

## Projected Losses Have Widened For Bond Insurers With RMBS And CDO Exposure

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Capital resources for the current and former 'AAA' rated primary bond insurers have been greatly pressured by the deteriorating performance of insured nonprime and second- lien residential mortgage-backed securities (RMBS) and related collateralized debt obligations of asset-backed securities (CDOs of ABS).

Since our analysis of the bond insurers' exposure to nonprime mortgages and second-lien transactions in the 2005-2007 vintages on Dec. 19, 2007, loss projections have continued to increase. Table 1 shows loss projections used in that original analysis, as well as the projections we are currently using. For instance, the projected losses for Alt-A, subprime, closed-end second, and home equity line of credit (HELOC) transactions in the 2007 vintage were 13.3%, 27%, 55.2%, and 37.9%, respectively, as of Oct. 20, 2008. This compares with projected losses of 3.5%, 18%, 40%, and 13%, respectively, on Dec. 19, 2007. The higher cumulative net loss assumptions reflect subsequently higher delinquencies and foreclosures and the expectation for home pricing depreciation beyond what was initially anticipated.

### ***Greater Loss Severity For Second-Lien Instruments***

Standard & Poor's Ratings Services' approach to estimating 2005-2007 vintage RMBS and CDO of ABS losses involves stressing par exposures using the current loss estimates in table 1. These loss assumptions were developed by Standard & Poor's structured finance group for all related sectors and vintages. For example, the current assumption for the 2007 subprime sector is that an average pool will incur losses of 27%. The assumption for the 2007 vintage is that an average CES pool will incur losses of 55.2%. In Standard & Poor's view, the most problematic exposure for the bond insurers are HELOC and CES transactions. Because of the

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greater loss severity associated with second-lien instruments, these two sectors represent 92% of all projected 2005-2007 RMBS losses.

Table 1

### ***Asset Class Cumulative Net Loss Assumptions (%)***

*Oct. 20, 2008*

| <i>Vintage</i> | <i>Alt-A</i> | <i>Subprime</i> | <i>Closed-End Second</i> | <i>HELOC</i> |
|----------------|--------------|-----------------|--------------------------|--------------|
| 2005           | 4.15         | 10.50           | 17.35                    | 6.93         |
| 2006           | 10.90        | 23.00           | 28.78                    | 22.62        |
| 2007           | 13.35        | 27.00           | 55.21                    | 37.89        |

*Dec. 19, 2007*

| <i>Vintage</i> | <i>Alt-A</i> | <i>Subprime</i> | <i>Closed-End Second</i> | <i>HELOC</i> |
|----------------|--------------|-----------------|--------------------------|--------------|
| 2005           | 2.75         | 5.75            | 17.25                    | 10.35        |
| 2006           | 3.50         | 15.50           | 40.00                    | 15.75        |
| 2007           | 3.50         | 17.99           | 40.00                    | 13.00        |

In our original RMBS loss analysis for the bond insurers, we assumed that insured transactions would perform somewhat better than the entire universe of nonprime loans because of the industry's underwriting standards, surveillance, remediation expertise, and special protections written into the deals. That assumption was supported recently when Standard & Poor's updated loss projections for 2005-2007 CES transactions' reported performance by both insured and uninsured deals. According to that report, the nonbond-insured average loss projected for 2005, 2006, and 2007 vintages were 21.5%, 49.9%, and 65.3% respectively. The bond-insured average loss projections were 17.4%, 28.8%, and 55.2%, respectively.

### ***Declining Capital Adequacy Margin Of Safety***

Nevertheless, these unprecedented levels of projected losses have in some cases overwhelmed capital resources. Table 2 compares current loss projections against claims paying resources. In determining capital adequacy, in addition to losses developed for all 2005-2007 vintage RMBS and CDOs of ABS exposures using the methodology described above, we calculated loss estimates for municipal exposure as well as non-2005-2007 RMBS and other asset-backed exposures using our traditional capital charge methodology. While we do not expect significant realized losses for either the municipal or other asset-backed sectors over the intermediate term, within our modeling analysis they nonetheless account for \$18.9 billion of theoretical losses. Total projected capital modeling losses for the current and former 'AAA' rated primary companies on a present value basis are about \$55 billion. While there are timing and other issues, a comparison of claims paying resources to projected modeling losses is insightful. Against projected modeling losses for these companies, claims paying resources total \$53.3 billion.

Table 2

### ***Projected Losses Vs. Claims Paying Resources***

*Expected Net Stress Test Losses*

*Oct. 20, 2008 (Mil. \$)*

|  | <i>Assured Guaranty Corp.</i> | <i>Ambac</i> | <i>CIFG</i> | <i>Financial Guaranty Insurance Co.*</i> | <i>Financial Security Assurance</i> | <i>MBIA</i> | <i>Syncora</i> | <i>Total</i> |
|--|-------------------------------|--------------|-------------|--|-------------------------------------|-------------|----------------|--------------|
|  |                               |              |             |  |                                     |             |                |              |

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Table 2

| Projected Losses Vs. Claims Paying Resources (cont. 'd)    |         |          |         |         |         |          |         |          |  |
|--|---------|----------|---------|---------|---------|----------|---------|----------|--|
| Expected Net Stress Test Losses                            |         |          |         |         |         |          |         |          |  |
| <i>RMBS asset class (2005-2007 vintage)</i>                |         |          |         |         |         |          |         |          |  |
| CES  | 134.2   | 1,475.5  | 279.2   | 2,337.4 | 171.2   | 5,126.4  | 642.6   | 10,166.5 |  |
| HELOCs   | 215.7   | 2,389.4  | 150.1   | 1,064.1 | 1,567.6 | 1,407.4  | 674.3   | 7,468.8  |  |
| NIMs   | 0.0     | 7.3      |         | 4.5     | 72.2    |          |         | 84.0     |  |
| Prime Alt-A  | 104.9   | 239.6    | 0.0     | 8.4     | 152.7   | 80.4     | 61.3    | 643.3    |  |
| Subprime   | 26.3    | 333.6    | 10.7    | 289.0   | 17.0    | 23.9     | 41.3    | 741.7    |  |
| Total  | 481.1   | 4,445.4  | 440.0   | 3,703.4 | 1,980.7 | 6,638.2  | 1,419.6 | 19,104.3 |  |
| Present value  | 416.6   | 3,849.4  | 381.0   | 3,206.9 | 1,715.1 | 5,748.1  | 1,229.2 | 16,542.8 |  |
| <i>CDOs</i>  |         |          |         |         |         |          |         |          |  |
| Gross  | 4.8     | 6,173.7  | 3,033.3 | 4,033.1 | 12.3    | 6,957.2  | 2,831.7 | 23,046.1 |  |
| Present value  | 3.9     | 5,052.2  | 2,426.6 | 3,226.5 | 9.8     | 5,580.2  | 2,265.4 | 18,564.6 |  |
| Total CDO of ABS and non-prime RMBS present value loss     | 420.5   | 8,901.6  | 2,807.6 | 6,433.4 | 1,724.9 | 11,328.3 | 3,494.6 | 35,107.4 |  |
| <i>Non 2005-2007 RMBS stress test present value losses</i> |         |          |         |         |         |          |         |          |  |
| Municipal  | 480.6   | 3,890.5  | 470.0   | 341.8   | 2,780.5 | 3,719.0  | 705.9   | 12,388.3 |  |
| Other structured   | 423.1   | 2,747.7  | 438.0   | 288.4   | 422.2   | 1,686.0  | 496.1   | 6,501.5  |  |
| GIC losses   |         | 248.0    |         |         | 450.0   | 361.0    |         | 1,059.0  |  |
| Total present value losses                                 | 1,324.2 | 15,787.7 | 3,715.6 | 7,063.6 | 5,377.6 | 17,094.3 | 4,696.6 | 55,056.2 |  |
| <i>Claims Paying Resources</i>                             |         |          |         |         |         |          |         |          |  |
| <i>June 30, 2008</i>                                       |         |          |         |         |         |          |         |          |  |
| Qualified statutory capital                                | 1,110.0 | 6,713.7  | (159.0) | 1,002.0 | 2,474.3 | 7,119.3  | (51.0)  | 18,209.3 |  |
| Loss and LAE reserve                                       | 40.0    | 2,640.9  | 2,285.1 | 1,831.0 | 1,101.3 | 1,866.4  | 2,219.0 | 11,983.7 |  |
| Unearned premium reserve                                   | 512.0   | 3,060.6  | 274.0   | 292.0   | 2,618.9 | 3,609.2  | 505.0   | 10,871.7 |  |
| Present value of annual premiums                           | 655.0   | 3,054.2  | 322.6   | 742.0   | 1,164.7 | 2,555.8  | 781.0   | 9,275.3  |  |
| Owners' capital commitment                                 |         |          | 305.5   | 0.0     |         |          |         | 305.5    |  |
| Standby line of credit                                     |         |          |         |         | 350.0   | 450.0    |         | 800.0    |  |
| Contingent trust preferred stock                           | 200.0   | 800.0    |         | 300.0   | 200.0   | 400.0    |         | 1,900.0  |  |
| Total  | 2,517.0 | 16,269.4 | 3,028.2 | 4,167.0 | 7,909.2 | 16,000.7 | 3,454.0 | 53,345.5 |  |

\*FGIC municipal losses subject to change based on final amount of reinsurance ceded to MBIA. FGIC claims paying resources are pro forma as of Sept. 30, 2008 (no assumption for changes to reserves). FSA's parent company Dexia has announced that it will provide \$500 million in a capital support agreement for its financial products business. Figures may not total due to rounding.

These timing and other issues are addressed in the Standard & Poor's capital adequacy model, which uses a seven-year pro forma statutory financial projection as its foundation for determining capital adequacy. The capital adequacy model adjusts for the fact that, for example, not all unearned premium reserve and annual premium revenue is available immediately. It also provides for, in a highly stressed context, the generation of investment income and losses, reinsurance recoverable discounts, and other ongoing operating expenses and revenue items. The end result of the Standard & Poor's capital modeling analysis is the margin of safety, which compares existing capital plus capital generated during the modeling period against losses. To obtain a 'AAA' rating, a bond insurer must have a margin of

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safety of at least 125%, signifying a solvent company and a capital cushion relative to the projected losses.

Table 3

| <b><i>Bond Insurers' Margin Of Safety</i></b> |                                   |              |                |   |   |                           |                |
|---|-----------------------------------|--------------|----------------|---|---|---------------------------|----------------|
|   | <i>Assured<br/>Guaranty Corp.</i> | <i>Ambac</i> | <i>CIFG</i>    | <i>Financial Guaranty<br/>Insurance Co.</i> | <i>Financial Security<br/>Assurance</i> | <i>MBIA<br/>Insurance</i> | <i>Syncora</i> |
| Rating as of<br>Oct. 31, 2008                 | AAA/Stable                        | AA/Negative  | B/Watch<br>Dev | BB/Watch Neg                                | AAA/Watch Neg                           | AA/Negative               | BBB-/Watch Neg |
| Margin of safety<br>(x)                       | 1.4-1.5                           | 1.1-1.2      | 1.3-1.4        | 0.6-0.7                                     | 1.3-1.4                                 | 1.0-1.1                   | 0.7-0.8        |
| Margin of safety<br>date (2008)               | June 30                           | Aug. 28      | June 11        | June 17                                     | Sept. 23                                | Aug. 25                   | June 19        |

### ***Dim Prospects For Raising Capital***

We believe that the prospects for raising additional capital for most bond insurers in the current environment are not good. Debt and equity capital is either unavailable or prohibitively expensive. Many companies have chosen to (or have been forced to) go into hibernation, hoping that run-off of existing risk and internal capital generation will, along with commutation strategies, combine to improve capital adequacy. However, in our view, hibernation can only be sustained for so long; some companies are either in or will be facing run-off.

Until ultimate losses are more certain, we are unlikely to raise our ratings on the bond insurers. Once there is greater clarity about losses in terms of the potential for upgrades, a positive margin of safety in and of itself is not likely to be sufficient for rating upgrades. Business health and competitive position, earnings and return on capital, and risk management, risk tolerance, and financial flexibility have been and will continue to be key credit factors in our analysis. Thus, a 'AAA' rating for a bond insurer is not simply a matter of capital adequacy.

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