

Special Report

Financial Guarantors — A Review of Recent Mark-to- Market Losses

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Related Research

- Financial Guarantors — 2007 Updated Financial Review, dated July 19, 2007.
- Financial Guarantors — Matrix Hypothetical Subprime Stress Test Results, dated Sept. 6, 2007.

■ Background

The deterioration of the subprime mortgage market in 2007 has created significant problems for a number of debt issues tied to subprime residential mortgages. Financial guarantors have insured exposures to subprime residential mortgages through subprime residential mortgage-backed securities (RMBS) and collateralized debt obligations of asset-backed securities (ABS-CDOs). Fitch has noted previously that the industry remains fairly well-insulated from the problems being faced in these sectors (see Fitch's Special Report: Financial Guarantors — 2007 Updated Financial Review, dated July 19, 2007, available at www.fitchratings.com).

However, problems that began in the U.S. subprime mortgage market have caused credit spreads to widen in those sectors, as well as many other sectors of the capital markets. Financial guarantors' financial statements are directly exposed to movements in credit spreads due to their exposure to pooled credit default swaps (CDS) that reference underlying obligations on corporate debt or ABS-CDOs. Recently, the reported U.S. generally accepted accounting principles (GAAP) net income for each financial guarantor has become adversely affected by the credit spread widening that has taken place in the past several months of 2007.

This is due to SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities," which requires certain financial guaranty contracts, including those executed via CDS to be marked-to-market, with the unrealized gains and losses being recorded through the income statement. As already announced by Ambac Financial Group, Inc., Fitch expects significant mark-to-market losses to be recorded against all financial guarantors' CDS portfolios during the third quarter of 2007. These large mark-to-market accounting losses are not expected to have any ratings implications for the financial guarantors rated by Fitch.

■ Issue

Generally, Fitch excludes the unrealized gains and losses from derivatives in its analysis of the financial guarantors' insured portfolios since these CDS contracts are effectively structured to mirror traditional financial guaranty insurance policies. Unlike a more typical CDS, financial guarantors specifically structure their CDS contracts so that they are not subject to liquidity risk. The financial guarantors do not subject themselves to collateral posting requirements (several

companies have legacy CDS exposures that are subject to collateral postings) based on market value declines often seen in other CDS executions, nor is there any payment accelerations built into the transactions. Furthermore, the financial guarantors insure these transactions until maturity (akin to a traditional financial guaranty policy), and are responsible for the payment of any missed principal and interest payments due over the life of a transaction. Over time the unrealized gains and losses on performing CDS transactions are expected to net back to zero as they reach maturity. Therefore, from a financial and capital modeling perspective, Fitch treats financial guarantors' insured CDS and traditional financial guaranty policies alike. To the extent that market prices reflect actual impairment in the underlying assets, Fitch captures this impairment through its proprietary capital model (Matrix) for financial guarantors. Within Matrix, simulated modeled losses will increase if the credit quality (reflected in its ratings) of an underlying exposure migrates downward and the financial guarantor's required claims-paying resources will rise accordingly.

In addition, in some instances, statutory capital, which is a key component of a financial guarantor's claims-paying resources, can be affected by a company's mark-to-market on its CDS exposures. As monoline companies, financial guarantors are not permitted to directly underwrite CDS or other derivatives out of their insurance operating companies. As a result, each financial guarantor has established different vehicles to underwrite CDS, with each guarantor then providing a guaranty on the CDS it insures. The counterparty to the CDS transaction effectively looks through the established vehicle to the insurance company providing the guaranty. Several financial guaranty insurance companies have wholly owned subsidiaries that underwrite CDS. Under statutory accounting principles (SAP), to the extent that any subsidiary of the insurance company has equity, but is not a separately audited entity, any capital at the entity (in this case the swap subsidiary), is not permitted to be treated as an asset or as part of the company's statutory capital. However, because the subsidiary is a GAAP entity where essentially all of the unrealized gains and losses on derivatives are being recorded, the insurance company's treatment under SAP requires it to reflect a negative book value of the subsidiary on its balance sheet (the negative mark) and the corresponding reduction to qualified statutory capital. If the negative mark-to-market reverses,

qualified statutory capital returns to its normal levels. In this case, where the swap subsidiary is a non-admitted asset, Fitch notes that although negative marks can recover, positive mark-to-market movements do not produce a corresponding increase to statutory capital. If the swap subsidiary is an admitted asset, the mark-to-market has no material negative impact on statutory capital.

Other companies do not face this change to statutory capital as a result of mark-to-market accounting because they create a separate trust for each CDS or counterparty, which is guaranteed by the financial guarantor. The trust is a variable interest entity (VIE) which is consolidated and marked under FIN 46 U.S. GAAP but not under SAP. Therefore, the mark does not affect statutory capital. Alternatively, if the company that underwrites the financial guarantor's swaps is a sister company (typically owned by the holding company), the entity is consolidated under U.S. GAAP and its swaps are marked-to-market, but are not under SAP. In light of the different vehicles that the financial guarantors utilize to underwrite CDS, Fitch believes it is appropriate to add back the unrealized loss to statutory capital because the unrealized loss does not reflect any decline to the claims-paying resources of the company and is expected to be reversed upon amortization of the underlying risk (as long as the loss is not realized). From a regulatory capital perspective, the companies whose statutory capital is negatively affected by the mark-to-market losses maintain statutory capital well above minimum regulatory thresholds and are in no danger of breaching these levels. Furthermore, Fitch believes this provides consistency to the treatment of capital between financial guarantors so that how the CDS is executed (versus the underlying credit quality of the CDS) is not a determining factor in calculating the adjusted claims-paying resources of a financial guarantor.

Finally, within the financial guarantors rated by Fitch, there currently exist no financial covenants within their outstanding debt obligations related to mark-to-market accounting losses under SFAS No. 133 that could force early repayment of the debt. On the other hand, several financial guarantors maintain financial covenants in their existing bank credit facilities at their respective holding companies that relate to minimum net worth based on U.S. GAAP (assets less liabilities), which could theoretically be impacted because the fair value of assets could be adversely impaired by mark-to-market losses. Many also have leverage ratio requirements or interest

coverage requirements that could also be affected. For the most part, the companies are well in excess of meeting these minimum thresholds. In addition, Fitch has not historically recognized the availability of these bank lines in its credit assessment of the financial guarantors, nor has it considered it within the context of capital adequacy. However, the rating agency does consider the potential benefits of the financial flexibility and liquidity that these bank lines may provide. With the exception of Radian Group Inc. (the parent company of Radian Asset Assurance Inc.), none of the other financial guaranty holding companies have drawn down on their available bank lines.

■ Conclusion

Fitch remains consistent in its view that mark-to-market losses from CDS within a financial guarantor's insured portfolio do not have direct ratings implications for the industry, given that the underlying CDS transactions still remain very highly rated (often well-above minimum 'AAA' thresholds), and are not expected to realize actual claim losses in the future. In fact, from an underwriting perspective, the widening of credit spreads actually improves the financial guarantors' pricing prospects on future business they may insure going forward. That said, the widening credit spreads generating the negative mark-to-market losses has been caused in part by

significant problems being experienced in the U.S. subprime mortgage markets. Currently, many of those problem assets support CDS transactions insured by a number of financial guarantors, especially ABS-CDOs that maintain a heavy concentration of recent vintage subprime mortgage collateral.

Deterioration of the underlying collateral is expected to reduce credit enhancement levels in many of the ABS-CDOs insured by the financial guaranty industry over the intermediate term. This deterioration may not directly impact the underlying ratings on many of these ABS-CDOs, since many of these transactions have significant credit subordination over and above minimum 'AAA' thresholds, although those guarantors heavily exposed to this sector will be monitoring their portfolios closely over the near- to intermediate-term. Those companies that maintained a sound underwriting discipline over the past several years—a period characterized by weaker credit standards and depressed pricing spreads—will be better positioned to take advantage of the more attractive business opportunities that are expected to be available in the foreseeable future. (See Fitch's Special Report titled *Financial Guarantors—Matrix Hypothetical Subprime Stress Test Results*, dated Sept. 6, 2007, available at www.fitchratings.com).