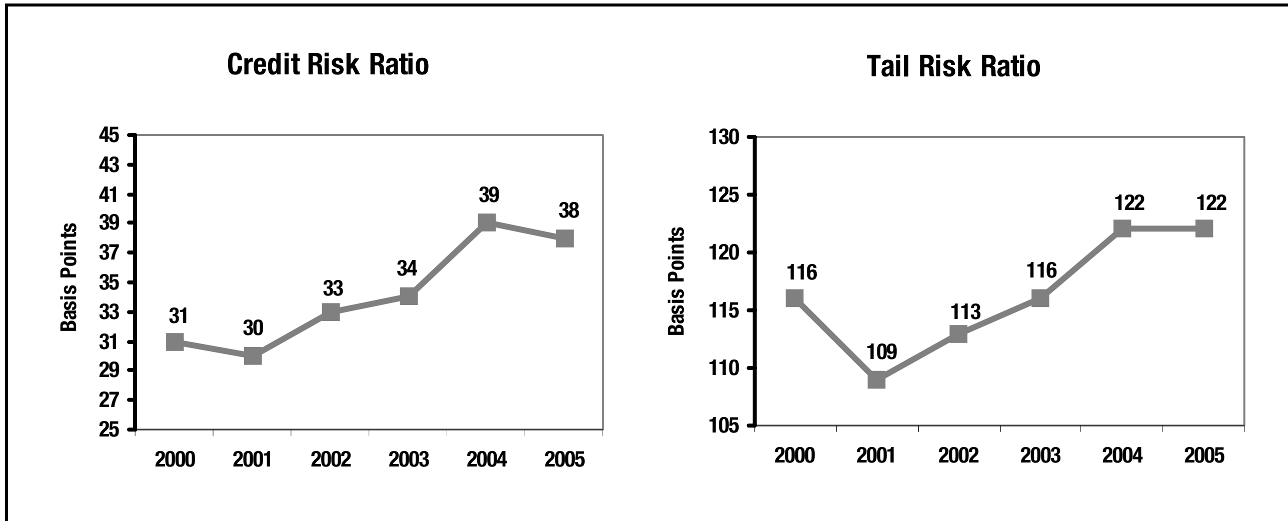
Finally, another way to boost returns on equity in a difficult underwriting environment is to increase financial leverage – including the use of hybrid forms of capital. For guarantors with debt capacity relative to Moody's financial leverage expectations, this is a viable option, though one not without risk, as higher levels of debt in a company's capital structure can result in increased vulnerability to unexpected losses. Additionally, increased debt leverage places incremental pressure on both the debt and insurance financial strength ratings since servicing such debt creates an incremental cash demand on the operating companies.

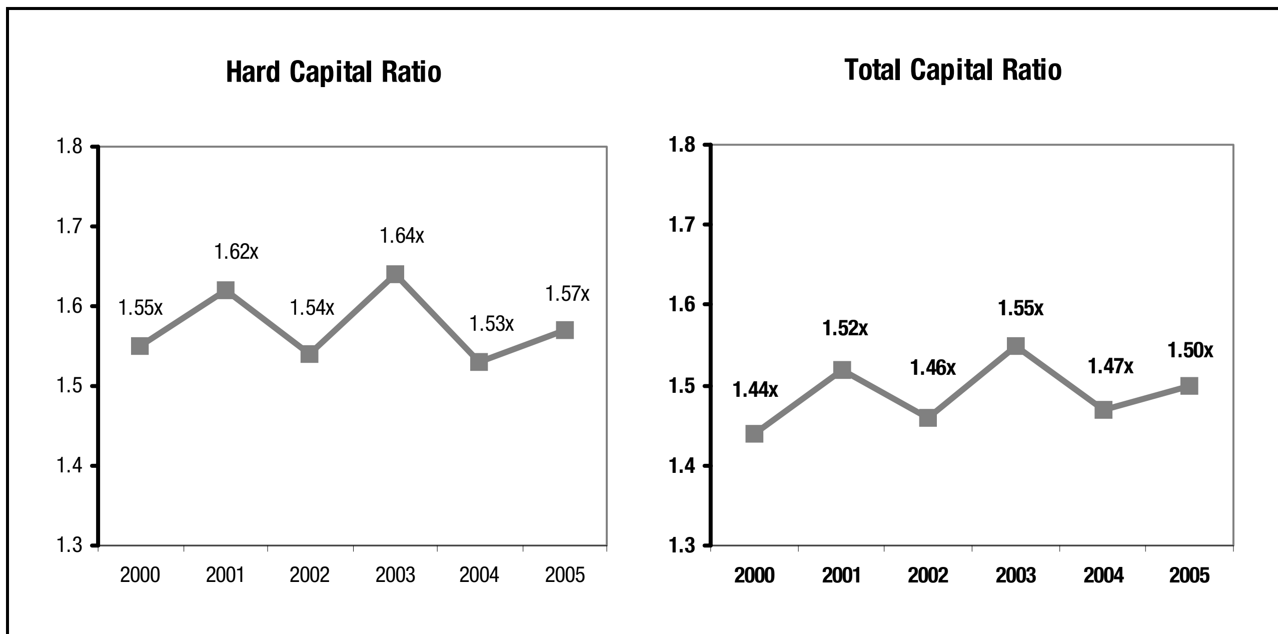
Capital Adequacy

HARD AND TOTAL CAPITAL RATIOS REMAIN STEADY, DESPITE INCREASED RISK

Moody's most recent financial guarantor model results (exposures as of YE2005, ratings as of 2Q2006) show relatively stable portfolio risk characteristics for the industry overall, though the longer term trend indicates a deterioration in overall portfolio credit quality. Capital adequacy ratios have largely remained stable, though some improvement has occurred during the past year. The declining trend in portfolio quality is primarily the result of two factors. The first relates to distress in various asset classes in which the guarantors participate, with U.S. airline Enhanced Equipment Trust Certificates (EETCs), manufactured housing loan ABS, Katrina-related credits and certain MBS exposures having the greatest impact on the model results. Secondly, the guarantors' insured portfolios continue to gradually shift from a low-risk U.S. municipal focus to more risky, but higher premium, ABS and international exposures.

For the financial guarantors at large, recent increases in capital levels have been sufficient to absorb the rise in modeled tail losses, as the industry's hard and total capital ratios improved slightly during 2005. 2006 underwriting volumes continue to show slower growth in today's tight credit-spread environment, and the guarantors' capital ratios are benefiting from portfolio run-off and refundings, thereby reducing the overall level of risk relative to capital. For some guarantors, however, model results are trending down, which is causing them to tread lightly or altogether avoid new volume in those sectors that have caused them difficulty. Furthermore, those guarantors with hard and total capital ratios closer to 1.3x may feel somewhat more constrained in managing exposure and capital over the coming year.





Trends in Capitalization

FINANCIAL LEVERAGE PINNED NEAR HIGH END OF EXPECTATIONS

In general, Moody's expects Aaa-rated guarantors to maintain financial leverage at the holding company at levels below 16%. In recent years, on an industry-wide basis, the primary guarantors have maintained a collective debt to capital ratio near 15% - largely kept static through the issuance of additional debt and buying back stock. Going forward, Moody's expects the guarantors to continue to attempt to maximize returns on equity capital through financial engineering – including the use of hybrid securities, which can receive favorable financial leverage treatment from Moody's due to the bifurcation of debt and equity content of such securities for our adjusted financial leverage calculations.

RECENT HYBRID SECURITIES TRANSACTIONS AUGUR NEW TREND

During 4Q2006, FSA, RAM Re and AGC issued hybrid securities that were accorded "Basket D" treatment on Moody's Hybrid Debt-Equity Continuum (considered to be 25% debt and 75% equity for financial leverage calculations). Moody's believes that other guarantors are likely to consider issuing such securities given their efficient cost relative to common equity and their relatively muted effect on adjusted financial leverage ratios.

MOSTLY QUIET ON THE SOFT CAPITAL FRONT

While Moody's rated a number of committed trust preferred soft capital facilities during 2003 and 2004, 2005 and 2006 have been largely quiet years, as the guarantors saw little need to increase total capital levels due to their current strong capital positions. In March 2005, Moody's rated a $200 million soft-capital facility (Woodbourne Capital Trusts I-IV) sponsored by AGC and a $100 million soft-capital facility (Hamilton Preferred Trusts I-II) sponsored by Assured Guaranty Re. However, as portfolios grow over the coming years, Moody's expects the guarantors to again turn their attention to supplementing their claims-paying resources with additional injections of soft capital.

REINSURANCE UTILIZATION

The ceded par to gross par outstanding ratio continued to decline during 2005, ending the year at approximately 15.3%, down from 15.7% at year-end 2004 and the recent high of 17.0% at year-end 2000. In Moody's opinion, firms that have ceded to gross par ratios below 10% have enhanced financial flexibility to reduce potential capital strain through increased reinsurance utilization.

Financial Guaranty Reinsurers

REINSURANCE MARKET SETTLES DOWN FOLLOWING CHANGES IN THE ROSTER

During 2003 and 2004, the financial guaranty reinsurance market was in flux. Multi-line reinsurers, such as American Re and AXA Financial exited the business, while Assured Guaranty Re and Radian Asset experienced contractions in their reinsurance books from primaries that either "clawed back" business due to rating changes or decided not to renew quota-share reinsurance treaties. The decision on the part of the established primaries to bring business back onto their books or retain a greater proportion of new business written was made possible by generally strong capital positions and was likely influenced by the fact that Assured Guaranty and Radian were competitors for primary business. Filling the void were two newly established companies, Channel Reinsurance Ltd. (Channel Re) and BluePoint Re Limited (BluePoint Re), which both began operations in 2004.

ROBUST CAPITAL LEVELS AT PRIMARIES AND LACK OF MARKET POWER CONTRIBUTE TO SECTOR HEADWINDS

In addition to the challenges we have outlined for the primary guarantors, the reasons behind the difficult market conditions for reinsurers today also have much to do with the primaries' stronger capital positions, the ever broadening diversification brought on by new security types and asset classes, and unique risk management objectives. The result has been that primaries simply have less need for blanket, proportional reinsurance (broad treaty share arrangements) than in the past. It is these types of arrangements that have been central to maintaining a reinsurance book of business that is highly diversified and profitable. Increasingly, primaries rely on reinsurance to manage their high single risk exposures and/or shape their insurance portfolio's risk profile, making the reinsurer more prone to adverse selection. Also adding to the malaise is the reinsurers' lack of marker power to drive pricing higher due to the small number of industry cedants and the high percentage of business obtained through quota-share treaties.

REINSURANCE REMAINS A KEY RELIEF VALVE FOR CAPITAL STRAIN

Despite the difficult environment for reinsurers and relatively strong levels of capital among the primaries, Moody's believes that all of the guarantors, particularly the newer entrants to the primary market, still need highly-rated reinsurance options for mitigating single large risks and optimizing diversification. The creation of Channel Re is a clear illustration of financial guarantors' interest in developing long-term solutions for their reinsurance needs. While guarantors have, in the past, invested in reinsurers (FSA investing in XLFA, MBIA investing in RAM Re), Channel Re was the first company set up to service a single client (MBIA).

Regulatory Environment

SEVERAL GUARANTORS RECEIVE SUBPOENAS RELATED TO MUNICIPAL GICS

In November 2006, several financial guarantors, including SCA, FGIC and FSA, announced that they had received subpoenas from the Antitrust Division of the U.S. Department of Justice and/or the Securities and Exchange Commission in connection with an ongoing criminal investigation of alleged bid rigging of awards of municipal GICs. The receipt of a subpoena is a formal request for information, but it does not indicate wrongdoing by the recipient. How-

ever, in some instances, subpoenas are means by which illegal actions or serious governance or control failures are uncovered. Moody's believes that active, independent board oversight of the company's response to the subpoena is critical. We will closely follow any developments related to the areas covered by the subpoena and will make further comments when new material information emerges.

SEC AND FASB REVIEW FINANCIAL ACCOUNTING PRACTICES OF INDUSTRY

In 2005, the Securities and Exchange Commission (SEC) initiated a review of the differences in loss reserving practices among the financial guarantors. Likewise, in mid-2005, the Financial Accounting Standards Board (FASB) added a project to its agenda to provide guidance on the accounting by financial guaranty insurers for claims liability recognition (including policies for loss reserves), premium recognition and the related amortization of deferred policy acquisition costs, specifically for financial guarantee contracts that are not accounted for as derivative contracts under FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*. While the ultimate outcome of these reviews remains uncertain with respect to both timing and substance, it is possible that changes to accounting guidelines promulgated by the SEC or FASB could impact the reported results of industry participants.

NAIC INSURER RECEIVERSHIP MODEL ACT

In March 2006, the National Association of Insurance Commissioners (NAIC) released a draft of Model Act 555, the "Insurer Receivership Model Act" (IRMA). The draft originally excluded mortgage insurance and financial guaranty insurance claims in the priority of distribution from Class 3 obligations (policyholder claim obligations), making such obligations appear to be classified as Class 6 obligations (claims of unsecured creditors). Subsequent drafts of IRMA appear to have dealt with this issue by deeming mortgage insurance and financial guaranty insurance claims to be Class 4 obligations, relegating unsecured creditor claims to Class 7 status.

MBIA SETTLEMENT NEGOTIATIONS ONGOING

The SEC along with the staffs of the New York Attorney General, U.S. Attorney's office for the Southern District of New York and New York Insurance Department began their investigations of MBIA in November 2004 covering five distinct issues. The Wells Notice issued by the SEC and the potential civil charges proposed by the New York Attorney General focused primarily on the AHERF reinsurance transactions. MBIA accrued $75 million in expenses in 3Q2005, based on its estimate of the aggregate penalties and disgorgement related to a settlement. The firm also restated the accounting for the remaining AHERF related agreements. While a settlement remains pending, Moody's expects a successful resolution of the regulatory investigations and has maintained its existing ratings and stable rating outlooks on MBIA Insurance Corporation and MBIA Inc.

Related Research

Special Comments:

Financial Guarantors: Hurricane Katrina Exposure Update, September 2006 (98981)

Evaluating Financial Guarantors' Exposure to Eurotunnel, August 2006 (98611)

Moody's Portfolio Risk Model Results for Financial Guarantors, August 2006 (98601)

Liquidity and Downgrade Risk In the Financial Guaranty Industry, July 2006 (98068)

The Effect of Hurricane Katrina on Guarantors' Capital Positions Appears Manageable, September 2005 (94273)

Loss Reserves on Financial Guaranty Insurance Contracts, April 2005 (92481)

Financial Guarantor Exposure to US Airline EETCs, March 2005 (91790)

Rating Methodology:

Moody's Rating Methodology for the Financial Guaranty Insurance Industry, September 2006 (98408)

Appendix 1: Moody's Rating Actions Since January 2004

Table 3: Summary of Moody's Rating Activity for Financial Guarantors: January 2004 to December 2006

Date	Company	Activity	Type	Rating
1/8/04	FGIC	Issuance of $250 million of 6.000% 30-year senior notes	Debt	Aa2
2/13/04	Channel Reinsurance Ltd.	Assigned initial IFSR at Aaa	IFS	Aaa
3/18/04	Sompo Japan Financial Guarantee Insurance Co.	Downgrade of IFSR to Aa3 (placed on review for downgrade on Dec. 19 2003)	IFS	Aa3
5/6/04	Assured Guaranty Corp.	Upgrade of IFSR to Aa1 (placed on review for upgrade on Apr. 9 2004 in conjunction with IPO)	IFS	Aa1
5/21/04	AGC US Holdings Inc.	Issuance of $200 million of 7.000% 30-year senior notes	Debt	A1
5/25/04	Radian Reinsurance, Inc.	Downgrade of IFSR to Aa3 (Radian Re subsequently merged into Radian Asset)	IFS	Aa3
5/25/04	Radian Asset Assurance	Assigned intial IFSR at Aa3	IFS	Aa3
7/16/04	FGIC	Issuance of $300 million Trust Securities, (Grand Central Capital Trusts I-VI)	Soft Capital	Aa2
7/28/04	Assured Guranty (UK) Ltd.	Assigned initial IFSR of subsidiary at Aa1	IFS	Aa1
10/18/04	MBIA UK Insurance Limited	Assigned initial IFSR of subsidiary at Aaa	IFS	Aaa
11/15/04	BluePoint Re Limited	Assgined initial IFSR at Aa3	IFS	Aa3
11/18/04	MBIA	Issuance of $350 million of 5.700% 30 year senior notes	Debt	Aa2
11/24/04	XLFA	Issuance of $200 million Trust Securities (Twin Reefs Pass-Through Trusts)	Soft Capital	Aa2
12/10/04	FGIC	Issuance of $75 million of 6.000% 30-year senior notes	Debt	Aa2
12/15/04	FGIC UK Limited	Assigned initial IFSR of subsidiary at Aaa	IFS	Aaa
2/11/05	Channel Reinsurance Ltd.	Issuance of $100 million Trust Securities (Two Rock Pass-Through Trust)	Soft Capital	Aa3
3/8/05	MBIA	Ratings Affirmed following restatements	IFS	Aaa
3/31/05	Assured Guranty Corp.	Issuance of $200 million Trust Securities (Woodbourne Capital Trusts I-IV)	Soft Capital	Aa3
3/31/05	Assured Guaranty Re	Issuance of $100 million Trust Securities (Hamilton Preferred Trusts I and II)	Soft Capital	A1
7/11/05	Sompo Japan Financial Guarantee Insurance Co.	Withdrawal of Aa3 IFSR	IFS	Withdrawn
7/15/05	Radian Reinsurance, Inc.	Withdrawal of Aa3 IFSR	IFS	Withdrawn
11/22/05	XLCA/XLFA	Ratings Affirmed following downgrade of XL Capital Ltd senior debt rating	IFS	Aaa
11/30/05	Ambac	Issuance of $400 million of 5.950% 30-year senior notes	Debt	Aa2
2/17/06	Ambac	Assigned provisional ratings to shelf registration of Ambac Financial Group, Inc.	Debt	(P)Aa2
4/7/06	XLCA/XLFA	Ratings Affirmed following Security Capital Assurance Ltd. IPO Filing	IFS	Aaa
4/10/06	RAM Reinsurance Company Ltd.	Rating Affirmed following RAM Holdings Ltd. IPO Filing	IFS	Aa3
6/27/06	Assured Guaranty Corp.	Revised Outlook on Aa1 IFSR to Postive from Stable	IFS	Aa1
10/23/06	PMI Guaranty Co.	Assigned initial IFSR at Aa3	IFS	Aa3
11/15/06	FSA	Issuance of $300 million of junior subordinated notes	Hybrid	A1
11/28/06	RAM Holdings Ltd.	Issuance of $75 million of preference shares	Hybrid	Baa1
12/13/06	Assured Guaranty US Holdings, Inc.	Issuance of $150 million of junior subordinated notes	Hybrid	A3

Source: Moody's

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