Special Comment

Moody's Global
Financial Guarantors

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Moody's Financial Guaranty Update: Frequently Asked Questions

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Introduction

There continues to be a high level of interest among investors in the financial guaranty industry, and in Moody's ratings of key players in the sector. Following the announcements of rating reviews of FSA and Assured Guaranty last week, and this week's announcement of SCA's agreements with XL Capital and Merrill Lynch, we have received a large number of calls from investors seeking our latest views on these issues.

Market participants also want to know how sustainable we think Aaa ratings are in this industry, our opinion on industry fundamentals, and the transactions most susceptible to further economic deterioration, to name but a few topics.

Because many of the calls received highlight common themes, we have organized this document around our responses to 10 of the most frequently asked questions.

Moody's Investors Service

Questions:

Q1. Why is Moody's considering downgrades of Assured and FSA when they have sufficient resources to meet your Aaa threshold? Has your methodology changed?

A: Based on recent discussions with investors and others in the marketplace, we note that some believe our rating approach begins and ends with a judgment about capital. That is, if a guarantor meets Moody's capital targets for a particular rating category, then it automatically receives that rating. This is not the case. Capitalization is, instead, a necessary, but insufficient, condition for a financial guarantor rating, as more fully outlined in our documented rating methodology.

We continue to rate financial guarantors based on our assessment of their positioning on five key rating factors, namely franchise value and strategy, portfolio characteristics, capital adequacy, profitability, and financial flexibility. These interdependent factors form the basis of a guarantor's operating dynamics and, in aggregate, provide a comprehensive picture of its overall credit profile. Although capitalization carries the most weight among the individual rating factors, other, more qualitative factors – including franchise value and financial flexibility – when taken together, have greater influence on the rating outcome.

With this as a backdrop, we've witnessed a dramatic change in the financial guaranty business in recent months, with fewer market opportunities and weaker market confidence for the industry overall. The structured market, for example, which generated about half of the industry's new business a year ago (and much more than that for Assured Guaranty), has ground to a virtual halt; at the same time, insured penetration rates in the municipal market have fallen from about 50% over the past several years to 20%-25% today. This sharp drop in overall market demand indicates a level of instability that, given the monoline orientation of the firms, raises questions about their Aaa ratings.

Beyond the negative implications of reduced customer demand, the business prospects and financial flexibility of financial guarantors have been exposed by recent events as being extraordinarily sensitive to shifting perceptions among intermediaries and customers about the value of their product. In this environment, Moody's has noted that even a slight decline in the credit profile of a guarantor can have a disproportionately negative effect on its ability to participate actively in the market. As such, the business viability of firms like FSA and Assured depends not only on customers' confidence that they will reliably meet any claim payments, but also on their ability to maintain a stable credit profile.

To date, FSA and Assured have fared better than many other financial guarantors by avoiding certain troubled sectors, although FSA's excess capitalization has been eroded quite a bit in the last year by mortgage-related losses. Moody's believes that both FSA and Assured will be able to meet claim payments with a very high degree of reliability. However, the compositions of their insured portfolios – and particularly their exposures to large and complex structured financings – may leave them vulnerable to a higher degree of volatility than their existing business models can sustain, at the current Aaa ratings.

As we've seen for other guarantors, not much has to go wrong for a company's fortunes to turn on a dime.

Q2. Do recent rating actions indicate that Moody's believes that Aaa ratings are no longer sustainable in this industry?

A: Moody's decision to place the ratings of FSA and Assured Guaranty on review for downgrade reflects company-specific credit issues and is not in itself a statement about the sustainability of triple-A ratings in the industry. These reviews were prompted by a substantial shift in demand for financial guaranty insurance, in addition to the presence of large, complex and concentrated risks within the portfolios of both firms in an environment where business opportunities have been exposed as being extremely sensitive to market confidence. FSA's review also reflects material credit stress within its insurance and financial products operations.

A natural follow-up question is whether we believe that a guarantor that insures only public sector risks (a "municipal-only" guarantor) is more likely to achieve a triple-A rating than a company with both municipal and structured exposures. It is an important question, as there are several existing and new players contemplating such a strategy.

The answer to this question is a qualified "yes". A municipal-only guarantor could certainly have a lower risk portfolio than a guarantor exposed to structured risks, therefore reducing the firm's likelihood of adverse development and lessening concerns about the confidence-sensitive nature of the business. Municipal exposures are generally of high credit quality, are frequently more granular, and appear to be less sensitive to the credit cycle.

However, not all exposures that could be considered part of a municipal-only strategy are low risk – there are several well-publicized cases where health care, infrastructure and essential service bonds have generated substantial losses. Furthermore, the municipal market is not immune to downward credit pressure, particularly in the current environment. Many municipalities are experiencing a decline in tax revenue, given the slowing economy and severe house-price depreciation, in addition to facing growing costs related to pension funding and infrastructure needs.

More broadly, the limited room for error associated with high operating leverage and a confidence-sensitive business model is likely to remain a credit issue for muni-only guarantors, despite the absence of structured risk. Additionally, the US municipal market opportunity, even for triple-A rated guarantors, could become narrower than in the past, given the market's evolving perception of low risk within the municipal sector and possible skepticism about the value of financial guaranty insurance.

Such a narrow business strategy, with limited core growth potential, is likely to generate increased competitive pressures that could, over time, adversely affect profitability and underwriting discipline.

The rating of a muni-only guarantor would be a function of its specific character, and would be based on Moody's judgments in the context of the five key rating factors outlined in our methodology. To merit a top rating from Moody's, whether Aa or Aaa, the guarantor would have to demonstrate a reliable plan for operating in a way that keeps the identified risks at a level consistent with extremely low expectations of loss without compromising the long-term economics of the business model.

Q3. How do you factor in the superior underwriting performance of FSA and Assured through this credit crisis?

A: In any period when insured losses are high, the distinct strategies and underwriting appetites of insurers are usually revealed in differential performance. Moody's has certainly observed this phenomenon in the current period of dislocation within the financial guaranty market. All financial guarantors rated by Moody's targeted their insurance underwriting to exposures that they believed would result in low losses under a range of stress scenarios; nevertheless, actual performance varied dramatically from firm to firm.

Among leading financial guarantors, the mortgage risk-underwriting strategies of FSA and Assured Guaranty were revealed as being more conservative than their competitors'. Both FSA and Assured pursued a relatively measured approach to US residential mortgage underwriting in recent years, but competitors SCA, CIFG and FGIC – and to a lesser degree MBIA and Ambac – accumulated very significant exposures relative to capital. And all of these competitors provided insurance against collateralized debt obligations, which were backed in large part by residential mortgage securities (ABS CDOs) -- a source of large losses.

The relatively strong underwriting performance of FSA and Assured during this credit crisis has been – and continues to be – an important consideration in Moody's rating analysis. However, our assessment of underwriting performance involves more than just an assessment of past performance; it incorporates judgments about the sustainability of that performance over time.

Part of the reason for our rating reviews of FSA and Assured is the growing belief – based on consideration of recent experience in the structured finance market – that this superior underwriting performance may not be able to be sustained. The lack of sustainability may be attributable more to specific individuals than to organizational constraints, or it may exist because the nature of certain insured exposures makes them intrinsically susceptible to unanticipated adverse developments -- or both.

Q4. If a decline in industry fundamentals is an important factor leading to the rating actions on FSA and Assured, why was Berkshire Hathaway Assurance not similarly affected?

A: Berkshire Hathaway Assurance Corporation (BHAC) is certainly exposed to many of the same industry dynamics as more established financial guaranty insurers that remain Aaa rated, but it does have a number of characteristics that set it apart from FSA and Assured Guaranty. These characteristics relate to the character of its insured portfolio and to the nature of its institutional support.

To understand why BHAC's Aaa rating was not reviewed along with the ratings of FSA and Assured, it is important first to understand the key differences between its exposures and those of its competitor financial-guaranty insurers. BHAC incepted its business recently, and management has limited its underwriting largely to US municipal sector exposure with extremely low levels of expected loss. BHAC does not have exposure to structured securities of any type. In fact, the majority of its insured transactions were executed in the secondary market and benefit from existing guaranties provided by other monoline financial guarantors. The quality and transparency of the BHAC portfolio is significantly different than is the case at either FSA or Assured.

Although the portfolio risk at BHAC is low and capitalization is high, the company would still be rated below Aaa, due to its positioning on the key rating factors, were it not for a guaranty from its Aaa-rated affiliate, Columbia Insurance Company. As outlined in Moody's credit opinion on BHAC, the company's stand-alone rating (before consideration of the guaranty) is Aa2.

Q5. What issues does Moody's intend to evaluate during the review process and what is the timing for reaching a conclusion?

A: During our review, we will consider the likely strategic direction of FSA and Assured given the changing dynamics within the industry and their specific credit issues, as well as the potential implications of any future regulatory changes to the credit profile of each company. Significant market developments have occurred over the last year, both in terms of changing new business prospects and an evolving competitive landscape for credit enhancement, and more changes are likely to occur in the future. In addition, the New York State Insurance Department has announced its intention to strengthen bond insurance regulation, which could well result in meaningful changes to how these firms conduct themselves.

Our reviews will also focus on the particular characteristics of each company's insured portfolios, particularly within the structured segment, that could make them susceptible to material losses as seen in the mortgage sector. FSA has already experienced significant losses relating to its exposure to residential mortgage-backed securities from within both its insurance and asset management operations, and the company remains vulnerable to additional losses in these areas. Assured's mortgage-related losses have been more limited, although the company has exposure to large single and sectoral risk concentrations that Moody's considers to be proportionately greater than other highly rated financial guarantors. Finally, Moody's will evaluate each company's business and franchise sensitivity to an erosion of market confidence, including any impact on financial flexibility.

As to the likely timing for reaching a conclusion, we currently expect to complete the review process by early September.

Q6. How sensitive are the various financial guarantors to future deterioration in mortgage performance?

A: All guarantors, except for Berkshire Hathaway Assurance Corp, have exposure to mortgage-related risks and would, therefore, be hurt by additional deterioration within the mortgage market. However, the sensitivity of individual guarantors' performance to further deterioration varies significantly, given the distinct risk profile of each company's insurance portfolio.

ABS CDOs, because of their very high operating leverage, are extremely sensitive to changes in performance of underlying sub-prime mortgage backed securities. Most sensitive of all are CDO-squared and mezzanine exposures because of the impact of leverage on leverage. However, in some instances, we have already assumed substantial impairment, leaving little room for further deterioration. Some guarantors may also commute certain of their ABS CDO exposures, thereby capping their losses.

After ABS CDOs, the next-most-sensitive instruments to changes in mortgage performance are insured mortgage-backed securities containing little or no remaining subordination. In such cases, additional mortgage losses would directly flow to the guarantor. Most of the mortgage-related losses recorded by the guarantors to date are concentrated in second liens, and we believe that such exposures present the largest risk to the guarantors in the event of further mortgage market deterioration.

Other segments of the guarantors' mortgage portfolios also carry risk, with Alt-A securitizations being a likely source of losses in some stress scenarios given their generally low attachment points. Subprime first-lien securitizations, on the other hand, are generally well positioned to absorb further stress. These transactions were typically underwritten to attach at the triple-A level and, therefore, benefit from substantial remaining subordination.

We have applied various stresses to the guarantors' mortgage-related portfolios. As discussed, the guarantors with the largest ABS CDO and second-lien mortgage exposures relative to capital are the most exposed to further deterioration in mortgage performance, as estimated by the difference between tail and expected losses relative to hard capital. SCA, FGIC and CIFG are the most exposed to further credit deterioration, although in SCA's case, the commutation of the Merrill Lynch CDOs would significantly reduce the variability of performance. Next on the list are MBIA, Ambac, and FSA, while Assured and Radian Asset are by far the least exposed to further mortgage deterioration.

Q7. Why are you concerned about structured sectors that are performing well? What types of transactions would be most susceptible to further economic deterioration and which guarantors are most exposed?

A: Our concern relates to the fact that large and potentially correlated risk exposures can have a materially negative impact on a guarantor's financial strength should the performance of those exposures deteriorate – and we don't have to look far to find stark evidence of how severe this impact can be. Recent events have demonstrated that the leverage and complexity of certain structured transactions have resulted in highly volatile performance when underlying losses diverge meaningfully from original expectations.

The lesson learned from this experience is that the accumulation of highly concentrated risk exposures, particularly within the structured segment, creates the potential for greater rating-transition risk and loss of market confidence for a guarantor, even if these transactions are performing well today.

For Assured Guaranty and FSA in particular, we note that both firms have accumulated large portfolios of pooled corporate exposures, totaling approximately $40 billion for Assured and $75 billion for FSA. Although these exposures have performed within expectations to date, the sheer size of these portfolios and their correlated sensitivity to deteriorating performance among corporate borrowers in an economic downturn could result in meaningful capital depletion if a few of these transactions were to sustain significant losses. Both companies are also exposed, to a lesser degree, to consumer asset-backed securitizations such as auto, credit card, and student loan deals, which – though well protected today – could be susceptible to weakening performance in an economic downturn.

With the exception of Berkshire Hathaway Assurance Corporation, other Moody's-rated financial guarantors also have exposure to these structured segments, creating some vulnerability to further economic deterioration. This is particularly so for highly levered resecuritization transactions, including some commercial real estate CDOs, where MBIA has accumulated sizable exposures.

Q8. To the extent that the ratings for firms within the industry migrate lower into the Aa range, how do you see that affecting the overall business?

A: There is little precedent from which to draw conclusions. The financial guaranty industry has historically been dominated by triple-A rated guarantors, with only two companies – ACA and Radian Asset – developing niche franchises in both the municipal and structured markets at the single-A and double-A level, respectively. Assured Guaranty operated with split ratings for quite some time, but it did not generate meaningful municipal volume until it was rated Aaa by all three rating agencies.

We believe that an absence or limited supply of triple-A rated financial guaranty insurance would increase the opportunities available to double-A rated insurers relative to historical levels because both issuers and investors would likely adjust to a changing landscape. The value provided by double-A rated insurance, however, would probably be seen by customers as being lower than that provided by triple-A credit enhancement. As a result, double-A rated insurance might benefit a narrower range of issuers and investors, and alternatives to insurance could become more attractive. Nevertheless, large segments of the municipal market, particularly small, less transparent, or higher-risk municipal issuers, might still improve their cost of debt by purchasing insurance.

Opportunities available to double-A guarantors would likely be more constrained, however, if certain guarantors were to remain triple-A rated. This would be so because investors in both structured and municipal markets have demonstrated a strong preference for credit enhancement at the triple-A level.

More broadly, we cannot rule out the possibility of further market changes, with new financial technologies or new entrants changing the competitive landscape. Europe, for example, has developed an active covered bond market to finance both municipal and mortgage debt. Adopting such a financing model in the United States could further reduce the opportunities available to financial guarantors.

Q9. How does Moody's view the recently announced agreement between SCA and Merrill Lynch regarding credit default swaps on troubled ABS CDO exposures? What are the implications for other guarantors?

A: SCA recently announced that it has reached an agreement with Merrill Lynch to terminate eight credit default swaps on ABS CDOs in return for a $500 million cash payment to Merrill.

From a capital adequacy perspective, SCA's commutation with Merrill is a clear positive because it eliminates a significant amount of estimated stress case losses from its portfolio. In our capital adequacy analysis, we are using stress-case losses, not expected losses, to benchmark capital adequacy. It is also important to remember that our target capital adequacy benchmarks include an additional 30% cushion on top of our stress-case modeled losses.

Depending on the particular circumstances surrounding these exposures, commutations can be in the business interest of both the guarantor and the bank counterparties. Guarantors benefit from reduced uncertainty regarding future losses and can free up significant amounts of capital to support other business. Bank counterparties can benefit by getting cash today and by eliminating the uncertainty related to the recoverability of a stream of payments that can stretch out over 30 years or more, as well as by de-leveraging the balance sheet. In some cases, commutations may also allow bank counterparties to record gains on positions relative to current marks.

Moody's believes that most guarantors are involved in discussions with bank counterparties for the commutations of credit default swaps on ABS CDOs, although in many cases, there remain significant obstacles to reaching agreements – primarily related to settlement amounts.

In the case of SCA's agreement with Merrill, the negotiated settlement has some elements that are typically associated with a distressed exchange. However, such a determination is ultimately a matter of judgment, and it depends on the specific circumstances of the guarantor, as well as the amount of the settlement compared to the economic value of the hedge.

Q10. Are you contemplating making changes to your rating methodology in the future?

A: To date, our analysis has been based solely on the existing methodology, although we have expanded the toolkit that we use to evaluate risk-adjusted capital adequacy by developing an alternative stress-case model for assessing mortgage-related exposures. We will continue to update these models to reflect new information about each company's capital position and our assessments about the risk profile of the underlying exposures.

In view of the experience of firms in this industry over the past year, however, Moody's will reassess certain aspects of the rating methodology. If we determine that significant changes to our existing methodology are warranted, we will likely issue a "request for comment" prior to implementation so that we can fully consider the views of various market participants.

Moody's Related Research

Announcement:

- July 29, 2008: Moody's reviews ratings of Security Capital Assurance subs XLCA and XLFA with direction uncertain; Debt ratings reviewed for possible downgrade
- July 21, 2008: Moody's reviews FSA's Aaa rating for possible downgrade
- July 21, 2008: Moody's reviews Assured Guaranty's Aaa rating for possible downgrade

Special Comment:

- Credit Implications of FAS 163 – FASB Guidance on Financial Guaranty Industry Accounting, July 2008 (109837)
- Interpreting Financial Guarantors' Mark-to-Market Losses, July 2008 (105498)
- Moody's Financial Guaranty Update: Frequently Asked Questions, January 2008 (107305)
- Moody's Updates Loss Projections for 2006 Subprime Loans, January 2008

Rating Methodology:

- Moody's Rating Methodology for the Financial Guaranty Insurance Industry, September 2006 (98408)
- The U.S. Municipal Bond Rating Scale: Mapping Municipal Bonds to the Global Rating Scale and Assignment of Global Scale Ratings to Municipal Obligations (102249)
- Mapping of Moody's Municipal Ratings to the Global Scale: Frequently Asked Questions (103423)
- Assignment of Wrapped Ratings When Financial Guarantor Falls Below Investment Grade, May 2008 (108924)
- Rating of Transactions Wrapped by Financial Guarantors: Frequently Asked Questions, December 2007 (105934)

To access any of these reports, click on the entry above. Note that these references are current as of the date of publication of this report and that more recent reports may be available. All research may not be available to all clients.

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