Special Comment

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| Contact | Phone |
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| ***New York*** | |
| Jack Dorer<br>Stanislas Rouyer<br>Matthew Noll | 1.212.553.1653 |


# Moody's 2003 Review and 2004 Outlook for the U.S. Financial Guaranty Industry

*The views presented in this Special Comment are based on comments made by Moody's analysts during a December 16, 2003 teleconference. The analysts participating in the teleconference included Jack Dorer, Senior Vice President and manager of Moody's Financial Guaranty team, Stanislas Rouyer, Senior Vice President, and Matthew Noll, Vice President-Senior Analyst.*

## Summary Opinion


The major financial guarantors rated by Moody's had another strong year in 2003. The first nine months of the year saw consistent growth in the guarantors' earnings and profitability, although a narrowing of credit spreads and rising rates may result in a slightly more subdued 2004. Overall, the financial guarantors possess high-quality business and investment portfolios, strong underlying assets, and a solid franchise that continues to support their Aaa ratings. Moody's outlook for the financial guaranty industry is stable.

The guarantors have had their resilience tested in recent years by the events of September 11th 2001, historic volumes of corporate defaults and downgrades in 2001-2003, and a series of strident attacks from critics. The industry has born these stresses well, with its high-level ratings and credit quality remaining intact.

In the future, the guarantors are likely to draw a greater portion of their business from outside their original core area of underwriting municipal bond transactions, a trend that has already become pronounced over the past several years. Guarantors are expected to continue underwriting diverse structured finance transactions, and will find a greater volume of their business coming from international transactions.


## Industry Health and Market Dynamics

The financial guaranty industry has been highly successful financially over its 30 year history, having accumulated more than $1.5 trillion of gross par outstanding. In many respects, however, the opening years of the 21st century have tested the resilience of the industry in ways no one has seen before or could have predicted.

In the last two and a half years, the guarantors faced three major stresses. First, the terrorist attacks in New York and Washington in September 2001 affected many of the guarantors' exposures; second, the highest corporate default rate in recent history impacted the guarantors' CDO portfolios; and third, an open and focused attack by some market participants on the guarantors' business model, which included a pointed questioning of their creditworthiness, occurred at the end of 2002.

Of these three stresses, the last one has had the most visible short-term consequences on the guarantors. It led to a significant widening of the CDS spreads on the guarantors to levels comparable to speculative grade credits. The CDS spreads have since returned to historical levels — levels that are, it is worth noting, somewhat disconnected from the guarantors' Aaa ratings, possibly reflecting a combination of supply-demand dynamics and some degree of market wariness about the industry.

By contrast, the peak rate of corporate defaults is the only one of the three stresses to have lasting, although manageable, consequences, since the guarantors' CDO portfolios have been negatively affected by the deterioration of the underlying collateral.

## DEMAND FOR FINANCIAL GUARANTY INSURANCE REMAINS STRONG

Despite these developments, the demand for financial guaranty insurance remains strong, driven in part by the markets' credit sensitivity and the growing demand in expanding target markets. The financial guarantors of today still have some of the same characteristics that were evident during their early days, but they have evolved considerably since then by expanding beyond their initial focus of underwriting municipal securities into the structured finance and international bond insurance markets.

Municipal underwriting still represents the core activity of most guarantors, but that portion of the guarantors' business has declined from more than 75% of par outstanding five years ago to about 60% today. Unlike structured finance, market share has remained fairly stable, with a penetration rate of approximately 45% to 50%. The relative decline therefore does not reflect a change in market interest in the guarantors' product, but rather growing opportunities outside of the municipal area. The enhanced liquidity of small issuers, reduction in single obligor constraints for large issuers, and greater overall credit comfort that comes with a wrap remain the core components of the service that the guarantors provide to the municipal sector, with little competition so far.

The near-term outlook for municipal underwriting is nevertheless mixed. With interest rates likely to rebound with an improving economy, the refinancing wave of the last couple of years is coming to a halt. The guarantors benefited from this wave through the recognition of unearned premiums on refinanced debt and greater market penetration. That being said, the current budget crisis at many state levels is likely to generate attractive premiums connected to the growing funding needs of many municipal issuers. Investor concerns should also keep the guarantors' market penetration high.

## EXPANSION OUTSIDE OF CORE BUSINESS AREA IS DRIVING GROWTH

The second phase of the guarantors' evolution has been their expansion into underwriting non-municipal exposures, primarily in the US structured finance sector. Structured finance exposures that were hardly noticeable ten years ago now represent approximately 25% of the guarantors' gross book, or a little less than half of their municipal exposure. This expansion represents a major shift in the guarantors' business model and risk profile, as the guarantors take on exposure to a new and wide variety of asset and corporate risks.

The wrapping of CDOs has been a particularly strong opportunity within the structured sector. The dynamics of demand for the financial guarantors' products are distinct from the municipal market and translate into a less predictable and more dynamic business. At the risk of oversimplifying the appeal of the guarantors' product, it can be said that the guarantors provide value in situations where the liquidity and credit premium required by the market for direct securitization is high and the guarantors' wrap can significantly reduce this market premium.

However, as asset types and issuers become more established and the market more efficient, helped in part by the guarantors' own actions, other types of market execution (generally senior-subordinated structures) become relatively more attractive. These market dynamics usually mean that the guarantors have to look for the next market development in order to maintain volume. We expect the guarantors' share of the US structured finance market to continue to erode over time, although certain sub-sectors, particularly in the sub-prime markets, should remain strong. Overall issuance volume should also come down as interest rates rise.

## RISING NON-U.S. EXPOSURES SIGNAL FUTURE BUSINESS INTERESTS

The third, and ongoing, phase of the guarantors' evolution is the growth of their international exposure. Non-US par outstanding now represents approximately 15% of the guarantors' book, or a quarter of the US municipal portfolio. Moody's believes that the secular trends outside of the US present tremendous long-term opportunities for the guarantors, and Europe appears to be where most of the medium term opportunities are located.

In many respects, international opportunities are expected to more than compensate for the less robust growth opportunities we foresee in the US market. It would be wrong, however, to assume that the international markets will present opportunities with the same characteristics as those in the US. Significantly, the European municipal markets present limited growth potential for the guarantors, reflecting the absence of non-taxable status and the smaller average size of municipalities in Europe. Most European opportunities are related to the ongoing market disintermediation from bank lending to market funding and to various privatization initiatives.

While the overall trend is positive, international growth has not been smooth and presents some unique hurdles. The guarantors' international growth to date has been growing by leaps and bounds, as a small number of large transactions have greatly affected the volume and premium written from one quarter to another. At the same time, the speed of bank disintermediation varies tremendously from country to country, and has not been as fast as some observers expected.

In addition, the consumer culture overseas is such that the supply of consumer loans for securitization is much lower than in the US. The nature of certain transactions currently written outside of the US — large project finance deals with marginal investment grade characteristics, for example — present unique credit challenges for the guarantors. All the same, the international markets are still relatively less familiar with the financial guarantors. Market receptivity and investor appetite for wrapped paper will likely expand.

### SUPPLY DYNAMICS

The origination capacity of the financial guarantors has grown significantly in recent years. The four long-established guarantors, namely Ambac, FGIC, FSA and MBIA, have been generating capital through retained earnings and market access, allowing them to write more business. New entrants such as CIFG and XL have added to this supply, while at the same time offering alternative sources to the market. Others, such as ACE Guaranty Corp. and Radian Asset Assurance, also appear committed to the financial guaranty business. Then there is always the possibility of new guarantors being created.

Turmoil in the reinsurance sector, with reinsurers being downgraded or choosing not to transact with the guarantors, has temporarily constrained the industry's total capacity, but we believe that this situation will correct itself as the guarantors take a more pragmatic approach to their reinsurance needs, as we will discuss later.

Probably the most significant development for the near-term supply of financial guaranty products is not the addition of new capital to the sector, but rather, the expected change of control at FGIC, an established company. FGIC has remained a first generation financial guarantor under GE's ownership, focusing essentially on domestic municipal underwriting. The acquisition of FGIC by an investor group led by the mortgage insurer PMI will most likely increase competition for structured finance underwriting, given that the firm is expected to pursue a strategy more in line with the other established guarantors as it tries to catch up on the structured finance side.

More generally, the size and predictability of international opportunities will determine the competitive environment in which the guarantors will operate due to the relative maturity of the US market and the growing pool of capital dedicated to financial guaranty. The long-term opportunities presented by the international markets are undeniable and commensurate with the capital dedicated to this sector, but the financial guaranty industry will be exposed to growing competitive pressures if the medium-term growth of these markets does not meet the guarantors' expectations.

## The Guarantors' 2003 Financial Performance

### LOW RATES AND WIDE CREDIT SPREADS YIELD STRONG RESULTS

The financial guarantors continued to perform solidly in 2003, with the year especially notable for strong pricing, premiums and earnings. Some metrics, however, indicate moderating performance. Par written volume, for example, will likely fall short of its 2002 levels as the result of a sizable drop in CDO underwriting and a further softening in global ABS par written. The year 2003 will also be notable for an increase in the volume of smaller claims, which is attributable to the overall credit deterioration across many industry sectors.

Credit spreads in 2003 are worthy of special mention, as we believe that conditions for pricing financial guarantees were at perhaps the best levels of the last two credit cycles — this was especially so for the muni sectors. Spreads between Baa and Aaa twenty-year municipals and Baa and Aaa seven-year corporates are our proxies for overall spread activity.

These indicators, which began widening in 1999 and 2000 and peaked for munis in the first quarter of 2003 and for corporates in the fourth quarter of 2002, have marked a substantial opportunity for the guarantors to capture value in underwriting a wide swath of fixed income securities. Credit spreads have since leveled back to points seen late in 2001 and early 2002, but still remain over two times their levels through the late nineties.

For the nine months ended September 30, Gross Par Written was down 3% relative to the same period in 2002, while Gross Premiums Written, which includes the present value of installment premiums, was up 27%. The strong rise in premiums in conjunction with a slowdown in volume can be explained by a number of factors. Writing longer-tenor securities, focusing on higher premium mix, or taking on more risk per unit of par written could each have caused such a divergence of premium and par. With the exception of the CDO drop off, however, business mix and average tenors appear to be generally consistent with 2002's underwriting experience. So, if the guarantors are not substantially changing their underwriting mix or standards, then the divergence could be a signal that investors and issuers are, at least temporarily, placing an increasingly higher value on the benefits of a wrap. This conclusion was one of the more positive credit signals for the guarantors this year.

Consistent with the overall trend, US municipal premiums, up nearly 30% this year, have been bolstered by pricing and strong issuance volume. Total municipal market issuance (unwrapped and wrapped) is expected to finish 2003 ahead of last year's record level of $358 million.

While volume is expected to decline when interest rates finally begin to rise, the pricing conditions may be somewhat more likely to persist. Many muni issuers are facing an ongoing need to alleviate the general feeling of concern that has been generated by a number of large issuers experiencing budget problems. These factors have led to insured penetration levels that are at, or above, 50% for the second year in a row.

International premiums, also up nearly 30% this year, have been driven by very strong pricing and solid volumes in transportation, education and government-related projects, mitigated by a significant drop-off in CDO activity. The reasons for strong premiums may include the complexity of the deals, lack of comfort with cross-border risks, and the fact that many project deals are structured to just reach a low investment grade, making them relatively more expensive to insure.

## AS SOME STRUCTURED SECTORS MATURE, THE NEED FOR FINANCIAL GUARANTY INSURANCE DECREASES

In the United States, asset backed par written for 2003 is likely to be one third off last year's pace, while premiums written are estimated to be off by about 10-15%, mostly due to a substantial withdrawal from the CDO markets, as well as because of sizable declines in MBS, home equity, auto loan and credit card asset classes.

The challenge for the guarantors is that issuers are increasingly structuring away the need for a wrap through the use of senior subordinate structures. Offsetting this negative trend is the fact that the *types* of ABS continue to grow. New ABS securitizations, which typically take investors time to get comfortable with, are generally good candidates for financial guaranty insurance.

Focusing just on CDO's, this sector still represents about 15% of the net par outstanding of the financial guarantors. Part of this year's decline in par written can be attributed to a conscious effort to improve selectivity in the CDO markets. Aggregate CDO par written, including international activity and synthetic CDOs will likely be under $40 billion this year — down from about $82 billion in 2002.

## WEAKENING CREDIT PROFILES AMONG CERTAIN MUNICIPAL ISSUERS

While there are positive trends developing in the credit profiles for some corporate related credits, the guarantors have probably not seen the end of the downgrades in the municipal sectors, where downgrades will outnumber upgrades by over 4:1 this year on a volume basis.

The recent downgrade of California to Baa1 with a negative outlook from A3 is something that Moody's is, of course, watching. California related exposures — general obligation and other muni-related — comprise about 10% of the entire insured portfolio of the guarantors, or around $150 billion.

To put this into perspective, we would emphasize that California is still an investment grade credit, and the severity of loss in the event of default for general obligation bonds is expected to be extremely low. We would also highlight that not all wrapped exposure in California is a direct obligation of the state and that none of the guarantors' obligations accelerate on default given the structure of their insurance policy.

It may also be worth noting some positive side effects to the California situation. Not only will there be a marginal increase in premiums that can be charged to the largest debt issuer in the country, but correlations in credit spreads may also help the guarantors draw higher premiums from all municipals. Nonetheless, the effect of the recent downgrade, and any further downgrades, on the credit profile of the overall industry could create a modest reduction in the capital cushion the industry enjoys.

## INCOME AND PROFITABILITY REMAIN STRONG

Turning to GAAP income and profitability metrics, each of the guarantors continue to show strong growth and excellent financial health. Through the first nine months of 2003, earnings were up by about 28% to $1.4 billion over the same period in 2002. Part of this growth was driven by the comparison to last year's data — which, barring a few large abnormal losses from several of the guarantors would have made this year's earnings growth somewhat more modest.

Operating expenses rose by 16% in 2003 to $870 million, driven by staff additions and higher reserving as a result of increased production and some portfolio credit deterioration. Revenues were up 26% to $2.8 billion. Profit margins improved by about one percent to 51.2%. Investment income was $833 million, exactly equal to last year's total through the first three quarters. Finally, as has been the case since the inception of the business, annual claims paid, while noticeably rising, represented just a couple of basis points of the total insured book of business and a small component of the overall earnings capacity of the firms. All in all, 2003 will be notable for the fact that, unlike 2002, there really have been no major loss events.

### RECENT MODEL RESULTS

Now to briefly touch upon the latest results of Moody's portfolio risk model. As we've discussed in the past, the modeling that we do is designed to assess how a guarantor's insured portfolio would perform under a wide variety of stress scenarios. In our analysis, we calculate not only expected losses for a portfolio, but also the potential loss variability around this expected case, which is largely a function of portfolio concentrations and risk correlations, as well as the impact that changing economic conditions have on loss levels.

Mid-year model results for the industry showed little change from year-end 2002 results. The industry remains strongly capitalized, with the ratio of capital to tail-level losses at around 1.5 times. These figures continue to demonstrate that the guarantors have sufficient levels of capital to cover stress-level losses. It's also worth noting that the downgrade of California's General Obligation bond rating to Baa1 from A3, while affecting the guarantors' largest single risk, does not have a material impact on model results. This reflects the lower expected default rate and severity associated with municipal securities as outlined in Moody's recent Municipal Bond Default Study.

## Recent Developments and Trends

### FINANCIAL LEVERAGE HAS BEEN TRENDING UPWARDS

For years, a number of guarantors have issued modest amounts of debt in the capital markets as a relatively inexpensive source of capital for their insurance operations. When the guarantors raise debt, they issue out of their holding company with the proceeds subsequently down-streamed into the insurance operating company where these funds are used to support the claims-paying resources of the guarantor.

Moody's typically rates the holding company debt below the insurance financial strength rating of the guarantor because the claims of creditors are subordinate to those of policyholders under US regulation. When evaluating how much debt is appropriate for a given rating level, Moody's takes into account the ability of the operating subsidiaries to service that debt over time.

Over the last year or so, Moody's has seen the guarantors' financial leverage — as measured by the ratio of debt to debt plus equity — increase above historical norms. As a reference point, financial leverage for the guarantors has typically fallen within a band of around 12-16%. Recently, though, the industry's leverage ratios have crept above 18% as companies took advantage of particularly favorable market conditions to lock-in low long-term rates.

Because the guarantors only issue debt every so often, they usually try to achieve a certain critical mass when they *do* issue in order to get better execution in the market. For this reason, it is not uncommon for leverage ratios to exceed historical norms temporarily, although Moody's would not consider such ratios to be sustainable for the sector over the long-term at current debt rating levels.

While financial leverage has been higher than normal for some companies due to recent debt issuances, the guarantors have also taken specific steps to mitigate the risk of this increased leverage. Ambac, for example, down-streamed to its operating company only a portion of its most-recent debt issuance, keeping some of the proceeds at its holding company invested in high-quality, liquid securities.

By not deploying the entire amount in its insurance operations and instead maintaining a portion of the proceeds at the holding company level in an economically defeased manner, Ambac was able to lock in low rates for the entire issuance while limiting the debt service burden on its insurance operating company.

Similarly, FSA's financial leverage temporarily increased above the norm when it issued debt last year, but in order to limit its total fixed charges dividend payments to its parent were suspended until leverage levels decreased. Leverage ratios for both companies have since come down closer to more normal levels.

### ADOPTION OF FIN 46: NO NET EFFECT ON THE GUARANTORS

Another industry development worth mentioning is the implementation of FIN 46, the FASB's new guideline on consolidating off-balance sheet Special Purpose Entities, or "SPEs". For the guarantors, this means that the exposures relating to some of the conduit programs they manage must now be reported on their balance sheets. The guarantors with conduit programs have for some years included disclosures about their SPE business activities in their financials, but the exposures were not included as part of the guarantors' assets and liabilities. Now that they are, both sides of the balance sheet are growing significantly — in one case, by over 40%. Most of these adjustments have already been incorporated into the guarantors' third quarter financials even though formal implementation of FIN 46 is not required until the fourth quarter of this year.

By way of background, the guarantors' conduit programs are designed to provide structured issuers with a funding alternative to issuing notes directly in the marketplace. The guarantors assume exposure to these programs by wrapping the assets that support the medium-term notes and asset-backed commercial paper issued by the conduits.

In Moody's analytical framework, the movement of these conduits onto the balance sheet has no impact on Moody's assessment of holding company financial leverage, nor does it impact Moody's view of the capital resources available to pay claims at the insurance operating company level. The insurance exposures that have been assumed through these programs have always been reported by the guarantors and are incorporated into our modeling of the insured portfolio. Furthermore, the risk acceptance guidelines that the guarantors use to underwrite these exposures are the same as those for their core financial guaranty business.

The programs themselves, which are rated by Moody's structured finance team, are typically managed on a matched-fund basis to mitigate interest rate and basis risk. Any residual liquidity risk in the guarantors' medium term note programs is managed through rigid covenants restricting unscheduled withdrawals by investors, while the liquidity risk in asset-backed commercial paper programs is assumed by highly rated banks, *not* by the guarantors themselves.

### THE MARKET FOR REINSURANCE IS CHANGING

Turning now to the market for financial guaranty reinsurance, the trends that we have observed over the last couple of years continue today and, in fact, seem to be accelerating.

The two largest firms among the traditional financial guaranty reinsurance providers continue to write reinsurance business, but they are both placing more emphasis on their own primary financial guaranty efforts.

Radian Re participates in the primary market through its sister company, Radian Asset Assurance, and has indicated that it will be placing particular emphasis on its primary business going forward.

ACE Guaranty Re changed its name to ACE Guaranty Corp. perhaps, in part, to emphasize that it is no longer just a financial guaranty reinsurer, but that it writes primary business as well. The firm also recently announced its plans to pursue an initial public offering of its financial guaranty business for strategic and capital allocation reasons, which Moody's believes is intended to reposition the firm within the financial guaranty space. As a result of these moves, both firms are becoming less dependent on the primaries for business and potentially more demanding regarding the terms of trade.

As for the other participants in the market, AXA ceased its financial guaranty reinsurance activities about a year ago, and a number of multiline reinsurers have either lessened their involvement or pulled back completely. Their actions have come about partly because of the downgrades of several companies that have diminished the value of their reinsurance, but also because the multilines are seeing more lucrative opportunities in their core markets.

What does all of this mean for the primaries? It means that reinsurance is becoming less available and more expensive.

Yet reinsurance continues to be important for the primaries, in our view, mostly as a way of shaping their portfolios and managing large single risks and risk concentrations. In response to these changing industry dynamics, we are beginning to see more direct involvement on the part of the primaries in designing their own reinsurance solutions.

One example is where the Aaa-rated primaries provide reinsurance to one another, particularly on large deals where single-risk concentrations are an issue. There are other examples as well. MBIA, for instance, has announced that it intends to form a new financial guaranty reinsurer that will provide it with added reinsurance capacity. The reinsurer will be funded largely by highly-rated third-party strategic investors. MBIA also made a strategic investment in RAM Re earlier this year. Through all of these efforts, the industry is hoping to create and maintain a reliable source of high-quality reinsurance for the long term.

## Rating Outlook — Stable

Our overall rating outlook for the financial guaranty industry is stable. The guarantors have continued to see robust demand for their product, and they have shown discipline in underwriting, structuring and pricing transactions over time. Some credits within the industry's insured portfolio have experienced some deterioration, and there is still the potential for further deterioration depending on how the economic cycle plays out. Nevertheless, the industry's overall portfolio quality remains strong, and capital growth has allowed the guarantors to maintain healthy risk-adjusted capital ratios consistent with their current rating levels.

A natural question to ask, though, is: What factors could potentially change this outlook and put downward pressure on the ratings?

When Moody's approaches this question, it focuses on several distinct areas. There is the potential for event risk, for example, causing a guarantor to suffer a large, unexpected credit deterioration or losses. Downward rating pressure could also occur if there were a significant change in business strategies, such as more lenient underwriting, risk management or surveillance standards, more aggressive financial management, or diversification into higher-risk activities.

A weakening of the guarantors' core franchise that changed the economic incentives driving business decisions could also lead to a downgrade. This could potentially come about if the balance between the supply and demand for financial guaranty insurance became out-of-sync.

One distinct risk would be that international growth does not materialize as quickly as expected, particularly given the maturity of the US markets. Another risk is that new competitors could drive down pricing.

Looking at the guarantors' competitive environment today, none of these potential risk factors are causing rating pressure for the industry. We expect that the guarantors' top priority will continue to be preserving their financial strength, which, in our opinion, is the primary source of their franchise value.

In the future, Moody's will continue to focus and comment on these important analytical factors in its ongoing analysis of the financial guarantors.

## Related Research

**Rating Methodology:**

Moody's Rating Methodology for Financial Guaranty Insurance Companies, December 2003 (80806)

*To access any of these reports, click on the entry above. Note that these references are current as of the date of publication of this report and that more recent reports may be available. All research may not be available to all clients.*

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**Authors**

*Jack Dorer*
*Stanislas Rouyer*
*Matthew Noll*

**Production Specialist**

*Ida Chan*