



Moody's Investors Service

**Credit Opinion: Assured Guaranty Municipal Corp.**

Global Credit Research - 05 Mar 2010

New York, New York, United States

**Ratings**

| Category  | Moody's Rating |
|---|----------------|
| Rating Outlook                                    | NEG            |
| Insurance Financial Strength                      | Aa3            |
| <b>Financial Security Assurance Holdings Ltd.</b> |                |
| Rating Outlook                                    | NEG            |
| Senior Unsecured                                  | A3             |
| Junior Subordinate                                | Baa1           |
| <b>Assured Guaranty (Europe) Ltd.</b>             |                |
| Rating Outlook                                    | NEG            |
| Insurance Financial Strength                      | Aa3            |
| <b>Financial Security Assurance Intl Ltd.</b>     |                |
| Rating Outlook                                    | NEG            |
| Insurance Financial Strength                      | Aa3            |
| <b>FSA Seguros Mexico S.A. de C.V.</b>            |                |
| Rating Outlook                                    | NEG            |
| Insurance Financial Strength                      | Aa3            |
| Insurance Financial Strength--National Scale      | Aaa.mx         |

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**Key Indicators**

| Assured Guaranty Municipal Corp.<br>(\$ mil.) | 2Q 2009 | 2008    | 2007    | 2006    | 2005    |
|---|---------|---------|---------|---------|---------|
| Gross Par Written (\$ million)                | 3,455   | 52,496  | 119,134 | 93,781  | 103,355 |
| Gross Premiums Written (\$ million) [1]       | 39      | 867     | 853     | 816     | 834     |
| Net Par Outstanding (\$ million)              | 402,650 | 424,393 | 406,457 | 359,560 | 337,483 |
| Hard Capital (\$ million)                     | 6,551   | 6,961   | 5,594   | 4,982   | 4,668   |
| Net Income (\$ million) (SAP) [1]             | (16)    | (1,377) | (66)    | 424     | 326     |
| Strategy & Franchise Value                    |         |         |         |         |         |
| % of Industry Net Par Outstanding             | 16.65%  | 16.94%  | 15.40%  | 15.60%  | 16.50%  |
| % of Industry Gross Par Written               | 6.35%   | 38.00%  | 18.60%  | 16.50%  | 19.70%  |
| Portfolio Characteristics                     |         |         |         |         |         |
| Credit Risk Ratio [2]                         | 62.7bps | 49bps   | 32bps   | 21bps   | 21bps   |
| Tail Risk Ratio [2]                           | 150bps  | 151bps  | 103bps  | 74bps   | 71bps   |
| Capital Adequacy                              |         |         |         |         |         |
| Hard Capital Ratio                            | Na      | Na      | 1.44x   | 1.78x   | 1.82x   |
| Total Capital Ratio                           | Na      | Na      | 1.32x   | 1.68x   | 1.73x   |
| Par Reinsured                                 | 22.66%  | 22.21%  | 25.31%  | 25.31%  | 26.33%  |

|                       |         |         |        |         |         |
|-----------------------|---------|---------|--------|---------|---------|
| Profitability         |         |         |        |         |         |
| Return on Equity [3]  | 4.81%   | -26.54% | 14.87% | 14.40%  | 13.48%  |
| Loss Ratio (SAP)      | 136.6%  | 480.2%  | 16.1%  | 0.0%    | 2.1%    |
| Expense Ratio (SAP)   | 46.7%   | 9.1%    | 30.0%  | 29.9%   | 27.8%   |
| Financial Flexibility |         |         |        |         |         |
| Earnings Coverage     | 7.70x   | 3.50x   | 11.37x | 18.34x  | 17.34x  |
| Cash Flow Coverage    | 7.50x   | 9.50x   | 3.47x  | 5.30x   | 5.60x   |
| Double Leverage       | 117.84% | 116.72% | 96.58% | 115.63% | 111.89% |

[1] As of first six months ending in June 30, 2009 [2] Model ratios as of 6/30/2009 [3] Annualized and excluding impact of gain/(loss) on derivatives for the period.

## Opinion

### SUMMARY RATING RATIONALE

The Aa3 insurance financial strength (IFS) rating, negative outlook, of Assured Guaranty Municipal Corp. (formerly Financial Security Assurance Inc.) reflects its strong competitive position being part of the only group currently writing substantial new business, healthy capital profile, and generally conservative risk management. These strengths are tempered by the operational leverage inherent in the business of a financial guarantor which makes the credit profile rather sensitive to the performance of individual insured sectors and even, in some cases, individual transactions. This has been particularly evident in the weakening of Assured Guaranty Municipal Corp.'s capital position resulting from the deterioration in the performance of the firm's insured portfolio - predominantly from mortgage related risks.

Assured Guaranty Municipal Corp. (AGM) is a direct writer of financial guaranty insurance. AGM is one of three main operating companies of Assured Guaranty Ltd. (issuer rating A3, negative outlook) and a wholly owned subsidiary of Financial Security Assurance Holdings Ltd. (senior unsecured debt at A3, negative outlook). The firm was acquired by Assured on July 1, 2009, with Dexia, AGM's former owner retaining the ownership and risks of the Financial Products business. Affiliated companies include Assured Guaranty Corp. (IFS rating at Aa3, negative outlook), which will write insurance on public finance and structured finance transactions, and Assured Guaranty Re Ltd. (IFS rating at A1, negative outlook), a Bermuda domiciled reinsurer. The credit profiles of the operating companies are differentiated but intertwined due to the group's flexibility in managing capital among these entities, as demonstrated by the recent intercompany capital support for Assured Guaranty Corp (AGC).

### Credit Strengths

- o Leading provider of financial guaranty insurance
- o High quality, well diversified insurance portfolio with nominal liquidity needs
- o No exposure to recent vintage ABS CDOs
- o Strong embedded earnings
- o Strategic fit with its new parent, Assured Guaranty Ltd.

### Credit Challenges

- o Sensitivity of franchise value and financial flexibility to changes in risk profile
- o Large RMBS exposures, particularly second lien and Alt-A, are generating substantial projected losses
- o Some risk concentrations in certain sectors such as pooled corporate risks and consumer ABS

### Rating Outlook

The negative outlook for Assured's ratings considers the meaningful remaining uncertainty about the group's ultimate credit losses, including claims on mortgage exposures and Assured's success in putting back mortgage loans that breached representations and warranties to lenders. The outlook also reflects the dislocation in the muni market and

recent volatility of Assured's new business volumes despite limited alternative forms of credit enhancement and virtual absence of financial guaranty competition. In Moody's view, it is unclear how demand for financial guaranty wraps and Assured's competitive position will evolve once the municipal finance market normalizes.

### **What Could Change the Rating - Up**

- o Substantial reduction in uncertainty associated with performance of the insured portfolio
- o Evidence that franchise value and market demand for AGM's wrapped transactions remain strong once the environment normalizes

### **What Could Change the Rating - Down**

- o Deterioration in portfolio credit characteristics
- o Sustained decrease in capital position to levels below the Aa3 confidence level, without corrective action
- o Deterioration in competitive environment or product demand

### **Notching Considerations**

There is a three notch differential between the Aa3 IFS rating of AGM and the A3 senior debt rating of FSA Holdings reflecting the subordination of holding company creditors which is consistent with Moody's standard notching practices for insurance companies. Assured Guaranty Ltd., the Group's ultimate holding company, is rated A3 and fully and unconditionally guarantees the senior debt of FSA Holdings.

The A3 issuer rating of Assured Guaranty Ltd. and A3 senior debt rating of Assured Guaranty US Holdings Inc. is three notches below the Aa3 financial strength rating of AGC and 2 notches from the A1 financial strength rating of the group's Bermuda reinsurance operations, Assured Guaranty Re Ltd., consistent with standard notching practice for US and Bermuda insurance companies.

### **Recent Results and Developments**

On February 25, 2009, Assured Guaranty Ltd. reported consolidated net income of \$97.2 million for 2009 compared to consolidated net income of \$68.9 million in the prior year. Assured's gross written premiums fell from \$618.3 million in 2008 to \$556.4 million in 2009. Shareholder's equity has increased substantially to \$3.5 billion at year end 2009 from \$1.9 billion in 2008 reflecting significant issuance of common stock and the acquisition of FSA.

### **Insurance Financial Strength Rating**

The key factors currently influencing the rating and outlook are:

#### **Factor 1 - Franchise Value and Strategy: Aa**

The level of demand for financial guaranty insurance over the near-to-medium-term is less certain than in the past, which has negative implications for the strength and stability of AGM's business franchise. While there continues to be a market for municipal bond insurance, prospective opportunities in the municipal sector are narrower than in the past given changing perceptions about municipal risk among buyers, lower confidence in the financial guaranty industry broadly and a trend toward alternative forms of execution, including the issuance of uninsured paper. Credit enhancement for smaller and more complex credits and the benefits of third party due diligence and liquidity will continue to influence investors' demand for wrapped transactions in the future. However, customer demand for AGM's wraps remain sensitive to market perception of the risk of the guarantor, with a possible fall-off in demand as a result of even moderate declines in the guarantor's credit profile. This susceptibility to changes in credit risk profile creates a "demand cliff" beyond that observed in most other industries.

#### **Factor 2 - Portfolio Characteristics: Aa**

AGM's insured portfolio is barbelled from a risk perspective, with a very high quality core municipal book offset by material stress among mortgage exposures, particularly with respect to second lien and Alt-A transactions. The company's decision to exclusively focus on underwriting municipal risks going forward will ultimately increase the proportion of high quality municipal transactions as the structured finance exposures run-off. Moody's expects substantial additional claims from second lien exposures and first lien (Alt-A and subprime) transactions. Such losses are partially mitigated by the firm's ability to "put back" to solvent lenders loans that are in breach of representations and warranties.

Factor 3 - Capital Adequacy: Aa

AGM's risk adjusted capital position has deteriorated as a result of increased expected and stress losses primarily attributable to the performance of the company's RMBS portfolio. AGM remains adequately capitalized for its current rating level, in Moody's view, despite some additional RMBS deterioration, with losses (before the benefit of put-backs estimated to be approximately \$700 million) on those exposures estimated to be about \$1.9 billion in the expected case and rising close to \$3.2 billion in a severe stress scenario.

Reinsurance is an important component of AGM's capital management strategy. Moody's general approach to assessing the benefit of reinsurance is to give 95% credit for the collateral in trust (e.g. Reg. 114 and supplemental trusts), and to consider additional credit based on the rating of the reinsurer for the uncollateralized tail loss level consistent with the insurer's rating (Aaa/Aa reinsurers get 90% credit, A reinsurers get 75% credit, whereas Baa rated reinsurer gets 50% credit).

Factor 4 - Profitability: A

Assured's future GAAP earnings will benefit from the application of purchase accounting to Assured's acquisition of FSA Holdings and the resulting increase in liabilities as balance sheet items were fair valued. The amortization of the resulting \$1.7 billion increase in liabilities will boost recognized revenues serving to offset increases in GAAP loss reserves. However, AGM's core economic profitability has suffered from unprecedented losses related to its mortgage exposures. We expect that incurred losses (net of the potential benefit of putbacks) will continue to increase. Emerging losses will be partially offset by higher premium rates for newly underwritten municipal transactions, providing the company can retain its market position as one of the largest providers of credit enhancement in the municipal finance market.

Factor 5 - Financial Flexibility: Aa

With substantially better performance than its peers, the Assured Group has been successful at accessing the capital markets during the credit crisis. Furthermore, ownership of two direct financial guaranty providers and a Bermuda domiciled reinsurer provides the group with additional flexibility to manage capital through intercompany capital transactions. Moody's believes, however, that the extreme sensitivity of a financial guarantor's franchise value to changes in its risk profile negatively affects financial flexibility, where even the best positioned firms could experience a dramatic constriction of financing options if material losses were to develop.

**Rating Factors**

**Assured Guaranty Municipal Corp.**

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| Financial Strength Rating Scorecard [1]               | Aaa   | Aa    | A | Baa |  | Score      | [2]Adjusted Score |
|---|-------|-------|---|-----|--|------------|-------------------|
| <b>Factor 1: Strategy &amp; Franchise Value (25%)</b> |       |       |   |     |  | <b>Aaa</b> | <b>Aa</b>         |
| % of Industry Net Par Outstanding                     | 16.6% |       |   |     |  |            |                   |
| % of Industry Gross Par Written                       |       | 6.4%  |   |     |  |            |                   |
| Moody's Adjusted Book Value/Book Value                | 1.69x |       |   |     |  |            |                   |
| Client Concentration                                  | x     |       |   |     |  |            |                   |
| Management, Governance & Risk Management Oversight    | x     |       |   |     |  |            |                   |
| <b>Factor 2: Portfolio Characteristics (20%)</b>      |       |       |   |     |  | <b>Aaa</b> | <b>Aa</b>         |
| Credit Risk Ratio                                     |       | 62.7  |   |     |  |            |                   |
| Tail Risk Ratio                                       |       | 150.3 |   |     |  |            |                   |
| % Below Investment Grade                              |       | 4.1%  |   |     |  |            |                   |
| S (WCL > 10% of HC) / HC                              | 10.0% |       |   |     |  |            |                   |
| <b>Factor 3: Capital Adequacy (30%)</b>               |       |       |   |     |  | <b>Aa</b>  | <b>Aa</b>         |
| Hard Capital Ratio                                    |       | X     |   |     |  |            |                   |
| Total Capital Ratio                                   |       | X     |   |     |  |            |                   |
| Par Reinsured   |       | 22.7% |   |     |  |            |                   |

|  |      |       |  |  |        |               |            |
|--|------|-------|--|--|--------|---------------|------------|
| <b>Factor 4: Profitability (15%)</b>         |      |       |  |  |        |               | <b>A</b>   |
| Return on Equity - 3 year average            |      |       |  |  | -16.4% |               |            |
| Loss Ratio (SAP) - 3-year average            |      |       |  |  | 211.0% |               |            |
| Expense Ratio (SAP) - 3-year average         |      | 28.6% |  |  |        |               |            |
| <b>Factor 5: Financial Flexibility (10%)</b> |      |       |  |  |        | <b>Aaa</b>    | <b>Aa</b>  |
| Earnings Coverage                            |      | 7.7x  |  |  |        |               |            |
| Cash Flow Coverage                           | 7.5x |       |  |  |        |               |            |
| Double Leverage                              | X    |       |  |  |        |               |            |
| Ease of Access to Capital                    | x    |       |  |  |        |               |            |
| <b>Aggregate profile</b>                     |      |       |  |  |        | <b>Aa3/A1</b> | <b>Aa3</b> |

[1] Scorecard as of 6/30/09, except where noted [2] The Scorecard rating is an important component of the company's published rating, reflecting the stand-alone financial strength before other considerations (discussed above) are incorporated into the analysis



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