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Of Bond Insurers, Assured Guaranty Ltd. Has The Largest Exposure To CDOs Of Trust Preferred Securities

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As the global recession continues, sectors other than residential mortgage-backed securities (RMBS) and collateralized debt obligations of asset-backed securities (CDOs of ABS) are emerging as potentially problematic for the bond insurers. One such sector is CDOs of trust preferred securities (TruPs), which fall under the broader category of CDOs of hybrid securities. Issued by financial institutions such as banks, insurance companies, or real estate investment trusts (REITs), these TruPs typically allow for optional payment deferral of up to five years without triggering a legal default. In general, Standard & Poor's Ratings Services believes that the risk of deferral and default is now heightened in view of deteriorated economic conditions and financial institutions' largely weak operating results.

The Assured Guaranty Ltd. group of companies (Assured)—which includes Assured Guaranty Corp. (AGC) and its reinsurance affiliate, Assured Guaranty Re Ltd. (AG Re)—stands out among bond insurers as having the greatest exposure to CDOs of TruPs (see Table 1). On a combined basis, AGC's and AG Re's direct exposure is \$7.1 billion.

Table 1

Monoline Bond Insurers CDOs Of TruPs Exposure As Of March 31, 2009

Company	Outstanding par exposure (Mil. \$)
AMBAC Assurance Corp.	628
Assured Guaranty Ltd.*	7,062
MBIA Insurance Corp.	639
Financial Security Assurance Inc.	178
The CIFG companies	2,132
Total	10,639

*Does not reflect \$30 million of TruPs at AG Re from third parties.

Excluding CIFG Guaranty, CIFG Europe, and CIFG North America Inc. (collectively referred to as CIFG), other bond insurers have generally limited exposure to TruPs within CDOs. Standard & Poor's is currently reviewing CIFG's TruPs as part of the ongoing analysis of its entire insurance portfolio. In addition, we will continue to monitor the underlying collateral within the deals of all bond insurance companies.

Of Assured's combined TruPs exposure, about \$5.7 billion is U.S. CDOs of TruPs, which fall into these categories:

- Bank TruPs, which are generally issued by small to midsize bank holding companies.
- Insurance TruPs, which small to midsize insurance companies generally issue.
- REIT TruPs, which are generally issued by equity or mortgage REITs.

Assured Guaranty Ltd. has an additional \$1.4 billion exposure to two CDO transactions backed by hybrid securities issued by European financial institutions/insurance companies and another two CDOs collateralized by a pool of European hybrid securities and corporate debt with some limited exposure to commercial mortgage-backed securities (CMBS) and financial institutions. For risk-sharing purposes within the group, AGC typically cedes about 25% of its exposure to AG Re.

Table 2

Capital Charge Trends For Assured Guaranty Ltd. As Of February 2009								
(Mil. \$)								
—U.S. and European TruPs—								
	Total number of Assured Guaranty Ltd. enhanced tranches on U.S. TruPs deals (for both AGC and AG Re)	Original Assured Guaranty exposure (for both AGC and AG Re)	Current Assured Guaranty exposure for both AGC and AG Re (as of last available trustee report)	Original capital charge for Assured Guaranty (for both AGC and AG Re) based on original exposure	Current capital charge for AGC based on outstanding exposure	Current capital charge for AG Re based on outstanding exposure	Average credit enhancement as of first-quarter 2009 (%)	Range of credit enhancement as of first-quarter 2009 (%)
Bank	38	3,285.0	3,106.0	3.1	150.5	33.7	40.5	19.3-83.4
Insurance	6	598.0	531.0	0.5	0.2	0.1	50.3	43.1-69.6
REIT	16	3,829.0	3,425.0	3.4	91.1	29.1	41.7	33.3-52.4
Total	60	7,712.0	7,062.0	7.1	241.8	62.9		

The REIT sector constitutes Assured's largest TruPs exposure at 48% (based on outstanding par), closely followed by the bank sector at 44%; insurance companies account for about 8%. Bank holding companies constituted a significant portion of the TruPs market because of the instrument's favorable tax treatment and regulatory capital eligibility. Under certain conditions, insurance companies also receive regulatory capital credit for TruPs issuances. The boom in the residential mortgage and housing markets encouraged the growth of mortgage and equity REITS, and in turn, REIT TruPs became an additional funding option for REIT managers.

Table 3

Rating Migration Of Assured Guaranty Ltd.'s CDOs Of TruPs As Of May 11, 2009									
U.S. and European	Original tranche rating distribution			—Current tranche rating category distribution—					
	AAA	AAA	AA	A	BBB	BB	B	Total	
Bank	38	3			15	18	2	38	
Insurance	6	5	1					6	
REIT	16	2	1	6	2	3	2	16	
Total	60	10	2	6	17	21	4	60	

Includes four European TruPs deals.

As of May 11, 2009, 83% of Assured's U.S. and European TruPs CDO portfolio experienced downward rating migration (see Table 3); 58% stayed investment grade, while the remainder moved mostly into the 'BB' range. Two of the four European TruPs CDOs remain at 'AAA'. The rating on one of the two European transactions is on CreditWatch with negative implications, though we expect to resolve the CreditWatch status of the rating within the next few weeks.

The substantial adverse ratings migration of Assured's insured TruPs securities reflect continued deterioration in the credit and liquidity profiles of TruPs issuers. Bank and REIT TruPS CDOs witnessed the most substantial downgrades, driven largely by the downturn in the U.S. housing market. Mounting deferrals and defaults of bank TruPS collateral within the CDO is one of the primary drivers of those downgrades. This is somewhat mitigated in deals where in the event of persistent failed coverage tests, waterfall mechanics allow for cash-flow diversions to pay-down the senior tranches that Assured enhances. Many of the TruPs CDOs were structured to begin cash-flow diversions upon one or two of the largest obligors deferring or defaulting. For Assured's total portfolio, 58 out of 60

tranches have experienced some deleveraging, either through pre-payments or through coverage test failures. This has resulted in 7% of the original TruPs CDO par having been paid down to date. About 83% of the TruPs CDO portfolio is experiencing at least one coverage test failure, resulting in Assured's exposure declining each quarterly period with excess spread.

In addition to fundamental credit deterioration, criteria changes also contributed to the downgrades. Standard & Poor's criteria for rating TruPs and other securities use a modeling approach that follows the terms of the transaction's documents, which often dictate that any security deferring payments is a defaulted security. However, Standard & Poor's Structured Credit Group recently revised its approach in determining the likelihood that the issuer will default or defer payments, the estimated recovery prospects, and the asset performance correlation within and among the industries represented in these CDO transactions.

Hybrid securities (such as TruPs) typically have a higher risk of nonpayment than the obligor's overall risk of default because they allow for the optional payment deferral without triggering a legal default across other debt. To reflect this in the modeling, the Structured Credit Group lowers the rating on the corporate issuer by a predetermined number of notches to reflect the higher likelihood of payment deferral for the hybrid instrument. In addition, the group revised the default/deferral patterns to reflect the expectation of the average time period when hybrids will default or defer throughout their expected life. This work takes into consideration the group's review of the U.S. banking sector's performance from 1934-2008 and an analysis of Federal Deposit Insurance Corp. (FDIC) interventions on depository institutions.

Lastly, based on results of this review, our criteria incorporate increased correlation assumptions for financial intermediaries, insurance companies, and REITs. For example, the intra-industry correlation applicable to financial intermediaries changed to 0.25 from 0.15. (For the complete list of criteria changes and explanations, see "Global Methodology For Rating Trust Preferred/Hybrid Securities Revised, Nov. 21, 2008, RatingsDirect.)

At issuance, all of the securities that AGC wrapped had 'AAA' underlying ratings. Although the ratings migration in Table 3 is substantial, capital consumption so far is only theoretical in the form of higher capital charges. Capital charges are theoretical worst-case loss estimates for a transaction in the context of a diversified portfolio of risks. Downgrades of tranches of CDO of TruPs have resulted in total capital charges increasing about 43 times, to \$305 million for the consolidated group. About 60% of the current total capital charges are in the banking sector.

To date, Assured has paid no claims on any TruPs CDO. In fact, credit enhancement at the Assured exposure level has room for more defaults and deferrals before incurred losses are likely. The average credit enhancement across Assured's TruPs CDO portfolio was about 42% as of March 31, 2009, down from 47% at inception.

This relatively favorable development is a function of the generally conservative standards AGC employed in underwriting its overall CDO (and RMBS) business. In addition, AGC has several arrangements in place, including a first-loss protection structure with third parties, which mitigate actual capital charges and potential losses. Furthermore, Assured is not obligated to pay principal losses until legal final maturity or—in some cases—until the collateral balance is zero, resulting in future payments of principal losses (if any) occurring in 20 to 33 years.

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We determined the CDO of TruPs capital charges using the scenario default rate (SDR) that our CDO Evaluator generated. The CDO Evaluator is Standard & Poor's primary means for estimating the level of gross defaults or deferrals that a pool of assets will likely experience under various stress scenarios. For a debt tranche issued by a CDO to achieve a particular rating, it will generally need to withstand the SDR of the pool of assets for that rating level.

Standard & Poor's Bond Insurance Group used the SDRs the CDO Evaluator generated for each CDO of TruPs deal to assess the difference between the credit support provided in the transaction and the level of credit support necessary for the transaction to achieve a 'AAA' rating (that is, the credit gap). If Assured's enhanced tranche was investment grade, the credit gap would be the difference between the 'AAA' SDR and the enhanced-tranche SDR, adjusted by a pool diversification factor. If the enhanced tranche was below 'BBB-', the credit gap would be the difference between the SDR at the 'AAA' and 'BBB-' levels (adjusted by a pool diversification factor) plus the difference between the SDR at the 'BBB-' level and the rating level of the enhanced tranche. We assumed a 0% recovery rate because TruPs are a subordinated security within an issuer's overall capital structure and because there is the possibility of deferrals, either voluntary or as a result of government policy initiative or regulator intervention.

We have incorporated the new, higher capital charges for AGC into our capital adequacy model, and the results were consistent with the current rating levels. The capital adequacy margin of safety for AGC is currently 1.6x-1.7x, well above the minimum requirement of 1.25x but still about 25 basis points lower than at the previous capital-charge level for the TruPs portfolio. To the extent that there are further deferrals or defaults on the underlying collateral, Assured's CDO of TruPs book of business is likely subject to further downward ratings migration. However, Assured's generally conservative underwriting policy of wrapping 'AAA' tranches in the CDO capital structures has, relative to the industry, given its book a business an incremental measure of economic and financial resilience.

Related Research

"Global Methodology For Rating Trust Preferred/Hybrid Securities Revised," Nov. 21, 2008, RatingsDirect.

"Review Results In Changes To Certain U.S. Financial Institutions' Hybrid Capital Issue Ratings," Feb. 24, 2009, RatingsDirect.

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