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Financial Guarantors

Financial Guarantors
U.S. and Canada
Special Report

Financial Guarantors — Industry Outlook

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Related Research

- *Fitch Discusses Financial Guaranty Capital Model and Ratings Methodology, March 19, 2008*
- *Congressional Testimony: The State of the Bond Insurance Industry, Feb. 19, 2008*
- *Financial Guarantors — Matrix Hypothetical Subprime Stress Test Results, Sept. 6, 2007*
- *Rating Guidelines for Financial Guarantors, Jan. 9, 2007*
- *The Fitch Matrix Financial Guaranty Capital Model, Jan. 9, 2007*

Overview

The purpose of this report is to provide an update on Fitch Ratings' views with respect to the outlook for the monoline financial guaranty industry, from both a ratings and fundamental perspective. The report explores various issues, including:

- Recent developments in the industry.
- Recent financial performance.
- Capital adequacy.
- Liquidity.
- Relative ratings and competitive positioning of the various financial guarantors.
- Guarantors' willingness to pay.
- Rating Outlooks: near and intermediate term.
- Overview of possible future changes in ratings methodology, and a view on how companies may need to better manage their sensitivity to ratings.
- Appendices discussing recent subprime analysis as well as a summary of key credit issues for each of the financial guarantors that carried an 'AAA' rating at the beginning of 2007.

Recent Developments

The financial guaranty industry has experienced unprecedented distress during the past nine months. The trouble is due directly to the industry's significant exposure to the U.S. residential mortgage market through both direct exposure to residential mortgage–backed securities (RMBS), but even more specifically, its significant exposure to collateralized debt obligations backed by structured finance (SF CDOs) assets, particularly those CDOs with a heavy concentration of subprime RMBS. This distress has caused numerous downgrades to formerly 'AAA' companies by Fitch, Standard & Poor's (S&P) and Moody's Investors Services (Moody's) in 2008.

Fitch is concerned that continued erosion in underlying RMBS can cause further deterioration in the insured portfolios over and above current expectations and even Fitch's most stressed assumptions. Such occurrences would be expected to put further pressure on existing ratings, and could potentially result in insolvencies for some of the weaker players.

Not every company's ratings have been directly affected to date. Financial Security Assurance Inc. (FSA) and Assured Guaranty Corp. (Assured) continue to maintain 'AAA' insurer financial strength (IFS) ratings from Fitch with a Stable Rating Outlook. This is due to Fitch's view that both companies were more disciplined during the last credit cycle relative to their peers. As a major example, neither company maintains exposure to SF CDOs that Fitch would view as being at risk of suffering a noteworthy loss. While neither FSA nor Assured is immune to potential future stress impacting the financial guaranty industry, Fitch believes at this time that this stress should be fairly

well contained, and to date both companies are benefiting from the challenges of their peers.

In looking ahead, Fitch believes there are three divergent challenges impacting the industry:

- How healthy, ongoing industry participants effectively deal with the rapidly changing industry landscape as well as with other healthy new market entrants which may enter the sector in the future. This includes how these companies react to any possible changes in ratings methodology or capital guidelines put forth by any of the rating agencies by which they are rated.
- For the guarantors that no longer carry 'AAA' ratings but are still highly rated, a question remains as to the degree these players will balance their commitment to maintaining the highest financial strength possible for their policyholders against the needs of shareholders. Fitch believes this question is of paramount importance, since several companies are engaged in ancillary businesses, such as the sale of guaranteed investment contracts (GICs), that could be materially impacted by downgrades to low investment grade by either Moody's or S&P. (Fitch believes a ratings withdrawal by either agency could also equate to a downgrade that could trigger acceleration or termination of these businesses). Once ratings have been downgraded below 'AAA' for these companies, there appears to be an increased willingness on the part of managements to reduce efforts to "maximize" the financial condition of its insurance subsidiary, but instead to focus on maintaining "adequate" degrees of financial strength. Recent examples include MBIA Inc.'s decision to forego down streaming $900 million from the holding company to its insurance subsidiary in order to maintain greater flexibility for the MBIA enterprise as a whole. In addition, and the potential plans to attempt to establish a new start-up "municipal-only" company by several downgraded companies, at first glance, appear to do little to resolve the troubles being experienced at the existing guarantor, but instead are aimed mainly to create value for shareholders by allowing the enterprise to write future business. While Fitch is not questioning the reasonableness of management's judgments in making these difficult decisions, they highlight the growing tension between shareholders and existing policyholder interests within the industry.

Current IFS Ratings

Company	IFS Rating	Rating Outlook
Assured	AAA	Stable Outlook
CIFG	CCC	Rating Watch Evolving
FGIC	BBB	Negative Outlook
FSA	AAA	Stable Outlook
SCA	BB	Negative Outlook

Source: Fitch.

- For others that are now lower rated, the risk of *technical insolvency* is also real, as rising losses deplete statutory capital levels, adding to the risk of regulatory intervention. Regulatory intervention, in the case of financial guarantees executed in credit default swap (CDS) form, could result in onerous settlement claims due to termination triggers embedded within CDS contract documentation. Each company's core challenge is to remain solvent, and evaluate if they best serve their stakeholders as ongoing operations, or by entering voluntary run-off. One possibility under discussion is the active restructuring/commutation of existing CDS exposures in exchange for long-term stakes in these firms.

Recent Financial Performance

Recent earnings across the financial guarantors have been very poor compared to historical standards, even for Assured and FSA, who have been able to avoid a majority of the current challenges with respect to subprime SF CDOs. The table below shows a summary of highlighted quarterly GAAP earnings as reported by each guarantor as of March 31, 2008 and Dec. 31, 2007. A discussion of recent financial performance cannot begin without mentioning the significant mark-to-market (MTM) losses being recognized mainly on SF CDOs which were executed as CDS. While Fitch has traditionally stated that our analysis of financial guarantors backs out temporary movements in MTM related to changes in credit spreads, we project that a material portion of recent MTM movements may be foreshadowing true permanent credit impairment which will need to be recognized in the future. The SF CDO MTM losses recognized to date are below Fitch's current projections of expected losses in the aggregate which total between $15 billion and $21 billion. To date, four of the subprime-exposed guarantors that have reported financial results through March 31, 2008 (Ambac Assurance Corp. [Ambac], Financial Guaranty Insuance Corp. [FGIC], MBIA Insurance Corp. [MBIA], and Security Capital Assurance Ltd. [SCA]), have taken reserves or permanent impairment charges totaling $6.0 billion on SF CDOs alone.

Quarterly Earnings

($ Mil.)

	3/31/08	12/31/07
Ambac	(1,660)	(3,256)
Assured	(169)	(260)
CIFG[a]	NA	NA
FGIC	(33)	(1,886)
FSA	(422)	(92)
MBIA	(2,406)	(2,302)
SCA	(97)	(1,198)

[a]CIFG has not reported financial results for these periods.
NA – Not available.
Source: Company filings.

Along with losses related to SF CDOs, the financial guaranty industry has also taken significant reserves against direct RMBS exposures, as the unprecedented market conditions have rapidly eroded the initial credit enhancement built into many of these transactions. Combined, the existing and projected future losses are materially impacting several companies' regulatory capital measures. To the extent loss provisioning reduces statutory capital levels below regulatory minimums, the risk of regulatory intervention increases under regulatory guidelines in both the US and Bermuda, even if the guarantor is liquid and able to pay claims. Fitch notes that CIFG, SCA and FGIC appear most exposed currently to possible regulatory capital issues given the current conditions of their statutory balance sheets.

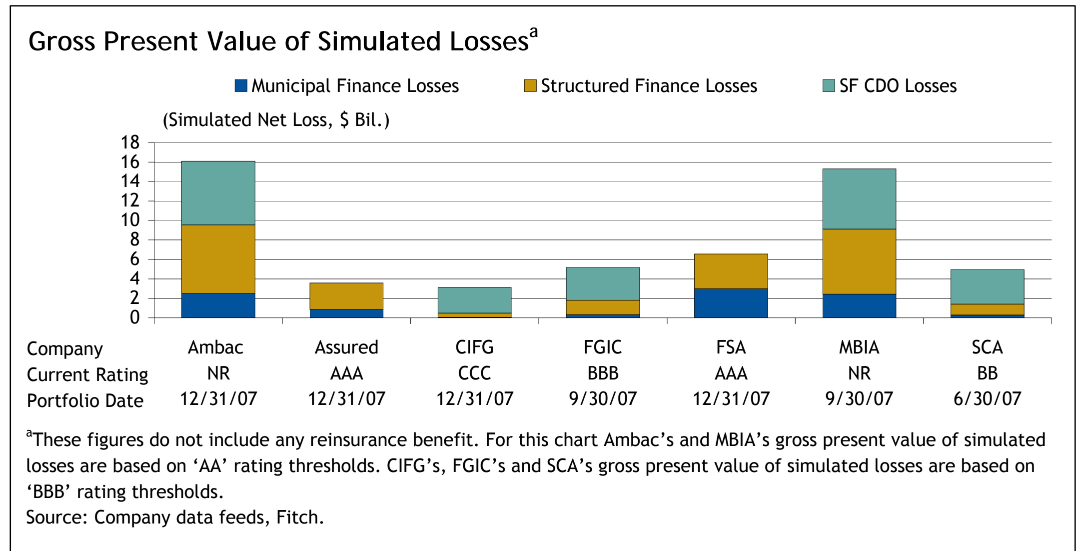
For some guarantors, bank covenants related to company lines of credit facilities were written to preclude access if minimum GAAP shareholders equity falls below certain thresholds. While these facilities are typically not included in Fitch's capital calculations for financial guarantors, a loss of access clearly reduces a given company's financial flexibility and financial strength. In addition, Fitch would assume companies rated at the strongest investment grade rating categories would not be restricted from accessing available credit facilities. Ambac, Assured, FGIC, MBIA and SCA have bank covenants linked to GAAP shareholders equity, which may require further renegotiations or risk cancellation, if GAAP equity levels further deteriorate.

Capital Adequacy

Fitch believes for modelling purposes that its expected loss estimates for SF CDOs equate approximately to an 'A' level IFS ratings stress. Accordingly, in order to address the necessary level of capital to support a financial guarantor at the highest IFS rating

levels, expected losses on the underlying collateral are further stressed to arrive at 'AA' and 'AAA' capital targets. This is done to capture the risk that losses could grow higher than expected due to a more severe downturn in the economy, sharper than expected declines in home prices, higher-than-expected loan defaults, or other adverse developments beyond expectations.

The range of expected losses on SF CDOs at a given rating stress was then added to the corresponding simulated loss estimates produced by Matrix for the remainder of each guarantor's insured portfolio, both structured and municipal finance, to produce the targeted claims-paying resources at a given rating level (see chart below).



[a]These figures do not include any reinsurance benefit. For this chart Ambac's and MBIA's gross present value of simulated losses are based on 'AA' rating thresholds. CIFG's, FGIC's and SCA's gross present value of simulated losses are based on 'BBB' rating thresholds.
Source: Company data feeds, Fitch.

A key conclusion from our detailed analysis of each financial guarantor's SF CDO exposures is that Fitch noticed a significant difference in the quality of transactions that were underwritten from one company to the next. In the case of Ambac for example, excluding the four CDO-squared transactions that Fitch expects will suffer catastrophic losses in the future, Fitch's analysis indicated that the remainder of Ambac's SF CDO portfolio had relatively lower loss expectations than the SF CDO portfolios of its competitors.

At the other end of the spectrum, SCA and CIFG were the most negatively impacted by the review. For SCA, this was due mainly to the significantly high expected losses projected against the company's exposure to non-senior, second-priority SF CDOs insured by the company. SCA was the only guarantor that insured a number of non-senior tranche SF CDO exposures. For CIFG, the company had a more significant exposure to mezzanine-CDOs compared to other participants in the industry. These mezzanine deals are comprised mainly of RMBS collateral originally rated in the 'BBB' rating category. Given their position in the securitization's capital structure, these transactions are at greater risk of suffering significant losses.

As shown in the chart above, exposure to SF CDOs has significantly weakened many guarantors capital adequacy position. Numerous downgrades to RMBS transactions such as subprime, Alt-A and prime second-lien mortgages have also contributed to higher simulated losses and capital targets. As of year-end 2007, the financial guaranty industry maintained approximately $74 billion of exposure to prime second-lien mortgages as an example. Along with the downgrades which have occurred to date,

Matrix Performance Statistics — Industry Summary

($ Bil.)

	Ambac	Assured	CIFG	FGIC	FSA	MBIA	SCA
Current Rating	NR	AAA	CCC	BBB	AAA	NR	BB
Portfolio Date	12/31/07	12/31/07	12/31/07	9/30/07	12/31/07	9/30/07	6/30/07
Adjusted Claims-Paying Resources (ACPR)							
AAA Threshold	14.9	3.9	3.0	4.9	5.6	14.8	3.6
AA Threshold	15.0	3.9	3.0	5.0	5.7	15.0	3.6
A Threshold	15.1	3.9	3.0	5.0	5.8	15.1	3.6
BBB Threshold	15.3	3.9	3.0	5.0	5.9	15.3	3.7
Target Claims-Paying Resources (TCPR)							
AAA Threshold	19.3–19.8	3.6	6.0–6.1	10.0–10.2	5.2	18.2–18.6	9.2–9.5
AA Threshold	15.0–15.7	2.7	5.2–5.5	8.1–8.5	4.0	14.6–15.2	7.5–8.1
A Threshold	10.7–12.1	2.2	3.6–4.5	5.8–6.7	3.2	9.9–11.7	4.9–6.1
BBB Threshold	7.9	1.5	3.2–4.2	4.7–5.2	2.3	8.2	4.3–4.9
Capital Excess/(Shortfall) (ACPR—TCPR)							
AAA Threshold	(4.4)–(4.9)	0.2	(3.0)–(3.1)	(5.1)–(5.3)	0.4	(3.4)–(3.8)	(5.6)–(5.9)
AA Threshold	0.1–(0.7)	1.1	(2.2)–(2.5)	(3.1)–(3.5)	1.7	0.4–(0.2)	(3.9)–(4.5)
A Threshold	4.4–3.0	1.7	(0.6)–(1.5)	(0.8)–(1.7)	2.5	5.2–3.4	(1.3)–(2.5)
BBB Threshold	7.4	2.4	(0.2)–(1.2)	0.3–(0.2)	3.6	7.1	(0.6)–(1.2)

Ambac – Ambac Assurance Corp. Assured—Consolidated Assured Guaranty Corp. and Assured Guaranty Re Ltd. CIFG – CIFG Guaranty. FGIC – Financial Guaranty Insurance Company. FSA — Financial Security Assurance Inc. MBIA — MBIA Insurance Corp. SCA — Security Capital Assurance Ltd. NR — Not rated.
Source: Company data feeds, Fitch.

Fitch further discounted guarantors' direct exposures to RMBS to incorporate the deteriorating trends which have continued throughout 2008.

Liquidity

Fitch has stated in a number of its recent commentaries that the financial guarantors maintain solid liquidity, particularly since the majority of the claims which Fitch projects will not have to be paid until many years into the future. Of even more importance, Fitch notes that the financial guaranty insurance companies, especially CIFG, FGIC and SCA, are not subject to any notable collateral posting or termination provisions which could effectively accelerate a draw on their existing capital resources.

However, this fact only remains in place as long as these insurance companies remain healthy, solvent companies. If any insurer were to enter an event of default, which for an insurance company may include being formally placed under supervision or in rehabilitation, then the financial guarantor could be subject to accelerated market-value based termination payments under credit default swaps (CDS) which it has written.

In the case of an event of default, standard International Swaps and Derivatives Association (ISDA) language calls for the MTM value of the CDS contract to be paid from an out-of-the-money defaulting party to the other. Given the current negative MTM valuations being reported by the financial guarantors, related mainly to their SF CDO exposures that are mainly executed in CDS form (though it also applies to other exposures executed via CDS such as synthetic corporate CDOs), these termination payments that would need to be made by the guarantor could be significantly greater than the guarantor's claims-paying resources. Given this potential liquidity risk, Fitch believes insurance regulators will evaluate a number of potential resolutions before subjecting a weakened guarantor to rehabilitation.

Fitch believes the holding companies of these pressured guarantors are likely to be at greater risk of default, given the increased probability that insurance regulators may proactively elect to suspend dividend payments from the operating to the parent

company while uncertainty remains. This risk has been incorporated into the holding company ratings of both SCA and FGIC. SCA's holding company has already elected to defer the March 2008 dividend payment on its $250 million series A perpetual noncumulative preference shares.

Fitch also believes that the higher-rated guarantors continue to maintain solid liquidity for the same reasons listed above. However, Fitch notes that Ambac, FSA, and MBIA's holding companies are involved to various degrees in ancillary businesses that could subject the insurance company to accelerated payments in the event of material downgrades to their insurance companies below the 'AA' rating category. One such business is their GIC or investment agreement businesses of these entities. The GIC businesses of these companies are subject to termination provisions in the event of such a material downgrade. Such an action would require the guarantor to settle any deficiencies in the event of a termination, and given the market value declines of RMBS-related and other assets in these GIC investment portfolios, this potential loss could be material. This risk has become elevated for Ambac and MBIA given the recent rating actions on these companies. Ambac has already announced it is winding down this business in an effort to alleviate this risk in the future. (See Appendix II for more information on holding company risk.)

Relative Positioning in the New Ratings Landscape

Fitch believes the differential in its ratings at this time within the financial guaranty industry is reasonable. For discussion purposes, it is useful to speak of the guarantors as being in one of three categories within the new landscape for ratings given their current ratings from Fitch, Moody's and S&P. Given the ratings sensitivity of the industry, the implications of the ratings from each of the agencies is important since any one rating can directly impact competitive positioning. Additionally, for some companies, the ratings of Moody's and S&P are linked to contractual rating triggers in GICs and other investment product-related exposures.

Assured and FSA

FSA and Assured are the only two financial guarantors with Stable 'AAA' ratings from Fitch, Moody's and S&P. Both FSA and Assured made the decision to avoid or limit exposure to SF CDOs, while their competitors became increasingly involved in the sector. Their ability to exercise caution while competitors generated what seemed to be handsome premiums from this business reflects well on their risk management discipline. As the financial guarantors that are exposed to subprime remain highly susceptible to future uncertainty related to their SF CDO exposures, confidence in FSA and Assured's financial strength has allowed both companies to significantly improve their market shares and pricing power compared to previous years.

Wider credit spreads, combined with a lack of clean 'AAA' capacity, has afforded FSA and Assured the opportunity to price new business at significantly higher spreads than had been originated in prior years. To support their current financial position and prepare for growth opportunities, both FSA and Assured have also bolstered their existing capital positions with separate capital raising initiatives in the past several months.

Fitch recognizes that FSA and Assured are not immune from problems being experienced in the U.S. mortgage markets. The recent first-quarter financial results would confirm these views. However, both FSA and Assured's troubles are centered on direct exposure to RMBS. While losses on these exposures are expected to be material, Fitch believes the absolute losses on these transactions will be manageable within the context of each company's existing capital base.

Fitch also expects all three rating agencies and regulators to re-examine various aspects of their methodologies and capital guidelines for the financial guaranty industry in the months ahead, with a likely outcome being higher capital guidelines and more restrictive criteria overall. This may present a near-to-intermediate term challenge for Assured and FSA who may then no longer meet updated guidelines to continue to be rated 'AAA' by all three agencies. Both companies would then need to make difficult decisions related to the economic costs of adapting to new guidelines as they are phased in by the agencies.

Ambac and MBIA

Excluding FSA and Assured, which maintain Fitch's highest ratings, the agency believes the major subprime exposed guarantors that have been able to attract additional capital resources since the mortgage crisis began, namely Ambac and MBIA, are in a better position to withstand the challenges relative to weaker competitors, although recent downgrades by other rating agencies and these company's subsequent responses have tempered this expectation.

Fitch believes both companies maintain enough capital to adequately support policyholder obligations with a reasonable margin of safety, though this margin has dropped significantly in the past year. As these companies are currently experiencing little to no growth, Fitch expects their excess capital positions to improve over time (assuming relative stability of underlying ratings in the existing insured portfolios), as each company should benefit from the amortization of existing insured obligations, some of which exhaust a material amount of targeted capital resources. However, continued deterioration in the direct RMBS portfolios of subprime, Alt-A, and second-lien has hindered capital improvements to date. In addition, both companies have acknowledged they will not be seeking additional capital raises for the foreseeable future.

Additionally, unlike their smaller competitors, the holding companies of each firm are engaged in ancillary businesses (such as GICs) that will subject the company's to potential collateral or liquidity calls in the event either insurance company is further downgraded by Moody's or S&P. The recent downgrade of MBIA by Moody's has already created a need for MBIA to post significant collateral with its GIC counterparties. If MBIA or Ambac's ratings are lowered below 'A–' by either agency, the GIC portfolios would be subject to termination by the counterparty. Such an event could immediately crystallize losses, which could exacerbate an otherwise orderly run-off of its business.

Of further concern, both companies have stated a desire to direct available capital to other stakeholders, to the detriment of existing policyholders at the rated insurance company. In the case of MBIA Inc., the parent of MBIA, it recently announced it was not going to down stream $900 million of available cash at the holding company to better fortify its existing policyholders. With Ambac, the parent company is potentially seeking to upstream dividends away from the insurance subsidiary's policyholders in order to help recapitalize a "municipal-only" bond insurance company. Fitch believes that both these actions could hamper the future financial flexibility of the insurance subsidiaries, especially given the future uncertainty with the expected level of future claims that each company will need to pay in the future.

CIFG, FGIC and SCA

CIFG, FGIC and SCA have each been downgraded to low investment grade or speculative-grade by all three rating agencies, and as a result Fitch believes the future for these three companies is far more uncertain. For various reasons, neither FGIC nor SCA has been able to attract additional capital resources needed to support their financial profile. As a result, Fitch has downgraded each company multiple notches in

the past few months. FGIC's IFS rating has been lowered to 'BBB', while SCA's insurance subsidiaries have been lowered to 'BB'. For both companies, expected losses on SF CDOs now comprise a high proportion of adjusted claims-paying resources (ACPR), and in the case of SCA, Fitch's expected loss projection makes up a high percentage of available claims-paying resources.

CIFG, on the other hand, did attract a $1.5 billion capital infusion from its shareholders in late-2007, which initially supported its rating at that time. However, further analysis indicated that CIFG's portfolio had deteriorated further, giving rise to increases in capital guidelines. More recently, CIFG's shareholders have indicated additional capital infusions were not likely, and there appears to be growing risks that CIFG may fail to meet its minimum statutory capital guidelines, which increases the risk of regulatory intervention and CDS acceleration. CIFG is currently rated 'CCC'.

To partially address the concerns over their capital positions each company suspended the underwriting of new business in an attempt to shore up their equity bases. Additionally, both FGIC and SCA have filed lawsuits against various counterparties looking to terminate certain SF CDO obligations they contracted to insure.

- FGIC filed suit against several counterparties, alleging that these counterparties had fraudulently induced FGIC to enter into a commitment to issue a financial guaranty policy on a large SF CDO known as Havenrock II, which is deteriorating rapidly. In addition, FGIC management believes that subsequent to year-end 2007, a party to the Havenrock II transaction failed to perform certain responsibilities, which in FGIC's view greatly reduces the company's potential liabilities under this transaction.
- SCA filed suit against Merrill Lynch International (MLI), looking to terminate seven credit default swap (CDS) contracts under which a subsidiary of SCA agreed to cover risk of losses on SF CDO transactions. In this case the seven CDS contracts are non-senior, second-priority SF CDOs which Fitch believes are at risk of experiencing significant losses. According to SCA, MLI repudiated the contracts by committing to provide third parties with the same CDO control rights that it previously promised to SCA. A federal judge recently issued a summary judgment on the case in favor of MLI.

With respect to the five downgraded companies, Fitch believes the inherent volatility still embedded within their insured portfolios, related to SF CDOs and direct RMBS transactions, will result in further pressure to each respective company's financial performance and capital position for the foreseeable future.

For more detail on Fitch's credit opinion on each of the seven financial guarantors discussed above, please see Appendix II on page 18. (Fitch notes that the ratings of Ambac and MBIA were withdrawn on June 26, 2008. At the time of the ratings withdrawal, both companies were rated 'AA' with a Negative Rating Outlook).

Willingness to Pay

Several companies have come under significant financial stress in the past six months related to their exposure to subprime mortgages and in particular SF CDOs, and these entities are now giving consideration to remediation solutions that can significantly reduce the size of potential future claim payments. Such solutions may include the attempt to commute existing CDS exposure back to their counterparty, as well as in isolated situations, legally disputing potential claims before they even arise. In the case of commutations, guarantors are offering financial consideration for the ability to cancel the existing CDS policy. In the case of SF CDOs, such cancellations could significantly reduce the potential claims a guarantor would be expected to pay and ultimately improve the company's financial condition.

With respect to legal disputes, both FGIC and SCA are currently in battle with respective counterparties related to specific troubled transactions. While the legal disputes brought on by FGIC and SCA are different in nature, the effective premise is the same. Fitch is not in a position to opine on the validity or merits of the existing disputes, although the agency acknowledges a ruling in FGIC and/or SCA's favor could have meaningful positive impact on each company's capital position and credit ratings in the future, since in both instances the exposures subject to the legal disputes account for a material percentage of the aggregate SF CDO expected losses estimated by Fitch.

It has been suggested that the selective termination of obligations, which are likely to suffer potential claims, could have damaging repercussions to the reputations of the impacted guarantors. However, given the magnitude of potential losses that are contemplated in these specific cases, Fitch believes it is not surprising that companies would look to protect their financial position in this fashion despite the risk of potential harm to their respective reputations. In fact, absent external financial support, Fitch does not believe any of these companies will be able to effectively improve its credit profile over the intermediate term without some material financial relief from these troubled obligations.

Fitch believes the fallout from these commutations and legal disputes could potentially have greater impact on the financial guaranty industry as a whole, as counterparties may begin to question the value of the credit protection insurance they are purchasing. Customers have recognized value in a financial guaranty policy as the insurers have always vowed to "pay first and dispute later." Fitch acknowledges that a perceived loss of confidence could damage the future value of a financial guaranty policy; however, Fitch believes these developments are isolated to a handful of transactions entered into between very sophisticated institutional counterparties. At the present time, Fitch does not anticipate guarantors rejecting claims as a viable credit remediation tool, particularly for those companies that have an objective of returning to an 'AAA' rating at some point in the future. Notwithstanding this point of view, Fitch acknowledges that the possibility of disputes increases for those companies that are unlikely to originate new business and transition into run-off mode in the future.

Rating Outlook: Near and Intermediate Term

Near-Term Outlook: Negative

Fitch believes the *near-term* rating outlook for the financial guaranty industry is negative. The negative outlook primarily reflects lingering uncertainty as to ultimate subprime-related losses, and questions as to whether companies have or will maintain the necessary level of capital to support their given ratings, particularly in times of stress. As can be seen in the table on page 2, of the seven financial guarantors rated 'AAA' for financial strength at the beginning of 2007, five companies have been downgraded by all three rating agencies (Fitch's IFS ratings on Ambac and MBIA were withdrawn on June 26, 2008, after being downgraded to 'AA' earlier this year), and Fitch believes each of these companies is susceptible to further ratings pressure in the future.

The negative industry outlook incorporates a risk several guarantors face that statutory capital levels may be depleted due to increasing losses as insured portfolios deteriorate, which could in turn result in both regulatory intervention and a possible termination settlement claim on various CDS positions. This could result in a steep "ratings cliff" as was most recently seen with the downgrade of CIFG.

Fitch expects it will be very difficult to stabilize the ratings of recently downgraded companies until they can more effectively limit the downside risk from their SF CDOs through reinsurance or other risk mitigation initiatives, or until the passage of time has provided greater clarity regarding the ultimate performance prospects for these exposures. Fitch also believes that further deterioration in real estate markets or the economy could expose financial guarantors to additional ratings downgrades. In addition, Fitch believes recent actions announced by several management teams to redirect claims-paying resources away from the current policyholders will add further pressure to the ratings.

Intermediate Term Outlook: Uncertain

While Fitch views the near-term rating outlook for the entire financial guaranty industry as negative, the agency views the *intermediate-term* rating outlook as uncertain. Accordingly, Fitch sees the potential for both downgrades and possibly upgrades once the near-to-intermediate term balance sheet issues related specifically to subprime losses are effectively stabilized for those financial guarantors that are ultimately able to remain viable.

The following are trends that speak to negative ratings pressures even beyond near-term subprime issues:

Tarnished Industry Reputation. As long as investors or issuers question the financial viability or ratings stability of a financial guarantor, history has shown that the demand for an affected company's products will be limited. Issuers will not use a financial guaranty unless there is a cost-saving in doing so—without investor demand that cost-saving is eliminated. Over the past few months, the five downgraded subprime-exposed financial guarantors' market share in their core U.S. municipal finance business has been anemic at best, due to a lack of demand. Three of these five companies, FGIC, SCA, the parent company of XL Capital Assurance Inc. (XLCA) and CIFG, have decided to formally suspend the origination of new business for an undetermined period of time to preserve capital. If these companies financial fortunes do not materially improve over the near-to-intermediate term, Fitch anticipates these companies would likely exit the market altogether via a voluntary run-off, regulatory actions or a potential sale to an existing player. While Ambac and MBIA have not formally announced a suspension of new business activities, their abilities to write new business declined greatly. Both companies are potentially looking to stay in the market by forming new "AAA municipal only" subsidiaries.

Declining Municipal Participation. The financial guarantors' market share of new U.S. municipal finance business has declined by nearly 50% to 26% in 2008 compared to 2007[1], as many obligors have chosen to either issue new debt uninsured or seek alternate forms of credit enhancement, such as bank letters of credit. For those deals that have been insured, FSA has garnered the majority of the share, with Assured picking up significant market share compared to previous years. More recent reports have also indicated that Berkshire Hathaway Assurance Corp. (BHAC) is attracting a lot of issuer and investor interest based on guarantees of its business via the 'AAA' rating of parent Berkshire Hathaway, Inc. However, much of BHAC's underwriting to date has been focused on secondary wraps of previously insured issuances. If the industry's municipal market share remains at these depressed levels in the future, Fitch believes the profile of the industry will change dramatically in the years ahead, and those changes could have ratings implications for the industry as a whole.

[1] Source: *The Bond Buyer.*

Possible Change in Municipal Ratings Scale. With recent discussions related to the potential for “harmonization” of the historically unique U.S. municipal finance ratings scale to align with the global ratings scale (see Fitch press release titled “Fitch Conference: Globalization, Money Fund Requirements Reasons to Rethink U.S. Muni Ratings” dated April 15, 2008), it has been suggested by some that pricing on future issuances of municipal bonds could contract to a level which would make bond insurance less attractive, and as a result, issuers may opt to forego it in the future. These issues will take time to work out, and Fitch will continue to monitor developments in the municipal finance market for implications on the rated financial guarantors. But regardless, if such changes in the rating scale were to occur, they would create another issue for companies to manage through.

Uncertainties for Structured Finance Business. While certain structured finance risks were the cause of the industry’s recent problems, structured finance has been a core source of revenues, profits and growth for the industry. With significant turmoil in many structured finance markets, and issuance in general at very low levels (year over year market-wide declines were between 80%–90% in first quarter 2008), it is unclear to what extent structured finance will contribute as a source of revenue and profit for the financial guarantors.

The following speak to developments that may ultimately provide positive support for ratings in the future:

Better Underwriting Risk Focus. Favorably, more recent underwritings have been focused on the traditional municipal finance sector, which Fitch believes is significantly less capital intensive and less volatile than structured finance. Additionally, most guarantors have indicated that even when structured finance markets again open up, their approach to growth and underwriting will be much more selective than in the past. This can add greater stability to the insured portfolios, and reduce the risk of future losses, while also aiding in the regaining of investor confidence.

Improved Risk Management. Even before the recent turmoil, financial guarantors were beginning to embrace enterprise risk management (ERM) concepts. Fitch expects companies will further ramp up efforts in this area, with special emphasis in trying to identify and limit tail risks, especially those linked to unanticipated correlations.

Regulatory Support. Insurance regulators, especially those in New York who act as the industry’s primary state regulator, have been very proactive in the past several quarters to support stability in the financial guaranty industry. This has included efforts to support new capital raises, approvals of new licenses, and being proactive in asking management teams to focus on swiftly addressing their issues. The regulators are also contemplating regulatory changes that may increase the amount of minimum capital required to conduct financial guaranty operations as well as place more constraints on the activities of financial guarantors, which may reduce the risk profile going forward. Fitch believes increased levels of regulatory scrutiny will likely remain an ongoing aspect of the financial guaranty landscape well into the future.

Finally, we see one core issue that can have both positive and negative ratings implications over the intermediate term:

Municipal-Structured Business Split. We believe the possible movement of a guarantor to separate their municipal and structured finance businesses into two distinctly capitalized and rated companies could have both positive and negative ratings implications. We believe most such structures would be designed to result in an upgrade in the municipal company to ‘AAA’ or ‘AA’, but would allow the structured finance company to remain at the current (downgraded) rating, or to be downgraded

further. Fitch believes it would be very difficult for a company to execute on a separated business plan, but we are also aware such options are being considered. A split business model is particularly challenging because one class of policyholders could effectively be subordinated to another, and as a result there are likely to be legal obstacles in effectuating this subordination.

Future Ratings Methodology

In light of the recent financial stress in the financial guaranty industry, and the level of ratings migration for some companies, Fitch will look to see if there are aspects of the methodology that can be enhanced to better assess risks, or add grater stability to ratings in the future during times of stress. Though none of these are definitive, some of the areas of Fitch's methodology which have preliminarily been flagged for review include:

- Greater emphasis on review of formal, robust contingency plans and potential introduction of new guidelines for contingent capital and contingent liquidity resources. (See Management of Rating Sensitivity section below for additional details on this concept.)
- To possibly discontinue the credit for certain types of so-called "soft capital" in Fitch's calculation of "leverageable" claims-paying resources, and to align claims-paying resource definitions with Fitch's general "equity credit" methodology for hybrid securities. This would mean, for example, Fitch would only provide claims-paying resources credit for preferred put facilities used by several guarantors when such facilities are actually drawn upon in times of stress.
- Greater emphasis in the ratings conclusion on qualitative evaluations of underwriting quality, growth trends, changes in portfolio mix and risk management. Fitch believes such analysis may prove to be a sound "early warning" indicator of prospective changes in financial strength in combination with risk based capital modelling.
- Reevaluation of guidelines and assumptions with respect to management, governance and sponsorship (ownership structure). This will include re-evaluation of the historical belief that shareholder and policyholder interests will be aligned in times of stress.
- Introduction of various non-risk based leverage guidelines to augment, and act as a "reality check," against risk-based capital modelling. These may include leverage measurements at the overall portfolio level, for correlated sectors, for large single risk concentrations, major counterparty concentrations, unseasoned lines of business, etc.
- Review of guidelines for start-up companies, with an expectation that minimum guidelines for "hard" capital potentially increasing to $1.0 billion from $500 million for an 'AAA' rating.
- Formalization of guidelines for financial guarantors in run-off.
- Review of certain assumptions in the Matrix capital model, as well as consideration of development of a secondary capital model that would use only public information.

Fitch expects to consult with the market over the next few months as we contemplate changes to its current rating methodologies. In the interim, Fitch welcomes any comments or views from the market.

Management of Rating Sensitivity

Recent history has demonstrated that negative press or market speculation, or the mere placement of a financial guarantor on Rating Watch Negative, can have a significant negative impact on its franchise, trading value, and financial flexibility. This is based on a widely held view of many investors that without the highest ratings, they question the value of the products sold by the financial guaranty industry. Similarly, from the issuer's perspective, insured debt must receive substantial recognition in price execution of the rating enhancement, or the economic benefit of insuring a debt issue is lost. (This has been confirmed recently by the actions of a limited number of issuers to cancel their insurance contracts despite the fact they had fully paid for the coverage.)

While one could argue that even highly rated 'AA' or 'A' guarantees continue to provide meaningful value, this has been a case where perceptions ultimately "trump" such theoretical arguments.

Fitch views the extreme ratings sensitivity within the financial guaranty industry as a core risk that the industry needs to manage with greater rigor in the future. In effect, recent history highlights how fragile and delicate the franchise of a financial guarantor can be, and the need for management teams to do a much better job at *contingency planning* in order to better manage downgrade risk, and to protect their franchises.

It is important to note that the historic financial guaranty business model was essentially single-pronged, and centered on *avoiding* situations of material deterioration in the insured portfolio via careful "zero or remote loss" underwriting. While careful underwriting must remain a core tenet within the industry, the industry has shown it is not infallible on this issue. Accordingly, Fitch believes that a commitment to careful underwriting is no longer enough to regain and maintain issuer and investor confidence, or to achieve or maintain 'AAA' ratings. The financial guaranty business model going forward, in Fitch's opinion, must move from being single-pronged to being two-pronged, as follows:

1. An ongoing focus on *avoiding undue risk* via careful underwriting and risk management.
2. Establishing, communicating and continually updating *contingency plans and contingent financial resources* to show the marketplace how capital will be replenished, or risk mitigated, on the assumption that problems will at some point inevitably emerge, again.

Fitch believes that the ineffectiveness of contingency planning throughout much of the industry was ultimately an important contributor to the industry's recent problems. As a result, Fitch expects that a key component of every healthy, stable financial guarantor in the future will be its ability to develop and communicate effective contingency plans, through the establishment of contingent financial resources that reduce or eliminate the need to raise costly capital during difficult financial markets. Fitch believes such available contingencies should *not* be leveraged, as the agency will not count contingent financial resources in the calculation of claims-paying resources. These contingencies would only be additive during times of significant market distress.

Not only will the establishment of such contingency plans and contingent resources be important rating considerations going forward, Fitch believes such plans will be useful in regaining issuer and investor confidence.

In addition to highlighting the need for comprehensive, effective contingency planning, the recent stress experienced by the financial guarantors also revealed some material weaknesses in the companies' core risk management frameworks.

- First, while enterprise-wide risk management has been implemented in most guarantors and enhancements have or are being made, factors such as correlation risk across asset classes and vintage years were underappreciated.
- Second, in some cases, capital management was heavily reliant on external sources (i.e., use of only rating agency models) versus internal modelling and rigor.
- Third and arguably most important, several financial guarantors demonstrated an unwillingness to slow down business growth in an environment of extremely tight credit spreads where the risk-reward relationship was becoming out of balance (less reward for the same or greater risk).

Accordingly, in addition to reviewing contingency planning, Fitch will increase its reviews of new business production. As part of this, Fitch will approach all forms of growth with greater caution in the ratings process going forward, as ultimately ill-advised growth, particularly products with less robust performance history, was at the root of the recent troubles facing the industry.

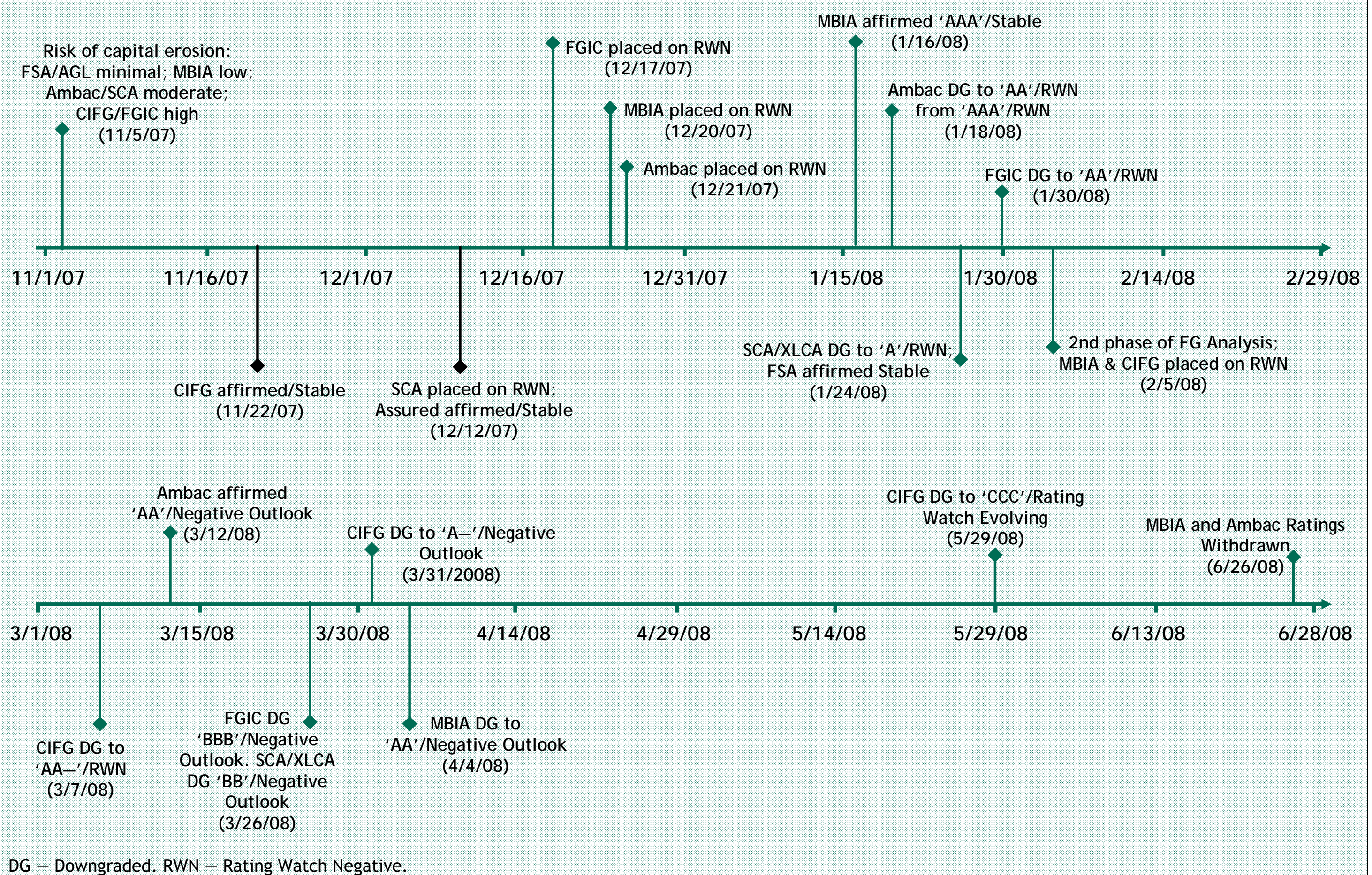
Appendix I

The Phases of the Subprime Ratings Analysis

Since the onset of the subprime and capital markets crisis, Fitch has spent considerable time reviewing and updating its ratings of the financial guaranty industry. Despite views to the contrary, it is important to note that Fitch has not changed its modelling process for assessing the capital adequacy of financial guarantors. However, given the rapid deterioration in subprime mortgage assets, and in particular SF CDOs, Fitch decided it was appropriate to incorporate more refined analytical processes to assess risk against this asset class. Such processes are summarized below.

Stress Test Analysis. As subprime issues started to crystallize, in September 2007 Fitch published an initial stress test analysis of the resiliency of the various financial guarantors' capital to possible credit deterioration in their portfolios. Two insurers were flagged as being most exposed—CIFG and FGIC—and both of these companies have been subsequently downgraded by all three rating agencies. SCA scored better than CIFG and FGIC on the stress test, but less favorably than all other companies.

Phase 1 Analysis. As signs of credit deterioration mounted, on Nov. 5, 2007, Fitch announced it was formally reviewing the ratings of the financial guarantors, and risk-ranked the various companies based on their level of exposure to SF CDOs with RMBS



A Note on Fitch's PV Discounting Assumptions

From a present value (PV) perspective, Fitch discounts the expected future loss rates by 5% over a two-year period for CDO-squareds, five years for mezzanine SF CDOs and seven years for high-grade SF CDOs, although the agency recognizes in individual instances ultimate principal payments may not be due for up to 30 years. These two-, five- and seven-year discount periods are based upon Fitch's estimates of when a high proportion of principal payments will become due or in the case of the guarantors, the time when the final claim for principal will be made. Such time is assumed to be when the collateral is completely exhausted, either as a result of default or a combination of collateral repayment and default.

While these estimates are difficult to forecast precisely, for the purposes of the analysis in question, Fitch has based its estimates on the likelihood of when different SF CDO types would reach their final settlement point. Fitch expects CDO-squareds to incur losses most quickly, because acceleration or liquidation of the "inner" CDOs will rapidly erode the underlying collateral pools. Mezzanine SF CDOs, which held concentrated amounts of subprime RMBS collateral originally rated in the 'BBB' category, will take somewhat longer for losses to erode the collateral pools, as loan-level losses within the RMBS transactions must reach through the original 'BBB' classes. High-grade SF CDOs are expected to require additional time, as loan-level losses within the RMBS transactions must reach the more senior tranches within the underlying RMBS transactions held by these SF CDOs.

collateral. Those two insurers with the most favourable risk rankings—Assured and FSA—remain the only guarantors with Stable 'AAA' ratings. This phase of analysis resulted in the downgrades of Ambac, FGIC and SCA. The ratings of MBIA and CIFG were originally affirmed at 'AAA' as each company was able to raise external capital to support their franchises at the time. A key aspect of this phase of analysis included Fitch's CDO team assigning internal unenhanced ratings to most of the SF CDOs insured by the various guarantors, including those SF CDOs not originally rated by Fitch. These assessments were based on detailed reviews of the underlying collateral and capital structures of the transactions. Thus, this part of the analysis was supported by extensive underlying ratings assessments by Fitch of the most troubled securities impacting guarantors' capital guidelines.

Phase 2 Analysis. Later on, based on new statistical data suggesting the emergence of higher underlying RMBS cumulative loss rates than previously used by Fitch, as well as many other market participants, Fitch embarked on a second phase of analysis of the financial guarantors. In this phase, Fitch "carved out" from our stochastic capital model the various SF CDOs and developed transaction-specific expected loss and stress loss amounts to help judge capital adequacy in a more granular and transparent manner. This phase of analysis resulted in downgrades of CIFG and MBIA, and further downgrades of FGIC and SCA.

Ongoing Surveillance and the Future. Fitch is now in a period of ongoing surveillance of the financial guarantors. Fitch will continue to monitor its projections made of expected losses on SF CDOs and compare to actual losses that have and will be expected to be recognized in the future.

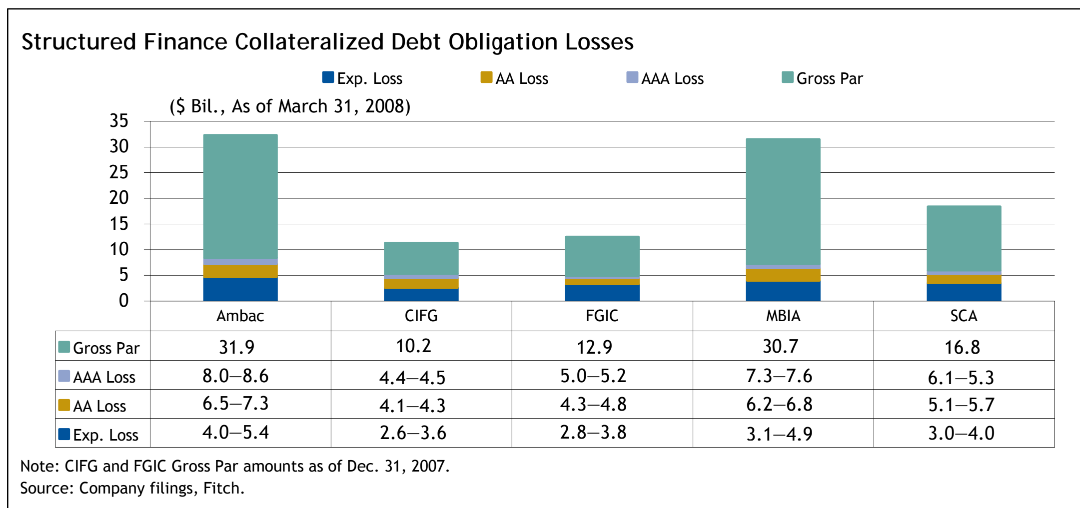
More recently, Fitch has been reviewing the performance of pre-2006 vintage RMBS and its implications on SF CDOs underwritten in those years. This review, in part, led to the recent rating actions on CIFG given this guarantor's heavy concentration of mezzanine SF CDOs (original underlying collateral rated 'BBB' or below) from that vintage year. Fitch is not expecting large changes to the projected loss estimates for other guarantors, since the other firms have little exposure to 2005 mezzanine SF CDOs.

Another important aspect of Fitch's future analysis will be the assessment of how each is dealing with their distressed exposures. Fitch does not believe company's can stabilize their financial situation without first taking actions to limit the downside risk from their problem credits.

Development of "Expected Losses"

Given the rapid deterioration experienced in the subprime and alternative-A "Alt-A" RMBS markets, Fitch has completed an extensive analysis of "expected losses" at the collateral pool level for each of the SF CDOs that Fitch believes were likely to be impacted by troubled RMBS. This exercise involved a bottom-up analysis by Fitch's Structured Credit Group of each SF CDO, and was conducted outside of the Matrix capital modelling process. This approach also allowed Fitch to develop deal-by-deal capital assessments that were set either equal to, or as a multiple of the expected losses, based on the rating stress level. Fitch believes this approach created greater transparency than attempting to use the stochastic process in Matrix to assess capital against SF CDOs, given the significant volatility inherent in this asset class

These expected losses represent an estimate of the range of future losses that Fitch believes each affected financial guarantor would be expected to incur over the entire life of these transactions, stated on a present value basis. The range of outcomes reflects remaining uncertainty as to the level of U.S. residential mortgage losses that will ultimately be incurred in SF CDOs insured by each guarantor.



	Ambac	CIFG	FGIC	MBIA	SCA
Gross Par	31.9	10.2	12.9	30.7	16.8
AAA Loss	8.0–8.6	4.4–4.5	5.0–5.2	7.3–7.6	6.1–5.3
AA Loss	6.5–7.3	4.1–4.3	4.3–4.8	6.2–6.8	5.1–5.7
Exp. Loss	4.0–5.4	2.6–3.6	2.8–3.8	3.1–4.9	3.0–4.0

Note: CIFG and FGIC Gross Par amounts as of Dec. 31, 2007.
Source: Company filings, Fitch.

Fitch's analysis of expected losses includes an assumption that underlying cumulative loss rates on U.S. residential mortgages supporting outstanding subprime RMBS pools will average 21% in the 2006 vintage year and 26% for the 2007 vintage year. These assumed cumulative loss rates are consistent with those currently used by Fitch for its ratings of outstanding RMBS transactions, and are being used by numerous other market participants as well. Fitch notes that when it discusses "expected losses," this is an analytical concept based on Fitch's assumptions. In the case of expected losses on SF CDOs, Fitch anticipates that the majority of these losses will not materialize for many years into the future. As a result, Fitch does not believe inferences should be made with respect to the applicability of these projections to any guarantor's loss provisioning or accounting policies. In fact, Fitch would not expect current levels of reserves for SF CDOs, which are based on generally acceptable accounting principles (GAAP) standards of "probable and estimable," to necessarily mirror the expected losses Fitch is projecting. Only over the course of time as projected losses on the underlying CDOs become crystallized will Fitch expect reserving levels by guarantors to approach the loss estimates that have been modelled.

Given Fitch's current projected loss estimates for 2006–2007 vintage subprime RMBS, it is expected that a high percentage of the underlying tranches that were originally rated below 'AAA' will potentially default and suffer significant losses. This development is expected to result in losses elevating well into the capital structure for many SF CDOs. Only those RMBS and SF CDO transactions from the 2006–2007 vintages that maintained very healthy levels of initial subordination are expected to avoid experiencing losses in the future.

Fitch projects the $114 billion of SF CDOs insured by the five downgraded guarantors will ultimately produce losses on a present value basis of approximately $15 billion to $21 billion. Through the first quarter of 2008, the financial guaranty industry has recognized $6.0 billion of this total through loss reserves or recognition of permanent impairment against the MTM on their income statement. In addition, unprecedented deterioration in each company's direct RMBS portfolios, in particular their prime second-lien and Alt-A mortgage exposures has helped exacerbate losses in late 2007 and 2008.

Appendix II

The following section contains a summary credit analysis for each of the financial guarantors followed by Fitch.

Financial Guarantor	Page Number
Ambac Assurance Corporation (Ambac)	19
Assured Guaranty Ltd. (AGL)	21
CIFG Guaranty (CIFG)	23
Financial Guaranty Insurance Company (FGIC)	25
Financial Security Assurance Inc. (FSA)	27
MBIA Insurance Corp. (MBIA)	29
Security Capital Assurance Ltd. (SCA)	31

Ambac

IFS Rating: Not rated

Fitch's ratings of Ambac were withdrawn on June 26, 2008.

Ambac Assurance Corporation (Ambac)

Credit Profile

- Ambac's credit profile in recent periods has deteriorated due mainly to expectations of significant expected losses from SF CDOs. Fitch believes uncertainty surrounding SF CDO losses will make it difficult for the company to stabilize its financial position until the downside risk is limited. Continued deterioration in Ambac's second lien RMBS exposures add further stress to the company's credit profile.
- Recent downgrades by Moody's and S&P to below 'AAA' have resulted in collateral posting requirements in the company's affiliated investment agreement business. While Fitch believes current collateral posting requirements are manageable, additional downgrades could result in further acceleration of liquidity or collateral calls against the insurance or holding company, which would create further negative pressure on the credit profile of the company.
- Downgrades have also created noticeable erosion in Ambac's franchise value in recent periods. Fitch believes the company will be extremely challenged in its ability to execute on its strategic business plans as the group is currently structured.
- The company raised $1.5 billion of new capital in March 2008. However, access to additional capital at this time is severely constrained given where the company's stock is trading.
- Positively, Ambac has a diversified insured portfolio across asset classes, with a strong back book of municipal exposures.
- The company's risk management framework has been improved, with a chief risk officer reporting to the board of directors and a strengthened surveillance and remediation team.

Key Credit Issues

- Fitch believes that Ambac's unadjusted claims-paying resources of $14.5 billion (as of Dec. 31, 2007) are adequate to meet policyholder obligations with a reasonable margin of safety, though this margin has dropped significantly in recent periods. As noted, Ambac's capital strength has been negatively impacted by the company's significant exposure to deteriorating SF CDOs and eroding second-lien exposures.
- Significant potential and expected losses from SF CDO exposures. Fitch's expected losses from SF CDOs fall within a range of $4.0 billion to $5.4 billion. Four SF CDO-squared transactions were the primary contributors to Fitch's expected loss estimated for Ambac's SF CDO portfolio, three of which were underwritten in 2007 and contributed almost half of the total expected loss. Excluding these SF CDO-squared transactions which totaled $2.4 billion net par outstanding, Fitch's expects Ambac's remaining SF CDO transactions, which totaled about $29.6 billion net par outstanding as of year-end 2007, to perform better than its peers.
- Second-lien direct RMBS exposures have experienced material deterioration and many are already paying claims. Ambac's second-lien exposures are concentrated in the 2006–2007 vintages (69% of the $17.3 billion exposure), which are the two worst performing vintages from the current credit cycle, make these exposures particularly troublesome. While the company has already taken material reserves against these exposures ($1.0 billion through March 31, 2008), Fitch believes there is potential that these losses could be higher.

- Given Ambac's current ratings, Ambac is not able to underwrite meaningful new business. Ambac's future ability to underwrite business is highly questionable, particularly in light of weakened demand for bond insurance as reflected in insured penetration. Furthermore, it is unclear that Ambac will be able to recover from the significant damage its reputation has suffered from the subprime crisis. The ability to execute on management's plans to recapitalize Connie Lee Insurance Co. as an 'AAA' municipal bond insurer is questionable.
- Core operating earnings will remain depressed over the near to intermediate term as underwriting has largely ceased and losses continue to filter through the insured portfolio.
- Fitch believes Ambac's GIC program could place future stress on the company's liquidity resources. Ambac currently has $7.7 billion of GIC liabilities, with about $3.3 billion tied to credit-linked notes (CLN) that provide credit enhancement to CDOs. More than one-third of these CDOs have underlying collateral that are RMBS or CDOs, whereas the rest have either corporate or commercial mortgage—backed securities (CMBS) collateral. Actual credit losses to these CDO transactions could cause Ambac to pay off the related GIC obligations earlier than anticipated. Ambac holds cash in excess of CDOs that are expected to draw, but should draws exceed this balance, Ambac could be forced to liquidate GIC program invested assets at prices significantly below par, resulting in a realized loss to Ambac. At year-end Ambac's market value of GIC assets was about $764 million below book value, but that gap is widening as market turmoil has continued to affect the market value of the RMBS assets within the portfolio.

AGL

IFS Rating: 'AAA'[a]

Rating Outlook: Stable

Last Rating Action: Dec. 12, 2007

[a]IFS rating is for primary financial guaranty company. Reinsurance subsidiary IFS is 'AA' .

Assured Guaranty Ltd. (AGL)

Rating Rationale

- The 'AAA' IFS ratings of AGL's primary financial guaranty subsidiary implies "Exceptional' financial strength, and reflects AGL's strong insured portfolio credit quality, and disciplined underwriting and risk management, exemplified by its minimal exposure to SF CDOs backed by subprime RMBS.
- The capital position was more than satisfactory to support the 'AAA' IFS ratings as of the most recent review.
- The parent holding company has recently shown excellent access to capital, including a $304 million public common equity issuance in December 2007 and a $1.0 billion capital commitment from WL Ross & Co. LLC, of which $250 million was funded in April 2008.
- These strengths are partially offset by recent deterioration in the direct RMBS portfolio, and trading values that lag competitor FSA.
- Given its current ratings, the company is currently taking advantage of attractive pricing opportunities in the direct market for the first time in its history. Additionally, AGL's reinsurance subsidiary has also been able to attract business at favorable risk-based pricing levels.

Capitalization

- AGL had excess capital of more than $150 million under Matrix, corresponding to a CCAR of about 1.05x 'AAA' guidelines as of Dec. 31, 2007. That said, continued strong growth over time (driven in part by ratings pressure at its peers) that is not supported by disciplined capital management could adversely impact future AGL Matrix results and pressure excess capital levels and ratings.
- This Matrix result includes $304 million of new capital raised in December 2007, as well as stresses made by Fitch to AGL's prime second-lien RMBS portfolio.
- Structured finance simulated net losses continue to dominate AGL's results, contributing about 76% of simulated net losses. Structured finance simulated losses were mainly attributable to non-CDO exposures rated 'BBB–' or lower.
- The recent reinsurance assumed from Ambac and FGIC increased by approximately $470 million the target claims-paying resources (TCPR) of AGL. This increase is reflected in the CCAR noted above.
- In its analysis of capital adequacy, Fitch is not factoring in the $750 million unfunded capital commitment from WL Ross. Assuming this commitment is drawn, it will give AGL significant room to further expand the business.

Key Rating Issues

- Fitch believes the underwriting processes and credit profile of AGL is sound, as illustrated by the company's decision to avoid SF CDOs, a sector that has been a source of substantial stress and rating pressure for many of their competitors.
- Nonetheless, ratings could be pressured over time if the company was unable to access further capital, if needed.
- Further rating stress could occur if a material, broad-based decline in demand for financial guaranty insurance, or an influx of aggressive new competitors materially weakened the franchise value of AGL below 'AAA' standards. In addition, an

inability or unwillingness on the part of AGL to adapt to likely future changes to rating agency criteria could put future pressure on the company's ratings.

- Additionally, Fitch notes AGL has exposure to sectors with elevated risk characteristics within the RMBS and CDO portfolios. Although Fitch's Stable Rating Outlook implies no downgrade is currently expected, the rating could be pressured by material credit deterioration in AGL's RMBS portfolio, or other structured finance asset classes, that lead to material additions to loss reserves outside of expectations.
- AGL has about $26 billion of exposure to the RMBS sector as of Dec. 31, 2007.
- The company recently paid claims on three troubled second-lien deals, including two large Countrywide deals issued in 2005 and 2007, respectively.
- Although AGL has posted no case basis reserves for their $6 billion of Alt-A exposures, Fitch has observed rapid deterioration in the transactions backed by these loans throughout the broader RMBS market. Thus, Fitch believes AGL may become susceptible to a noteworthy level of claims on these exposures over time. Positively, Fitch notes the exposure of AGL in this sector is exclusively to the senior-most tranches of the capital structure, predominantly carrying original ratings of 'AAA'.
- AGL has $6 billion of exposure to subprime "basket trade" RMBS transactions as of Dec. 31, 2007. In addition to their subprime loan quality, these transactions are "last to pay" in the cash flow water-fall, so are subject to greater negative migration risk than other senior 'AAA' tranches. Fitch will continue to monitor these exposures which could potentially develop into a source of pressure within AGL's portfolio.

CIFG

IFS Rating: 'CCC'
Rating Watch: Evolving
Last Rating Action: May 30, 2008

CIFG Guaranty (CIFG)

Rating Rationale

- The 'CCC' ratings of CIFG denote "very weak" financial strength, and heavily reflect the sharp deterioration in CIFG's modeled capital position in recent periods due to sharp declines in the credit quality of its insured portfolio.
- The Evolving Rating Watch incorporates the fact that while the company has been actively negotiating to commute many of its SF CDO risks, which would meaningfully reduce its TCPR and limit its downside risk to this asset class, if a commutation is unsuccessful, there is the possibility that a regulator can initiate insolvency proceedings, which would trigger the termination and acceleration based on current mark-to-market values on $57 billion of CDS. If this were to occur, CIFG would not have enough claims-paying resources to meet these obligations and its rating would most likely fall in the 'D' category. However, if the commutation is successful, the company would have significant excess capital for its rating category and it may be possible for the company to be upgraded. If the company were to enter an orderly run-off, there would need to be clear indications that capital would be retained at levels consistent with a higher rating, and claims would be serviced appropriately throughout the run-off period.
- Further declines in capital adequacy, which could be caused by additional unforeseen losses from CIFG's SF CDOs and/or material weakening or deterioration in other subsectors to which the company has meaningful exposures or actions by existing shareholders, including attempts to remove capital, that would weaken the company's current capital position would further weaken CIFG's credit profile. Fitch would be especially concerned with such actions if CIFG entered into a distressed run-off.
- Fitch believes CIFG's current capital position is materially below a level consistent with investment-grade standards.
- The rating also reflects CIFG's lack of portfolio diversification and material concentration in CDOs, including investment grade, high-yield and SF CDOs, which comprise almost 50% of the company's insured portfolio (excluding commercial ABS CDOs) based on net par outstanding at year-end 2007.
- Significant potential and expected losses from its $9.7 billion exposure to SF CDOs will make it difficult for the company to stabilize its credit trend until the downside risk is limited.
- CIFG has made many recent meaningful improvements to its risk management framework and refocused a potential future business plan on municipal finance. However, new business has been suspended until the company can reestablish strong investment grade ratings.
- The ratings no longer reflect the previous support provided by CIFG's current shareholders, Caisse Nationale des Caisses d'Epargne et de Prevoyance (CNCE) and Banque Federale des Banques Populaires (BFBP), who have indicated no further capital support is forthcoming.

Capitalization

- Fitch believes that CIFG's pro forma claims-paying resources, which include the $1.5 billion capital infusion in late 2007 from its shareholders CNCE and BFBP, fall materially below Fitch's standard for an investment-grade level of capital.

- The primary driver behind CIFG's capital shortfall relative to prior (higher) ratings categories comes from Fitch's estimate of expected losses from CIFG's SF CDO portfolio of $2.6 billion to $3.6 billion. SF CDOs contribute about two-thirds to three-quarters of simulated losses in determining CIFG's TCPR. CIFG's SF CDO exposures are predominantly Mezzanine deals, where the underlying collateral was originally rated 'BBB'. These transactions are very susceptible to rapid deterioration and Fitch believes losses on these deals could be significant.
- Other large drivers in simulated losses include CIFG's high-yield and investment grade corporate CDOs. While CIFG's investment-grade corporate CDOs are primarily rated 'AAA', they are mostly in junior tranches of the senior classes.

Key Rating Issues:

- Significant potential and expected losses from SF CDO exposures. Fitch believes the losses from these exposures will be material and it will be difficult to stabilize the rating without limiting this downside risk.
- Materially diminished franchise value as a result of downgrades to CIFG's ratings from all three major rating agencies.
- CIFG is the smallest financial guarantor and the company has had limited success in establishing a municipal franchise. Given the market dislocation and damage to its reputation, as well as its current ratings, from it is highly uncertain whether the company will be able to execute on its business plans to focus on underwriting municipal business. Fitch believes CIFG will be extremely challenged in its ability to underwrite new business.
- Updated, consolidated financials have not been finalized and publicly disclosed since March 2007. This reflects a material weakness in the company's financial reporting and accounting function.
- Earnings will continue to remain pressured because of the company's inability to write new business and the losses that will be coming through the insured portfolio from its exposure to RMBS (primarily through SF CDOs).
- Shareholders have expressed an unwillingness to provide further capital support. The company is currently actively engaged in risk remediation strategies in relation to its SF CDOs. Previously, active support provided by all of CIFG's parent companies was a critical factor in Fitch's rating assessment of CIFG.

FGIC

IFS Rating: 'BBB'
Rating Outlook: Negative
Last Rating Action: March 26, 2008

Financial Guaranty Insurance Company (FGIC)

Rating Rationale

- The recent downgrades reflect the considerable deterioration that has taken place in FGIC's insured portfolio over the past year. This credit deterioration has significantly impaired FGIC's capital and financial position compared to historical norms.
- The rating also reflects uncertainty with respect to FGIC's future business plan and capital strategy, which could include legally operating with separate municipal finance and structured finance operating subsidiaries.
- Despite the recent credit deterioration, Fitch believes FGIC's modeled capital position remains consistent with investment grade standards. This analysis takes into account FGIC's substantial exposure to distressed SF CDOs and deterioration to the company's insured RMBS portfolio. Favorably, FGIC's decision to cease underwriting new financial guaranty business for a period of time should help FGIC conserve capital, although little benefit has been achieved to-date.
- The rating assumes FGIC will be unable to raise meaningful third-party capital to support its franchise.
- Fitch does not believe FGIC can achieve any level of stability until it limits the downside risk from its exposure to SF CDOs and direct RMBS.

Capitalization

- FGIC's unadjusted claims-paying resources of $5.3 billion are adequate for its 'BBB' rating under Fitch's modeling. FGIC's capital position has been significantly impacted by the recent subprime review conducted by Fitch because of the company's significant exposure to SF CDOs. As seen on the table on page 5, FGIC's targeted claims-paying resources fall well below higher-rating thresholds.
- The most significant contribution to FGIC's capital utilization is from its SF CDOs. Fitch's expected losses from this subsector fall within a range of $2.8 billion to $3.8 billion, which Fitch uses as its capital target for ratings of 'A' and lower. Losses from SF CDOs were nearly 56% of the company's modeled losses.
- In addition, the company's exposure to deteriorating second-lien exposures that are heavily concentrated in the second half of 2005 through 2007 vintages, which are the weakest performing vintages in the current credit cycle, is also contributing heavily to the company's declining capital position.
- Finally, low attachment point structured finance business (typically in the 'BBB' or non-investment-grade rating categories) also contributes meaningfully to simulated losses in Matrix.

Key Rating Issues

- FGIC has recently filed suit in the Supreme Court of the State of New York against several parties, alleging its subsidiary FGIC UK had been fraudulently induced to enter into a commitment to issue a financial guaranty policy on a large SF CDO known as Havenrock II. The collateral underlying this commitment is deteriorating rapidly and material losses are anticipated. Through this lawsuit, FGIC is seeking to terminate its commitment. In addition, FGIC management believes that subsequent to year-end 2007, a party to the Havenrock II transaction failed to perform certain responsibilities, which in FGIC's view greatly reduces the company's potential liabilities under this transaction. While Fitch is not in a position to opine on the

validity or merits of the existing legal dispute, Fitch notes that a ruling in FGIC's favor could positively impact the company's capital position and credit ratings in the future. Fitch believes it could be several years before the dispute is settled. At the end of 2007, FGIC posted a $950 million GAAP loss reserve against Havenrock II, and increased this to about $1.2 billion at the end of the first quarter of 2008.

- Following a fourth-quarter 2007 net loss of $1.9 billion (including the Havenrock reserves); the company recognized it could fall below prescribed regulatory minimum capital requirements under New York State Insurance law. Further, as of Dec. 31, 2007, FGIC UK failed to meet the minimum capital guidelines of its primary regulator, the UK Financial Services Authority, as a result of loss reserves posted in connection with certain SF CDOs. FGIC UK has submitted a plan to its primary regulator in connection with this concern. Financial stress resulting in a regulatory minimum capital level being breached, in tandem with an inability to attract external capital, could cause the New York State Insurance Department to place FGIC, or the UK Authority to place FGIC UK, under supervision or in rehabilitation. Under such a scenario, the degree of ratings migration could be severe.
- In response to capital concerns, FGIC has solicited and received indications of interest from a range of strategic partners, reinsurers and private equity providers, which are currently being evaluated.
- Fitch notes one of the plans under discussion include a restructuring of FGIC's operations, calling for establishment of a newly licensed insurance entity that will focus solely on global municipal finance and infrastructure, while avoiding the riskier structured finance business lines. Accordingly, fresh capital ultimately may not be available to equally support all policyholders residing today in the existing operating company. Thus, execution of such a segregated operating company structure could potentially result in additional downgrades to the current company rated by Fitch, even if the newly formed company is able to achieve a higher rating.
- FGIC has experienced material deterioration in second-lien exposures that are already paying claims. The second-lien exposures are concentrated in the second half of 2005 through the 2007 vintages (73% of the $19.6 billion exposure). While the company has already taken material reserves against these exposures (about $300 million through March 31, 2008), Fitch believes it is highly likely these losses could ultimately be higher, potentially straining capital resources at the 'BBB' level. Similar concerns could be brought about by additional unforeseen losses from FGIC's SF CDOs, and/or material weakening or deterioration in other subsectors to which the company has meaningful exposures.
- Although FGIC's decision to cease underwriting new financial guaranty business for a period of time should help FGIC's conserve capital, the company could find it quite difficult to re-establish a market presence in the event it is ultimately able to successfully address its portfolio concerns and capital shortfall, given the present challenging financial guaranty landscape.

FSA

IFS Rating: 'AAA'
Rating Outlook: Stable
Last Rating Action: Jan. 24, 2008

Financial Security Assurance Inc. (FSA)

Rating Rationale

- The 'AAA' IFS rating implies 'Exceptionally Strong' financial strength, and reflects FSA's strong insured portfolio credit quality and disciplined underwriting and risk management, exemplified by its minimal insured exposure to SF CDOs backed by subprime RMBS.
- These factors, which have helped contribute to FSA's rating stability, have substantially strengthened FSA's trading values relative to its traditional competitors, increasing the profitability of new business written across all sectors.
- FSA's parent company, Dexia S.A., has consistently been a solid sponsor of FSA, infusing $500 million into the company to support growth during the first quarter of 2008, and providing a $5.0 billion stand-by line of credit to support the parent company's GIC operations during the second quarter of 2008.
- Although the capital position is presently satisfactory to support the AAA IFS ratings, recent deterioration in the direct RMBS portfolio, particularly in the Alt-A and second-lien sectors are pressuring FSA's excess capital position. Favorably, FSA has announced it will discontinue underwriting these sectors going forward.
- The company benefits from attractive pricing opportunities on new business.

Capitalization

- FSA had excess capital of more than $400 million under Matrix, corresponding to a CCAR of about 1.08x at the 'AAA' guidelines as of Dec. 31, 2007. That said, continued strong growth over time (driven in part by ratings pressure at its peers) that is not supported by disciplined capital management could adversely impact future FSA Matrix results and pressure excess capital levels and ratings.
- This Matrix result includes $500 million of new capital raised in the first quarter of 2008, as well as stresses made by Fitch to address the declining credit quality of FSA's prime second-lien and Alt-A RMBS insured portfolio and liquidity concerns pertaining to its GIC program.
- Structured finance simulated net losses continue to dominate FSA's results, contributing about 62% of simulated net losses. Structured finance simulated losses were mainly attributable to non-CDO exposures rated 'BBB–' or lower.

Key Rating Issues

- Fitch believes the underwriting capability and credit profile of FSA is very disciplined, as illustrated by the company's decision to avoid SF CDOs, a sector that has been a source of substantial stress and rating pressure for many of their competitors.
- Nonetheless, ratings could be pressured over time if the company was unable to access further capital, if needed.
- Further rating stress could occur if a material, broad-based decline in demand for financial guaranty insurance, or an influx of aggressive new competitors materially weakened the franchise value of FSA below 'AAA' standards. In addition, an inability or unwillingness on the part of FSA to adapt to likely future changes to rating agency criteria could put future pressure on the company's ratings.
- Additionally, Fitch notes FSA has exposure to sectors with elevated risk characteristics within its RMBS portfolio. Although Fitch's Stable Rating Outlook

implies no downgrade is currently expected, the rating could be pressured by material credit deterioration in FSA's' RMBS portfolio, or other structured finance asset classes, that lead to material additions to loss reserves outside of expectations.

- FSA has about $29 billion of exposure to the RMBS sector as of Dec. 31, 2007, with significant credit deterioration noted in its $9 billion second-lien HELOC portfolio and its $2.7 billion Alt-A portfolio.
- The company recently paid claims on eight troubled second-lien HELOC deals totaling $4.6 billion of net par outstanding, and four troubled Alt-A closed end second (CES) transactions totaling $784 million of net par outstanding. These transactions were primarily underwritten during the troubled 2006 and 2007 vintage years and FSA expects total claims to ultimately exceed $400 million. Favorably going forward, the company has discontinued underwriting certain consumer sectors, including second-lien RMBS.
- Fitch believes FSA's GIC program could place future stress on the company's liquidity resources. FSA currently has $6 billion of GIC liabilities tied to credit linked notes (CLN) that provide credit enhancement to SF CDOs. Actual credit losses to these SF CDO transactions could cause FSA to pay off the related GIC obligation earlier than anticipated. FSA presently holds in excess of $1 billion of cash to mitigate this risk, but should draws exceed this balance, FSA could be forced to liquidate GIC program invested assets at prices significantly below par, resulting in a realized loss to FSA. Presently the market value of FSA's GIC assets, much of which is subprime, Alt-A and second-lien RMBS, is $3.8 billion below book value on a pretax basis.
- This reduction in book value has significantly depleted FSA's shareholder's equity as of March 31, 2008. Analytically, Fitch reverses negative marks against equity that would be viewed as temporary. However, Fitch also recognizes that FSA's GIC business is subject to immediate termination if it is ever downgraded below 'A–'. While that scenario seems highly unlikely at this juncture, if the event were to occur, these market value losses would potentially become crystallized over a very short time period.

MBIA

IFS Rating: Not rated

Fitch's ratings of MBIA were withdrawn on June 26, 2008.

MBIA Insurance Corp. (MBIA)

Credit Profile

- MBIA's credit profile in recent periods has deteriorated due mainly to expectation of significant expected losses from SF CDOs. Fitch believes uncertainties surrounding SF CDO losses make it difficult for the company to stabilize its financial position until the downside risk is limited. In addition, the company's credit profile is at risk from further deterioration in its direct RMBS portfolio.
- Recent downgrades by Moody's and S&P have resulted in acceleration of liquidity and collateral calls against MBIA's affiliated investment management services (IMS) business, which have significant investment agreements that are guaranteed by the insurance company. MBIA expects that it will require $2.9 billion of cash to meet obligations as a result of termination payments to guaranteed investment contracts (GICs) and is subject to additional collateral posting requirements of $4.5 billion related to its GICs. While Fitch notes the company has available resources to meet these current obligations, the rating agency believes this puts the holding company under further stress. Based on current valuations, MBIA has a shortfall (greater than $1.5 billion) in its IMS invested assets relative to its liabilities and over time the company is likely to face incremental losses from this business as a result of the negative carry. In addition, at current rating levels, Fitch does not believe that MBIA can issue new GICs which would provide additional liquidity. In addition, further downgrades by Moody's or S&P could result in further acceleration of liquidity or collateral calls against the insurance or holding company, which would create further negative pressure on MBIA's credit profile.
- Downgrades have also resulted in noticeable erosion in MBIA's franchise value in recent periods. Fitch believes the company will be extremely challenged in its ability to execute on its strategic business plans as the group is currently structured.
- MBIA Inc. recently indicated it would not inject $900 million of cash into the insurance company, weakening that entity's capital position relative to prior expectations.
- The company raised $2.6 billion of new capital since Jan. 2008. However, access to additional capital at this time is severely constrained given where the company's stock is trading, coupled with recent comments by management.
- Positively, MBIA has a well-diversified insured portfolio across asset classes, with a strong back book of municipal exposures.
- Improving risk management framework and seasoned risk remediation. Notable achievements include the favorable resolution of MBIA's Eurotunnel exposure, as well as various asset classes within structured finance.

Key Credit Issues

- MBIA's unadjusted claims-paying resources of $16.1 billion are adequate to meet policyholder obligations with a reasonable margin of safety, though this margin has dropped significantly in recent periods. As noted, MBIA's capital position has been negatively impacted by the company's significant exposure to SF CDOs, and exposure to deteriorating second-lien exposures that are heavily concentrated in the 2006 and 2007 vintages, which are the worst-performing vintages in the current credit cycle.

- Significant potential and expected losses from SF CDO exposures, which include what the company calls "multi-sector CDOs" and "multi-sector CDO-squared" exposures. Fitch's expected losses from this subsector fall within a range of $3.1 billion to $4.9 billion. While MBIA noted in its first quarter 2008 earnings release that it is "off risk" on two of its SF CDO exposures, these particular SF CDOs combined contributed negligible losses in Fitch's estimation of expected and stressed losses, and have little noticeable impact on the agency's view on MBIA's capital strength.
- Material deterioration in second-lien exposures that are already paying claims. The second lien exposures are concentrated in the 2006-2007 vintages (77% of the $18.1 billion exposure), which are the two weakest performing vintages from the current credit cycle, make these exposures particularly troublesome. While the company has already taken material reserves against these exposures ($1.1 billion through March 31, 2008), Fitch believes there is potential that these losses could be higher.
- Given MBIA's current ratings, MBIA is not able to underwrite meaningful new business. MBIA's future ability to underwrite business is highly questionable, particularly in light of weakened demand for bond insurance as reflected in insured penetration. Furthermore, it is unclear that MBIA will be able to recover from the significant damage its reputation has suffered from the subprime crisis. The ability to execute on management's plans to possibly form an 'AAA' municipal bond insurer is questionable.
- Material holding company risks, which include writing single-name corporate credit default swaps and negative basis trading activity, as well as IMS business activities, such as GICs, which under a stress, could leave the holding company constrained or create a call on the insurance company's guaranty of the investment agreement liabilities of the IMS business. Given the recent downgrade by Moody's to below the 'AA' category, this risk has become significantly elevated due to ratings triggers. Some of these holding company activities are inconsistent with the risk parameters established by MBIA for its financial guaranty operating companies, such as negative basis trading and writing single-name corporate CDS with terms that require collateral posting and cash settlement of credit events.
- Core operating earnings will remain depressed over the near to intermediate term as underwriting results are expected to be sharply below historical norms as losses continue to filter through the insured portfolio.

SCA

IFS Rating: 'BB'
Rating Outlook: Negative
Last Rating Action: March 26, 2008

Security Capital Assurance Ltd. (SCA)

Rating Rationale

- The recent downgrades reflect the considerable deterioration that has taken place in SCA's insured portfolio over the past year. This credit deterioration has significantly impaired SCA's capital and financial position compared to historical norms.
- The ratings reflect the company's inability, as of yet, to execute on its recapitalization plan, as the company has not raised any additional capital since its portfolio started deteriorating. This, in part, reflects very limited support provided by majority shareholder XL Capital Ltd.
- Fitch currently estimates that expected losses on SCA's SF CDOs will ultimately fall within a range of about $3 billion to $4 billion on a present value basis, which puts tremendous pressure on the company's claims-paying resources of $3.6 billion at March 31, 2008.
- Fitch's target capital position for SCA assumes that it will remain on risk for the seven SF CDOs currently under dispute with Merrill Lynch International (MLI). A summary judgment has recently been granted in favor of MLI, and SCA plans to issue an appeal to defend its position. These transactions make up approximately 56% of SCA's $3 billion to $4 billion of expected losses.
- SCA's existing capital position is fairly close to breaching minimum regulatory capital requirements.

Capitalization

- Fitch views SCA's modeled capital position as being very weak in comparison to other players in the industry due to the expected level of losses on SF CDOs and RMBS transactions, falling considerably below Fitch's investment grade standards.
- SCA's capital position leaves little room to absorb additional losses from the remainder of the insured portfolio beyond SF CDOs.
- SCA has ceased underwriting new business for an indefinite period of time and dismissed most of its origination staff in order to preserve capital and put together a restructuring plan. With time, this will improve the company's capital position, assuming no further deterioration in the insured portfolio.
- Our analysis incorporates the benefit of excess-of-loss reinsurance policies through subsidiaries of XL Capital Ltd. (XL Capital), SCA's largest shareholder.
- As of March 31, 2008, XLCA had a cushion of $83.9 million over the New York Insurance Department minimum capital requirement, while XLFA maintained an $823 million cushion over the Bermuda regulatory minimum. While SCA currently maintains a sufficient amount of regulatory capital under Bermuda and New York guidelines, further write-downs would be expected to lead to a continued erosion of the capital base. This increases the probability that regulatory intervention could occur which could create an acceleration of SCA's CDS exposures on an MTM basis.

Key Rating Issues

- Significant potential and expected losses from SF CDO exposures. Fitch believes that the losses from these exposures will be material and it will be difficult to stabilize the rating without limiting this downside risk.

- Due to the rapid deterioration in the US housing market, SCA has already started paying claims on some of its second-lien RMBS transactions. While the problems in the second-lien book have been more immediate, many of the Alt-A and subprime deals are likely to perform worse than initial projections. As of March 31, 2008, SCA maintains $4.2 billion of direct exposure to Alt-A or subprime RMBS and $4.8 billion to direct second-lien RMBS.
- Outside of SF CDOs, SCA holds $13.7 billion of non-senior exposure in its insured portfolio, albeit all transactions initially had material subordination, and were rated 'AAA' upon origination. Non-senior transactions tend to experience significantly higher losses in the event of default.
- SCA has exposure of approximately $810 million to Jefferson County, Ala., sewer bonds. In June, 2008, the insurer made a payment of $10.6 million to the holders of Jefferson County's sewer warrants. Unless a solution is negotiated with the county's lenders in the near term, SCA would be expected to make further payments in the coming months.
- Favorably, SCA's $4 billion GIC portfolio has been completely unwound by an affiliate of XL Capital Ltd.
- SCA has benefited from reinsurance support being provided by a subsidiary of XL Capital, although at this time Fitch is not incorporating any further support into our ratings assessment. SCA is in communication discussions with XL Capital with respect to certain of these reinsurance protections, which if consummated could be either positive or negative for the rating depending on the pricing of the transaction.

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