Special Comment

June 2004

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Financial Guarantors Pursue Modest Diversification Outside Core Business

Summary Opinion

The primary financial guarantors, often referred to as 'monoline' bond insurers, are governed by a body of insurance regulation[1] that defines their monoline structure. In their three decades of operation, the guarantors have essentially remained single product companies and have made few attempts to diversify outside of their core line of business. Over the last ten years, however, the financial guarantors have begun to develop modest franchises in some non-financial guaranty business segments operating through subsidiaries of their holding companies. These new activities have, to a limited extent, diversified the guarantors' revenue streams. For the primary companies rated by Moody's, non-financial guaranty business operations accounted for approximately 6% of revenues and 3% of pre interest and tax profits as of year-end 2003.

The guarantors have diversified primarily into synergistic product lines that add value to their insurance product or derive benefits from the guarantors' core competencies in credit risk analysis and management. Based on this strategy, the guarantors participate in some sub-segments of the investment management market and financial services sector. They have garnered sizeable market share in a few select areas such as Municipal Guaranteed Investment Contracts (MuniGICs).

In general, the guarantors have adhered to the same conservative risk management strategy for their non- financial guaranty business lines that they use in their core financial guaranty business. The guarantors' ability to assess and manage credit risk has proven to be a valuable and relevant skill in the context of these newer businesses. Equally important is their ability to monitor, hedge and manage their exposure to other risk factors such as market risk, liquidity risk and operational risk. Because the guarantors' franchise value is ultimately dependent on their overall reputation as risk managers, it is imperative that these non-core business risks are carefully managed and well contained.

On a stand alone basis, the guarantors' non-financial guaranty activities are sometimes more volatile than their core business. In addition to credit risk that is broadly in line with the underwriting standards they follow in their core business, these activities also assume elements of market and liquidity risk. In the past, certain diversification attempts have had unexpected financial implications and a few ventures were discarded as a matter of strategic intent. Nonetheless, given the modest size of most of the guarantors' non-financial guaranty activities and their conservative risk management strategies, Moody's believes these products and services can function as complementary activities that add value to the firms' core financial guaranty franchises while enhancing their overall income potential. This assessment is based on the expectation that the guarantors will not take on larger or riskier mandates, and will continue to operate in synergistic business lines.

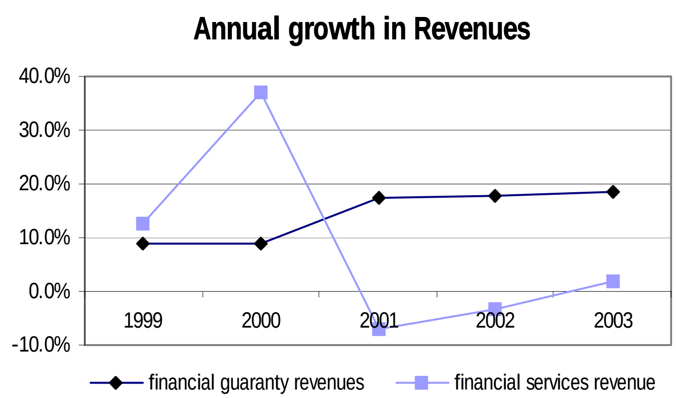
Moody's ascertains a capital charge for each of the guarantors' non-core activities based on its risk characteristics, size and experience. The capital charge is incorporated into our calculation of hard and total capital available to support a firm's financial guaranty obligations, and therefore, has an impact on the results of Moody's insured portfolio risk model. However, because this analysis is geared to modest levels of exposure, Moody's analytical conclusions could be different if the metrics were to change.

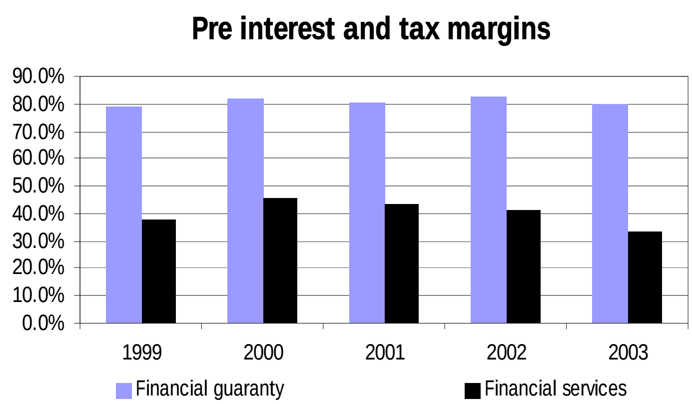
1. *In the late 1980s, laws were passed by some state legislatures which established regulatory rules specific to financial guaranty insurance. For example, financial guarantors, governed by the monoline regulatory framework, are often explicitly excluded from the state guaranty programs.*

Growth of Non-financial Guaranty Business Ventures

The financial guaranty business began in 1971 when the first financial guaranty insurance policy was written. In the ensuing two decades, the scope of the guarantors' core business grew considerably: the bond insurance product was extended to the US asset-backed and international markets, New York State enacted Article 69 imposing financial strength requirements and limiting the scope of activities of the primary financial guarantors, and monoline bond reinsurers came into existence. During this time, the guarantors did not venture into non-core areas given the strong growth in size and scope of their financial guaranty insurance activities. MBIA and Ambac were the first guarantors to diversify beyond traditional financial guaranty business in the early nineties and only in the second half of the decade did these companies record significant revenue and portfolio growth.

MBIA's first steps beyond the financial guaranty arena were to launch its GIC product, its municipal investment advisory service and its fixed income management service in 1993. Ambac began its diversification efforts in 1992 by launching its GIC and issued its first interest rate derivative products in 1994. Since then, other investment management products have been introduced by the guarantors, including medium term notes and asset backed commercial paper issued through funding programs. MBIA is presently the only active participant in the fee-based financial services sector, offering investment management services, cash management services, and municipal advisory services. Until recently, Ambac had a small presence in the investment management/cash management area, but the company decided to withdraw from this business[2]. Ambac is the only financial guarantor to offer derivative products[3].





a.Analysis based on data only for MBIA, Ambac and FSA, the three companies that have sizeable non-financial guaranty portfolios.

b.Data adjusted to exclude extraordinary items such as merger expenses, one time loss reserves/investment portfolio losses and mark to market changes.

c.Net Revenues (interest income -interest expense) have been used in these charts. Some companies report gross revenues for their non financial guaranty operations and those have been adjusted in these calculations.

The financial guarantors offer these ancillary products and services through wholly owned subsidiaries of their holding companies. The financial performance of these entities is consolidated in the financial reports of the holding company.

Revenue growth in the non-financial guaranty segment has lagged revenue growth in the guarantors' main financial guaranty business over the last five years, notwithstanding the guarantors' increased participation in non-financial guaranty business lines. In the years 1999 and 2000, the guarantors' aggregate non-financial guaranty revenue grew faster than their main business line, due primarily to MBIA's acquisition of 1838 Investment Advisors[4], an investment management firm. Since 2000, however, growth in financial guaranty revenues has been considerably higher than revenue growth in the guarantors' non-core activities. Favorable business conditions in the financial guaranty market and weak performance in the investment management and advisory sectors, related in part to weak stock markets, have contributed to this outcome.

The pretax margins for the industry's non-financial guaranty activities are lower than those for the core financial guaranty business. The competitive advantage enjoyed by the financial guarantors in the credit enhancement industry as compared to the myriad sources of competition in the financial services business undoubtedly contributes to these lower margins. To some extent, however, these margins understate the contribution of the industry's non-financial guaranty business lines, as the financial guaranty subsidiary earns premiums for the insurance they provide to their MTN and GIC liabilities.

2. *Ambac's press release cites their intention to focus on the financial guaranty business and complementary services as the reason for their decision.*
3. *We view credit derivative products to be an extension of their core business despite some material differences and they are not part of this report. See Moody's Special Comment 'Credit Default Swaps versus Financial Guarantors- Are the risks the same?', June 2001.*
4. *MBIA announced sale of this company in March 2004.*

Product Structures

The non-financial guaranty product portfolio can be broken down into two main segments:

1. Products employing a spread based model such as GICs, derivative products and funding programs. The liabilities issued through these programs explicitly benefit from a guaranty issued by the financial guaranty subsidiary to honor the commitments associated with these products. Hence, the viability of these products is dependent on the rating and the franchise value of the financial guaranty operation.
2. Businesses that bring in fee based income such as investment management services, cash management services and municipal advisory services. These services are mainly offered to financial guaranty clientele to improve the guarantors' relationships with their clients.

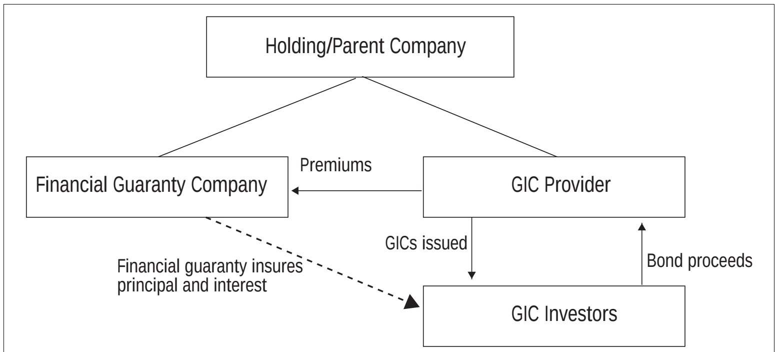
GUARANTEED INVESTMENT CONTRACTS (GIC)

As the name suggests, GICs are guaranteed return investment products where the principal repayment profile is customized and some contracts also permit flexibility in draw schedules. The guarantors have participated in this business for ten years, issuing GICs primarily to municipal debt issuers. More recently, the guarantors have also issued GICs for Credit Linked Note (CLN) issues and project finance issues in the international markets. As of 4Q2003, net outstanding GIC liabilities issued by the guarantors in aggregate were $19.7 billion. Because MuniGICs account for about 70% of the guarantors' GIC portfolios, we will focus our remarks on this segment of the market.

For some types of municipal bonds, such as construction funds and debt service reserve funds, bond proceeds are not deployed by the issuer immediately upon issuance. Instead, municipal issuers invest the proceeds, until such funds are needed, in high quality investment vehicles such as government securities, money market instruments, managed portfolio products, and MuniGICs. The returns from the first two types of investments are relatively low, however, and managed portfolio products sometimes involve embedded interest rate and credit risks for the investor.

MuniGIC contracts from highly rated entities, on the other hand, offer an assured rate of return that is typically higher than government securities or money market instruments. Furthermore, the draw schedules of MuniGICs are customized to match the issuer's deployment schedule and can offer some flexibility for unscheduled withdrawals. The credit quality of the GIC provider is another important investment factor, and as a result, only highly rated entities can effectively compete in this segment. The market for MuniGICs is estimated to be between $60-100 billion[5] of annual issuance, varying with the total amount of municipal bonds issued in the marketplace in any given year.

The guarantors have also issued GICs that serve as collateral in credit linked note transactions that are part of synthetic CDO structures. In these cases, sellers of credit protection invest in notes that would be used to compensate the credit protection buyer in the event of default. The note proceeds are invested in GICs and other secured instruments and the income earned on the collateral is passed on to the CLN investors as payment for providing credit protection. No drawdown on the GIC will occur prior to the maturity date as long as the underlying credit does not default. CLNs are often senior tranches in the CDO structure, with substantial collateral protection existing below this tranche; hence the risk of an unscheduled draw is minimal.



The financial statements of the GIC issuing company are consolidated with the parents' financials for all of the guarantors except XLCA.

Moody's-rated financial guarantors active in this market issue GICs at Aaa rates based on the guaranty provided by the bond insurer. The funds are invested in highly rated instruments, typically averaging in the Aa-range or better. Some of the more popular asset classes include asset backed securities, mortgage backed securities and municipal bonds. GIC providers retain the spread between investment returns and funding costs after paying administrative expenses and credit enhancement fees (the latter being earned by the financial guaranty operating company.)

Three established monoline financial guaranty companies, MBIA, Ambac and FSA, sponsor and manage GIC programs through their subsidiaries. More recently, XLCA has entered the business by guaranteeing the GICs issued by XL Asset Funding, a subsidiary of XL Life and Annuity Company. Apart from the financial guarantors, some banks,

5. Source: *The Bond Buyer*

broker dealers and insurance companies also participate in this market. Other Aaa-rated issuers of MuniGICs include AIG, Caisse des Depots and the several Landesbanks.

Risk Assessment

The risks undertaken in the guarantors' GIC programs are somewhat different from those assumed in their core financial guaranty business. When the insurers guaranty GIC liabilities, all of the risks associated with these programs ultimately devolve on the insurer. Moody's review of the guarantors' participation in this business therefore takes into consideration both the significant risks and the risk mitigating factors that are structured into these programs.

- The credit risk generated by a guarantor's GIC program is largely similar to the investment exposure assumed in its financial guaranty operations, although any hedging transactions entered into by the program also create counterparty risk. The guarantors manage this risk by dealing only with highly rated counterparties, by closely managing counterparty risk concentrations, and entering into swap agreements that require posting of collateral beyond certain thresholds.
- One of the prime objectives of the guarantor-sponsored GIC programs is to manage the programs on a matched duration basis. Mismatches in the asset/liability schedule would expose the program to market risk factors such as price risk, reinvestment risk and interest rate risk. Some programs hedge these risks using swaps.
- Most of the GICs issued to municipal issuers have flexible draw schedules. This structure increases their exposure to liquidity risk and, potentially, to market risk. GIC issuers include covenants in their agreements to restrict unscheduled withdrawals and to highlight specific instances where an early drawdown is not permitted (such as to reinvest funds elsewhere at a higher rate.) The GIC administrators also manage this risk by trying to identify the potential for early withdrawals and by maintaining a minimum level of liquid assets. In some instances, they also have separate liquidity lines to support these obligations. Minimum liquidity levels are sized according to stress case liability payout scenarios.
- The GIC business of the guarantors exposes them to operational risk at two levels. The day-to-day activities of the firm involve timely and accurate execution of many tasks such as accounting, fund transfers, reporting and documentation among others. The probability that errors on any of these functions could result in financial losses for the company is an important component of operational risk. Managerial oversight, reporting controls and operational reviews are some other important measures taken by the guarantors to mitigate operational risk. Equally important to the estimation and evaluation of operational risk is the ability to recover from unanticipated 'event risk-like' situations such as large market movements, liquidity stress and system failures. In Moody's view[6] the capability of an entity to respond to these circumstances would depend to a large extent on its operating discipline, strategic planning and financial risk management plan. All the guarantors have established procedures and systems to address these and other operational risks associated with their GIC programs. It is significant to note that none of the programs experienced severe levels of stress in the post September 11 turbulent market period.

Many GIC products contain embedded rating triggers[7] that prompt remedial action in the event of a guarantor downgrade. These clauses magnify the risk to the guarantors in distress scenarios, although the triggers are generally more than two notches below the guarantors' current ratings. Commonly used remedial clauses include assignment clauses, collateral posting and, in more drastic situations, return of invested funds. Many of these risks are a function of the investment guidelines, investment management strategy and operating standards of the programs.

Based on an analysis of the investment guidelines, liability acquisition guidelines, asset liability management strategy, operational practices and track record of the program, Moody's determines a capital charge for that program. Since the financial guaranty insurance provided to GIC obligations is not part of Moody's Portfolio Risk Model, this capital charge also covers credit risk. The amount of this charge is then deducted from our computation of capital resources available to support the insurance obligations when we run our portfolio risk model. It is significant to note, however, that this analysis is geared to assess modest levels of exposure to this business. Moody's analytical conclusions could be different if the relative scale of these operations were to increase.

FUNDING PROGRAMS ISSUING MEDIUM TERM NOTES AND ASSET BACKED COMMERCIAL PAPER[8]

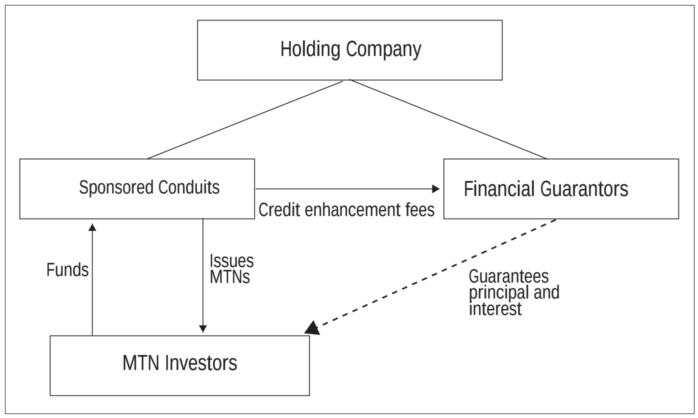
The guarantors also manage funding programs that are designed to provide a value-added product for their structured finance underwriting clientele that earns a spread by participating in the asset liability management business. In a few instances, these products have been created to accommodate investor requests for a specific structure, i.e., a reverse inquiry transaction. These programs issue Medium Term Notes (MTNs) and Asset Backed Commercial Paper (ABCP) and invest the proceeds in high quality securities. There are currently five active MTN programs managed by

6. See Moody's Special Comment " Financial Institutions' Enterprise Risk Management' December 2001
7. See Moody's Special Comment 'Rating Triggers in the Financial Guaranty Industry' July 2003
8. The guarantors also insure MTNs and ABCPs issued by third party conduits. This activity is part of their mainline underwriting strategy for their bond insurance portfolio, with the insurers assuming credit risk. This exposure is not part of the current analysis.

the guarantors and one active ABCP program. An additional MTN conduit is in runoff. As of year-end 2003, the guarantors had outstanding liabilities of $12.1 billion associated with these business lines.

Under the funding program structure, lower rated issuers can issue paper at attractive rates by transferring high quality assets to bankruptcy remote vehicles. The program manager seeks to maximize the spread between the yield on the portfolio and the vehicle's cost of funding, while maintaining asset credit quality above certain prescribed levels. The competitive advantage enjoyed by the guarantor sponsored conduits vis-à-vis other SPE conduits is that the guarantor becomes a 'one-stop shop' for debt issuance services, thereby reducing the administrative costs associated with having many intermediaries in the debt issuance process. For investors, the conduits provide attractive investment options in highly rated investment vehicles.

The guarantors insure all of the assets acquired by their MTN programs using the same underwriting process that they follow in their core financial guaranty business. They also wrap the MTNs issued, and as a result, the MTNs carry the insurance financial strength rating of the guarantor. By contrast, the liabilities issued by the ABCP conduit managed by MBIA's Triple A-One Funding are not insured by MBIA, although all of the assets are insured.



MBIA, Ambac and FSA participate in this segment by sponsoring dedicated subsidiaries within their corporate structure. Originally, these programs were off-balance sheet conduits, but more recently MBIA and FSA consolidated these programs onto their financial statements in line with the FASB's FIN 46 guideline[9]. Ambac's programs are structured as QSPE conduits that do not have to be consolidated as per the current scope of FIN 46. XLCA has recently incorporated an off-balance sheet conduit called Gulf Stream to issue MTNs, but this conduit has not issued any liabilities to date.

The spread generated in the investment management process is the prime source of revenue for the conduits. The expenses incurred include credit enhancement fees paid to the insurance company and the administrative expenses associated with the operation of the program.

Risk Assessment

In general, the guarantors manage their funding programs conservatively. The Structured Finance team at Moody's rates the MTN and ABCP programs. These rating assessments are a crucial part of our analysis of this business.

- All of the assets acquired by the MTN and ABCP programs are subject to the underwriting guidelines that exist in their core business. Therefore, any credit risk associated with these activities is similar to exposures in their regular insurance business. Counterparty risk stemming from the swaps used to hedge market risk is another potential source of credit risk, although the guarantors deal with only highly rated counterparties and place limits on their risk exposure in order to mitigate this risk.
- With one exception, all of the MTN programs sponsored by the guarantors are managed on a match funded basis and are therefore not exposed to liquidity risk. The one MTN program that is managed on a key rate duration matched basis is exposed to some liquidity risk, which we account for in the capital charge assessed to the program. By contrast, ABCP programs typically have duration mismatched structures. A key focus of these programs is to ensure adequate liquidity support in the event that their liabilities cannot be rolled over. The ABCP program managed by MBIA uses backup liquidity lines from highly rated banks to address this issue. MBIA is therefore not exposed to liquidity risk. These lines do not have any embedded rating triggers except default by MBIA. To date, this program has not drawn on the liquidity line.
- The match funded MTN programs are not exposed to market risk as the liabilities' payment schedules mirror the inflows from their assets. The duration matched program and the ABCP program are not structured to match the asset and liability payment schedules and, consequently, they could be exposed to market risk factors such as interest rate, reinvestment or pricing risk.
- As in the case of the GIC programs, the operational risk associated with this investment management product is a risk factor. Similar to the GIC programs, the guarantors have established procedures to address operational risks associated with the daily activities and event risk type situations.

9. *See Moody's Special Comment "Impact of FIN 46 on the Financial Guarantors" November 2003.*

As all the MTN liabilities are wrapped by the guarantor, these liabilities are included in our portfolio risk model and the risk charge incorporates operational risk. The ABCP liabilities are not wrapped by the guarantor, however the underlying assets are wrapped and the individual obligations are supported with separate liquidity lines, hence operational risk to MBIA is limited.

- The guarantors wrap all of the liabilities issued by their MTN programs; therefore reputational risk associated with the MTN programs is absorbed by the insurance company.

Unlike the GIC programs, all the assets acquired by the programs described above except the duration matched MTN program are included in Moody's portfolio risk assessment model, wherein they translate into a capital charge similar to all other insurance risks. The backup liquidity lines in the ABCP program provide effective protection against liquidity risk. The duration-matched MTN program assumes some market risk and liquidity risk, for which Moody's applies a comprehensive capital charge. Based on the current scale of the guarantors' conduit operations, Moody's views these programs as being complementary to their core financial guaranty activities while offering some potential for incremental revenues. As with the guarantor's other non-financial guaranty activities however, if the risks, scope and size associated with these activities were to change in a meaningful way, our conclusions could be different.

DERIVATIVE PRODUCTS

The industry is also involved to a limited extent in the derivative business[10], providing risk management products and services to bond insurance clients. Ambac is the only financial guarantor currently participating in this segment, which it does through its wholly-owned subsidiary, Ambac Financial Services LLC. (AFS). Gross notional exposure outstanding for AFS as of 4Q2003 was $30 billion and net exposure[11] was $12 billion. Interest rate swaps and basis swaps account for about 70% of AFS's derivative product portfolio, while cross currency swaps and balance guaranty swaps make up most of the balance. Ambac also issues Total Return swaps through Ambac Capital Services LLC (ACS), a wholly owned subsidiary of Ambac Assurance Corporation.

Like other derivative instruments, the products issued by AFS are market risk management tools designed to facilitate risk transfer. Derivative products are attractive to issuers because they offer simple, customized solutions to asset-liability mismatches, have lower issuance costs than bond issues, and can be unwound easily. The derivatives market is very competitive with many players and product variants. In the municipal derivatives market alone, current outstanding contracts are estimated to be between $200-$400billion[12] with all of the major banks and financial institutions competing.

The swaps markets are organized and conducted according to ISDA (International Swaps and Derivative Association) guidelines. Counterparties often hedge their exposure by entering into swaps with other derivative contract providers, and ISDA contracts permit counterparties to net all amounts due and owed while also allowing for the posting of collateral when net mark-to-market exposure exceeds a certain threshold amount. Because the management of counterparty credit exposure is such an important facet of the business, highly rated players like the financial guarantors can generally obtain favorable pricing and terms in this market.

Ambac's chosen role in the derivatives market is to provide swaps largely to municipal entities and other financial guaranty clients in connection with their financings. Ambac's involvement in the sector is designed to increase the value of its financial guaranty services for issuers, while also enabling the firm to earn incremental income. An example might be where an issuer of dollar denominated fixed rate notes that have been wrapped by Ambac buys a currency swap from AFS to convert the exposure to a Euro denominated liability. AFS, in turn, will typically hedge its exposure to currency risk by entering into an offsetting currency swap transaction with a highly rated bank or financial institution. Because the swaps of AFS are guaranteed by Aaa-rated Ambac Assurance, AFS can take advantage of its strong counterparty position by earning a spread between the two offsetting swaps in the above example, while at the same time, containing its own exposure to market risk.

Risk Assessment

AFS has deployed prudent risk management guidelines and strategies to manage its derivative business products. While net outstanding derivatives exposure is not large relative to Ambac's insurance par in force, the potential risks associated with this business are different from those of its core financial guaranty operation.

Moody's analysis incorporates both the specific risk factors and customized risk mitigating features associated with the derivative product program.

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10. The characteristics of a financial guaranty policy that could expose the guarantors to interest rate or currency risk are generally incorporated in the transaction structure. However in a few instances, the guarantors hedge residual exposure to undesired market risks using swaps. Such swaps and related positions are excluded from our analysis in this report, as these transactions are not intended to be revenue generators. As mentioned earlier this report does not cover credit derivatives products.

11. Since most of the exposures are perfectly hedged to offset market risk factors, the residual outstanding exposure retained by AFS is much smaller than the gross notional exposure. Net exposure = Gross exposure – perfectly hedged instruments

12. See Moody's Special Comment "Swaps and the Municipal Market: The Impact of Swaps and FASB 133 on Municipal Credit Quality" dated October 2002

- In all of its swap contracts, AFS assumes the risk that one of its counterparties could default. When a municipal client that has obtained insurance from Ambac also enters into a derivatives contract with AFS, counterparty risk has typically already been assessed as part of the bond underwriting process. Offsetting trades with professional swap dealers also create counterparty risk. To manage this risk, AFS deals only with highly rated banks and financial institutions under Master ISDA agreements and has established detailed guidelines and limits on its counterparty risk exposures. In the total return swap product, ACS assumes credit risk to the underlying collateral but in most instances the collateral has been wrapped by Ambac or some other highly rated financial guarantor.
- While the derivatives business also exposes Ambac to market risk, most of this risk is hedged by entering into offsetting swaps with highly-rated counterparties as described above. In this way, market risk is effectively "transformed" into counterparty risk, although with certain products such as basis swaps[13] some market risk is retained by AFS.
- Swaps positions are settled periodically on an aggregate basis. Disruption in the swap settlement process could stress the liquidity position of the unit, which would be a concern if AFS's net positive positions were with relatively lower rated counterparties. AFS mitigates this risk by incorporating tight guidelines with respect to counterparty credit ratings and collateral posting.
- As with other non-financial guaranty products, operational and reputational risks also exist for the derivatives business.

Master ISDA agreements with counterparties typically require collateralization when net mark-to-market exposures exceed certain thresholds. The level of these thresholds often varies with the rating of the counterparty such that, if a counterparty is downgraded, the amount of the threshold will decrease. Therefore, if Ambac were to be downgraded, it would impact the amount of collateral that it would have to post under the terms of its Master ISDA agreements. To mitigate the potential for posting collateral, Ambac strives to balance-out trades under each of its Master ISDA agreements to avoid overexposure to any one counterparty.

Recognizing that there are some incremental risks associated with this business, Moody's assesses a capital charge that is deducted from total capital to determine the amount of capital resources available to pay insurance claims.

REVENUE ENHANCEMENT SERVICES

MBIA offers a number of products through its MuniServices Company, which was formed in 1996 to provide local governments with technical and administrative services to enhance their revenue streams. Currently, the services offered by this company include Tax Review and Analysis, Tax Discovery and Compliance, and Revenue Information Services.

The performance of this business unit was disappointing between 1996 and 1999, characterized by many acquisitions, divestures and losses. During this period, the company acquired four companies -- Capital Asset Holdings, Municipal Tax Bureau (MTB), MuniFinancial, and Municipal Resource Consultants (MRC). In 1998, the combined operation lost $11 million, mainly due to the poor performance of MTB and Capital Asset Holdings. The company sold its investment in MuniFinancial during 1999 and recorded a large write-down for its investment in Capital Asset. Since completing the unit's reorganization in 2000, MBIA has reduced the scope of its activities and its net financial results have not been significant.

Risk Assessment

MBIA's current strategy of offering consultative services to its municipal clientele does not represent any tangible increase in risk for the firm, and therefore, a discrete capital charge is not assessed by Moody's. Yet, the potential reputation risk associated with underperformance in this business line could not only be detrimental to the specific franchise value of MBIA MuniServices' program, but could also potentially affect the parent company's relationship with its clients.

OTHER FEE-BASED SERVICES

MBIA offers investment management and advisory services, cash management services, and investment administration services primarily to its existing clientele under the broad umbrella of asset management services. These services are distinct from the investment agreement and funding conduit products that have been discussed in previous sections. In the GIC and MTN products, the guarantor assumes principal and return risk when liabilities are issued at guaranteed rates. In the fee based service lines, by contrast, in most cases MBIA operates as a third party investment manager, with the investor bearing return risk. MBIA MISC manages three pooled invest-

13. For some transactions, interest rate or currency risk exposure is hedged, but AFS retains basis risk.

ment programs with $3.1 billion of assets under management where MBIA Inc has committed to fund declines in asset value. In general the programs are typical money market funds where the possibility of fund declines is extremely remote. The assets are held in third party safekeeping accounts and the investment services company mainly provides documentation and reporting services.

As of year-end 2003, the businesses of MBIA Asset Management LLC, a wholly owned subsidiary of MBIA Inc., included the following three subsidiaries: 1838 Investment Advisors, MBIA Capital Management Corporation, and MBIA Municipal Investors Service Corp. Their activities are summarized below:

Entity	Portfolio	Performance
1838 Investment Advisors	Full services asset management firm investing in large and small cap equities, fixed income and balanced portfolios. Institutional focus.	MBIA acquired this entity in 1999. The lackluster performance of the equity markets has led to a decline in assets under management MBIA announced the sale of this entity in March 2004 for a small profit.
MBIA Capital Management Corp.	Fixed income investment management services for public entities, pension funds and not for profit organizations. SEC registered investment advisor.	This company is the fixed income investment manager for all MBIA entities except 1838 Investment Advisors. Total third party assets under management: $3.1 billion
MBIA Municipal Investors Service Corp. (MBIA MISC)	Cash management, investment fund administration and fixed rate placement services provided to local governments.	Strong business growth occurred in the first half of the 1990's propelled by soft equity markets, although the benign interest rate environment of the last few years has had a negative impact. Assets under management: $11.2 billion

MBIA's recent move to sell its stake in 1838 Investment Advisors, the equity investment advisory unit, is viewed by Moody's to be positive step for the company. MBIA intends to increase focus on the fixed income based asset management units that have more in common with their core activities.

Until recently, Ambac also participated in the investment advisory and cash management business through its affiliate, Cadre Financial Services. In February 2004, Ambac sold its interest in Cadre to PFM Asset Management, attributing this decision to its objective of focusing on its core financial guaranty business. Ambac recorded a $9.2million charge in its fourth quarter 2003 income statement related to this sale.

Risk Assessment

As the service provider companies do not directly assume return risk in these product lines, the risk profile of these entities is based on their exposure to operational risk and reputation risk. The ability to ensure operational and regulatory compliance and the ability to exercise adequate controls to mitigate fraud risk are the key performance attributes for these lines. Failure to focus on these issues could result in tangible losses, as the service provider might have to compensate the investor for losses incurred and could also face regulatory sanctions. All of these factors, as well as the need to manage portfolio returns to meet investors' expectations (for those products that involve active investment management) are also potential sources of reputation risk for the guarantor.

Many of the core competencies associated with these business activities are different from those of a financial guarantor, although many of the guarantors have gained investment management expertise over time by managing their own investment portfolios in house. The returns from this business are also not commensurate with those in the financial guaranty business. Yet, Moody's does not believe that these activities contribute significantly to MBIA's overall risk profile given its current strategic focus and scale of operations, and therefore, we do not assess a separate capital charge in our analysis of the insured portfolio.

Conclusion

The involvement of the guarantors in these non-core business lines has allowed the companies to earn incremental revenue and, in some cases, to further solidify their relationships with their bond insurance clients. Most of these programs are designed to assume modest levels of credit risk while hedging market risk, with the guarantors operating under prudent risk management guidelines to suit their low-risk appetites. On balance, Moody's views the risk characteristics associated with these activities as being compatible with the risk profile of the financial guaranty business, although the income earned from these businesses is not that material to the whole.

Given the type of non-financial guaranty businesses that the guarantors are currently involved in and the relatively modest scale of those businesses, Moody's does not view the guarantors' non-financial guaranty activities as posing any material threat to the guarantors' Aaa insurance financial strength ratings. However, if the guarantors were to diversify into higher-risk activities or if the scale of existing non-financial operations were to grow significantly, Moody's assessment could change.

	MBIA	FSA	AMBAC	XLCA
GIC	MBIA Investment Management Corp (IMC)- $7.0billion[a]	FSA Financial Products Group (FPG)- $4.2billion[b]	Ambac Capital Funding Inc - $6.0billion	XL Asset Funding – $1.5 billion
Investment Advisory and Management	3 companies- $17.7 billion 1838 Investment Advisors(1838) - $3.4 billion MBIA Capital Management Corp (CMC)- $3.1 billion MBIA Municipal Investors Service Corp. (MISC) - $11.2 billion			
Funding Conduits (MTN and CP programs)	4 programs -$9.0 billion Triple-A One Funding- ABCP conduit. Meridian Funding LLC.-MTN conduit Polaris Funding - Inactive MTN conduit MBIA Global:- MTN program that operates as an extension to the GIC business	MTN conduit: $1.6 billion[c] FSA Global Funding Limited	2 MTN conduits structured in QSPE form $1.5 billion Juneau Investments and Aleutian Investments	
Municipal Advisory	MuniServices Company - Operating income in 2003- $1.0 million			
Derivative products[d] (excluding credit derivatives)			Ambac Financial Services LLC and Ambac Capital Services. LLC	
Others	AME[e], conduit sponsored by MBIA (45%), AMBAC(45%) and Radian Re(10%) to participate in leveraged lease transactions	Premier International Funding -Payment undertaker in leveraged lease transactions- $0.3 billion	AMEC[e] conduit sponsored by MBIA (45%), AMBAC(45%) and Radian Re(10%) to participate in leveraged lease transactions	

a. also included in the assets managed by MBIA CMC
b. After elimination of GIC issues to FSA Global and Canadian Global
c. This amount excludes approximately $8.8 billion of exposure eliminated in consolidation and related to defeased transactions where FSA Global Funding and Premier International Funding, each FSA subsidiaries, are counterparties.
d. We view credit derivative products as an extension of their core business with limited incremental risk. They are not part of this special comment.
e. AME is a conduit in runoff mode

Related Research

Special Comment

Moody's Review and 2004 Outlook for the US Financial Guaranty Industry, December 2003, #80778

Impact of FIN 46 on Financial Guarantors, November 2003, #80089

Rating Methodology

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

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Report Number: 87306

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