

## RESEARCH

## Subprime Exposure Is Unlikely To Cause Bond Insurers Major Difficulties

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Exposure to the subprime mortgage sector does not threaten the rating stability of the bond insurers. Above and beyond their benchmark of underwriting transactions to an investment-grade standard, the industry has exceeded this minimum measure in such a way that macro subprime problems have been limited. Nevertheless, this is a developing story in its early stages, and Standard & Poor's Ratings Services will continue to monitor any developments that might affect insurer ratings.

Subprime mortgage portfolios (excluding subprime mortgages in CDOs treated separately) mostly range from 1% to 3% of total insured exposure for the primary bond insurers. The one exception is Assured Guaranty Corp. (AGC), whose exposure is higher at 6.9% due to the transitional nature of its portfolio resulting from its shift to primary insurer from reinsurer. More informative than the aggregate numbers, however, are the underlying credit quality statistics. Principal among the practices mitigating risk in the subprime sector is underwriting quality. Recognizing the inherent potential default volatility in this sector, very limited business was underwritten in the 'BBB' category. With the exception of ACA Financial Guaranty Corp. (ACA), in which two small, short-term reinsured transactions skew the results, weighted average ratings for all of the primary companies' subprime mortgage portfolios are in the 'A' to 'AAA' rating categories.

### Exposure To 2006 Business Generally Low Among Bond Insurers

As reported in the financial media, subprime mortgage business written in 2006 was of especially low quality. This vintage of business is characterized by very liberalized lending standards. In anticipation of those developments, most of the industry reduced volume in 2006. With two exceptions, exposure to the 2006 subprime vintage as a percent of total subprime mortgage exposure comprised just a small portion of the total subprime portfolio, ranging from 0% to 12% (see tables 1A and 1B). The exceptions to this business limitation were AGC and The CIFG Group (CIFG). As relatively new primary companies, their respective managements were conflicted by a need to demonstrate business viability and growth while recognizing the increasing risks to this sector. Both addressed this dilemma by only underwriting 2006 transactions with 'AAA' and super 'AAA' underlying ratings. Overall, the weighted average ratings on AGC's and CIFG's entire subprime mortgage book of business are very strong 'AA+' and 'AAA', respectively.

While not directly reflected in underlying ratings, originator and servicer quality is another important component of subprime mortgage risk management. The bond insurers generally have rigorous standards for seller/servicers in terms of their operating histories and financial strength. Servicing removal triggers are another common technique used in direct transactions to control servicer risk. The disruption in the market has caused financial distress for a number of subprime servicers. In fact, several servicers, most notable among them New Century Mortgage Corp., have been removed from Standard & Poor's select servicer list. Removal suggests that the servicer may no longer be capable of performing its servicing duties in an effective manner. Our review of seller/servicer concentrations in the 'AAA' bond insured transactions found generally limited exposure to these weakened servicers.

Case reserves have been established in most cases, and the relatively low level of these reserves (the highest being 0.37% of total subprime mortgage exposure) generally reflects reasonable underwriting success to this point. More importantly from a future development perspective is the speculative-grade

category. The percent of speculative-grade subprime mortgages in the total subprime mortgage portfolio ranges from 0% to 7.5% for the 'AAA' companies. While this is relatively high by total insured portfolio standards, where a large exposure to low-risk GO and essential use public finance debt keeps the total speculative-grade average in the 1.0% to 1.5% range, we believe the development of future losses will not be material in relation to the future earnings and capital positions of the companies.

Speculative-grade exposure for the nine primary bonds insurers is about \$1.7 billion. This can be viewed as a starting point in speculating about potential losses. However, it is only a starting point because: (1) reserves already exist for some of the most problematic speculative-grade exposures, (2) only some fraction of the unreserved speculative-grade transactions may default, (3) loss severity will vary, and (4) losses will create a tax benefit relative to earnings. In that context, the speculative-grade exposure of 7.5%, on average, to qualified statutory capital of \$22.6 billion for these primary companies as of Dec. 31, 2006, indicates that, at worst, some fraction of one year's worth of earnings could be affected.

**Table 1A**

'AAA' Bond Insurers' Exposure To Subprime Mortgages							
As of Dec. 31, 2006							
(\$000s)	Ambac	AGC	CIFG	FGIC	FSA	MBIA	XLCA/XLFA
Net subprime mortgage par exposure by vintage							
2006	1,213,837	3,651,008	609,187	380,870	258,931	385,208	0
2005	1,948,123	66,089	1,296,480	4,379,409	1,068,306	286,195	387,648
2004	1,026,516	342,712	129,799	2,104,113	2,539,872	650,016	915,175
2003	2,890,962	556,581	0	0	164,903	9,689	2,870
Prior to 2003	3,368,577	66,819	0	603,525	899,901	4,446,098	110,128
Total subprime mortgage net par	10,448,014	4,683,207	2,035,467	7,467,917	4,931,913	5,777,206	1,415,820
Total net insured portfolio (par)	519,043,000	68,370,000	74,654,136	299,899,300	376,500,000	617,553,000	118,012,000
Subprime mortgage net par as % of total net par insured portfolio	2.01	6.85	2.73	2.49	1.31	0.94	1.20
2006 vintage (par) as % of total subprime mortgage net par	11.62	77.96	29.93	5.10	5.25	6.67	0.00
Subprime mortgage case reserves	100	2,485	0	20,721	1,225	21,138	0
Case reserves as a % of subprime mortgage net par	0.00	0.05	0.00	0.28	0.02	0.37	0.00
Weighted average rating of total net subprime mortgage par	A-	AA+	AAA	A	AA+	AA	AA+
Speculative-grade subprime par	678,181	59,832	0	290,207	122,024	431,020	2,270
Speculative-grade exposure as a % of subprime mortgage net par	6.49	1.28	0.00	3.89	2.47	7.46	0.16
Qualified statutory capital	6,397,629	917,000	668,356	2,405,100	2,554,100	6,558,696	1,391,000
Total claims-paying resources	13,018,290	1,982,000	1,330,081	4,743,000	6,055,800	13,326,003	2,666,000
Speculative-grade % of qualified statutory capital	10.60	6.52	0.00	12.07	4.78	6.57	0.16

**Table 1A**

<b>'AAA' Bond Insurers' Exposure To Subprime Mortgages (cont.)</b>							
Speculative-grade % of total claims-paying resources	5.21	3.02	0.00	6.12	2.01	3.23	0.09

Ambac—Ambac Assurance Corp. AGC—Assured Guaranty Corp. CIFG—The CIFG Group. FGIC—Financial Guaranty Insurance Co. FSA—Financial Security Assurance Inc. MBIA—MBIA Insurance Corp. XLCA—XL Capital Assurance Inc. XLFA—XL Financial Assurance Ltd.

**Table 1B**

<b>Niche Bond Insurers' Exposure To Subprime Mortgages</b>			
<b>As of Dec. 31, 2006</b>			
<b>(\$000s)</b>	<b>ACA</b>	<b>Radian</b>	<b>Totals/averages for 'AAA' and niche insurers</b>
Net subprime mortgage par exposure by vintage			
2006	0	63,256	6,562,297
2005	8,500	61,418	9,502,168
2004	0	212,588	7,920,791
2003	0	163,649	3,788,652
Prior to 2003	0	66,519	9,561,565
Total subprime mortgage net par	8,500	567,429	37,335,473
Total net insured portfolio (par)	46,254,000	103,966,000	2,224,251,436
Subprime mortgage net par as % of total net par insured portfolio	0.02	0.55	1.68
2006 vintage (par) as % of total subprime mortgage net par	0.00	11.15	17.58
Subprime mortgage case reserves	0	376	46,044
Case reserves as a % of subprime mortgage net par	0.00	0.07	0.12
Weighted average rating of total net subprime mortgage par	BB	A-	AA-
Speculative-grade subprime par	8,500	94,426	1,686,461
Speculative-grade exposure as a % of subprime mortgage net par	100.00	16.64	4.52
Qualified statutory capital	387,121	1,337,900	22,616,902
Total claims-paying resources	882,500	2,719,800	46,723,474
Speculative-grade % of qualified statutory capital	2.20	7.06	7.46
Speculative-grade % of total claims-paying resources	0.96	3.47	3.61

ACA—ACA Financial Guaranty Corp. Radian—Radian Asset Assurance Inc.

## Exposure To Subprime Mortgages In CDOs

The bond insurers also have exposure to subprime mortgages in their CDO business (see table 2). We treat this exposure separately because the CDOs contain other asset classes and are also dependent on those classes for the ultimate performance. In addition, for managed CDOs, asset-class percents can change within limits at the discretion of the asset manager, although it would be unlikely for a significant volume of depressed subprime assets to be traded out at this time. With the exception of Radian Asset Assurance Inc., whose CDO portfolio carries a weighted average underlying rating of 'AA', consistent with its 'AA' rating and niche market position, insured CDO exposure for the remaining primary companies have underlying weighted average ratings of 'AAA'. This underwriting conservatism dates back to CDO

business written in 2000 and 2001. For prior business, the combination of underlying ratings in the 'BBB' and 'A' categories combined with the substantial corporate credit deterioration at the time led to higher capital charges and some losses. While that volatility was mostly in the corporate sector, the subsequent underwriting conservatism extended across all CDO types.

Finally, ACA is unique in the industry due to its asset management business. ACA, to facilitate this business, particularly prior to 2005, purchased equity interests in the CDOs that it managed. The amount of outstanding equity interests that have exposure to subprime transactions totaled \$119.3 million as of Dec. 31, 2006. By holding some or all of the equity layer of a CDO, ACA is at risk for the performance of all the collateral backing the transaction, with losses limited to the notional value of the equity layer. Just 1.9% of the collateral was rated speculative grade. To hedge the risk of potential losses on the collateral, ACA has purchased \$37 million in credit protection against the performance of certain tranches of indices of subprime-backed transactions.

**Table 2**

<b>Bond Insurers' Exposure To CDOs With Subprime Collateral</b>									
<b>As of Dec. 31, 2006</b>									
<b>(Mil \$)</b>	<b>ACA</b>	<b>Ambac</b>	<b>AGC</b>	<b>CIFG</b>	<b>FGIC</b>	<b>FSA</b>	<b>MBIA</b>	<b>Radian</b>	<b>XLCA/XLFA</b>
CDOs net par insured with subprime exposure	10,247.9	19,241.2	771.5	7,825.9	5,998.7	372.8	16,605.6	769.3	9,545.5
% subprime collateral	71.0	25.1	20.9	68.2	61.0	15.8	12.4	51.1	18.7
Weighted average rating of exposure	AAA	AAA	AAA	AAA	AAA	AAA	AAA	AA	AAA
Equity tranche exposure*	119.3								
% subprime collateral	69.0								
Weighted average rating of exposure	A								

\*Equity tranche exposure is to ACA Capital Holdings Inc. and subsidiaries. ACA—ACA Financial Guaranty Corp. Ambac—Ambac Assurance Corp. AGC—Assured Guaranty Corp. CIFG—The CIFG Group. FGIC—Financial Guaranty Insurance Co. FSA—Financial Security Assurance Inc. MBIA—MBIA Insurance Corp. Radian—Radian Asset Assurance Inc. XLCA—XL Capital Assurance Inc. XLFA—XL Financial Assurance Ltd.

## Mixed Effects For The Industry

In conclusion, volatility can be a good thing for the bond insurance business. With this in mind, it's likely to be a sellers market for financial guaranty wraps in this sector as issuers look to originate transactions to increasingly anxious buyers. Nevertheless, the industry can best be characterized as proceeding opportunistically in this market. We believe insurance will continue to be written only for top-tier originator/servicers, and credit enhancement requirements will likely exceed historical requirements. In this environment it's likely that better pricing opportunities will also be the norm. In terms of loss potential, for the existing portfolio we believe the observed and expected future adverse development will cause some higher capital charges as some ratings move downward. In addition, earnings may be affected for some companies, although not to a point where ratings are threatened.

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