

Mortgage-Related Losses Aren't Over For Bond Insurers

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Standard & Poor's Ratings Services has increased its projections for bond insurer losses from exposure to residential mortgage-backed securities (RMBS) and collateralized debt obligations of asset-backed securities (CDOs of ABS). This reflects the continued deterioration of Alternative-A (Alt-A), subprime, closed-end second (CES), and home equity line of credit (HELOC) mortgages backing the 2005–2007 RMBS vintages.

The most recent revision was on July 6, 2009, when our structured finance ratings group increased its projected lifetime losses for Alt-A and subprime mortgages (see table 1). We made these changes primarily because we observed increasing loan delinquencies in these mortgage types, greater-than-expected market value declines, and growing inventories of real estate-owned properties.

Our first revision of projected losses was in December 2007, and since then we've increased our projections another four times due to the severity of the housing and economic downturn. In December 2007, our loss expectations for the loans backing the 2007 Alt-A and subprime asset classes were 3.5% and 17.0%, respectively. With the July 2009 changes, those loss assumptions have increased to 27.0% and 40.0%.

Notwithstanding the increased cumulative loss assumptions for the Alt-A and subprime sectors, the industry's RMBS exposure to HELOC and CES products account for the majority of our projected RMBS loss. Given these products' second-lien positions, with loss severities at or approaching 100%, they account for 76.6% of total RMBS projected losses.

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Table 1

Asset Class Cumulative Net Loss Assumptions (%)				
<i>Vintage</i>	<i>Alt-A</i>	<i>Subprime</i>	<i>Closed-end second*</i>	<i>HELOC</i>
<i>July 2009</i>				
2005	10.00	14.00	17.35-21.55	6.93
2006	22.50	32.00	28.78-49.94	22.62
2007	27.00	40.00	55.21-65.32	37.89

*Lower number for CES RMBS, higher number for CES within collateralized debt obligation.

Some Bond Insurers Took A Harder Hit

Among the bond insurers hardest hit by the persistent deterioration in mortgage loan performance is Ambac Assurance Corp. (Ambac). In October 2008, we projected a present value loss for Ambac on its related RMBS and CDO of ABS exposure of \$8.9 billion. By July 2009, we were estimating present value of losses of \$10.6 billion. In addition to its RMBS exposure for the Alt-A and subprime asset classes, Ambac has a larger component of these sectors in its CDO of ABS exposure relative to the industry, and those related present value losses increased to \$5.9 billion in July 2009 from \$5.0 billion in October 2008.

The sole remaining 'AAA' rated bond insurers—Assured Guaranty Corp. (Assured) and its new sister company, Financial Security Assurance Inc. (FSA)—showed large percentage increases in projected RMBS losses, but, in our view, their absolute loss expectations remain manageable relative to capital resources, and are well below industry norms. Assured showed the largest percentage increase, with total projected RMBS and CDO of ABS losses almost doubling, to \$813.9 million currently from a present value loss estimate of \$420.5 million in October 2008. However, Assured by a significant margin continues to post the lowest loss estimate for any of the current and former 'AAA' bond insurers. Likewise, FSA showed a relatively large increase of 49% in assumed losses to \$2.6 billion currently from \$1.7 billion in October 2008. Most of the change occurred in the Alt-A sector, which includes their option adjustable-rate mortgage (ARM) exposure category, which rose to \$707 million in July 2009 from \$153 million in October 2008. Both FSA and Assured had the foresight to largely avoid the CDO of ABS sector as evidenced by respective loss estimates of \$4.5 million and \$24.2 million.

The Alt-A and the subprime mortgage sectors' continued poor performance caused MBIA Insurance Corp.'s (MBIA) projected RMBS losses to increase by about \$400 million to \$6.1 billion as of July 2009, from \$5.7 billion in October 2008. Overall, including CDOs of ABS, the present value loss number fell slightly to \$11.1 billion as of July 2009 from \$11.3 billion due to some commutation success.

Table 2

Projected Losses Versus Claims-Paying Resources						
<i>—Estimated net stress test losses—</i>						
<i>July 2009</i>						
	<i>Assured Guaranty Corp.</i>	<i>Ambac</i>	<i>CIFG</i>	<i>FSA</i>	<i>MBIA</i>	<i>Total</i>
<i>RMBS asset class (2005-2007 vintage)</i>						

Table 2

Projected Losses Versus Claims-Paying Resources (cont. 'd)						
	—Estimated net stress test losses—					
CES	134.2	1,475.5	279.2	171.2	5,126.4	7,186.5
HELOCs	215.7	2,389.4	150.1	1,567.6	1,407.4	5,730.3
NIMs	0.0	8.1		153.0		161.1
Alt-A	422.0	975.8	2.8	706.7	355.7	2,463.1
Subprime	162.8	587.3	62.5	343.8	157.2	1,313.6
Total	934.7	5,436.2	494.6	2,942.3	7,046.8	16,854.6
Present value	809.4	4,707.3	428.4	2,547.8	6,102.0	14,594.8
CDOs						
Gross	5.7	7,410.0	109.5	30.3	6,296.0	13,851.45
Present value	4.5	5,928.0	87.6	24.2	5,036.8	11,081.16
Total CDO of ABS and non-prime RMBS present value loss	813.9	10,635.3	516.0	2,572.0	11,138.8	25,675.99
Non-2005-2007 RMBS stress test present value losses						
Municipal	795.0	3,185.0	N.M.	2,343.0	310.0	6,633.00
Other structured	531.0	2,115.0	N.M.	136.0	1,689.0	4,471.00
Total present value losses	2,139.9	15,935.3	516.0	5,051.0	13,137.8	36,779.99
RMBS and CDO of ABS claims-paid inception to June 30, 2009	(467.1)	(1,168.6)	(254.0)	(1,565.6)	(2,654.0)	(6,109.30)
Stress test losses net of claims-paid	1,672.8	14,766.7	262.0	3,485.4	10,483.8	30,670.69
	—Claims-paying resources—					
As of June 30, 2009						
Qualified statutory capital	1,084.9	494.9	220.9	1,964.2	4,242.0	8,006.90
Loss and LAE reserve + estimated impairment losses	26.1	6,350.6	671.1	1,514.5	858.0	9,420.30
Unearned premium reserve	742.8	2,525.0	131.3	2,454.2	730.0	6,583.30
Present value of annual premiums	660.6	2,581.3	213.2	793.0	1,948.0	6,196.10
Owners' capital commitment	0.0	0.0	0.0	0.0	0.0	0.00
Standby line of credit	0.0	0.0	0.0	0.0	0.0	0.00
Contingent trust preferred stock	200.0	0.0	0.0	200.0	0.0	400.00
Total	2,714.4	11,951.8	1,236.5	6,925.9	7,778.0	30,606.60

*Syncora announced restructuring and CDS commutation on July 17, 2009. N.M.—Not meaningful.

Bond insurer CIFG (collectively CIFG Guaranty, CIFG Europe, and CIFG Assurance North America Inc.) was the only insurer to show a material overall decline in its projected RMBS and CDO of ABS losses, due to successful commutation of about \$12 billion in notional amount of CDO of ABS. Projected CDO of ABS losses declined from a present value of \$2.8 billion in October 2008 to \$87.6 million currently. Nevertheless, remaining RMBS losses combined with the cost of commutation have left the company in a precarious capital position. For example, CIFG North America was, as of June 30, 2009, \$363 million below the \$65 million minimum that New York State insurance law requires. Its affiliates are likewise at risk.

Following Syncora Guarantee Inc.'s July 17, 2009, announcement concerning substantial restructurings and commutations, Standard & Poor's is reevaluating its loss estimates for this company. Syncora management believes this restructuring will result in a change in June 30, 2009, pro forma

policyholder surplus from a deficit of about \$4.1 billion to approximately \$178 million. Although the New York State Insurance Department has restricted the company from making any claim payments, this may change following the restructuring and commutations.

How We Assess Margin Of Safety

When we determine losses in our capital adequacy margin of safety analysis, we assume substantial losses for the municipal and other asset-backed sectors in addition to losses associated with 2005 to 2007 vintage, non-prime RMBS and CDO of ABS sectors. The margin of safety expresses the relationship between theoretical losses generated by the capital adequacy model and capital remaining at the end of the period of stress. While we do not expect significant realized losses for either of the municipal and other asset-backed sectors over the intermediate term, within our modeling analysis they nonetheless account for \$11.1 billion of theoretical losses.

Looking at individual companies, we note that Assured's margin of safety increased by about 10% since last reported due to higher expected premium rates in the municipal sector. FSA's margin of safety also increased by about 10% mostly as a result of the capital charge reduction associated with the transfer of the company's financial products business to former parent Dexia.

Table 3

<i>Bond Insurers' Margin Of Safety</i>					
<i>September 2009</i>					
	<i>Assured Guaranty Corp.</i>	<i>Ambac Assurance Corp.</i>	<i>CIFG Group</i>	<i>Financial Security Assurance Inc.</i>	<i>MBIA Insurance Corp.</i>
Rating as of Sept. 15, 2009	AAA/Negative/—	CC/Negative/—	CC/Negative/—	AAA/Negative/—	BBB/Negative/—
<i>Margin of safety as published</i>					
Nov. 6, 2008	1.4 to 1.5	1.1 to 1.2	1.3 to 1.4	1.3 to 1.4	1.0 to 1.1
<i>Margin of safety</i>					
as of Sept. 9, 2009	1.5 to 1.6	0.6 to 0.7	N.M.	1.4 to 1.5	0.7 to 0.8

N.M.—Not meaningful.

Since our prior report of November 2008, MBIA's margin of safety has slipped by about 30% to a current range of 0.7x to 0.8x. Losses have taken their toll on the margin of safety not only in terms of paid claims but also in the assumed tax benefit of tax-loss carry-forwards. It is our view, based on its tax share filing status, that MBIA Inc. will not be able to fully realize the tax benefit of MBIA's operating losses. The effective tax rate we used in determining after-tax losses was 20% compared with the 35% in our earlier analysis. MBIA's capital and risk profile also changed substantially in connection with the creation of National Public Financial Guarantee Corp. Having transferred its public finance portfolio to National, MBIA likewise transferred about \$3.4 billion of theoretical public finance claims. Correspondingly, with the transfer of some capital and unearned premium reserve from MBIA to National, claims-paying resources for MBIA have declined to \$7.8 billion as of June 30, 2009, from \$16.0 billion on June 30, 2008.

Ambac Assurance Corp.'s margin of safety currently falls in a range of 0.6x to 0.7x, down from 1.1x to 1.2x in November 2008. Most notably, paid and reserved losses have caused Ambac's statutory capital to decline to \$495 million on June 30, 2009, from \$6.7 billion one year earlier. In addition to

the increased loss assumptions on its 2005-2007 RMBS and CDO of ABS exposure, a change in the assumed tax benefit of the tax-loss carryforwards also affected capital adequacy. It is our view that based on its tax filing status, holding company Ambac Financial Group Inc. will not be able to fully realize the tax benefit of Ambac's operating loss. The effective tax rate we used in determining after-tax losses was 17% compared with the 35% we cited in November 2008.

We have not calculated a margin of safety for either Syncora or CIFG. We view Syncora as being effectively under regulatory control, given that the insurance department has notified the company to suspend its claim payments. For CIFG, which is in such a precarious capital position, our analysis is more focused on expected losses relative to the existing insured portfolio and capital base and whether regulatory intervention would be triggered.

Related Research

“ Standard & Poor's Revises U.S. Subprime And Alternative-A RMBS Loss Assumptions For Transactions Issued In 2005, 2006, And 2007,” July 6, 2009

“ Projected Losses Have Widened For Bond Insurers With RMBS And CDO Exposure,” Nov. 6, 2008

“ Bond Insurer Industry Overview And Analytical Focus,” June 29, 2006

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