

Company Reviews

Operating Companies

ACA Financial Guaranty Corp.

Analysts: Richard P Smith, New York (1) 212-438-2095; Robert E Green, New York (1) 212-438-2013

AFFIRMED

CREDIT PROFILE

Fincl strength rtg A
Fincl enhancement rtg A

OUTLOOK: **STABLE**

Rationale

The 'A' financial strength, financial enhancement, and counterparty credit ratings on ACA Financial Guaranty Corp. (ACA) reflect the company's substantially enlarged capital base; its strong result under Standard & Poor's Ratings Services' capital adequacy test for bond insurers; the successful implementation of its simplified, more focused, lower risk business strategy; and its stabilized management team.

In May 2004, Standard & Poor's placed its ratings on ACA on Credit-Watch with negative implications in the wake of the separation of two top officers from the company, which created uncertainty as to whether new capital could be found in a timely manner to meet Standard & Poor's minimum capital requirements. Alan S. Roseman was named president and CEO of ACA that same month, and played a crucial role in successfully raising the new capital in a relatively short period of time and reorganizing and stabilizing the management team. On Sept. 30, 2004, Standard & Poor's removed the ratings from Credit-Watch following the receipt of \$146 million in new policyholder surplus. This capital contribution boosted total statutory capital above Standard & Poor's minimum requirement and also contributed to an acceptable result for ACA in the Standard & Poor's capital adequacy stress test. Operating and financial results in 2005 reflect the successful execution of the company's simplified,

lower risk business strategy. New business origination was strong, particularly in the structured credit segment; CDO assets under management grew substantially; and earnings grew sharply. As of Dec. 31, 2005, ACA's capital and other claims-paying resources totaled \$723.9 million. When measured against a theoretical worst-case loss scenario for the insured portfolio, policyholders' surplus and other claims-paying resources yielded a capital adequacy margin of safety between 1.0x-1.1x. This compares very favorably with Standard & Poor's minimum requirement of 0.8x for an 'A' rated bond insurer.

Outlook

The stable outlook reflects the company's refocused lower risk business plan, its solid positions in each of its three business lines, its sound capital position, and the expectation of continued improvement in the company's market acceptance.

Management And Corporate Strategy

ACA is a Maryland-domiciled financial guarantee insurance company wholly owned by ACA Capital Holdings, Inc. (ACA Holdings), a Delaware incorporated

company. ACA Holdings' current investor group is displayed in table 1.

On May 10, 2006, ACA Holdings filed a registration statement with the SEC for a proposed IPO of the company's shares. While the final details of the offering have yet to be determined, the current plan contemplates an offering during the second half of 2006 of around \$100 million, of which the majority will represent new money. Proceeds to ACA are likely to be retained at the holding company level to maximize the company's ability to support its various activities.

Senior management is headed by Alan S. Roseman, president and CEO, who joined to lead ACA's recapitalization. William Tomljanovic, executive vice president and a veteran of ACA, is head of credit; Ted Gilpin is executive vice president and CFO; Nora Dahlman is managing director and general counsel; and Joseph Pimbley is executive vice president and head of institutional risk management. Ruben Selles, executive vice president (public finance), Laura Schwartz, senior managing director (CDO asset management), and James Rothman, senior managing director (structured credit), run the operating groups.

Table 1 ACA Financial Guaranty Corp. Investor Group

Owner	Number of board seats	% owned
Bear Stearns Merchant Banking	2	34.3
Stephens Group Inc.	1	16.5
Third Avenue Trust	1	15.6
Chestnut Hill Ventures	1	13.6
Aegon USA Inc.	0*	5.0
Others and management	4†	15.0

*Aegon is an observer. †Two board seats from management, two independent.

The company's niche strategy in the municipal market focuses on targeting one-off and smaller transactions, deals with a unique "story," and sectors that are "underserved" by the 'AAA' bond insurers. Student housing, Native American tribal transactions, charter schools, and not-for-profit cultural institutions are some examples of what the company sees as underserved sectors. ACA believes that its target market provides significant opportunities because insurance penetration in this market is significantly lower than the approximate 60% penetration found in the 'AAA' insurers' target market. From a credit quality standpoint, ACA targets issuers with underlying ratings that are either low investment grade or in the 'BB' category.

CDO asset management is one of the core components of ACA's nonmunicipal strategy. The CDO business is structured and managed by ACA subsidiary ACA Management, LLC. The company receives fees for originating and structuring CDOs and managing the financial assets that comprise the CDO. The ability to compete in this business is a function of a company's success in effectively building and managing pools of credit exposures and does not require ACA to insure credit risk. This contrasts with the financial guarantee business, where credit risk is insured and the rating on the insurer is a critical component of that company's ability to compete. The company's specialized staff with appropriate credit and risk-management experience manages the CDOs in terms of asset selection and monitors the credit-worthiness of the underlying issuers. In addition to management fees and structuring revenue, ACA typically assumes a portion of the risk and the residual return associated with the CDO's equity tranche. Within the context of generating acceptable returns, management's goal in this market is to build its investor base by structuring and demonstrating lower credit risk volatility to investors with respect to deals under management. Standard & Poor's has rated all of ACA's CDOs and affirms that this is the approach being utilized.

Several deals include features to mitigate volatility, such as equity return "caps" and cash-flow diversion to achieve over-collateralization requirements. To date, investment banks that have done deals with ACA include Commerzbank, UBS, West LB, CSFB, Banc of America, Citigroup, Merrill Lynch, RBS Greenwich Capital, and Bear Stearns.

Looking ahead, the company has indicated that future business will be less capital-intensive when compared with the historical book of business. For example, of the five deals closed in 2005, ACA purchased equity interests in four in percentages ranging from 10%-24%. This compares with ACA taking 100% of the equity exposure on deals written prior to 2004. The company has also been more selective in assuming warehousing risk in connection with the process of assembling the assets used to fund the CDOs.

In its structured credit business, which was established as a line of business in July 2002, ACA is not an insurer in the traditional sense in the structured finance market. Instead, this business takes primarily 'AAA' credit risk in traded synthetic markets, using an insurance policy as credit support. For example, ACA has had good success assuming exposure to very low risk "super-senior" CDO tranches, where the goal of the counterparty is risk transfer and the associated mark-to-market relief. Active counterparties total 21 and include U.S., European, and Asian banks and U.S. non-bank broker/dealers.

Business Review

ACA has experienced strong growth in the CDO origination/management business, with its affiliates originating 15 CDO transactions through March 2006

Table 2 ACA Financial Guaranty Corp. Business Statistics

(Mil \$)	—Year ended Dec. 31—				
	2005	2004	2003	2002	2001
Net par exposure	21,516.5	11,295.7	8,412.7	6,317.0	5,623.6
Adjusted Gross Premiums Written					
U.S. public finance	36.8	27.0	49.1	45.5	16.4
U.S. asset-backed and other	131.7	44.3	49.5	1.8	2.8
U.S. total	168.5	71.3	98.6	47.3	19.2
International public finance	0.0	0.0	0.0	0.0	0.0
International asset-backed and other	0.3	7.8	0.0	34.1	3.8
International total	0.3	7.8	0.0	34.1	3.8
Total adjusted gross premiums written	168.8	79.2	98.6	81.5	23.0
Net premiums written	86.6	49.4	65.9	49.5	5.5
Gross Par Written					
U.S. public finance	599.6	450.7	1,082.5	875.0	365.6
U.S. asset-backed and other	10,744.1	4,960.0	1,282.2	0.0	0.0
U.S. total	11,343.7	5,410.8	2,364.7	875.0	365.6
International public finance	0.0	0.0	0.0	0.0	0.0
International asset-backed and other	4.5	69.5	486.9	817.6	294.1
International total	4.5	69.5	486.9	817.6	294.1
Total gross par written	11,348.2	5,480.3	2,851.6	1,692.6	659.7
Net par written	11,348.2	3,988.3	2,782.6	1,634.2	654.7

since business line inception in 2002, including one transaction in the first quarter of 2006. Assets under management as of March 31, 2006, totaled \$11.4 billion, up from \$7.8 billion as of Dec. 31, 2004. While ACA's consolidated CDO exposure as of as of March 31, 2006, was \$189.1 million, ACA Financial Guaranty Corp.'s at-risk portion was limited to \$128.4 million due to ongoing pay-downs of the insured funding liabilities. CDO assets consist of investment-grade corporate securities, ABS, and leveraged loans. ACA's goal is to complete three to five transactions per year going forward, managing a portfolio of 15 to 20 on average when the business is fully ramped up. The credit risk associated with the equity exposure is mitigated by business revenue. In the expected case operating environment, structuring, asset management fees, and equity returns are projected to be in excess of the equity exposure, mitigating the equity risk in the sense that equity risk is being "defeased" over time. To estimate losses in the Standard & Poor's capital adequacy model, both CDO risk and revenue are stressed to an 'AAA' level of volatility using Standard & Poor's CDO evaluator technology.

ACA's structured credit insured portfolio totaled about \$14.6 billion in exposure as of Dec. 31, 2005. The capital charge on this business fell to 1.2% in 2005 from about 3.5% a year earlier. The high level of the capital charge in 2004 reflects a substantially deteriorated MBS component of the portfolio, primarily relating to manufactured housing exposure, including some mezzanine tranches. The improvement in 2005 reflects the fact that ACA wrapped about \$10 billion of transactions during the year, most of which were 'AAA' super-senior transactions. The super-'AAA' transactions carry a very low capital charge of 0.10%.

The municipal finance segment has been the slowest to regain prior levels of market acceptance following the company being removed from CreditWatch in September 2004, as investors have slowly

readjusted the trading levels they accorded ACA-insured bonds. Gross insured par in 2005 was \$599.6 million, up 33% from \$450.7 million in 2004 but still well below the levels achieved in 2002 and 2003. The health care and education segments were the greatest contributors to par written during the year.

Speculative-grade exposure at year-end 2005 represented 11.9% of the insured

portfolio, down from 20.7% as of Dec. 31, 2004. The 11.9% overall result is the weighted average of 39.9% for municipal finance and virtually none for structured credit. Across all the product lines, including the CDO asset manager business and products where the company is no longer active such as securitization of manufactured housing loans, the speculative-grade exposure was 11.7% of the portfolio.

Table 3 ACA Financial Guaranty Corp. Insurance Portfolio Statistics

(Mil \$)	2005 industry average % of par	2005 % of par	—Year ended Dec. 31—			
			2005 par	2004 par	2003 par	2002 par
Public Finance						
GO	21.9	2.8	600.0	749.8	659.5	560.5
Utility	9.7	1.4	304.7	283.3	289.2	216.0
Tax-backed	8.8	3.8	820.8	784.6	767.3	623.3
Hospitals	4.7	7.5	1,615.1	1,431.5	1,422.5	1,332.0
Transportation	5.4	2.0	434.5	438.4	409.6	288.8
Colleges and universities	3.2	6.6	1,412.9	1,327.8	1,162.6	947.3
Investor-owned utilities	1.6	0.6	125.3	131.2	131.2	131.2
Housing	1.8	1.3	279.5	237.6	232.7	157.4
Special revenue	0.6	0.5	111.5	37.3	25.8	19.0
Other	3.3	2.1	451.8	545.8	504.0	436.9
Total	61.2	28.6	6,156.1	5,967.4	5,604.4	4,712.4
Domestic Asset-Backed and Corporate Finance						
MBS	4.5	1.1	234.3	265.0	317.5	440.0
Home equity loan	2.9	0.0	8.5	0.0	0.0	0.0
Auto loan	1.8	0.0	0.0	0.0	0.0	0.0
Other consumer asset-backed	1.5	0.0	0.0	0.0	0.0	0.0
Commercial asset-backed	7.0	0.0	0.0	0.0	0.0	0.0
Bank/financial institutions	0.3	0.0	0.0	0.0	0.0	0.0
Other	7.6	66.4	14,289.3	4,151.6	1,179.0	0.0
Total	25.6	67.5	14,532.1	4,416.6	1,496.5	440.0
International						
Public finance	3.4	0.0	0.0	0.0	0.0	0.0
Asset-backed	9.5	0.0	0.0	481.8	1,311.6	1,164.6
Other	0.4	3.8	828.3	429.9	0.0	0.0
Total	13.3	3.8	828.3	911.7	1,311.6	1,164.6
Total net par outstanding	100.0	100.0	21,516.5	11,295.7	8,412.5	6,317.0

Table 4 ACA Financial Guaranty Corp. Financial Statistics

(Mil \$)	—Year ended Dec. 31—				
	2005	2004	2003	2002	2001
Insurance Company*					
Total assets	595.4	540.5	374.1	304.9	238.4
Cash + invested assets	578.6	521.9	342.3	265.5	227.7
Unearned premiums	249.2	209.2	188.0	142.1	104.1
Statutory capital	340.5	326.1	169.3	144.8	120.8
Net premiums earned	46.6	28.2	20.1	11.4	1.6
Losses and LAE	9.4	23.5	0.0	0.0	0.9
Underwriting expense	28.2	22.4	18.6	17.6	22.0
Investment income including gains	19.8	14.9	14.5	14.4	17.9
Net income	20.2	5.9	15.8	8.8	(3.3)
Loss ratio (%)	20.2	83.3	0.0	0.0	56.3
Underwriting profitability ratio (%)¶	19.3	(62.8)	7.5	(54.4)	(1,331.3)
Holding Company (ACA Capital Holdings, Inc.)§					
Total assets	5,798.2	5,680.4	3,468.4	917.0	299.1
Stockholders' equity	384.3	364.9	194.1	158.5	170.9
Net income	28.8	(3.5)	20.8	(7.7)	2.6
Debt and preferred stock/capitalization (%)	17.2	18.0	23.5	9.9	0.0
Return on average equity, annualized (%)	7.7	1.3	0.1	(0.0)	1.8

*Statutory basis of accounting. ¶Underwriting profitability ratio = (net earned premiums - underwriting expenses and losses)/net earned premiums. §GAAP basis of accounting.

Table 5 ACA Financial Guaranty Corp. Capital Statistics

(Mil \$)	—Year ended Dec. 31—				
	2005	2004	2003	2002	2001
Portfolio Risk					
Municipal insurance weighted average capital charge (% of average annual debt service)	66.6	63.6	62.0	67.4	65.6
Asset-backed capital charge (% of par)*	1.2	3.5	4.1	1.1	4.3
Claims-Paying Resources					
Statutory capital	340.5	326.1	169.3	144.8	120.8
Letters/lines of credit	0.0	0.0	0.0	0.0	0.0
Stop-loss treaty	0.0	0.0	10.0	30.0	135.0
Unearned premiums	249.2	209.2	188.0	142.1	104.1
Present value of annual premiums	134.2	68.1	64.7	41.8	22.9
Total	723.9	603.4	432.0	358.7	382.8
Capital Adequacy					
Capital remaining at end of depression test	50-100	N/A	N/A	N/A	N/A
Margin of safety (x)	1.0-1.1	0.9-1.0	0.8-0.9	0.8-0.9	0.8-0.9

*Figures for 2002-2005 exclude CDO equity exposure. N/A—Not applicable.

A total of three insured credits, representing \$76.3 million in par value, were negatively affected by Hurricane Katrina. All are current on their obligations, and no claims are expected at this time.

Surveillance of the outstanding insured municipal portfolio is managed by a managing director with a total staff of six professionals, including a remediation specialist. This level of surveillance resources is appropriate given that the company's business segments require more intensive and more frequent surveillance than is the case across the entire financial guarantee industry. Surveillance for the structured credit business is handled by the institutional risk management group, which also supports the CDO asset management business.

Finances

Statutory financial results in 2005 reflect a substantial increase in premiums earned and a significant decline in losses and loss expenses incurred. On the strength of stronger asset-backed business origination and amortization from the larger unearned premium reserve, premiums earned increased by 65% to \$46.6 million. Underwriting expenses increased by 26% to \$28.2 million, reflecting the growth of the business, and losses and loss expenses incurred were \$9.4 million, down from \$23.5 million in 2004—leading to an underwriting profit of \$9.0 million in 2005 compared with the year-earlier loss of \$17.7 million. Nearly 75% of the losses and loss expenses were related to losses on a portfolio of securitized manufactured housing bonds that were originally insured in 1999. Investment income was \$19.8 million for the year ended 2005, up 33% from 2004 results. Excluding realized gains and losses, investment income was \$20.7 million, up 37% from 2004, reflecting improved cash flow in 2005 and the full-year benefit of the capital infusion completed in the fall of 2004. Cash and investment assets totaled \$578.6 million for the company as of Dec. 31, 2005. The credit quality of ACA's investment portfolio is strongly investment grade. About 72.3%

Table 6 ACA Financial Guaranty Corp. Liquidity Analysis

Assets/Resources as of Dec. 31, 2005	Haircut (%)	Amount (mil \$)
Cash and short-term investments	0.0	46.7
Treasury and government agency fixed-income securities	10.0	177.7
Corporate and ABS/MBS bonds	50.0	194.0
Bank lines of credit	0.0	0.0
Other	100.0	38.5
Total		456.9
Adjusted cash totals after haircut		303.6
Municipal bonds (informational/back-up only)		121.7
Potential Uses (Occurring in the Full Year 2006)		
Largest net total payments in 2006 associated with a municipal obligor default		10.3
Largest net bullet maturity default (potentially includes IOUs, international, or "guaranteed" maturity bonds)		9.4
Largest debt service reserve draw		0.0
90 days of payments associated with the largest servicer default		2.2
Largest financial service obligations, such as largest unscheduled draw on a municipal investment contract		0.0
Largest individual "single name" credit default swap or single name in a defaulted synthetic structure		54.5
Holding company debt and dividend servicing needs		6.5
Other		0.0
Total usage		82.9
Net (assets - usage)		220.7
Liquidity ratio (x)		3.7

of the company investment portfolio is rated 'AAA' and just 1.4% is speculative grade. Additionally, 7.7% of the portfolio falls into the 'AA' category, 11.0% into the 'A' category, and 7.6% into the 'BBB' category. After-tax statutory net income for ACA was \$20.2 million in 2005, up 242% from the \$5.9 million reported in 2004.

Appropriate risk-adjusted pricing also remained in evidence. For the 2005 public finance book of business, the weighted average capital charge was 65.5% and the weighted average premium rate was 3.4%, with a resulting profitability index of 5.2%. While ACA's municipal profitability index is slightly below the levels achieved by 'AAA' primary insurers, the business is at least as profitable because an 'A' rated bond insurer is required to maintain comparatively less capital than an 'AAA' rated bond insurer.

In addition, despite the measured pace at which the market has adjusted its trading levels for ACA-insured bonds following the resolution of its Credit-Watch status in 2004 and in an environment where higher rated bond insurers were facing competitive pressures to lower premium rates, ACA was able to post a municipal profitability index that was higher than the year before.

In the structured finance sector, ACA wrote business in 2005 with an average annual premium rate of 0.18% and an average capital charge of 0.29%, resulting in a profitability index of 63.4%. While well above the results for the structured finance segments of the 'AAA' rated bond insurers, this result is not comparable with their results because of ACA's single focus on very high-quality synthetic tranches of portfolios of predominantly corporate credit risk. This

type of risk is thought to be one of the most profitable for the bond insurers and often exhibits profitability ratios at or above 50%.

Capitalization

As of Dec. 31, 2005, capital and other claims-paying resources totaled \$723.9 million, up 20% from year-end 2004. The year-to-year increase was primarily the result of the strong new business originations, which added to the base of premiums to be earned over the coming years. Statutory capital increased 4% to \$340.5 million. When measured against a theoretical worst-case loss scenario for the insured portfolio, including the equity tranches of the proprietary CDO business and related fee income, capital and other claims-paying resources yielded a capital adequacy margin of safety between 1.0x-1.1x. This compares very favorably with Standard & Poor's minimum requirement of 0.8x for an 'A' rated bond insurer. The margin of safety improved in 2005 from the 0.9x-1.0x range in 2004 on the strength of the strong actual and projected highly profitable new business origination in the structured credit segment, along with a reduction in risk in the CDO origination segment due to ACA's lower participation in the equity tranches. This year's margin of safety result does not benefit from the proposed IPO. ACA intends to manage its capital base to achieve a margin of safety that is close to the minimum 'AA' standard of 1.0x.

ACA's modest ability to pay dividends to its holding company is a restraint that contributes positively to its capital management strategy. As of Dec. 31, 2005, ACA had a negative earned surplus of \$107.2 million, which precludes the payment of extraordinary dividends. On an annual basis, the Maryland insurance commissioner has approved the payment of interest on a \$10 million ACA-issued surplus note held by its parent and dividends sufficient to service a portion of the holding company's debt. Total interest and dividend payments in 2005 were \$2.6 million.

Liquidity for the company's traditional bond insurance operation is consistent

with rating expectations, with cash and very liquid fixed income investments well in excess of the largest theoretical discrete claim payments occurring this year in the municipal and structured credit business lines. Liquid resources as of Dec. 31, 2005, totaled \$304 million, and theoretical payments for 2006 were \$83 million, resulting in a liquidity ratio of 3.66x.

Liquidity necessary to support the CDO

origination/management business has declined due to the reduced equity retention by the company. In 2005, ACA retained a total of \$17.3 million over five transactions. The 2005 issue of \$100 million of medium-term notes due 2010 has allowed the company to pay down many of the equity funding notes that had been used to fund retentions in prior years, freeing up future cash flows and significantly enhancing the company's liquidity profile. ■

Ambac Assurance Corp.

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AFFIRMED

CREDIT PROFILE

Fincl strength rtg	AAA
Fincl enhancement rtg	AAA

OUTLOOK: **STABLE**

Rationale

The 'AAA' financial strength and financial enhancement ratings on Ambac Assurance Corp. reflect the company's:

- Well-defined, yet flexible, financial guarantee business plan;
- Conservative underwriting and risk-management strategies; and
- Solid capital position, strong claims-paying resources, and proactive capital sourcing philosophy.

Ambac has proven its ability over the years to effectively meet the changing environment of the financial guarantee industry. By building capabilities in a number of asset classes and geographic regions, management is able to capitalize on opportunities to grow the business when credit quality and profitability goals can be achieved. In 2005, management capitalized on favorable opportunities primarily in the domestic public finance, asset-backed, and pooled debt markets. Longer term, the strategy is to further expand the company's presence in Europe, to continue to expand into less-competitive public finance sectors in which the company's structuring capabilities can be applied to create value-added business, and to continue to broaden the company's capabilities in the growing global structured finance market.

Conservative risk-management standards are at the foundation of Ambac's financial guarantee underwriting. Though the company has expanded into new securitization structures, asset classes, and public finance sectors, its underwriting staff brings a broad credit background to

the underwriting process. The use of structured finance methodologies enables Ambac to mitigate much of the higher risk associated with its expanded public finance underwriting initiative in order to operate within its conservative underwriting guidelines.

As of Dec. 31, 2005, Ambac's capital and other financial claims-paying resources totaled \$11.8 billion. Solid additions to the contingency reserve, unearned premiums, and the present value of future installment premiums, partially offset by significantly increased dividends to the parent company, enabled claims-paying resources to grow 7% in 2005, more than keeping pace with the 4% growth in par exposure. When measured against a theoretical worst-case loss scenario for the insured portfolio, as well as worst-case losses associated with products offered by financial service affiliates, policyholders' surplus and other claims-paying resources yield a capital adequacy margin of safety between 1.3x-1.4x. This compares favorably with Standard & Poor's minimum requirement of 1.25x for an 'AAA' rated bond insurer.

Outlook

The stable outlook reflects Ambac's strong franchise value, solid capital position, and prudent underwriting strategy.

Management And Corporate Strategy

Ambac's strategy of building and maintaining a staff that has depth and breadth of experience has served it well over the years. From early 2002 to mid-2005, a period of planned transitions and unexpected turnover, Ambac had been able to carry on in a "business as usual" manner with little, if any, sign of disruption or loss of momentum and with little need to reach outside of the organization. The

current senior management team has been in place since mid-2005 and is headed by Robert Genader, chairman, president, and CEO. John Uhlein, executive vice president, is responsible for structured finance, global utilities, and emerging markets. Senior managing directors Kathleen McDonough and Robert Shoback are responsible for public finance, Thomas Gandolfo is responsible for investments and capital market activities as well as Ambac's structured credit (CDO) businesses, and Douglas Renfield-Miller is responsible for international (other than emerging markets) activities and is based in London to heighten Ambac's presence in Europe. David Wallis is responsible for portfolio and market risk management, William McKinnon is responsible for credit risk management, and Kevin Doyle is general counsel. Sean Leonard, formerly a partner with PricewaterhouseCoopers LLP, is senior vice president and CFO. Gregg Bienstock is senior vice president responsible for human resources, global marketing, administration, and technology.

Ambac's corporate strategy is focused on the risk-reward dynamics of the financial guarantee business. Under this strategy, management places more emphasis on acceptable returns than on market share based on par written. Ambac will always seek out those segments that offer the most attractive profitability, but in the current environment where premium levels are under pressure and there may not be a sufficient volume of business that produces target returns, Ambac will be more likely to choose to pass on a deal rather than accept one with marginal profitability.

While much of management's efforts in recent years has centered on the growth of global structured and asset-backed

business and privatization initiatives in Europe, there continues to be a strong push into less-competitive public finance transactions. In this area, management is attempting to de-commoditize domestic public finance through the use of value-added structures. The company bids on and wins some transactions in the lower risk, commodity-like sectors, but these are not a primary focus for the company. Management has found that the less-competitive sectors, such as higher education, military housing, and 501(c)3 organizations, yield better economic results. These sectors offer transactions in which Ambac can add value due to its expertise in structuring, yet the risks associated with the deals are public finance risks. Only the complexity of the deals sets them apart from traditional public finance insurance.

For many years, MBS and home equity have been the largest components of domestic structured finance exposure, reflecting the significant opportunities and explosive growth in the MBS market. While this asset class still represented more than 38% of outstanding segment net par exposure as of Dec. 31, 2005, down from over 45% at the end of 2004, it has declined in relative terms due to significant prepayment activity and as Ambac has broadened its structured finance activities. Domestic structured finance underwriting activities include the auto finance, student loan, structured insurance, credit card receivables, and commercial asset-backed sectors. The auto finance book is weighted toward rental car fleet financing, while the student loan book of business has

shown good growth and is very slow to run off, thereby providing a stable source of premium income. Within the domestic structured finance market, management typically targets large, high-quality seller/servicers.

In terms of international business, management has looked to Europe, Asia/Pacific, and certain emerging markets as providing good growth opportunities. Trends supporting this view within Europe include the privatization of state-owned public services and very strong growth of credit derivatives in the financial institutions community. In addition, there has been a developing fixed income and ABS market since the introduction of the euro with less reliance on banks for financing. In the Asia/Pacific region, markets are less developed and opportunities have been limited to certain niche markets. In Japan, Ambac is a leading insurer in the consumer finance sector, while in Australia the bulk of the opportunities have been in utility financings and privatization-related transactions.

Ambac generally avoids taking direct single-name corporate exposure other than certain regulated utilities, but is comfortable taking indirect diversified corporate exposure through its pooled debt obligations book of business. The pooled debt sector had been a substantial growth area, but new business written declined sharply in 2003 and 2004 as spreads tightened. For 2002, the sector represented 17% of gross par guaranteed during the year and 14% of year-end exposure. By 2004, the segment had dropped to 6% of new business but rebounded to 13% of new business written in 2005. At year-end 2005, reflecting the reduced level of new business written over the past few years and significant maturities of outstanding transactions in 2005, pooled debt obligation exposure represented less than 10% of total net par exposure, one of the lower concentrations among the leading bond insurers. Exposure is assumed through credit enhancement to diversified pools of corporate risk that are tranching to provide a significant level of first-loss protection

Table 1 Ambac Assurance Corp. Consolidated Business Statistics

(Mil \$)	—Year ended Dec. 31—				
	2005	2004	2003	2002	2001
Net par exposure	479,084.0	459,432.0	425,854.0	379,211.0	318,043.0
Adjusted Gross Premiums Written*					
U.S. public finance	613.0	566.0	732.0	633.0	407.0
U.S. asset-backed and other	417.0	355.0	392.0	361.0	268.0
U.S. total	1,030.0	921.0	1,124.0	994.0	675.0
International public finance	122.0	137.0	202.0	61.0	139.5
International asset-backed and other¶	98.0	230.0	163.0	245.0	159.5
International total	220.0	367.0	365.0	306.0	299.0
Total adjusted gross premiums written	1,249.0	1,288.0	1,489.0	1,299.0	974.0
Net premiums written	966.0	977.0	1,006.0	790.0	588.0
Gross Par Written					
U.S. public finance	57,551.0	48,668.0	45,095.0	45,009.0	34,763.0
U.S. asset-backed and other	55,051.0	49,339.0	48,134.0	46,167.0	34,193.0
U.S. total	112,602.0	98,007.0	93,229.0	91,176.0	68,956.0
International public finance	4,262.0	4,157.0	3,666.0	1,193.0	3,076.0
International asset-backed and other	8,414.0	15,942.0	18,444.0	24,008.0	18,101.0
International total	12,676.0	20,099.0	22,110.0	25,201.0	21,177.0
Total gross par written	125,278.0	118,106.0	115,339.0	116,377.0	90,133.0
Net par written	116,563.0	117,253.0	102,582.0	106,115.0	82,947.0

*Adjusted gross premiums written include up-front and present value of installment premiums. ¶Includes structured credit derivatives with domestic exposure.

that must be completely used up before the company would pay a claim. Typically, at inception, the tranches of pooled corporate transactions where Ambac provides enhancement are rated at least 'AAA', with few exceptions at 'AA', and many are actually super-'AAA'. A periodic review of the company's pooled debt

exposure shows that, although there had been some deterioration in the protection supporting Ambac in a few of the transactions, the remaining levels of protection are still very strong. Potential claims from this segment of the business should be limited unless the economy slips into a deep, extended period of weakness.

Ambac's single-risk management is conservative with existing exposures well within regulatory standards and rating agency guidelines. In municipals, the company is willing to take larger single-name exposures where the credit is an essential service and has a solid rating. It is willing to take larger exposures rela-

Table 2 Ambac Assurance Corp. Consolidated Insurance Portfolio Statistics

(Mil \$)	2005 industry average % of par	2005 % of par	—Year ended Dec. 31—			
			2005 par	2004 par	2003 par	2002 par
Public Finance						
GO	21.9	12.1	57,982.0	49,394.0	44,350.0	41,359.0
Utility	9.7	7.7	36,872.0	36,321.0	33,598.0	33,289.0
Tax-backed	8.8	8.5	40,787.0	35,671.0	28,281.0	25,323.0
Hospitals	4.7	5.7	27,143.0	23,977.0	22,120.0	20,675.0
Transportation	5.4	5.0	23,718.0	21,188.0	18,244.0	15,218.0
Colleges and universities	3.2	4.2	20,054.0	18,056.0	15,778.0	14,138.0
Investor-owned utilities	1.6	3.4	16,398.0	15,449.0	14,480.0	14,285.0
Housing	1.8	2.1	10,152.0	9,163.0	9,014.0	8,345.0
Special revenue	0.6	0.0	0.0	0.0	0.0	0.0
Other	3.3	9.9	47,358.0	45,928.0	43,929.0	40,518.0
Total	61.2	58.7	280,464.0	255,147.0	229,794.0	213,150.0
Leases contained in above	4.7	8.7	41,802.0	40,340.0	38,050.0	34,795.0
Domestic Asset-Backed and Corporate Finance						
MBS	4.5	8.0	38,436.0	35,241.0	24,928.0	12,661.0
Home equity loan	2.9	2.3	11,021.0	17,907.0	25,891.0	36,601.0
Auto loan	1.8	2.6	12,246.0	8,005.0	5,676.0	4,411.0
Other consumer asset-backed	1.5	4.3	20,529.0	18,509.0	17,678.0	14,537.0
Commercial asset-backed	7.0	8.1	38,659.0	30,373.0	28,515.0	27,434.0
Bank/financial institutions	0.3	0.4	1,721.0	1,761.0	1,255.0	1,103.0
Other	7.6	1.1	5,342.0	5,210.0	5,701.0	1,590.0
Total	25.6	26.8	127,954.0	117,006.0	109,644.0	98,337.0
International						
Public finance	3.4	3.6	17,083.0	14,908.0	11,579.0	7,646.0
Asset-backed	9.5	11.2	53,489.0	71,247.0	74,499.0	59,757.0
Other*	0.4	0.0	94.0	1,124.0	338.0	322.0
Total	13.3	14.8	70,666.0	87,279.0	86,416.0	67,725.0
Total net par outstanding	100.0	100.0	479,084.0	459,432.0	425,854.0	379,211.0

*Includes structured credit derivatives with domestic exposure.

tive to its capital for structured financings where the expected loss-given default is a low percent of par insured.

Business Review

Ambac reported a modest increase in originations in 2005, with gross par written up 6% to a record \$125.3 billion. Gains in U.S. public finance and U.S. structured finance, up 18% and 12%, respectively, offset a 37% drop in international originations. International public finance originations were off just 3%, while international structured finance originations fell 47%. For the first time since 2001, gross par written in the U.S. public finance sector exceeded par written in the U.S. asset-backed sector. This current relationship can be attributed to a strong year in domestic public finance par issuance volume and

high insurance penetration in that market, combined with slower growth in structured finance. Longer term, the relative contribution of public finance par written to the total might decrease as domestic structured finance and international become more prominent due to their higher growth potentials. Still, Ambac's emphasis on the less-competitive sectors of domestic public finance does not appear to have inhibited growth opportunities.

With regard to domestic public finance, those sectors with the greatest year-to-year percent increase were investor-owned utilities, housing, health care, and transportation. In addition to investor-owned utilities and health care, the lease and tax-backed and GO sectors were the significant contributors to the year-to-year increase in dollar volume of new

transactions. On the downside, the utility sector posted significant year-to-year percent and dollar-volume declines. Overall, premium pricing was soft in the public finance sector for the second year in a row. Current pricing levels are roughly midway between the peak reached in 2003 and the trough of 1997. Credit quality remains sound, however, averaging solidly in the 'A' category.

Growth in Ambac's domestic structured finance segment was the result of significant year-to-year percent and dollar-volume gains in the pooled debt sector, offset by a decline in the mortgage-backed and home equity sector. The asset-backed and conduits sector was another significant contributor to the year-to-year increase in dollar volume of new transactions. Reflecting industry conditions, pricing was soft in this segment as well for the second consecutive year, reversing a trend of several years of improvement that peaked in 2003. Current pricing levels are at the low end of the range of yearly results since 2000. This period is appropriate for comparison since annual production in these years included a meaningful component of pooled corporate obligations, which typically exhibit very favorable pricing levels. Results prior to 2000 are not as comparable because there was not a significant volume of pooled corporate obligations in the business mix.

The international business is dominated by large deals that account for a significant proportion of any year's originations. This results in annual results that can vary considerably from year to year based on when a small number of large transactions are completed. Ambac has been building international staff to allow it to fully participate in the substantial opportunities it foresees in Europe, particularly in the U.K. (infrastructure) but increasingly on the continent (structured finance and infrastructure) and in Asia (Japan and Australia). In 2005, Ambac opened an office in Milan, Italy, to continue its expansion in Europe and broaden its market reach and geographic presence. The company is very selective regarding emerging markets risk, focusing primarily

Table 3 Ambac Assurance Corp. Consolidated Financial Statistics

(Mil \$)	—Year ended Dec. 31—				
	2005	2004	2003	2002	2001
Insurance Company*					
Total assets	9,122.1	8,439.9	7,353.7	6,195.5	5,380.5
Cash + invested assets	8,948.4	8,307.3	7,234.7	6,101.2	5,294.8
Unearned premiums	3,187.0	2,948.1	2,627.4	2,209.5	1,860.0
Statutory capital	5,693.0	5,264.7	4,526.0	3,736.3	3,261.9
Net premiums earned	770.1	665.3	600.9	456.6	353.6
Losses and LAE	73.1	81.0	36.7	33.5	(1.9)
Underwriting expense	124.0	109.4	83.7	77.8	72.4
Investment income including gains	387.8	435.9	367.0	337.0	274.8
Net income	697.0	676.7	598.0	502.1	410.0
Loss ratio (%)	9.5	12.2	6.1	7.3	(0.5)
Underwriting profitability ratio (%)¶	74.4	71.4	80.0	75.6	80.1
Holding Company (Ambac Financial Group, Inc.)§					
Total assets	19,725.1	18,749.6	16,747.3	15,355.5	12,267.7
Stockholders' equity	5,372.2	5,024.5	4,254.6	3,625.2	2,984.0
Net income	751.0	724.6	618.9	432.6	433.0
Debt/capitalization (%)	18.2	13.6	15.7	14.5	17.1
Return on average equity (%)	14.4	15.6	15.7	13.1	15.5

*Statutory basis of accounting. ¶Underwriting profitability ratio = (net earned premiums - underwriting expenses and losses)/net earned premiums. §GAAP basis of accounting.

on transactions where sovereign risk is either structurally minimized (future flow transactions) or is otherwise addressed (for example, requiring the participation of a multilateral financial agency).

Compared with year-end 2001, net par outstanding at year-end 2005 in the international finance segment, excluding the pooled debt obligation sector, grew 119%, powering Ambac's overall 51% growth in net par outstanding over this period. The global pooled debt sector and the domestic asset-backed segment each grew 53% over this time frame. Despite a generally robust market, the domestic finance segment grew only 48%. Going forward, the international business is expected to continue to offer the greatest opportunities for growth.

Ambac's speculative-grade exposure was \$5.1 billion as of Dec. 31, 2005, up 12% from the \$4.5 billion reported a year earlier. The year-to-year change is primarily the result of the negative effects of Hurricane Katrina and deteriorating credit quality in the airline industry, which affected both enhanced equipment trust certificate transactions and one airport-related transaction, offset by the maturity of a large international pooled debt obligation. The combined par value of transactions affected by these three factors exceeds the total year-to-year change in speculative-grade exposure. The U.S. investor-owned utilities sector experienced positive credit quality development while the mortgage-backed and home equity sector declined due to prepayments. Hurricane Katrina-related exposure included above was \$368 million, primarily GO bonds, which represented about two-thirds of the total increase in speculative-grade exposure. Total speculative-grade exposure was equal to 1.1% of net par outstanding, or 89% of statutory capital compared with 1.0% at the end of 2004.

The global pooled debt segment, which received heightened attention in years past as corporate credit quality was under pressure, has performed well. Speculative-grade exposure at year-end 2005 was less than \$384 million, down from just under \$1 billion a year earlier. The 2005 amount represents 7.6% of the total speculative-grade

exposure, or 0.8% of the \$45.9 billion of pooled debt obligations outstanding. The level of speculative-grade exposure in this segment is less than the overall percent of speculative-grade exposure across the entire book of business. Moreover, this segment has the highest credit quality profile of any of the various sectors in which Ambac participates; in the past several years, new pooled debt originations have been structured to achieve predominantly 'AAA' underlying ratings.

Affiliates

Over the past several years, there has been little emphasis on the growth of Ambac's financial services businesses. Management continues to focus primarily on the growth of the global capital markets and the role of financial guarantees and Ambac within these markets. Nevertheless, there is still an effort to cross-sell the products offered by the financial services business units and to seek more ways to improve the operating efficiency of these businesses. Ambac's affiliate financial services business lines include investment agreements, along with inter-

est-rate and currency swaps offered through the following:

- Ambac Capital Funding Inc. provides investment agreements to municipal and structured finance issuers and had total guaranteed investment agreements outstanding of \$6.4 billion as of Dec. 31, 2005.
- Ambac Financial Services LLC and Ambac Capital Services, LLC provide interest-rate, currency, and total return swaps to municipal and structured issuers with a notional amount outstanding of \$17.2 billion as of Dec. 31, 2005. Ambac hedges certain risks with professional counterparties, and such hedge amounts are excluded from the notional amount shown above.

While the investment agreement and interest-rate and currency swap businesses benefit from solid management and conservative risk-management systems and procedures, they are nonetheless inherently riskier than financial guarantee insurance. They also generate capital charges that, for the investment-agreements business, are higher-than-average municipal and asset-backed capital charges. This

Table 4 Ambac Assurance Corp. Consolidated Capital Statistics

(Mil \$)	—Year ended Dec. 31—				
	2005	2004	2003	2002	2001
Portfolio Risk					
Municipal insurance weighted average capital charge (% of average annual debt service)	13.7	13.6	13.5	13.3	13.1
Asset-backed capital charge (% of par)	2.0	1.9	1.7	1.9	2.2
Claims-Paying Resources					
Statutory capital	5,693.0	5,264.7	4,526.0	3,736.3	3,261.9
Contingent capital	800.0	800.0	800.0	800.0	800.0
Stop-loss treaty	0.0	0.0	0.0	0.0	0.0
Unearned premiums	3,187.0	2,948.1	2,649.3	2,209.5	1,860.0
Present value of annual premiums	2,165.9	2,059.8	1,555.6	1,342.2	987.8
Total	11,845.8	11,072.6	9,530.9	8,088.1	6,909.7
Capital Adequacy					
Capital remaining at end of depression test	3,500-3,550	3,700-3,750	2,700-2,750	2,300-2,350	2,100-2,150
Margin of safety (x)	1.3-1.4	1.4-1.5	1.3-1.4	1.3-1.4	1.3-1.4
Reliance on soft capital (%)	13.6	11.4	11.7	17.3	18.7

occurs because the principal risk of worst-case market value declines for investment agreement financial instruments are more severe relative to worst-case credit default scenarios for investment-grade credits in the Ambac-insured portfolio. The swaps company relies on Ambac sureties for purposes of achieving 'AAA' counterparty status. Therefore, the capital charge is derived from swap credit exposure, which is included in Ambac's insured net par.

Finances

Adjusted gross premiums written fell 3% to \$1.25 billion in 2005. International asset backed was the weakest sector, down 57%, more than offsetting 17% and 8% gains in U.S. asset backed and U.S. public finance, respectively. The international

public finance sector was down as well, falling 11%. For the second year in a row, adjusted premiums declined despite an increase in gross par written. This adverse trend is primarily the result of heightened pricing competition that has resulted from lower market growth, a greater number of competitors, and tight credit quality spreads in several markets. Relative to the universe of 'AAA' rated bond insurers, the decline in the relationship of premium charged to risk assumed at Ambac was moderately less severe. For example, in the U.S. public finance sector the profitability index for Ambac, which relates premium rates to risk assumed, was off 8% in 2005 compared with 2004, versus a 13% decline for the industry. The deterioration in the price-for-risk relationship was

observed across the industry in all sectors; nevertheless, current price levels still generate acceptable returns on investment.

In 2005, Ambac reported a 21% increase in statutory underwriting income, to \$573.1 million, on the strength of a 16% increase in premiums earned, to \$770.1 million, and a 10% decline in losses and loss expenses incurred, to \$73.1 million. Loss expenses were lower in 2005 due to the absence of a large reserve taken in 2004 on an enhanced equipment trust obligation, partially offset by reserve additions on health care and public finance transportation issues. Loss expenses in 2005 included a minimal amount of case-basis reserves related to issuers affected by Hurricane Katrina. Under GAAP accounting, which currently allows for the booking of loss reserves where losses are likely but do meet the case-basis standard of "probable and estimable," Ambac took a \$91.5 million loss reserve for future losses on Katrina-affected issuers. To date, Ambac has paid a small number of claims and has received full reimbursement.

Although the statutory expense ratio rose from a very low 11.3% in 2004 to 12.8% in 2005, it is still the lowest in the industry. With the higher cost to originate structured finance sector rising to represent a greater portion of adjusted premiums written and with Ambac continuing to add staff to support the expected growth in Europe, it is understandable that the expense ratio would rise. Ambac has been the most cost efficient of the major bond insurers for many years.

Ambac's stream of net investment income remains secure, as the high-quality, consolidated \$8.9 billion investment portfolio is conservatively invested in fixed-income assets, of which 85% are rated 'AAA'. Included in the 'AAA' total are \$54 million of securities, or 0.6% of the portfolio, that have been insured by Ambac. Net investment income, including realized gains and losses, fell 11% to \$387.8 million. The decline in investment income was primarily the result of lower investment yields and fewer realized gains. Ambac reported statutory net income of \$697 million in 2005, up 3%.

Table 5 Ambac Assurance Corp. Consolidated Liquidity Analysis

Assets/Resources as of Dec. 31, 2005	Haircut (%)	Amount (mil \$)
Cash and short-term investments	0.0	369.7
Treasury and government agency fixed-income securities	10.0	2,160.1
Corporate and ABS/MBS bonds	50.0	186.9
Bank lines of credit	0.0	400.0
Other	100.0	114.4
Total		3,231.1
Adjusted cash totals after haircut		2,807.2
Municipal bonds (informational/back-up only)		6,223.7
Potential Uses (Occurring in the Full Year 2006)		
Largest net total payments in 2006 associated with a municipal obligor default		161.1
Largest net bullet maturity default (potentially includes IOUs, international, or "guaranteed" maturity bonds)		50.0
Largest debt service reserve draw		250.2
90 days of payments associated with the largest servicer default		168.2
Largest financial service obligations, such as largest unscheduled draw on a municipal investment contract		192.8
Largest individual "single name" credit default swap or single name in a defaulted synthetic structure		40.0
Holding company debt and dividend servicing needs		136.0
Other		0.0
Total usage		998.3
Net (assets - usage)		1,808.9
Liquidity ratio (x)		2.8

Capitalization

Ambac's existing capital resources, future earnings, and cash flow generated a solid margin of safety when stressed in Standard & Poor's Ratings Services' capital adequacy model. The company's 2005 margin of safety reverted back to the 1.3x-1.4x range from the 1.4x-1.5x range reported for 2004. Ambac has carefully managed its capital adequacy over the years, generally reporting margins of safety solidly in the 1.3x-1.4x range. In that context, the return to the 1.3x-1.4x range in 2005 is more in keeping with the company's longer term strategy rather than a decline that signals a capital adequacy weakness. The decline in Ambac's margin of safety is due to higher capital charges in both the global municipal and structured finance businesses and a greater reduction in capital due to dividends paid to the parent, net of capital infusions, in 2005 versus 2004. The margin of safety expresses the relationship between theoretical losses generated in the capital adequacy model and capital remaining at the end of the theoretical depression. Ambac's margin of safety exceeds Standard & Poor's 'AAA' 1.25x minimum requirement for an 'AAA' rated company.

In 2005, dividends exceeded capital contributions by \$137 million, whereas in 2004 the comparable number was \$25 million. The higher dividends in 2005 were used by the parent company to return funds to shareholders by repurchasing common stock, reflecting an envi-

ronment where slower expected growth than in the past led to opportunities to repurchase shares at a price significantly below adjusted book value. Ambac has proactively managed its capital position over time, raising or returning capital as conditions warrant.

Regarding the use of contingent capital, Ambac's 13.6% reliance-on-soft-capital ratio remains well in compliance with Standard & Poor's 'AAA' maximum requirement of 33.0% and is below typical industry usage, which averages in the mid-teens. One of the reasons why Ambac's reliance on soft capital is below the industry average is that the company has taken back business previously ceded to certain reinsurers. Typically, Ambac has the right to take business back if a reinsurer is downgraded. In 2004, Ambac took back \$8.5 billion of par exposure that had been ceded to Axa Re Finance S.A. and American Reinsurance Co., and in 2005 Ambac took back \$6.5 billion of par exposure ceded to Radian Asset Assurance Inc. to avoid an undue concentration of exposure to a particular reinsurer. In early 2006, Ambac took back an additional \$3.9 billion of par exposure from Axa Re Finance S.A. and American Reinsurance Co.

A significant component of Ambac's claims-paying resources are \$800 million of asset-backed capital commitment securities. Auction-rate market securities—issued under the names of Dutch Harbor Finance Sub-Trusts I, II, III, and IV and Anchorage Finance Sub-Trusts I,

II, III, and IV—were sold to create pools of funds that are available for the purchase of preferred stock that will be issued by Ambac at its discretion. The structure and operating constraints of the transactions eliminate market value risk and minimize credit risk in the asset pool. Key strengths of these arrangements include their perpetual nature, the absence of restrictions governing when Ambac can draw funds or how much can be drawn (subject to the facility limit), and the funded nature of the agreements that eliminates concerns regarding the willingness and ability of a third party to perform.

Standard & Poor's reviews a bond insurer's cash position and its ability to raise additional cash against conservatively defined theoretical payments associated with a company's various product lines. The approach to this analysis is that there could be unexpected liquidity demands on an insurer in periods of economic tranquility as well as stress. Liquidity resources and potential liquidity demands are examined for the current year and several subsequent years.

Ambac's liquidity ratio as of Dec. 31, 2005, was 2.81x, well in excess of what is thought to be prudent for a bond insurer. Liquid resources totaled \$2.8 billion available for year-end 2005. Of this, \$400 million was existing lines of credit. Against these resources, Ambac has theoretical payments in 2006 totaling \$1 billion. ■

Assured Guaranty Corp.

Analysts: Robert E Green, New York (1) 212-438-2013; Richard P Smith, New York (1) 212-438-2095

AFFIRMED

CREDIT PROFILE

Fincl strength rtg	AAA
Fincl enhancement rtg	AAA

OUTLOOK: **STABLE**

Rationale

The 'AAA' rating on Assured Guaranty Corp. (AGC) reflects improving direct business results, a strong capital position, and conservative underwriting standards. AGC's revised business plan involves transitioning to a direct financial guarantor from predominately a financial guarantee reinsurer. Direct adjusted gross premiums written in 2005 totaled \$127 million, compared with \$69 million in 2004. In the asset-backed market, which accounted for 80% of 2005 adjusted gross premiums written, progress is also being made with respect to diversifying by asset type and internationally. In the public finance market, in part because of AGC's split credit rating, the company remains a niche player in sectors less favored by the established 'AAA' companies, although progress is being made here as well. The risk profile of the insured portfolio is not significantly different from 'AAA' industry norms. The weighted average capital charge for the public finance book of business is 12.4% as of Dec. 31, 2005, compared with the industry average public finance capital charge of 11.7%. The company's year-end 2005 weighted average asset-backed capital charge for the entire book of business is 1.4%, down from 1.6% a year earlier. The weighted average asset-backed capital charge for the industry as of Dec. 31, 2005, is 1.83%. Total claims-paying resources were \$1.6 billion as of year-end 2005, a roughly 5% decline from the previous year. The decline is mostly related to the second-quarter 2005 transfer of \$19.4 bil-

lion of Financial Security Assurance Inc. (FSA) reinsurance business from AGC to sister reinsurance company Assured Guaranty Re Ltd. (AGRe). The company's margin of safety as of Dec. 31, 2005, falls in a range of 1.5x-1.6x, which is in excess of the Dec. 31, 2005, industry average of 1.4x-1.5x. The margin of safety expresses the relationship of theoretical losses occurring during a severe stress modeling exercise to capital remaining at the end of the modeling period.

Outlook

The stable outlook is based on strong capitalization at the rating level, conservative investment policy, conservative underwriting, and expected improvement in direct production.

Management And Corporate Strategy

AGC had good success in 2005 with respect to the organizational transition associated with holding company AGRe's dual-product strategy. First, using AGC's 'AAA' platform, the company intends to expand the direct financial guarantee business beyond its historical focus on credit derivatives and into the traditional financial guarantee markets. AGC has concurrently stopped accepting new reinsurance business in all but very unusual circumstances. AGC is licensed in 48 states, the District of Columbia, and Puerto Rico. The second aspect of the plan is to direct new reinsurance opportunities, and transfer existing reinsurance business whenever possible, to sister 'AA' reinsurance companies Assured Guaranty Re International Ltd. and Assured Guaranty Re Overseas Ltd., together known as AGRe. The 'AA' platform is more suited to the reinsurance line, as this product can be susceptible to adverse selection, is dependent on a relatively few ceding com-

panies, and is generally less profitable than direct financial guaranty business. AGC plans to cede about one-third of its annual production to AGRe. With a combined statutory capital base of about \$1.5 billion, AGC and AGRe together have reasonable single-risk capacity. In the second half of 2005, the transition was substantially hastened when about \$19.4 billion of reinsurance ceded by FSA to AGC was transferred to AGRe.

CEO Dominic Frederico, formerly vice chairman at ACE Limited, heads the companies that now comprise Assured Guaranty Ltd., and, along with CFO Robert Mills, actively participates in the management of the various subsidiaries. At the AGC level, Michael Schozer, president, formerly a managing director responsible for structured finance and credit derivatives at Ambac Assurance Corp., heads the management team.

The company's product mix was also modified in connection with the company's IPO on April 28, 2004. Previously, Assured Guaranty Ltd. was 100% owned by ACE Limited. Following the IPO, Assured Guaranty Ltd. is now 65% owned by the public and 35% by ACE Limited. In connection with AGC's new strategic focus on direct financial guaranty business, the company eliminated two product lines that had previously been meaningful contributors to its operations but were not consistent with an 'AAA' risk profile. The trade credit business that AGC began to write for its own account beginning in 2002 has been reinsured to a subsidiary of ACE Limited. AGC is no longer underwriting this line. The single-name corporate swap business was put into runoff in April 2003 and the risk has mostly been transferred to outside counterparties.

Industrywide volume is currently constrained by tight credit spreads, a very

competitive environment, and investor demand for senior-subordinated structures. However, AGC does not seem to be sacrificing underwriting quality to gain business, as demonstrated by the relationship of average premium rates charged in 2005 compared with the risk of the business. Management recognizes that a poor credit decision, especially at this juncture, could be damaging to the company. In addition to the current difficult spread and competitive environments, AGC's unique, principal challenge remains the fact that another rating agency has assigned the company a financial strength rating below 'AAA'. This rating split has a negative effect on market acceptance and the trading value of the company's bonds. This is especially true in the public finance market. Having only entered the direct financial guaranty business in 2004, AGC continues to ramp up its public finance capabilities. As of January 2006 the company had 11 full-time professionals in the public finance group, up from seven as of year-end 2004. Kathy Evers is the managing director in charge of AGC's public finance group. Ms. Evers was a senior analyst at Financial Guaranty Insurance Co. (FGIC) on its public finance underwriting team. William Dorante is a managing director in AGC's public finance group, with responsibility for managing the company's West region. Mr. Dorante has been involved in the public finance and financial services markets for more than 15 years, and was also an analyst at FGIC. William Hogan is a managing director with responsibility for the health care, investor-owned utilities, and domestic project finance sectors. He has previously worked at FSA. John Trahan, hired in 2006, is a managing director with responsibility for the East region. He has 18 years of public finance experience, most recently as director at BNP Paribas.

A comprehensive investor outreach program is headed by Patrick Early, previously vice president and manager of municipal bond research for A.G. Edwards and Sons. Patrick reports to Michael Schozer, president of AGC. The investor outreach has resulted in an increase in the number of investors and broker dealers, especially

regional dealers, who have approved for investment bonds wrapped by AGC. Nevertheless, the split rating situation limits the company's competitive position in the public finance market. Some institutional

investors simply, as a matter of policy, require straight 'AAA' ratings from the two major rating agencies.

In the public finance market, AGC insured-bonds continue to trade "wide"

Table 1 Assured Guaranty Corp. Business Statistics

(Mil \$)	—Year ended Dec. 31—				
	2005	2004	2003	2002	2001
Net par exposure	52,659.0	74,001.0	78,399.0	72,259.0	69,185.0
Adjusted Gross Premiums Written*					
U.S. public finance	23.5	56.5	79.5	70.1	58.4
U.S. asset-backed and other	75.1	73.9	89.2	102.9	86.1
U.S. total	98.6	130.3	168.7	173.0	144.5
International public finance	9.9	23.6	11.4	5.4	0.6
International asset-backed and other	27.7	18.5	19.8	7.7	9.1
International total	37.6	42.1	31.2	13.1	9.7
Total adjusted gross premiums written	136.2	172.4	199.9	186.1	154.2
Net premiums written	92.5	59.9	256.5	150.0	87.7
Gross Par Written					
U.S. public finance	1,076.6	3,022.3	4,572.1	7,271.7	7,226.4
U.S. asset-backed and other	12,739.6	12,947.8	7,526.1	9,335.9	7,675.6
U.S. total	13,816.1	15,970.0	12,098.2	16,607.5	14,902.0
International public finance	500.7	1,240.5	660.2	385.0	362.7
International asset-backed and other	2,799.7	596.2	1,853.2	907.2	3,099.2
International total	3,300.4	1,836.8	2,513.4	1,292.3	3,461.9
Total gross par written	17,116.5	17,806.8	14,611.6	17,899.8	18,363.9
Net par written	10,737.0	7,645.5	14,587.0	16,731.5	13,953.0

*Adjusted gross premiums written include up-front and present value of installment premiums and exclude trade credit.

Table 2 Assured Guaranty Corp. Par By Source

Year Ended Dec. 31, 2005		
(Mil \$)	Gross par in force	Gross par written
Direct	39,131.0	16,969.0
Ambac Assurance Corp.	7,061.0	0.0
Financial Guaranty Insurance Co.	7,750.0	0.0
Financial Security Assurance Inc.	403.0	131.0
MBIA Insurance Corp.	14,411.0	17.0
Other	124.0	0.0
Total	68,880.0	17,117.0

(at higher yields) versus the mature 'AAA' bond insurers. This differential, related to its split rating, makes it difficult for AGC to compete on 'A' or better rated municipal transactions in both the competitive and negotiated markets. Instead, AGC focuses its efforts on negotiated transactions in certain sectors, including health care, private higher edu-

cation, special assessment/municipal utility districts, and municipal certificates of participation. Most transactions are rated near 'BBB', although some health care system transactions and municipal certificates of participation have been rated 'A' or higher. AGC has differentiated itself with a willingness to underwrite smaller transactions in the \$12 million-

\$15 million range and one-off transactions. Management reports that progress has been made in the area of trading value for fixed-rate transactions, where its bonds trade about 15 basis points higher than the mature 'AAA' bond insurers. In comparison, management feels that this spread was about 25 basis points one year ago.

Table 3 Assured Guaranty Corp. Insurance Portfolio Statistics

(Mil \$)	—Year ended Dec. 31—					
	2005 industry average % of par	2005 % of par	2005 par	2004 par	2003 par	2002 par
Public Finance						
GO	21.9	9.2	4,861.0	9,124.8	10,606.0	10,182.0
Utility	9.7	9.4	4,942.0	9,166.9	11,440.0	10,790.0
Tax-backed	8.8	5.9	3,093.0	8,199.6	8,407.0	7,510.0
Hospitals	4.7	5.0	2,655.0	3,911.8	6,272.0	6,323.0
Transportation	5.4	6.2	3,268.0	5,031.7	5,383.0	5,547.0
Colleges and universities	3.2	1.2	629.0	798.5	882.0	841.0
Investor-owned utilities	1.6	1.8	944.0	1,100.2	1,357.0	1,311.0
Housing	1.8	0.8	396.0	961.5	937.0	878.0
Special revenue	0.6	0.0	0.0	0.0	0.0	0.0
Other	3.3	0.9	476.0	594.4	309.0	140.0
Total	61.2	40.4	21,264.0	38,889.6	45,593.0	43,522.0
Leases contained in above	4.7	3.3	1,763.0	3,514.0	3,902.0	3,717.0
Domestic Asset-Backed and Corporate Finance						
MBS	4.5	9.5	4,980.0	1,943.5	1,695.0	2,855.0
Home equity loan	2.9	0.0	0.0	6,007.6	1,920.0	489.0
Auto loan	1.8	0.7	366.0	959.4	1,395.0	1,667.0
Other consumer asset-backed	1.5	2.6	1,392.0	2,077.9	2,416.0	2,363.0
Commercial asset-backed	7.0	32.0	16,841.0	15,687.5	17,498.0	11,509.0
Bank/financial institutions	0.3	0.1	32.0	57.0	231.0	774.0
Other	7.6	1.0	523.0	841.8	2,078.0	3,295.0
Total	25.6	45.8	24,134.0	27,574.7	27,233.0	22,954.0
International						
Public finance	3.4	4.2	2,236.0	3,041.0	2,336.0	1,872.0
Asset-backed	9.5	8.1	4,250.0	3,815.0	2,208.0	2,375.0
Other	0.4	1.5	776.0	681.2	1,028.0	1,536.0
Total	13.3	13.8	7,261.0	7,537.2	5,572.0	5,783.0
Total net par outstanding	100.0	100.0	52,659.0	74,001.4	78,399.0	72,259.0

AGC has had better success in the U.S. asset-backed market, where investors are somewhat less rating sensitive. Success has been demonstrated in terms of volume growth, sector diversification and, according to the company, improvement with respect to trading value differentiation. In 2005, 64% of direct transactions were financial guaranty executions, with the balance via credit default swaps. Financial guaranty execution is up from 54% in 2004.

AGC's mortgage and asset-backed group is headed by Stephen Donnarumma, managing director, formerly with FGIC. Paul Livingstone, previously with Ambac Assurance Corp., heads the CDO and structured credit group. The transactions closed in 2005 were a more diverse mix of cash flow CLOs, trust-preferred CDOs, middle-market CLOs, market value CLOs, and super-senior synthetic CDOs. The company's goal in this sector is to focus on primary deals in all categories in order to be among the top monolines in this sector. In the ABS market, AGC was able to broaden its underwritings with transactions closed in the rail car, fleet auto, equipment lease, and future-flow categories. The company also successfully closed its first Regulation XXX transaction and excess SIPC transaction. In the MBS market, the company closed its first prime home equity loan transaction.

The company's international business platform is 'AAA' rated subsidiary Assured Guaranty (UK) Ltd. This company is authorized to write financial guaranty insurance in the U.K. by The Financial Services Authority. The company has also received authority to conduct business in other European Economic Area jurisdictions on a passported basis. The rating is based on the close operational and financial ties of the company with its parent company Assured Guaranty Corp., including firmwide risk-management regimes, underwriting support provided by the parent, strong financial support in the form of quota-share and excess-of-loss reinsurance, and a net-worth maintenance agreement. The scope and depth of the parental support have resulted in Assured Guaranty (UK) Ltd. being designated a "core" sub-

sidary. Marc Bajer joined Assured Guaranty Corp. in September 2005 as the managing director in charge of Assured Guaranty (UK) Ltd. Mr. Bajer was previously global co-head of debt and structured capital markets for Commerzbank AG London.

Negative aspects of the company's split rating are also strongly felt internationally. Much management emphasis is in the area of relationship development with banks and investors. Targeted sectors include ABS and MBS, structured finance, public finance, project finance, and private finance initiative markets. CDOs are a sector where the company has had good results, however, with \$2 billion of international CDOs closed in 2005. Management looks to build on this momentum by targeting quality managers and new European structures like market value and credit opportunity funds. The company also did its first private finance initiative transaction in the first quarter of 2005.

Governance

Standard & Poor's has a positive view of Assured Guaranty Ltd.'s corporate governance practices. This is based on the high level of engagement of the board of directors, the relatively small size of the company and its business, and the growing emphasis on risk management on and off the board.

With a manageable 10 members and a relatively small, but growing insured portfolio, Assured Guaranty Ltd.'s board can play a more active monitoring role than most boards in the financial guarantee industry. Moreover, directors' backgrounds and skills, many of which include direct experience with financial guarantee, make monitoring easier. Further assisting the board in its work, and a real strength of this board, are its committees, which are led by experienced and motivated chairmen. The board has successfully navigated the challenges presented by an IPO

Table 4 Assured Guaranty Corp. Financial Statistics

(Mil \$)	—Year ended Dec. 31—				
	2005	2004	2003	2002	2001
Insurance Company*					
Total assets	1,140.7	1,278.2	1,207.8	1,042.7	948.8
Cash + invested assets	1,086.3	1,200.8	1,155.4	978.8	906.2
Unearned premiums	233.8	405.8	466.7	369.9	351.5
Statutory capital	854.8	755.1	655.6	594.0	557.2
Net premiums earned	88.9	120.6	159.0	104.9	66.4
Losses and LAE	16.2	(10.1)	41.2	37.1	12.2
Underwriting expense	(17.3)	64.0	82.0	56.5	44.6
Investment income including gains	50.7	52.4	49.4	51.1	49.4
Net income	100.9	103.2	66.6	46.2	44.9
Loss ratio (%)	18.2	(8.4)	25.9	35.4	18.4
Holding Company (Assured Guaranty Ltd.)†					
Total assets	2,677.0	2,694.0	49,552.8	43,450.9	37,186.8
Stockholders' equity	1,662.0	1,527.6	8,834.8	6,388.7	6,106.7
Net income	188.0	182.8	1,417.5	76.5	(146.4)
Debt/capitalization (%)	10.6	11.4	21.2	26.1	30.2
Return on average equity (%)	12.4	10.1	18.2	1.2	(2.5)

*Statutory basis of accounting. †ACE Limited was the holding company from 1999–2003.

in 2004, a change in board leadership, and turnover in its own membership.

Since its IPO, Assured Guaranty Ltd. has taken significant steps to distance itself from its previous parent company (and still its largest owner), ACE Limited. For its part, ACE Limited's investment in Assured Guaranty Ltd. has become a passive one, with few direct influences on company management, strategy, or direction.

The company's underwriting and risk-management committee structures were improved in 2005 with the establishment of the risk oversight committee of the board of directors. This committee is charged with reviewing overall underwriting risk-management guidelines and policies. This also includes monitoring risk-based capital adequacy and reserving policy. This board committee supports the committee structure at the AGC level that includes the underwriting committee, the loss-reserve committee, and the portfolio risk-management committee. The portfolio risk committee interfaces with the board

and performs such tasks as approving lines of business and setting sector limits.

Business Review

The company made good strides in the area of direct asset-backed production in 2005. Direct adjusted gross premiums written in the U.S. structured finance sector totaled \$74 million in 2005, up from \$51 million in 2004. The company also made good strides in the international structured finance market with \$27.7 million of adjusted gross premiums written in 2005 compared with \$9 million in 2004. Total U.S. asset-backed and international structured finance par written in 2005 was \$15.5 billion, a 39% increase over 2004. Some sectors of the asset-backed market—the CDO market in particular—are less sensitive to the company's split credit rating. The mix of U.S. business insured in 2005 was dominated by the CDO sector, at 66% of par written, followed by the mortgage and home equity sector at 26%. Commercial asset-backed

deals accounted for 7% of par insured in 2005. Most of the company's asset-backed international insurance written in 2005 was in the CDO sector. Because of the heavy weighting toward CDOs, the company's domestic weighted average capital charge for the 2005 book of asset-backed business was 0.70%, well below the industry average of 2.30%. This contributed to a profitability index (weighted average premium rate divided by weighted average capital charge) of 16.6% for the 2005 book of domestic asset-backed business, substantially above the 2005 industry average of 8.3%.

Direct public finance adjusted gross premiums written in 2005 totaled \$20 million, up from \$6 million in 2004 and reflecting the improvements the company has made in transitioning from a reinsurer to primary company. About \$947 million of gross public finance par written in 2005 was U.S. direct business, compared with \$195 million in 2004.

Due mostly to the effect of the split rating on market demand, the capital charge for public finance business written in 2005 was 21.5%, about 2.5x as much as the 2005 industry average of 9.1%. The company's position in the market requires it to focus mostly on 'BBB' or 'BBB-' credits in sectors such as higher education, health care, and municipal utilities. Noteworthy, however, and indicative of a reasonable pricing strategy, about the same 2.5x spread exists between AGC's average premium rate for the 2005 book of business of 1.14% compared with industry average of 0.51%. As a result, the AGC profitability index for the 2005 book of public finance business of 5.4% is not too far off the 2005 industry average of 5.6%.

In 2005, some AGC risk-management functions were reorganized. A separate credit risk management group led by Howard Albert, chief risk officer, was established with the responsibility of developing and implementing credit policy and for managing the credit approval process. Separately, a risk-management and surveillance group was created with responsibility for surveillance, risk remediation, and portfolio risk management.

Table 5 Assured Guaranty Corp. Capital Statistics

(Mil \$)	—Year ended Dec. 31—				
	2005	2004	2003	2002	2001
Portfolio Risk					
Municipal insurance weighted average capital charge (% of average annual debt service)	12.4	11.4	10.6	10.5	10.9
Asset-backed capital charge (% of par)	1.4	1.6	1.7	2.2	3.0
Claims-Paying Resources					
Statutory capital	854.8	755.1	655.6	594.0	557.2
Letters/lines of credit	0.0	0.0	175.0	175.0	150.0
Contingent preferred security	200.0	200.0	0.0	0.0	0.0
Stop-loss treaty*	80.0	80.0	80.0	240.0	300.0
Unearned premiums	233.8	405.8	466.7	369.9	351.5
Present value of annual premiums	254.0	267.8	293.3	197.2	113.7
Total	1,622.6	1,708.7	1,670.6	1,576.0	1,472.4
Capital Adequacy					
Capital remaining at end of depression test	500-550	600-650	350-400	500-550	350-400
Margin of safety (x)	1.5-1.6	1.7-1.8	1.3-1.4	1.5-1.6	1.4-1.5
Reliance on soft capital (%)	30.6	28.5	19.4	8.0	19.8

*Expires in 2008; no capital modeling credit given.

A major development concerning the overall insured book of business in 2005 was the transfer of \$19.1 billion of par ceded by FSA from AGC to sister company AGRe. FSA and AGRe have had a good reinsurance relationship for many years, and the transfer facilitated management's plan to make AGRe the principal reinsurance provider within Assured Guaranty Ltd. Also, to assist the company with respect to a sector concentration, FSA agreed to reassume \$820 million of health care risk that it had previously ceded to AGC. Mostly as a result, total net par outstanding declined to \$52.6 billion as of Dec. 31, 2005, down from \$74 billion on Dec. 31, 2004. Of the \$52.6 billion total, 48.9% is direct par and the balance is reinsurance written prior to establishment of AGRe as the group's reinsurance provider. Less than \$200 million of par was reinsured by AGC in 2005, mostly from FSA to accommodate certain single-risk constrained names.

Because of the reinsurance legacy, good acceptance in the structured finance market in lower risk sectors, and somewhat limited public finance production, the risk profile of this portfolio is not significantly different from industry norms. The weighted average capital charge for the public finance book of business is 12.4% as of Dec. 31, 2005, up from 11.4% the prior year due mostly to the transfer of FSA business and the higher risk profile of direct business written in 2005. The year-end 2005 industry average public finance capital charge is 11.7%. The company's year-end 2005 weighted average asset-backed capital charge for the entire book of business is 1.4%, down from 1.6% a year earlier. The large amount of 'AAA' shadow-rated CDOs insured in 2005 contributed to the decline. The weighted average asset-backed capital charge for the industry as of year-end 2005 is 1.83%.

The reinsurance transfer, as well as new business written, has also affected the underlying ratings distribution of the insured portfolio. As of Dec. 31, 2005, 42.1% of the portfolio was shadow rated in the 'AAA' category compared with 30.7% a year ago. This improvement is

due to the large amount of direct CDO business written in the past two years.

AGC's sector mix is somewhat different than that of the overall industry but is expected to trend toward industry norms as the revised business plan is implemented. For example, GO debt, a sector where AGC is currently challenged due to its split rating, accounted for 9.2% of the portfolio compared with the industry average of 21.9%. Alternatively, the U.S. commercial asset-backed sector (including CDOs) comprises 32% of AGC's portfolio compared with 7% for the industry average. The U.S. asset-backed book business comprises the largest component of the insured book at 45.8%; this compares with 25.6% for the industry on average. The percent of underlying ratings in the

'AA' and 'A' categories declined somewhat, to 15.5% and 26.1%, respectively, due to the reinsurance transfer. The 'BBB' category was about the same at 14.7%, and the speculative-grade percent fell to 1.6% as of Dec. 31, 2005, compared with 2.0% one year earlier.

Finances

AGC's business and organizational transition has likewise affected the company's statutory balance sheet and financial results. Net premiums earned decreased to \$88.9 million for the year-ended Dec. 31, 2005, compared with \$120.6 million at year-end 2004. The decline was mostly due to the transfer of FSA-reinsured business to AGRe as well as a decline in the amount of other reinsurance written and

Table 6 Assured Guaranty Corp. Liquidity Analysis

Assets/Resources as of Dec. 31, 2005	Haircut (%)	Amount (mil \$)
Cash and short-term investments	0.0	56.3
Treasury and government agency fixed-income securities	10.0	41.6
Corporate and ABS/MBS bonds	50.0	189.1
Bank lines of credit	0.0	200.0
Other	0.0	0.0
Total		487.5
Adjusted cash totals after haircut		388.5
Municipal bonds (informational/back-up only)		762.1
Potential Uses (Occurring in the Full Year 2006)		
Largest net total payments in 2006 associated with a municipal obligor default		67.2
Largest net bullet maturity default (potentially includes IOUs, international, or "guaranteed" maturity bonds)		25.0
Largest debt service reserve draw		40.0
90 days of payments associated with the largest servicer default		96.6
Largest financial service obligations, such as largest unscheduled draw on a municipal investment contract		0.0
Largest individual "single name" credit default swap or single name in a defaulted synthetic structure		0.0
Holding company debt and dividend servicing needs		4.5
Other		0.0
Total usage		233.3
Net (assets - usage)		104.1
Liquidity ratio (x)		1.7

earned. Earned premium was considerably higher in 2003 at \$159 million due to the company's participation in the trade-credit reinsurance business; AGC exited that line of business in 2004. Losses and loss-adjustment expense was \$16.2 million in 2005 compared with a recovery of \$10.1 million in 2004. Most of the loss reserving was due to a reinsured EETC transaction. The balance of the reserve was likewise reinsurance-related. The company had a loss ratio of 18.2% in 2005. However, the loss reserve is not really comparable with prior-year results due to the trade-credit line, which was a "for-loss" business. AGC's loss ratio is only slightly above the 12% industry average for 2005. Also, because of the FSA reinsurance transfer and the related returned ceding commission, underwriting expenses totaled \$17.3 million in 2005 compared with \$64 million in 2004. Investment income for 2005 was \$50.7 million, a 3.2% decline compared with 2004. The lower investment income, offset somewhat by positive cash flow from operations and slightly higher interest rates, was due to the FSA reinsurance transfer-related decline in the unearned premium reserve to \$233.8 million as of year-end 2005 compared with \$405.8 million a year earlier. Statutory net income for the company in 2005 was \$100.9 million, about flat with the prior year. Return on average statutory capital for the company was 12.5%.

Cash and invested assets totaled \$1.1 billion as of Dec. 31, 2005, down from \$1.2 billion one year earlier. BlackRock became AGC's portfolio manager in January 2005. Key investment objectives in the context of preserving the company's 'AAA' rating are to maximize after-tax book income while generating a competi-

tive total rate of return and to maintain sufficient liquidity to cover unexpected, stressful losses. Among the investment guidelines is a requirement that all bonds have a minimum rating of 'A'. There are sector limits for ABS, MBS, and corporate bonds. For the tax-exempt portfolio, to manage investment risk in relation to insured portfolio risk, health care issues are not permitted unless rated 'AAA'. There are other limits tied to insured portfolio concentrations. Currently, the average rating on the fixed-income portfolio is 'AA+' and the average duration is 5.1 years. About 48% of the tax-exempt portfolio consists of bonds guaranteed by monoline bond insurers. AGC, however, does not invest in its own wrapped bonds.

Capitalization

Total claims-paying resources were \$1.6 billion as of year-end 2005, a roughly 5% decline from the previous year. The decline is mostly related to the second-quarter 2005 transfer of FSA reinsurance business from AGC to AGRe. Within this total, statutory capital for the company increased to \$855 million as of Dec. 31, 2005, a 13.2% increase from the prior year due to the generation of \$100 million of net income. However, both the unearned premium reserve and the present value of annual premium accounts declined due to the transfer of the FSA book of business. The unearned premium reserve as of Dec. 31, 2005, was \$234 million, down from \$406 million a year earlier. The present value of annual premiums at year-end 2005 was \$254 million, down from \$268 million at year-end 2004.

The company's other claims-paying resource, unchanged from last year, is a \$200 million contingent preferred stock facility called Woodbourne Pass Through

Trust Securities, which issued pass-through trust securities in March 2005 and invested the proceeds in a portfolio of short-term, highly rated assets that are managed to 'AAA' criteria. The custodial trusts have entered into agreements that allow AGC to put its preferred stock to the trusts, at which time holders of the trust securities will become holders of AGC preferred stock. The trusts are rated 'A+', which reflects the rating that would be applied to preferred stock of AGC. The put option would likely be exercised only in a severe claims-paying environment.

With respect to theoretical losses in the Standard & Poor's capital model, theoretical losses were higher than last year due to the expectation of increased capital charges for both the asset-backed and public finance sectors. The company's margin of safety as of Dec. 31, 2005, falls in a range of 1.5x-1.6x, which is down from the previous year but in excess of the Dec. 31, 2005, industry average of 1.4x-1.5x. The margin of safety expresses the relationship of theoretical losses occurring during the modeling exercise to capital remaining at the end of the modeling period. AGC's reliance on soft capital (claims paid by third parties) is above the industry norm at about 30.6%. However, because most of this business has been, or will be, ceded to sister company AGRe as part of an overall strategic relationship, the obligations of AGRe are viewed as more secure than a typical third-party relationship.

Liquidity for AGC is measured by comparing cash and discounted investments that are available for reverse repurchase agreements against the largest single use of funds in each of the company's various business or risk sectors. For AGC, this results in an acceptable ratio of 1.67x. ■

Assured Guaranty Re Ltd.

Analysts: Robert E Green, New York (1) 212-438-2013; Richard P Smith, New York (1) 212-438-2095

AFFIRMED

CREDIT PROFILE

Fincl strength rtg	AA
Fincl enhancement rtg	AA

OUTLOOK: **STABLE**

Rationale

Assured Guaranty Re Ltd. and its subsidiaries Assured Guaranty Re Overseas Ltd. and Assured Guaranty Mortgage Insurance Co. are collectively known as AGRe. The company's strategic relationship with 'AAA' rated sister company Assured Guaranty Corp. (AGC) should provide it with a source of ongoing, diversified investment-grade reinsurance business. AGC's business plan anticipates ceding about 33% of its annual gross par written to AGRe. AGRe also benefits from technical and administrative assistance from AGC. AGRe's ability to offer facultative reinsurance capacity to the primary bond insurers is an additional source of business that will help in terms of diversity and economies of scale. Statutory capital for the company as of Dec. 31, 2005, was \$691 million, and the company's margin of safety falls in a range of 1.3x-1.4x. The margin of safety represents the relationship of the company's ending capital position in the Standard & Poor's Ratings Services capital adequacy model to losses incurred under a theoretical worst-case loss scenario. This margin of safety is above the 1.0x minimum requirement for 'AA' reinsurers. Underwriting is to investment-grade standards. Capital charges, which are proxies for the risk profile of the insurance portfolio, are 10.1% for the insured public finance book and 1.9% for the asset-backed book of business. These numbers are generally in line with 2005 industry averages. While the insured book of business does exhibit some

above-average concentrations by sector, this should improve with time.

Outlook

The stable outlook is based on the company's conservative underwriting and investment policy and strong capital profile, along with the continuing success of sister company and major source of business AGC.

Management And Corporate Strategy

The AGRe business plan centers on providing monoline financial guaranty reinsurance capacity both to its sister company AGC and to other financial guarantors. While AGRe has gone through some changes, it has, going back to its predecessor corporate identity Capital Reinsurance Co., an 18-year track record of offering financial guaranty reinsurance. To support this strategy, and in connection with the April 2004 IPO of parent company Assured Guaranty Ltd., business lines that were not consistent with the monoline bond insurance business were eliminated. These included the sale of the single-name CDS book of business in 2005 and the transfer of auto residual value insurance, equity CDO, trade credit, and title business to affiliates of ACE Limited in 2004. With its dedicated monoline reinsurance platform in place, AGRe is now well positioned to offer reinsurance capacity to the industry. Correspondingly, sister company AGC is only writing reinsurance in a very limited capacity and predominantly operating as a direct primary company. The transition to distinct reinsurance/direct business platforms was hastened when Financial Security Assurance Inc. (FSA) agreed to transfer \$19.4 billion of reinsurance business in 2005 from AGC to AGRe.

AGRe benefits from operating flexibility in that it can offer facultative and treaty capacity to both the industry and to AGC. With a combined statutory capital base of about \$1.5 billion, AGRe/AGC offers the marketplace reasonable single-risk capacity.

AGRe also has a small, niche reinsurance business line of providing reinsurance capacity to the private mortgage insurance industry. This is not mortgage insurance capacity in the traditional sense, but represents transactions that are structured to provide AGRe with an investment-grade level of protection. Standard & Poor's, in its shadow rating process, has confirmed this investment-grade underwriting approach, and the transactions have been capital-charged accordingly.

The AGRe consolidated group includes Assured Guaranty Re Ltd. (formerly Assured Guaranty Re International Ltd.) and its subsidiaries Assured Guaranty Re Overseas Ltd. and Assured Guaranty Mortgage Insurance Co. Intercompany excess-of-loss reinsurance treaties and keep-well agreements allow the companies to be rated on a consolidated basis. The agreements provide that sufficient capital and liquidity will be provided to each subsidiary to allow them to meet their obligations.

David Penchoff was named president and COO of AGRe in December 2005, succeeding Pierre Samson. Mr. Penchoff was previously CUO of AGRe. He has more than 20 years of experience in the U.S. and international fixed-income markets, including 10 years at MBIA Insurance Corp., where he was a managing director of the public finance department. He reports to Dominic Frederico, CEO of Assured Guaranty Ltd., and is supported by Gary Burnet, director and CCO, who was previously a risk manager with ACE Capital Re. The company

has a relatively small staff of nine professionals, but benefits from administrative and technological support from sister

company AGC. All underwriting and management decisions, however, are made by AGRe in Bermuda.

Governance

Standard & Poor's positive assessment of Assured Guaranty Ltd.'s corporate governance practices is founded on the high level of engagement of the board of directors, the relatively small size of the company and its business, and the growing emphasis on risk management on and off the board. In turn, our assessment of the corporate governance practices of AGRe is assessed in the context of close oversight by Assured Guaranty Ltd.'s board of directors and committees.

With a manageable 10 members, and with a relatively small but growing insured portfolio, Assured Guaranty Ltd.'s board can play a more active monitoring role than most boards in the financial guarantee industry. Moreover, directors' backgrounds and skills, many of which include direct experience with the financial guarantee industry, make monitoring easier. Further assisting the board in its work, and a real strength of this board, are its committees, which are led by experienced and motivated chairmen. The board has successfully navigated the challenges presented by an IPO in 2004, a change in board leadership, and turnover in its own membership.

Since its IPO, Assured Guaranty Ltd. has taken significant steps to distance itself from its previous parent company (and still its largest owner), ACE Limited. For its part, ACE Limited's investment in Assured Guaranty Ltd. has become a passive one, and there are few direct influences on company management, strategy, or direction.

With respect to AGRe, we found its activities to be closely monitored by board and management. The chairman of the audit committee insists on reviewing the minutes of each AGRe board meeting (as well as the firm's other subsidiaries), and consideration has been given to appropriate control mechanisms at the parent level.

Business Review

The FSA bulk reinsurance transaction dominated business results in 2005. An amount equal to \$19.4 billion of reinsurance originally ceded by FSA to AGC was

Table 1 Assured Guaranty Re Ltd. Business Statistics

(Mil \$)	—Year ended Dec. 31—		
	2005	2004	2003
Net par exposure	49,806.0	21,590.0	9,125.0
Adjusted Gross Premiums Written*			
U.S. public finance	76.8	97.7	32.0
U.S. asset-backed and other	55.7	38.4	19.8
U.S. total	132.6	136.1	51.8
International public finance	12.6	18.7	9.5
International asset-backed and other	42.5	40.3	3.1
International total	55.1	59.1	12.6
Total adjusted gross premiums written	187.7	195.2	64.4
Net premiums written	122.8	17.8	232.9
Gross Par Written			
U.S. public finance	5,733.8	7,972.0	1,533.8
U.S. asset-backed and other	6,809.4	6,313.5	727.1
U.S. total	12,543.2	14,285.5	2,260.9
International public finance	561.4	878.9	281.4
International asset-backed and other	2,155.3	1,198.4	158.5
International total	2,716.6	2,077.2	439.9
Total gross par written	15,259.9	16,362.7	2,700.9
Net par written	15,210.0	15,478.5	2,700.9

*Adjusted gross premiums written include up-front and present value of installment premiums.

Table 2 Assured Guaranty Re Ltd. Par Exposure By Source

Year Ended Dec. 31, 2005		
(Mil \$)	Gross par in force	Gross par written
Direct	5,340.0	200.0
Assured Guaranty Corp.	13,556.0	6,094.0
Ambac Assurance Corp.	4,638.0	2,604.0
Financial Guaranty Insurance Co.	1,945.0	1,409.0
Financial Security Assurance Inc.	26,185.0	4,475.0
MBIA Insurance Corp.	619.0	0.0
Other	1,355.0	478.0
Total	53,638.0	15,260.0

transferred to AGRe in 2005. This transaction materially contributed to overall insured portfolio growth of 124%, to \$49.8 billion, as of Dec. 31, 2005.

Excluding this one-off transaction, sister company AGC was the greatest source of reinsurance business, ceding \$6 billion, or about 40% of total reinsurance assumed in 2005. FSA, Ambac Assurance Corp., and Financial Guaranty Insurance Corp. also ceded business of \$4.5 billion, \$2.6 billion, and \$1.4 billion, respectively.

AGRe did not have a reinsurance relationship with MBIA Insurance Corp. in 2005.

In the area of underwriting, all facultative transactions are subject to review and approval by AGRe's credit committee, which is composed of the president, CCO, and the structured finance and municipal underwriters. The newly established risk oversight committee of the board of directors provides additional oversight. This committee is charged with reviewing overall underwriting risk-management guidelines and policies. This also includes monitoring risk-based capital adequacy and reserving policy. At the holding company level, the portfolio risk-management committee establishes risk limits, monitors compliance, and reviews and approves new asset classes.

The risk profile and average premium rates for business assumed in 2005 were consistent with the overall industry. For public finance business assumed in 2005 from unrelated ceding companies, the weighted average capital charge was 10.20% and the weighted average premium rate was 0.73%, for a profitability index for the year of 7.10%. For comparison, the profitability for the 'AAA' industry average was 5.6%. For asset-backed reinsurance business assumed from unrelated ceding companies in 2005, some adverse selection was apparent, as the weighted average capital charge was a relatively high 3.8%. The profitability index for this book of business for AGRe was 6.8%, compared with the 'AAA' industry average of 8.29%. However when AGC business is included in the calculation, AGRe's structured finance profitability index increases to 10.7%.

Because the primary bond insurers use reinsurance mainly for single-risk capacity and portfolio shaping, there are some differences in the average sector mix of the industry compared with AGRe; however, overall in terms of capital charges, which determine losses in Standard & Poor's capital adequacy model, the risk profile of the total insured book of business is acceptable. The capital charge for the public

finance book of business as of Dec. 31, 2005, is 10.1% compared with 11.7% capital charge for the entire industry as of Dec. 31, 2005. AGRe's asset-backed capital charge is 1.90% compared with the 2005 industry average of 1.83%. The average credit quality of the insured book of business is 'A+', with 51% rated 'AA-' or better. Speculative-grade exposure totals \$493 million. In the public finance sector,

Table 3 Assured Guaranty Re Ltd. Insurance Portfolio Statistics

(Mil \$)	2005 industry average % of par	—Year ended Dec. 31—			
		2005 % of par	2005 par	2004 par	2003 par
Public Finance					
GO	21.9	14.3	7,104.5	2,745.3	1,073.3
Utility	9.7	11.8	5,895.1	2,614.7	2,015.3
Tax-backed	8.8	15.2	7,578.4	1,883.1	560.1
Health care	4.7	7.5	3,719.3	2,674.0	190.1
Transportation	5.4	6.3	3,139.1	905.9	630.7
Colleges and universities	3.2	1.1	548.1	148.3	52.0
Investor-owned utilities	1.6	1.0	487.4	180.1	45.8
Housing	1.8	1.5	751.9	176.3	82.4
Special revenue	0.6	0.0	0.0	125.9	8.0
Other	3.3	0.6	281.4	0.0	0.0
Total	61.1	59.2	29,505.0	11,453.6	4,657.7
Domestic Asset-Backed and Corporate Finance					
MBS	4.5	9.4	4,690.6	681.1	71.1
Home equity loan	2.9	0.0	0.0	2,009.7	157.6
Auto loan	1.8	0.8	392.4	317.8	76.5
Other consumer asset-backed	1.5	0.9	438.2	82.4	4.0
Commercial asset-backed	7.0	15.6	7,787.9	3,128.1	2,389.5
Bank/financial institutions	0.3	0.1	28.4	129.3	10.6
Other	7.6	2.2	1,105.9	1,120.1	543.6
Total	25.6	29.0	14,443.0	7,468.6	3,252.9
International					
Public finance	3.4	5.4	2,681.0	1,084.1	305.6
Asset-backed	9.5	4.8	2,411.3	754.0	866.0
Other	0.4	1.5	765.2	830.2	42.4
Total	13.3	11.8	5,858.0	2,668.2	1,214.0
Total net par outstanding	100.0	100.0	49,806.0	21,590.5	9,124.6

Table 4 Assured Guaranty Re Ltd. Financial Statistics

(Mil \$)	—Year ended Dec. 31—		
	2005	2004	2003
Insurance Company*			
Total assets	1,331.2	1,147.3	1,376.1
Cash + invested assets	1,136.2	892.4	1,015.9
Unearned premiums	362.3	195.5	240.4
Shareholder equity	806.3	693.0	632.3
Net premiums earned	92.6	64.0	133.5
Losses and LAE	(68.2)	(32.4)	89.6
Underwriting expense	39.1	40.2	45.2
Investment income including gains	45.4	42.4	49.0
Net income	136.6	101.6	115.7
Loss ratio (%)	(73.7)	(50.6)	67.1
Holding Company (Assured Guaranty Ltd.)†			
Total assets	2,677.0	2,694.0	49,552.8
Stockholders' equity	1,662.0	1,527.6	8,834.8
Net income	188.0	182.8	1,417.5
Debt/capitalization (%)	10.6	11.4	21.2
Return on average equity (%)	12.4	10.1	18.2

*Consolidated GAAP balance sheets. †ACE Limited was the holding company from 1999–2003.

Table 5 Assured Guaranty Re Ltd. Capital Statistics

(Mil \$)	—Year ended Dec. 31—		
	2005	2004	2003
Portfolio Risk			
Municipal insurance weighted average capital charge (% of average annual debt service)	10.1	10.1	7.1
Asset-backed capital charge (% of par)	1.9	2.0	2.0
Claims-Paying Resources			
Statutory capital	691.0	596.0	560.0
Stop-loss treaty	0.0	0.0	0.0
Losses and LAE	26.0	103.0	390.0
Unearned premiums	356.0	186.0	233.0
Present value of annual premiums	174.0	132.1	90.0
Total	1,247.0	1,017.1	1,273.0
Capital Adequacy			
Capital remaining at end of depression test	250-300	150-200	N/A
Margin of safety (x)	1.3-1.4	1.2-1.3	N/A
Reliance on soft capital (%)	3.4	5.0	N/A

Notes: Claims-paying resources are Assured Guaranty Re estimates of U.S. statutory accounting. The company files Bermuda statutory financial statements. N/A—Not applicable.

as of year-end 2005, GO debt is 14.7% for AGRe compared with 21.9% for the industry average. Offsetting this difference, tax-backed debt for AGRe is 15.6% compared with 8.8% for the industry average. Health care and utility exposures are also somewhat higher than the industry average. In the asset-backed sector, commercial asset-backed exposure as of year-end 2005 was 16.1% compared with the industry average of 7.0%. This is due to the substantial amount of CDO business insured by AGC and reinsured to AGRe.

Finances

AGRe's consolidated GAAP balance sheet and financial statement results were substantially affected by unusual events in 2005. Total assets were \$1.3 billion as of Dec. 31, 2005, a 16% increase over the prior year. The company's unearned premium reserve as of Dec. 31, 2005, was \$362.3 million, an 85.3% increase over the prior year due mostly to the acquisition of the FSA bulk reinsurance transaction as well as other up-front premium reinsurance business written. The FSA transaction also had a positive effect on net premiums earned, which were \$92.6 million for the year ended Dec. 31, 2005, a 45% increase over the prior year. Total expenses in 2005 were affected by a loss recovery of \$68.2 million due to a favorable litigation settlement relating to reinsurance claims incurred in 1998 and 1999. Net investment income in 2005 was \$45.4 million, a 7% increase relative to the prior year due to the larger investment portfolio. Net income for the year-ended Dec. 31, 2005, was \$136.6 million, a 34% increase over prior-year results. Normalizing net income for 2005 to adjust for the litigation settlements yields net income of \$92.7 million. This results in a return on average equity of 12.4% for the period.

Cash and invested assets for 2005 totaled \$1.1 billion. Investment objectives, in the context of preserving the company's 'AA' rating, are to maximize after-tax book income while generating a competitive total rate of return and to maintain sufficient liquidity to cover unexpected, stressful losses. Because of

the company's domicile in the tax haven of Bermuda, only about 6% of its investments (fixed-income securities) are in tax-exempt bonds. The larger sector exposures are various MBS and ABS at 55.1%, and U.S. Treasury and agency fixed-income securities at 26.0%. Short-term investments total 4.4% of the investment portfolio. Credit quality for the investment portfolio is very strong with about 91% of the total portfolio

invested in bonds rated 'AAA'. There are no speculative-grade bonds in the investment portfolio. The average duration of the portfolio is 3.7 years. Bond insurers guarantee about \$32.6 million of bonds. AGRe does not invest in the guaranteed bonds of sister company AGC.

Capitalization

AGRe's capitalization profile is strong in the context of its insured portfolio and its

'AA' financial strength rating. Total claims-paying resources are \$1.2 billion as of Dec. 31, 2005, a 23% increase over the prior year-end period. Within that total, statutory capital was \$691 million, the unearned premium reserve was \$356 million, and the present value of annual premiums was \$174 million. The risk profile of the company's reinsured asset-backed portfolio improved somewhat, with the weighted average capital charges falling to 1.9% at year-end 2005, down from 2.01% a year earlier. This movement is attributable to the large amount of low-risk CDO business written by AGC and reinsured to AGRe. The capital charge on the reinsured public finance book of business as of Dec. 31, 2005, was 10.1%, essentially unchanged from the previous year. The company's margin of safety fell in the low end of the 1.3x-1.4x range as of year-end 2005. This is the ratio of theoretical losses incurred in the Standard & Poor's capital adequacy model plus ending capital, divided by theoretical losses incurred. AGRe is currently neither a user of reinsurance or soft capital to manage its insured risk, but this could change modestly going forward.

The company has a very strong ratio of liquid assets to theoretical claim payments coming due in the current year from each of its various sources of liquidity risk. With only a modest amount of tax-exempt investments, AGRe has a larger-than-average proportion of investments in corporate bonds and other more liquid financial assets that are readily available to support reverse repurchase transactions. Liquid assets net of haircuts total \$774.9 million. This is measured against the largest single use of funds in each of the company's various business or risk sectors, which totals \$232.6 million. ■

Table 6 Assured Guaranty Re Ltd. Liquidity Analysis

Assets/Resources as of Dec. 31, 2005	Haircut (%)	Amount (mil \$)
Cash and short-term investments	0.0	52.3
Treasury and government agency fixed-income securities	10.0	259.3
Corporate and ABS/MBS bonds	50.0	363.3
Bank lines of credit	0.0	100.0
Other	0.0	0.0
Adjusted cash totals after haircut		774.9
Municipal bonds (informational only)		65.9
Potential Uses (Occurring in the Full Year 2006)		
Largest net total payments in 2006 associated with a municipal obligor default		27.1
Largest net bullet maturity default (potentially includes IOUs, international, or "guaranteed" maturity bonds)		8.5
Largest debt service reserve draw		62.9
90 days of payments associated with the largest servicer default		111.5
Largest financial service obligations, such as largest unscheduled draw on a municipal investment contract		0.0
Largest individual "single name" credit default swap or single name in a defaulted synthetic structure		1.0
Holding company debt and dividend servicing needs		21.0
Other		0.0
Total usage		232.6
Net (assets - usage)		542.3
Liquidity ratio (x)		3.3

BluePoint Re Limited

Analysts: Richard P Smith, New York (1) 212-438-2095; David Veno, New York (1) 212-438-2108

AFFIRMED

CREDIT PROFILE

Fincl strength rtg	AA
Fincl enhancement rtg	AA

OUTLOOK: **STABLE**

Rationale

The 'AA' financial strength and financial enhancement ratings on BluePoint Re Limited (BluePoint) reflect the successful execution to date of a business plan that contemplated establishing sound relationships with several ceding companies, solid capital adequacy, and access to resources from Wachovia Corp. (Wachovia), its sole owner. BluePoint is a Bermuda-domiciled monoline financial guarantee reinsurance company that commenced operations in November 2004. BluePoint has established solid relationships with several bond insurers, which should lead to a diversity of sources of business. Despite being a relatively new company, BluePoint is viewed as a credible source of reinsurance because of its Wachovia ownership and its independent status. The margin of safety based on a nine-year stress test (five years of growth and four years of stress) was in the range of 1.4x-1.5x, which is well in excess of Standard & Poor's Ratings Services' 1.0x minimum required for an 'AA' rated company. The margin of safety compares theoretical "worst-case" losses incurred in Standard & Poor's capital adequacy modeling analysis with the company's claims-paying resources. Owner Wachovia sees BluePoint as a strategic investment that complements its structured products platform and its own balance sheet securitizations. Wachovia also provides certain analytic and back-office support to BluePoint.

Outlook

The stable outlook reflects BluePoint's solid capital position, the strong operating support and oversight from its financially strong owner Wachovia, and Standard & Poor's expectation for prudent underwriting and risk management.

Management And Corporate Strategy

BluePoint Re, domiciled in Bermuda, is a wholly owned subsidiary of Bermuda-based BluePoint Holdings Ltd., which in turn is 100% owned by Wachovia Corp. (A+/Watch Pos/A-1). BluePoint Holdings has no other businesses other than BluePoint Re. Wachovia's motivation for sponsoring this company is threefold. First, Wachovia's structured product platform has a significant presence in the financial guaranty community and BluePoint provides greater access and understanding of a key client base. Second, Wachovia viewed a reinsurance platform as an efficient mechanism to invest in attractive and highly rated ABS and municipal assets. Finally, as Wachovia securitizes many assets off its own balance sheet, BluePoint provides additional capacity to the monolines that "wrap" these transactions.

Wachovia has explicitly expressed, in the form of a board of directors' resolution, its support for BluePoint Re through agreements not to dividend out earnings for the first five years of operation. It has also approved the business plan, which projects future capital infusions to support growth.

Wachovia will exercise control through its members on the board of directors. It will not be actively involved in the day-to-day functioning of the company (other than through the service-level agreements under which Wachovia will provide many services to BluePoint). Currently, the

board is composed of nine individuals, six of whom are Wachovia senior executives, two are management representatives, and one is fully independent. A board underwriting committee will approve BluePoint's underwriting guidelines and review all transactions quarterly.

BluePoint Re has been formed to be a reinsurer providing treaty and facultative capacity to the leading primary monoline bond insurers. Wachovia has significant relationships with the primary bond insurers through its structured product platform and its treasury group, and BluePoint can benefit from those close ties. In addition, BluePoint can reinsure transactions from the monolines that are originated by Wachovia.

From an underwriting perspective, the company has adopted guidelines that are consistent with primary insurers' guidelines. BluePoint has significant carve-outs in its treaties to prevent or limit the acquisition of undesired credits.

Both the municipal and the asset-backed business will be obtained through a combination of treaty and facultative transactions. Near term, BluePoint expects the business to break down as 50% quota-share treaties, 25% facultative, and 25% credit default swaps. By sector, the business would break down as 40% structured finance and 60% municipal. However, as BluePoint is recently formed, these percentages are likely to change over time. In particular, the structured finance percentage is expected to grow as the effects of BluePoint's initial municipal portfolio are diluted.

Typical of many reinsurers, the company operates with a thin staff. Current headcount is six professionals, unchanged from the prior-year level, including separate heads of municipal and structured finance underwriting, a structured finance

underwriter (new in 2005), and an analytics/surveillance person. The company's access to Wachovia's operational, financial, and analytical resources offsets its thin staffing level, and BluePoint staff makes all underwriting decisions.

John McEvoy, CEO, heads senior management. Mr. McEvoy, a capital markets veteran, was co-founder of Creditex Inc., a technology-focused brokerage company servicing the credit derivative industry. Sanford Goldstein joined BluePoint on June 28, 2006, as president. He was previously a managing director at MBIA Insurance Corp., with significant experience in a variety of asset classes within structured finance. Mr. Goldstein replaces Dan Farrell, formerly president and CUO, who resigned from his management positions at the end of March 2006 to take a position within parent company Wachovia Corp. Mr. Farrell will remain on the BluePoint board and is expected to continue to actively lend his expertise to the firm. Mr. Goldstein will join the board and a yet-to-be-determined individual will step down, keeping the board at nine individuals. The remainder of the team is composed of Geoff Imboden, CFO; Paul Chung, structured finance underwriter; Robert O'Brien, head of municipal underwriting; and Peter Lang, responsible for analytics and surveillance.

Wachovia's STAR (Structured Transactions and Analytic Research) group, a team of approximately 30 people in the treasury function whose job is to analyze Wachovia's various exposures, supports BluePoint's asset-backed underwriting and surveillance functions. Effectively, this group will provide analytical support based on underlying collateral assumptions driven by BluePoint. The management team in Bermuda will make all underwriting decisions based on a variety of factors, including the analytics provided by STAR. The underwriting committee, composed of the CEO, president, and all underwriters, votes on all transactions and must provide 100% approval for a transaction to be approved.

Business Review

Gross par written in 2005 was \$5.5 billion, up from \$3.8 billion in 2004. The

2004 volume included \$3.3 billion that was the result of BluePoint acquiring portions of two blocks of municipal business

Table 1 BluePoint Re Limited Business Statistics

(Mil \$)	—Year ended Dec. 31—	
	2005	2004
Net par exposure	8,675.0	3,792.4
Adjusted Gross Premiums Written*		
U.S. public finance	46.4	37.1
U.S. asset-backed and other	24.3	0.7
U.S. total	70.7	37.8
International public finance	2.1	1.3
International asset-backed and other	9.5	0.0
International total	11.7	1.3
Total adjusted gross premiums written	82.3	39.1
Net premiums written	23.0	38.4
Gross Par Written		
U.S. public finance	2,040.0	3,523.2
U.S. asset-backed and other	2,934.0	200.0
U.S. total	4,974.0	3,723.2
International public finance	290.0	69.2
International asset-backed and other	194.0	0.0
International total	484.0	69.2
Total gross par written	5,458.0	3,792.4
Net par written	5,458.0	3,792.4

*Adjusted gross premiums written include up-front and present value of installment premiums.

Table 2 BluePoint Re Limited Par By Source

Year Ended Dec. 31, 2005		
(Mil \$)	Gross par in force	Gross par written
Ambac Assurance Corp.	830.0	743.0
Financial Guaranty Insurance Co.	195.0	195.0
Financial Security Assurance Inc.	5,052.0	2,189.0
MBIA Insurance Corp.	0.0	0.0
XL Financial Assurance Ltd.	792.0	525.0
Other ceding companies	50.0	50.0
Direct	1,756.0	1,756.0
Total	8,675.0	5,458.0

from Financial Security Assurance Inc. (FSA). These blocks had been ceded by FSA to two reinsurers, but subsequently were reacquired because FSA no longer received reinsurance credit due to the downgrades of these reinsurers.

BluePoint has gained treaty agreements with many of the primaries, and all the primaries have sought facultative capacity from them. Currently, BluePoint has

treaties with Ambac Assurance Corp., FSA, and XL Financial Assurance Ltd., and has negotiated increased treaty shares with each of these ceding companies for 2006. Facultative transactions have been executed from all the primary insurers. For 2005, approximately 38% of gross par written were transactions ceded under the three treaties, while 30% were facultative submissions. The balance was

“direct” transactions where BluePoint provides credit protection to counterparties by writing CDS, primarily on structured finance transactions where BluePoint is not in direct competition with the primaries.

BluePoint has been successful in acquiring business that provides competitive pricing. The U.S. municipal business written by BluePoint in 2005 had a Standard & Poor’s profitability index of 6.34% compared with the ‘AAA’ rated company average of 5.57%. Likewise, the U.S. structured finance segment, aided by the direct business, which generates strong profitability, had a profitability index of 12.75%, well above the ‘AAA’ company average of 8.29%. Only the international structured finance segment, which represented less than 4% of total gross par written, posted a below-industry-average profitability index. The profitability index divides a period’s weighted average premium rate by the period’s weighted average capital charge. The index is a measure that allows for the comparison of premium rate changes while holding risk (average capital charge) constant.

Net par outstanding as of Dec. 31, 2005, was \$8.7 billion, of which 60% was U.S. public finance and 33% was U.S. structured finance. International, nearly two-thirds of which was public finance, comprised the remainder. Compared with the industry composite, BluePoint’s portfolio contains slightly more U.S. structured finance exposure and slightly less international exposure; the municipal component was comparable. Over time, BluePoint’s participation in the direct business will likely result in a structured finance segment that is proportionately higher than the industry average.

Reinsurance was the predominant source of business, accounting for 80% of the net par outstanding. Direct transactions accounted for the remaining 20% of the portfolio. The credit quality of the outstanding portfolio is excellent. Three-quarters of the portfolio has underlying ratings of ‘A’ or better. The capability to do direct CDS business enhances BluePoint’s ability to construct a portfolio that

Table 3 BluePoint Re Limited Insurance Portfolio Statistics

(Mil \$)	2005 industry average % of par	—Year ended Dec. 31—		
		2005 % of par	2005 par	2004 par
Public Finance				
GO	21.9	31.4	2,727.0	1,817.4
Utility	9.7	8.3	722.0	577.2
Tax-backed	8.8	7.5	653.0	511.3
Hospitals	4.7	6.1	532.0	304.8
Transportation	5.4	5.4	465.0	248.7
Colleges and universities	3.2	0.9	80.0	38.9
Investor-owned utilities	1.6	0.0	0.0	0.0
Housing	1.8	0.5	40.0	24.7
Special revenue	0.6	0.0	0.1	0.0
Other	3.3	0.2	20.0	0.2
Total	61.2	60.4	5,239.1	3,523.2
Domestic Asset-Backed and Corporate Finance				
MBS	4.5	4.3	376.0	0.0
Home equity loan	2.9	0.1	12.6	150.0
Auto loan	1.8	4.2	367.0	50.0
Other consumer asset-backed	1.5	0.0	3.0	0.0
Commercial asset-backed	7.0	4.2	368.5	0.0
Bank/financial institutions	0.3	2.3	200.0	0.0
Other	7.6	18.0	1,563.0	0.0
Total	25.6	33.3	2,890.1	200.0
International				
Public finance	3.4	4.2	365.7	69.2
Asset-backed	9.5	1.5	126.0	0.0
Other	0.4	0.6	53.7	0.0
Total	13.3	6.3	545.4	69.2
Total net par outstanding	100.0	100.0	8,674.6	3,792.4

contains a significant component of 'AAA' quality business. At year-end 2005, 20% of the portfolio had underlying ratings in the 'AAA' category.

Underwriting quality is targeted at the investment-grade level, but BluePoint has indicated it might do a small percentage (not likely to exceed 1%-2%) of speculative-grade credits—primarily in shorter term transactions in the net interest margin securities and reserve fund replacement markets. As of Dec. 31, 2005, there were three speculative-grade transactions in the portfolio, totaling \$6 million. The largest of the three is a \$5.8 million asset-backed transaction that is currently performing and is expected to mature in 2006 without resulting in any claims.

BluePoint had three municipal finance exposures totaling \$4.8 million (net par outstanding) from the geographic region affected by Hurricane Katrina. These exposures represent less than 0.1% of total par outstanding and can be easily handled should claims occur.

BluePoint may reinsure business from the primary ceding companies that is Wachovia-originated. In total, Wachovia-originated business could represent approximately 5%-7% of the company's total business over time.

As is common for many reinsurers, BluePoint will rely on the primary insurers to do surveillance. In addition, BluePoint will conduct surveillance on ABS using Wachovia's STAR resource. BluePoint will periodically conduct reviews of the ceding companies, including their underwriting and surveillance functions, and their administration of the treaties.

Finances

For the year ended Dec. 31, 2005, on a GAAP basis, BluePoint recorded gross premiums earned of \$10.8 million. Underwriting expenses, including a nominal amount of unallocated loss reserves, were \$13.1 million and investment income was \$13.1 million, resulting in net income of \$10.8 million. As a Bermuda-domiciled reinsurer, BluePoint does not pay income taxes. Net income represented a 3.6% return on average equity.

Table 4 BluePoint Re Limited Financial Statistics

(Mil \$)	—Year ended Dec. 31—	
	2005	2004
Insurance Company*		
Total assets	340.6	327.5
Cash + invested assets	335.6	321.4
Unearned premiums	44.0	37.7
Statutory capital	289.9	284.4
Net premiums earned	10.8	0.8
Losses and LAE	0.4	0.1
Underwriting expense	14.6	17.0
Investment income including gains	12.1	2.1
Net income	8.1	(14.2)
Loss ratio (%)	3.4	6.9
Underwriting profitability ratio (%) [¶]	(38.6)	N/A
Holding Company (Wachovia Corp.) \$		
Total assets	520,755.0	493,324.0
Stockholders' equity	47,561.0	47,317.0
Net income	6,643.0	5,214.0
Debt/capitalization (%)	70.0	70.0
Return on average equity (%)	14.0	13.1

*Statutory basis of accounting. [¶](Net earned premiums - underwriting expenses and losses)/net earned premiums. \$GAAP basis of accounting. N/A—Not applicable.

Table 5 BluePoint Re Limited Capital Statistics

(Mil \$)	—Year ended Dec. 31—	
	2005	2004
Portfolio Risk		
Municipal insurance weighted average capital charge (% of average annual debt service)	8.3	8.2
Asset-backed capital charge (% of par)	2.1	3.0
Claims-Paying Resources		
Statutory capital	289.9	284.4
Letters/lines of credit	0.0	0.0
Owner capital commitment	0.0	0.0
Stop-loss treaty	0.0	0.0
Unearned premiums	44.0	37.7
Present value of annual premiums	33.8	0.5
Total	367.7	322.6
Capital Adequacy		
Capital remaining at end of depression test	200-250	200-250
Margin of safety (x)	1.4-1.5	1.4-1.5
Reliance on soft capital (%)	0.0	0.0

The investment portfolio will be managed in the same conservative fashion as is the case at other financial guarantors. The asset-management function has been outsourced to BlackRock Financial Manage-

ment, Inc. Asset-management guidelines are appropriately conservative, calling for all U.S. dollar investments, a minimum individual instrument rating of 'AA-', and an average portfolio rating of 'AAA'. As of

Dec. 31, 2005, 81% of the portfolio was 'AAA' rated., with the balance in the 'AA' category. The benchmark portfolio includes a 25% component of three-month T-Bills.

Standard & Poor's reviews a bond insurer's cash position and its ability to raise additional cash against conservatively defined theoretical payments associated with a company's various product lines. The approach to this analysis is that there could be unexpected liquidity demands on an insurer in periods of economic tranquility as well as stress. Liquidity resources and potential liquidity demands are examined for the current year and several subsequent years.

BluePoint's liquidity ratio as of Dec. 31, 2005, was 1.97x, well in excess of what is thought to be adequate for a bond insurer. Liquid resources totaled \$253.8 million. Against these resources, BluePoint has theoretical payments in 2006 totaling \$129 million. For the present time, BluePoint will not have any liquidity lines.

Capitalization

BluePoint Re was initially capitalized with \$300 million. There are no soft capital or owner capital commitments. Results of the Standard & Poor's capital adequacy model indicate a margin of safety of 1.4x-1.5x, well in excess of the 1.0x minimum requirement for an 'AA' company. Sensitivity analysis testing shows that BluePoint is most sensitive to changes in capital charges. However, in a scenario where capital charges are increased 10%, the company would still exceed the 'AA' margin of safety standard by a wide margin. ■

Table 6 BluePoint Re Limited Liquidity Analysis

Assets/Resources as of Dec. 31, 2005	Haircut (%)	Amount (mil \$)
Cash and short-term investments	0.0	38.1
Treasury and government agency fixed-income securities	10.0	174.0
Corporate and ABS/MBS bonds	50.0	118.1
Bank lines of credit	0.0	0.0
Other	0.0	0.0
Total		330.2
Adjusted cash totals after haircut		253.8
Municipal bonds (informational/back-up only)		1.2
Potential Uses (Occurring in the Full Year 2006)		
Largest net total payments in 2006 associated with a municipal obligor default		31.0
Largest net bullet maturity default (potentially includes IOUs, international, or "guaranteed" maturity bonds)		6.0
Largest debt service reserve draw		13.0
90 days of payments associated with the largest servicer default		4.0
Largest financial service obligations, such as largest unscheduled draw on a municipal investment contract		0.0
Largest individual "single name" credit default swap or single name in a defaulted synthetic structure		75.0
Holding company debt and dividend servicing needs		0.0
Other		0.0
Total usage		129.0
Net (assets - usage)		124.8
Liquidity ratio (x)		2.0

Channel Reinsurance Ltd.

Analysts: David Veno, New York (1) 212-438-2108; Richard P Smith, New York (1) 212-438-2095

AFFIRMED

CREDIT PROFILE

Fincl strength rtg	AAA
Fincl enhancement rtg	AAA

OUTLOOK: **NEGATIVE**

Rationale

The 'AAA' financial strength and financial enhancement ratings on Channel Reinsurance Ltd. (Channel Re) reflect the company's strong capital position, along with an underwriting strategy to selectively accept business that proves beneficial to the company and ensures at least parity between the risk assumed by the company and that retained by MBIA Insurance Corp. (MBIA), its sole source of business. As of Dec. 31, 2005, the company's margin of safety was in the 2.2x-2.3x range, which significantly exceeds Standard & Poor's Ratings Services' minimum 'AAA' requirement of 1.25x. The investors in Channel Re have a keen awareness of the risks that have faced reinsurers in the past—namely adverse selection in business assumed. Steps have been taken to ensure that business ceded by MBIA is similar in risk profile and premium rates to that retained by MBIA. Additionally, the investment in Channel Re by MBIA and its desire for 'AAA' reinsurance capacity aligns the interests of the two companies. While Channel Re has taken steps to address Standard & Poor's concerns relating to certain aspects of the company's corporate governance policies and procedures, and has increased staffing to improve its ability to perform underwriting and portfolio analysis, these changes will need to be evaluated over time to judge their effectiveness. Also of interest is the final regulatory settlement between MBIA and both the SEC and New York State attorney general stemming from

their investigation of various topics, including MBIA's relationship with Channel Re. Once the settlement is announced, Standard & Poor's will evaluate any implications for Channel Re's business and financial strength.

Outlook

The outlook is negative. While there have been a number of enhancements to board of director processes and some significant personnel changes on the board, as well as noteworthy changes to staffing, the effectiveness of the changes can only be judged over time. In addition, the search for a new chair of the board has not been completed, and time will be needed to assess this person's performance and impact on the company. Channel Re will need to demonstrate that the profitability of its business lines, as well as its overall operating performance, are sustainable at an 'AAA' level as the company matures. Should the company not prove successful in these efforts, the rating would be reassessed. Additionally, should the final regulatory settlement involving MBIA result in changes to Channel Re's and MBIA's reinsurance relationship, a reassessment of Channel Re's rating would occur.

Management And Corporate Strategy

Channel Re is a Bermuda-domiciled financial guarantee reinsurance company beginning its third year of business. Investors in Channel Re include Renaissance Re Holdings Ltd. (45.4% voting interest), Partner Reinsurance Co. Ltd. (27.7%), Koch Financial Re Ltd. (9.5%), and MBIA (17.4%). Renaissance Reinsurance Ltd. is a global provider of property catastrophe risk and noncatastrophe specialty reinsurance. Partner Reinsurance Ltd. provides multiline reinsurance

to insurance companies including property and casualty/motor, catastrophe, life, alternative risk transfer, and specialty lines. MBIA is a financial guarantor that provides credit enhancement for public and private sector clients, both domestically and internationally. Koch Financial Re Ltd. is a subsidiary of Koch Industries, formed solely to hold the investment in Channel Re. Koch Industries has business interests in energy, chemicals, minerals, real estate, and financial services. Through its subsidiary Koch Financial Corp., Koch Industries provides financing solutions for state and local governments nationwide.

Channel Re was established in 2004 to provide 'AAA' reinsurance capacity to MBIA. Due to various rating actions in 2003, along with changes in Standard & Poor's soft capital criteria in 2002, MBIA received less credit for business ceded to certain reinsurers. MBIA's interest in the formation of Channel Re was to replace the lost credit it previously received. For the other investors in Channel Re, the formation of the company provided a method of participation in the financial guarantee market and an uncorrelated source of revenue in terms of their main businesses.

Currently, Channel Re's sole source of business is a share of MBIA's treaty, which includes public finance, structured finance, future-flow, health care, and investor-owned utilities transactions, as well as transactions ceded on a facultative basis. There are transaction par limits in place for each sector of the treaty to control the growth and risk profile of Channel Re's insured portfolio. Furthermore, there is a mechanism in place ensuring Channel Re could never be the sole or dominant reinsurer for any treaty transaction. Channel Re has no rights to business

not offered through the treaty, and there is no guaranty on the overall profitability of Channel Re by MBIA. Furthermore, if Channel Re begins to experience losses in its insured portfolio, it has no rights that could force MBIA to cede business to it in such a way as to compensate Channel Re for losses it has incurred.

Management continues to be led by Michael Maguire, CEO and chief underwriter; however, there have been a number of changes in staffing. Paul Watson replaced Elizabeth Sullivan as the CFO in October 2005. Mr. Watson has 20 years experience working in various financial reporting positions within the insurance industry on Bermuda. Joanna Turner joined Channel Re in July 2006 as senior accountant. Ms. Turner has five years of accounting experience with two international accounting firms.

Arthur Dial, vice president, continues to be responsible for public finance underwriting; he has 16 years experience as a public finance analyst, 11 of those with a rating agency. Peter Li replaced Chris Lynch as senior analyst responsible for structured finance underwriting. Mr. Li comes to Channel Re with eight years of structured finance experience, including five years at a major bond insurer. In May 2006, Armand Foy joined Channel Re as a structured finance analyst; he has eight years of experience in structured finance, including two years of underwriting financial guarantees.

With the staff additions, Channel Re has taken steps necessary to address Standard & Poor's concerns about Channel Re's ability to adequately perform underwriting and portfolio analysis and provide an acceptable risk-management function.

The company has strengthened its ability to keep pace with the growing complexity of the financial guarantee industry with the addition of a seasoned structured finance analyst. The current staffing level is sufficient for a reinsurer and should provide enough support to enable the company to conduct business should a staff member leave.

Governance

Standard & Poor's recent assessment of Channel Re's governance centers on enhancements to board of director processes and significant personnel changes on the board and staff. It is worth noting that governance enhancements were already being considered prior to the June 2005 rating outlook revision to negative. The board now has a meaningful committee structure composed of directors from each of Channel Re's investors. In addition, the composition of the board has changed, most markedly with regard to the retirement of former MBIA-connected Chair David Elliott. Four new directors from the founding investors have now joined the board.

A search is currently under way for a nonexecutive chair without ties to any of the company's shareholders. Among reasons given for this initiative is that a chair unconnected with any of the investors will provide a level of evenhandedness as far as all of the company's investors (and its policyholders) are concerned. Although familiarity with Channel Re's business would be an asset for the new chair, this is regarded by the current board as less important than relevant "other company" board experience, bearing in mind the financial guaranty expertise already represented among the directors. Once the new chair is in place, Channel Re's CEO will continue to report to the chairman.

The role of the board's committees appears to have become more formalized, particularly with regard to the specific tasks of each committee, now contained in more detailed charters and with a meaningful division of labor for each. While the actual effectiveness of each of these committees remains for future assessment, it is noteworthy that

Table 1 Channel Reinsurance Ltd. Business Statistics

(Mil \$)	—Year ended Dec. 31—	
	2005	2004
Net par exposure	33,218.0	30,686.0
Adjusted Gross Premiums Written*		
U.S. public finance	11.0	25.1
U.S. asset-backed and other	41.2	21.8
U.S. total	52.2	46.8
International public finance	12.3	27.0
International asset-backed and other	46.7	22.0
International total	59.0	49.1
Total adjusted gross premiums written	111.2	95.9
Net premiums written	111.2	249.1
Gross Par Written		
U.S. public finance	1,100.7	1,636.0
U.S. asset-backed and other	2,629.1	1,874.0
U.S. total	3,729.7	3,510.0
International public finance	241.9	212.6
International asset-backed and other	5,319.5	2,335.0
International total	5,561.4	2,547.6
Total gross par written	9,291.1	6,057.6
Net par written	9,291.1	6,057.6

*Adjusted gross premiums written include up-front and present value of installment premiums.

the underwriting committee composition reflects concerns about its independence from the company's sole customer. MBIA only possesses observer rights on that committee.

An outside chair and a board whose functions have been appropriately formalized represent an important governance enhancement for all Channel Re investors and policyholders. Effective governance requires all of Channel Re's directors to be actively involved, and the new committee structures will likely help to ensure this. Overall, our assessment of these initiatives is positive. However, board effectiveness cannot be exhaustively addressed either by personnel changes or the introduction of a nonexecutive chair. The new chair and each of the committees need a track record to establish their credibility.

Business Review

In 2005, total gross par written rose 53%, whereas adjusted gross premiums rose by just 16%. Management's business volume projections at the beginning of 2005 included an increased amount of international business based on market trends and guidance from MBIA. These projections came to fruition in 2005 as the international structured finance par written more than doubled to represent 57% of total par written compared with 39% in 2004. This underwriting outcome has a significant effect on the company's capital adequacy, as the international business tends to be well priced in terms of capital at risk.

Adjusted gross premiums for the international structured finance business line also more than doubled, and represented the greatest contributor to adjusted gross premiums written at 42%. The company experienced a very strong year in CDO volume, with CDO insured par accounting for approximately 86% of total par written for this business line. Other sectors in which business was conducted included pooled corporate obligations and MBS. For this business line, Channel Re reported a per-period weighted average premium rate of 20 basis points and a 1% capital charge, which produced a profitability index of 20%; the index is down 22% from 2004.

For the U.S. structured finance business line, adjusted gross premiums written increased by 89% on a 40% increase in gross par written. The major contributors to growth in insured par were CDOs, auto loan transactions, and pooled corporate obligations. Of these, the auto loan transactions were the drivers in the growth of adjusted gross premiums writ-

ten, as this sector tends to have one of the higher premium rates. However, with higher premium rates comes higher risk. Although the per-period weighted average premium rate rose 18%, the per-period weighted average capital charge doubled to 2.94%. For 2005, Channel Re's U.S. structured finance profitability index declined by 42%, to 8.8%.

Table 2 Channel Reinsurance Ltd. Portfolio Statistics

(Mil \$)	2005 industry average % of par	—Year ended Dec. 31—		
		2005 % of par	2005 par	2004 par
Public Finance				
GO	21.9	11.7	3,890.6	3,910.0
Utility	9.7	7.7	2,573.1	2,761.0
Tax-backed	8.8	4.3	1,440.6	1,644.0
Health care	4.7	6.2	2,045.0	2,127.0
Transportation	5.4	5.8	1,932.2	2,144.0
Colleges and universities	3.2	1.5	495.1	510.0
Investor-owned utilities	1.6	1.1	365.6	539.0
Housing	1.8	1.1	379.9	456.0
Special revenue	0.6	1.2	393.1	363.0
Other	3.3	0.0	7.4	8.0
Total	61.2	40.7	13,522.6	14,462.0
Leases contained in above	4.7	0.0	0.0	1,088.0
Domestic Asset-Backed and Corporate Finance				
MBS	4.5	0.6	214.6	321.0
Home equity loan	2.9	1.9	640.1	1,041.0
Auto loan	1.8	2.5	816.6	1,210.0
Other consumer asset-backed	1.5	1.2	386.8	606.0
Commercial asset-backed	7.0	15.2	5,053.2	3,508.0
Bank/financial institutions	0.3	0.0	13.6	175.0
Other	7.6	1.0	324.6	267.0
Total	25.6	22.4	7,449.4	7,128.0
International				
Public finance	3.4	5.8	1,917.0	1,990.0
Asset-backed	9.5	31.1	10,328.7	7,106.0
Other	0.4	0.0	0.0	0.0
Total	13.3	36.9	12,245.7	9,096.0
Total net par outstanding	100.0	100.0	33,217.7	30,686.0

Channel Re's U.S. public finance gross par insured was down 33% and adjusted gross premiums written were down by an even greater 56%. Some of this decline

was due to the competitive environment in the insured U.S. public finance market, although the type of business assumed in 2004 somewhat leads to an overstatement of the declines in par and adjusted gross premiums written for 2005. In 2004, MBIA made relatively large cessions of "back-book" policies to Channel that included capacity constrained credits. These types of cessions do not represent flow business, but are one-off transactions. Cessions in 2004 also included higher capital charge (and premium) business, such as investor-owned utilities. Overall, 2005 business had lower capital charges but also much less premium. The change in the mix of business factored into a 30% decline in the profitability index to 6.46%. Although the weighted average capital charge fell 7%, the implied premium rate for the period fell by 35%.

Comment has been made in the marketplace that MBIA is dumping poorly

priced and higher risk business in Channel Re. Based on the Standard & Poor's profitability studies this is not the case. The profitability indices for Channel Re's business lines in 2005 were greater than those of MBIA and the industry average for the 'AAA' rated companies. In terms of risk, with the exception of the international public finance business line, the weighted average capital charge for each business line was equal to or less than MBIA's. Although the international public finance business line had a higher weighted average capital charge than MBIA's in 2005, this line of business was the smallest for Channel Re and produced a profitability index that was 1.6x greater than MBIA's. This highlights the effectiveness of Channel Re's management to selectively accept business that proves beneficial to the company.

Finances

At its formation, Channel Re accelerated the generation of earned premiums and net income by entering into an agreement to reinsure pre-existing public finance and structured finance business from MBIA. This pre-existing book comprised \$15.2 billion of public finance par and \$11.5 billion of structured finance par. This exposure represents business taken back by MBIA from Axa Re Finance, Radian Reinsurance, and American Reinsurance for which MBIA no longer received full credit for the cessions in Standard & Poor's capital adequacy model.

For 2005, Channel Re's operating income was little changed at \$28.9 million on a U.S. GAAP basis. Due to the assumption of the pre-existing book of business and its revenue-generating capabilities, Channel Re does not have to suffer through years of high underwriting cost and overhead relative to earned premiums, which is typical of a start-up bond insurer. However, due to recent hires, operating income could be somewhat lower.

On a U.S. statutory accounting basis, the company had an underwriting expense ratio of 25%. This is down from 28% in 2004 and is attributable to the absence of expenses and premiums associ-

Table 3 Channel Reinsurance Ltd. Financial Statistics

(Mil \$)	—Year ended Dec. 31—	
	2005	2004
Insurance Company*		
Total assets	604.0	556.7
Cash + invested assets	592.0	546.1
Unearned premiums	202.0	203.0
Statutory capital	392.0	348.8
Net premiums earned	58.0	46.1
Losses and LAE	4.4	1.0
Investment income including gains	16.9	12.5

*Statutory basis of accounting.

Table 4 Channel Reinsurance Ltd. Capital Statistics

(Mil \$)	—Year ended Dec. 31—	
	2005	2004
Portfolio Risk		
Municipal insurance weighted average capital charge (% of average annual debt service)	13.8	13.0
Asset-backed capital charge (% of par)	1.5	1.6
Claims-Paying Resources		
Statutory capital	392.0	348.8
Contingent capital	0.0	0.0
Letters/lines of credit	100.0	80.0
Owner capital commitment	0.0	0.0
Stop-loss treaty	0.0	0.0
Unearned premiums	202.0	203.0
Present value of annual premiums	192.0	148.1
Other	0.0	0.0
Total	886.0	779.9
Capital Adequacy		
Capital remaining at end of depression test	650-700	400-450
Margin of safety (x)	2.2-2.3	1.6-1.7
Reliance on soft capital (%)	8.4	7.3

ated with the assumption of the pre-existing business. This ratio should improve as Channel Re benefits from installment premiums generated by a growing structured finance portfolio. However, due to recent hires, this ratio could be higher in 2006.

With regard to its only other earnings component, Channel Re reported \$19.5 million in investment income. The \$497.3 million investment portfolio has an 'AAA' average credit quality and includes U.S. government securities, corporate obligations, and MBS. There are no investments in the portfolio that carry a financial guarantee from MBIA.

Capitalization

Channel Re's statutory capital totaled \$392 million as of Dec. 31, 2005. The company's only other source of capital is \$100 million in contingent capital. The board and management have agreed to certain dividend restrictions to ensure that Channel Re's capital position remains above rating agency thresholds.

Channel Re's existing capital resources, future earnings, and cash flow generated a satisfactory margin of safety when stressed in Standard & Poor's capital adequacy model. As of year-end 2005, the company's margin of safety

was within the 2.2-2.3x range. The margin of safety expresses the relationship between theoretical losses generated in the capital adequacy model and capital remaining at the end of a theoretical depression. Channel Re's margin of safety significantly exceeds Standard & Poor's 1.25x minimum requirement for an 'AAA' rated company.

Channel Re's margin of safety is up significantly from year-end 2004 due to business volume assumptions. First, the amount of business written in 2005 was 14% less than what was projected in last year's capital adequacy test. Second, based on current market conditions, the amount of business the company assumes it will write in this year's capital adequacy test is 52% less than what was assumed in last year's test. The combination of less business written and, to a lesser extent, the revenue generating power of the assumed pre-existing book of business leads to the improvement in the margin of safety.

Standard & Poor's reviews a bond insurer's cash position and ability to raise additional cash against conservatively defined theoretical payments associated with the company's various product lines. The approach to this analysis is that there could be unexpected liquidity demands placed on an insurer in periods of economic tranquility as well as stress. Liquidity resources and potential liquidity demands are examined for the current year and several subsequent years. Channel Re's conservative investment and liquidity strategies and single-risk management standards produce a satisfactory liquidity ratio of 2.9x. Available liquid resources totaled \$454 million as of Dec. 31, 2005. ■

Table 5 Channel Reinsurance Ltd. Liquidity Analysis

Assets/Resources as of Dec. 31, 2005	Haircut (%)	Adjusted (mil \$)
Cash and short-term investments	0.0	95.0
Treasury and government agency fixed-income securities	10.0	259.0
Corporate and ABS/MBS bonds	50.0	100.0
Bank lines of credit	0.0	0.0
Other (non-U.S. government securities)	10.0	0.0
Total		454.0
Municipal bonds (informational only)		9.8
Potential Uses (Occurring in the Full Year 2006)		
Largest net total payments in 2006 associated with a municipal obligor default		34.9
Largest net bullet maturity default		19.9
Largest debt service reserve draw		15.4
90 days of payments associated with the largest servicer default		88.8
Largest unscheduled draw on a municipal investment contract		0.0
Largest individual "single name" credit default swap		0.0
Holding company debt and dividend servicing needs		0.0
Total		159.0
Liquidity ratio (x)		2.9

CIFG Guaranty, CIFG Europe, CIFG Assurance North America Inc.

Analysts: David Veno, New York (1) 212-438-2108; Richard P Smith, New York (1) 212-438-2095

AFFIRMED

CREDIT PROFILE

Fincl strength rtg	AAA
Fincl enhancement rtg	AAA

OUTLOOK: **STABLE**

Rationale

The 'AAA' financial strength and financial enhancement ratings on CIFG Guaranty, CIFG Europe, and CIFG Assurance North America Inc. (collectively CIFG, or the company) are based on a consolidated margin of safety that is comfortably above Standard & Poor's Ratings Services' required 'AAA' level, a conservative approach to underwriting, sound risk-management practices, and strong European parentage that provides entry into European markets. The combined operations of CIFG produced a margin of safety based on Standard & Poor's capital adequacy test that was in the 1.4x-1.5x range. Unlike business written in past years, par written in 2005 was more diverse in terms of business line and sector, which has added some degree of diversification to the company's business and insured portfolio. CIFG appears to be gaining investor acceptance, as the company reported an increase in par written in each of its business lines in a financial guarantee market that is currently highly competitive. With competition comes pricing pressure, however, and management's strategy of emphasizing risk-adjusted returns as opposed to par written volume or market share that might not produce outstanding growth is a sound underwriting strategy.

Outlook

The stable outlook reflects CIFG's strong capital position, conservative underwriting strategy, and improving market acceptance, along with the commitment

of its owners to the business. The outlook also reflects Standard & Poor's expectation that there will be improvement in the company's earnings, as well as continued progress made in diversifying its public finance and structured finance sector participation. The rating and outlook would be reassessed if the company does not prove successful in meeting these expectations. At this time, a pending change in ownership does not have an effect on the company's outlook, but Standard & Poor's will monitor the progress of the change to assess the company's continued adherence to its sound underwriting strategy.

Management And Corporate Strategy

CIFG Guaranty is a France-domiciled financial guarantee reinsurance company whose direct wholly owned subsidiaries are CIFG Assurance North America Inc., a U.S.-domiciled direct financial guarantor; and CIFG Europe, a France-domiciled direct financial guarantor. CIFG Guaranty is a subsidiary of CIFG Holding, which in turn is owned by Caisse Nationale des Caisses d'Epargne et de Prevoyance (CNCE; AA/Stable). CNCE's capital is 65% owned by 34 regional French banks and 35% owned by Caisse des Dépôts et Consignations (CDC; AAA/Stable), a financial institution that performs public-interest missions on behalf of France's central, regional, and local governments.

As the number of states in which CIFG is licensed to conduct business has grown to 46, the company has begun to make progress in the new-issue market and has increased participation in primary market transactions. Management's stated objective is to build a full-service, diversified financial guarantor that focuses on the markets traditionally served by the 'AAA'

rated financial guarantors. The additional licenses have led to steady growth in par written and have provided opportunities for diversification of CIFG's guaranteed portfolio into a greater number of sectors. The company's underwriting activities in the U.S. public finance market continue to be focused on the lower risk sectors of GO, sales tax, and special tax bonds. To help gain name recognition and liquidity in the market, the company has developed underwriting guidelines and operating procedures that allow it to efficiently underwrite smaller transactions in the competitive sale market. The company is also active in larger, negotiated segments of the U.S. public finance market and has selectively underwritten health care risk, among others.

Underwriting activities within global structured finance have involved transactions relating to consumer assets, commercial assets, and financial structures such as CDOs, CBOs, CLOs, and consumer trade receivables. Much of the structured finance underwriting activity has been weighted toward diversified CDOs with 'AAA' attachment points. Underwriting in the U.S. market has expanded to include RMBS and CMBS, student loans, and rental fleets. Recently, the company broadened its international sector participation to include U.K. RMBS, whole business securitizations, CMBS, and emerging market future flow transactions.

Within the European public finance market, CIFG Europe selectively underwrites project finance and public-private partnership transactions, as well as sub-sovereign government debt obligations. This is the smallest line of business for the company and, based on industry trends, it is likely that it will remain so. The relationship with its shareholder

base, however, has provided CIFG opportunities in the European public finance market that might not be available to other bond insurers.

Essentially, the same management team leads all the companies, with experienced underwriters in place to meet the specific underwriting needs for each company. The senior management team is led by Jacques Rolfo, CEO; Michel Rouzioux, managing director, European operations and reinsurance; and James O'Keefe, CFO. Underwriting is led by Steve Klein, head of global public finance and infrastructure; and Andrew Dym, who heads global structured finance. There is one risk-management team to oversee consolidated risk exposure, led by Charles Webster Jr., head of risk management, and Paul Kwiatkoski, head of surveillance.

With regard to the recent agreement signed between Groupe Banque Populaire (GBP) and Caisse Nationale des Caisses d'Epargne (CNCE) setting out the terms and conditions of the creation of a new joint subsidiary, NATIXIS, at this time there is no effect on the rating of CIFG. It is expected the transaction will close by the end of the year. NATIXIS will become the new owner of CIFG Holding, which will continue to hold 100% ownership in CIFG. GBP and CNCE will each have a 34% share of NATIXIS and the public will own 32%. At closing, CDC will sell its interest in CNCE. There is expected to be no change in management or underwriting strategy due to the new ownership structure.

Business Review

In 2005, total gross par written rose 67%, whereas adjusted gross premiums rose by 35%. Unlike business written in past years, par written in 2005 was more diverse in terms of business line and sector. Global structured finance remains the principal source of par written, but within this business line there was greater sector diversification. One noteworthy aspect of CIFG's business written is that U.S. public finance par written rose 26%, but adjusted gross premiums written for this business doubled, accounting for 37% of total

adjusted gross premiums written—the highest of the four business lines. For the first three months of 2006, CIFG continued its positive production trends, reporting an almost threefold increase in gross par written to \$6.1 billion and adjusted gross premiums written of \$43.7 million, which is three and a half times greater than the same period in 2005. The growth in business is somewhat deceptive, as the company is starting with a lower base on which to build; however, the fact that, as a relatively new entrant to the market, it has increased business in a very competitive environment is an acknowledgment of the success of management's underwriting strategy.

Although much of U.S. public finance par written in 2005 was exposure within New York and Puerto Rico, the number

of transactions insured had greater geographic diversity than in past years. In addition, the company underwrote transactions for the first time in the private higher education, student housing, and project finance sectors. While its underwriting activities have broadened geographically and by sector, the company continues to target opportunistic situations where competition is lower. However, in the current environment those opportunities might be few, and the company's U.S. public finance profitability index bears this out. For 2005, the implied premium rate rose 14% to 57 basis points, but due to increased underwriting in some of the higher capital charge sectors the gross per period weighted average capital charge increased 84% to 12.2%. These move-

Table 1 CIFG Consolidated Business Statistics

(Mil \$)	—Year ended Dec. 31—			
	2005	2004	2003	2002
Net par exposure	42,583.7	24,697.8	12,345.3	2,279.7
Adjusted Gross Premiums Written*				
U.S. public finance	60.7	30.6	42.0	12.1
U.S. asset-backed and other	37.3	21.2	34.7	12.8
U.S. total	98.0	51.8	76.7	24.9
International public finance	24.5	16.1	30.4	2.1
International asset-backed and other	40.9	52.7	24.2	6.3
International total	65.4	68.9	54.6	8.4
Total adjusted gross premiums written	163.4	120.6	131.3	33.3
Net premiums written	108.5	75.1	83.4	16.8
Gross Par Written				
U.S. public finance	5,517.1	3,074.4	2,332.0	694.4
U.S. asset-backed and other	7,731.7	4,085.3	4,899.4	986.0
U.S. total	13,249.0	7,160.0	7,231.0	1,680.0
International public finance	2,026.4	1,449.2	902.2	92.9
International asset-backed and other	6,006.6	4,132.9	1,952.7	579.0
International total	8,033.0	5,582.1	2,854.9	671.9
Total gross par written	21,281.8	12,741.8	10,086.3	2,352.3
Net par written	21,083.0	12,572.0	10,036.3	2,257.3

*Adjusted gross premiums written include up-front and present value of installment premiums.

ments in the components of the company's profitability index led to a 38% decline in the index to 4.7%. As CIFG has moved more broadly into all sectors of the market, a decline from earlier levels was anticipated, and does not represent a loosening of credit standards.

Par written for the U.S. structured finance business line was up 89% to \$7.7

billion and adjusted gross premiums written increased 76% to \$37.3 million. A change in the company's business mix that was more concentrated in the lower risk, low premium rate business led to the lesser rise in adjusted gross premiums written than par written. Management has stated that the company experienced noteworthy growth in the primary and secondary market 'AAA' rated consumer asset transactions. This fact is illustrated in the company's U.S. structured finance profitability index. For 2005, the profitability index rose 66.0%, to 23.7%, on a 50% decrease in the per-period weighted average premium rate and a 71% decrease in the per-period weighted average capital charge to 10 basis points and 41 basis points, respectively. Management does expect diversification to continue in this business line; therefore, it is expected that the weighted average capital charge will rise due to expanding underwriting activities in higher capital charge sectors. In terms of underwriting risk, management remains selective in the type of risk it will insure, even if the risk-reward characteristics of the transaction appear acceptable.

Structured finance has been the dominant component of CIFG's international business activities. With the exception of a few transactions, European structured finance business underwritten has been composed of high-quality CDOs. Within these transactions, CIFG's attachment point is at the 'AAA' tranches, where the premium rates are low due to the low risk associated with the attachment point. This helps to explain the 45% increase in gross par written, compared with a 22% decrease in adjusted gross premiums written. However, the company did insure a number of transactions in 2005 that were not typical of business written in the past, including U.K. mortgage and whole business securitizations and Turkish and Brazilian future-flow transactions. The effects of the slight change in the mix of business underwritten led to a 36% increase in the per-period weighted average capital charge. With the per-period weighted average premium little changed, the profitability index declined 29.0%, to 22.3% in 2005.

Table 2 CIFG Consolidated Portfolio Statistics

(Mil \$)	2005 industry average % of par	2005 % of par	—Year ended Dec. 31—			
			2005 par	2004 par	2003 par	2002 par
Public Finance						
GO	21.9	11.5	4,887.7	2,645.5	1,508.5	514.5
Utility	9.7	2.4	1,029.3	777.3	682.8	106.7
Tax-backed	8.8	3.6	1,539.4	1,147.7	191.3	8.2
Health care	4.7	2.1	880.5	165.9	21.6	0.0
Transportation	5.4	0.4	150.0	53.8	0.0	0.0
Colleges and universities	3.2	1.3	542.4	0.0	50.0	50.0
Investor-owned utilities	1.6	0.3	109.9	111.1	100.0	0.0
Housing	1.8	0.4	177.8	0.0	0.0	0.0
Special revenue	0.6	5.1	2,177.7	1,171.0	513.0	0.0
Other	3.3	0.0	0.0	0.0	0.0	0.0
Total	61.2	27.0	11,494.7	6,072.3	3,067.3	679.4
Leases contained in above	4.7	3.0	1,285.6	706.6	313.6	74.7
Domestic Asset-Backed and Corporate Finance						
MBS	4.5	1.4	601.8	511.3	0.0	0.0
Home equity loan	2.9	5.9	2,510.4	1,109.9	705.3	0.0
Auto loan	1.8	0.7	307.8	442.8	251.8	0.0
Other consumer asset-backed	1.5	2.1	912.7	251.0	251.0	0.0
Commercial asset-backed	7.0	4.3	1,847.4	1,088.2	1,000.0	100.0
Bank/financial institutions	0.3	0.0	0.0	0.0	0.0	0.0
Other	7.6	21.3	9,080.4	5,550.6	3,301.9	806.0
Total	25.6	35.8	15,260.4	8,953.9	5,510.0	906.0
International						
Public finance	3.4	7.6	3,255.4	2,257.2	1,112.5	203.3
Asset-backed	9.5	28.0	11,936.6	7,011.9	2,525.6	491.0
Other	0.4	1.5	636.6	402.4	129.9	0.0
Total	13.3	37.2	15,828.6	9,671.5	3,768.0	694.3
Total net par outstanding	100.0	100.0	42,583.7	24,697.8	12,345.3	2,279.7

In the European public finance market, the company insured a diverse number of transactions, including sovereigns, infrastructure transactions, and health care facilities. This line of business is the smallest contributor to the company's overall business volume. However, as private infrastructure financing continues to grow in Europe, CIFG's European parentage should serve the company well.

Finances

On a consolidated U.S. GAAP basis, the companies' underwriting income for 2005 was €8.5 million (US\$10 million), compared with underwriting income of €2.6 million (US\$3.1 million) in 2004. The company's results are beginning to reflect the benefits associated with additional licenses, name recognition, and a growing book of business. The ability to book more up-front premium business, combined with structured finance installment premiums, has helped to offset the high level of operating cost relative to business generation that is typical of a relatively new entrant to the financial guaranty business. For 2005, underwriting expenses rose 23%, whereas earned premiums rose 43%. On a U.S. statutory basis, the company had an underwriting expense ratio of 19.5%, down slightly from 20.3% in 2004.

Concerning its other earnings component, the company reported €14.8 million (US\$17.6 million) of investment income and €2.5 million (US\$2.9 million) of net realized investment gains. The investment portfolio has an 'AAA' average credit quality and comprises short-term money market instruments, U.S. government securities, and municipal obligations. As the book of insured par has grown, management has invested the premium dollars in higher yielding longer term assets. Approximately 15% of the investment portfolio is invested in short-term securities, down from 75% as of Dec. 31, 2005. For 2005, consolidated U.S. GAAP net income was €14.4 million (US\$17.1 million), up from €7.5 million (US\$10.2 million) in 2004.

Capitalization

The strength of CIFG North America's and CIFG Europe's capital positions is derived from the strength of CIFG Guaranty. CIFG Guaranty has provided a letter of support to CIFG Europe that stipulates that CIFG Guaranty will maintain capital and surplus to policyholders at all times in an amount of not less than €20 million. In addition, there is a stop-loss treaty in place in which CIFG Guaranty will pay all losses of CIFG Europe in excess of €20 million. CIFG North America also has a letter of support from CIFG Guaranty providing that CIFG Guaranty will maintain capital and surplus to policyholders of CIFG North America at all times in an amount of not less than \$80 million. In addition, there is a quota-share reinsurance treaty in which up to 90% of CIFG North America's business can be ceded to CIFG Guaranty.

CIFG had \$591 million of pro forma statutory capital as of Dec. 31, 2005. In December 2004, CIFG Holding closed on a \$200 million debt facility with CNCE. At that time, an initial draw of \$90 million was contributed to CIFG, with the remaining available for future draws. In 2005, \$8.5 million was drawn down from the facility to meet holding company expenses, leaving \$101.5 available to CIFG to support business growth. As of Dec. 31, 2005, CIFG's margin of safety was in the 1.4x-1.5x range. Although the margin of safety is down from the 2.0x-2.1x range reported as of Dec. 31, 2004, it is well above the 1.25x required by Standard & Poor's criteria for an 'AAA' rated financial guarantor.

There were several factors that led to the decline in the margin of safety, none of which indicate a current problem

Table 3 CIFG Consolidated Financial Statistics

(Mil \$)	2005	—Year ended Dec. 31—		2002
		2004	2003	
Insurance Company*				
Total assets	818.1	787.7	622.6	291.9
Cash + invested assets	790.7	775.5	610.0	291.9
Unearned premiums	190.7	122.4	80.0	15.9
Statutory capital	590.9	653.3	524.8	271.0
Net premiums earned	40.5	32.8	10.9	0.9
Losses and LAE	0.0	0.0	0.0	0.0
Underwriting expense	48.1	43.3	44.7	24.7
Investment income including gains	20.5	12.4	12.1	9.3
Net income	17.1	10.8	(24.4)	(16.6)
Loss ratio (%)	0.0	0.0	0.0	0.0
Underwriting profitability ratio (%) [¶]	N/A	N/A	N/A	N/A
Holding Company (CIFG Holdings Consolidated)[§]				
Total assets	877.0	850.0	664.0	314.0
Stockholders' equity	556.0	612.0	630.0	281.0
Net income	11.0	11.7	1.8	(8.0)
Debt/capitalization (%)	17.7	14.7	0.0	0.0
Return on average equity (%)	1.9	1.9	0.4	0.0

*Statutory basis of accounting. [¶](Net earned premiums - underwriting expenses and losses)/net earned premiums. [§]GAAP basis of accounting. N/A—Not applicable.

Table 4 CIFG Consolidated Capital Statistics

(Mil \$)	—Year ended Dec. 31—			
	2005	2004	2003	2002
Portfolio Risk				
Municipal insurance weighted average capital charge (% of average annual debt service)	9.2	7.8	8.4	9.0
Asset-backed capital charge (% of par)	0.7	1.0	1.0	1.8
Claims-Paying Resources				
Statutory capital	590.9	653.3	524.8	168.5
Contingent capital	0.0	0.0	0.0	0.0
Letters/lines of credit	0.0	0.0	0.0	0.0
Owner capital commitment	101.5	110.0	0.0	0.0
Stop-loss treaty	0.0	0.0	0.0	0.0
Unearned premiums	190.7	113.8	80.0	12.4
Present value of annual premiums	186.0	134.7	77.3	0.0
Total	1,069.1	1,011.8	682.1	180.9
Capital Adequacy				
Capital remaining at end of depression test	500-550	800-850	650-700	200-250
Margin of safety (x)	1.4-1.5	2.0-2.1	1.8-1.9	1.5-1.6
Reliance on soft capital (%)	4.3	4.9	0.0	0.0

Table 5 CIFG Consolidated Liquidity Analysis

Assets/Resources as of Dec. 31, 2005	Haircut (%)	Adjusted (mil \$)
Cash and short-term investments	0.0	48.1
Treasury and government agency fixed-income securities	10.0	549.9
Corporate and ABS/MBS bonds	50.0	32.7
Bank lines of credit	0.0	101.5
Total		732.2
Municipal bonds (informational/back-up only)		72.0
Potential Uses (Occurring in the Full Year 2006)		
Largest net total payments in 2006 associated with a municipal obligor default		32.1
Largest net bullet maturity default		3.0
Largest debt service reserve draw		8.5
90 days of payments associated with the largest servicer default		7.6
Largest unscheduled draw on a municipal investment contract		0.0
Largest individual "single name" credit default swap		0.0
Holding company debt and dividend servicing needs		4.5
Total		55.7
Liquidity ratio (x)		13.2

relating to the company's insured portfolio. The assumption for the amount of business written in the first year of the model is greater than in last year's capital adequacy test. For public finance, the amount of business written was 79% higher than last year, and for structured finance it was 35% higher. In the capital adequacy test, simply assuming a greater amount of business to be written in the first year of the model will stress a company's claims-paying resources, as this business is assumed to grow at an accelerated stress rate during the growth years of the model. Adding further stress to the company's claims-paying resources were a 17% increase in the weighted average public finance capital charge and an assumed 45% reduction in the weighted average structured finance premium rate. The combination of a greater amount of assumed business and lower premium income for the public finance business line and higher capital charges for the structured finance business line led to higher theoretical losses in the capital adequacy test of CIFG.

Standard & Poor's reviews a bond insurer's cash position and its ability to raise additional cash against conservatively defined theoretical payments associated with an insurer's various product lines. The approach to this analysis is that there might be unexpected liquidity demands on an insurer in periods of economic tranquility as well as stress. Liquidity resources and potential liquidity demands are examined for the current year and several subsequent years on a pro forma basis. CIFG's conservative investment and limited par outstanding produces an acceptable liquidity ratio 13.2x. Liquid resources totaled \$631 million as of year-end 2005. ■

Financial Guaranty Insurance Co.

Analysts: Robert E Green, New York (1) 212-438-2013; Richard P Smith, New York (1) 212-438-2095

AFFIRMED

CREDIT PROFILE

Fincl strength rtg	AAA
Fincl enhancement rtg	AAA

OUTLOOK: **STABLE**

Rationale

The 'AAA' financial strength and financial enhancement ratings on Financial Guaranty Insurance Co. (FGIC) reflect, in the context of new owners and an expanded business plan, the assembling of a solid management team coupled with expectations for continued improvement in financial performance, continued conservative underwriting, and adequate capitalization at the rating level.

FGIC has a senior management team that is very experienced and well regarded in the industry, led by CEO Frank Bivona, who joined management at the time of the sale of the company from General Electric Capital Corp. (GECC) to a group of investors including the PMI Group. In support of FGIC's broader underwriting initiative, expansion and new procedures have been undertaken in the areas of credit and portfolio risk management. In addition to a more seasoned staff profile, headcount for these two groups is expected to increase to 25 by year-end 2006, up from 18 a year earlier. Notwithstanding FGIC's expanded public finance product line, one of management's stated goals is to continue to have the lowest-risk municipal book of business in the industry. FGIC has a 6.9% weighted average capital charge for its in-force public finance book of business and an 8.8% capital charge for public finance business written in 2005; both capital charge measurements are well below the Dec. 31, 2005, industry average of 11.7%. Progress has been made with respect to the key goal of improving the ROE measurement for holding company

FGIC Corp. ROE was 9.5% for 2005, up from 8.6% in 2004. FGIC remains burdened by its pre-2004, GECC legacy book of generally under-priced municipal business. FGIC Corp. returns trail the lower-to-mid-teen ROEs posted by several of the company's 'AAA' competitors. Nevertheless, FGIC expects strong improvement over the next several years as older business runs off and is replaced by insured debt that is better priced and more diversified. FGIC's capital adequacy margin of safety is on the low end of the 1.3x-1.4x range; the Standard & Poor's Ratings Services minimum for an 'AAA' rated bond insurer is 1.25x. The margin of safety is the ratio of losses paid plus ending capital in the Standard & Poor's capital adequacy model to losses paid.

Outlook

The stable outlook is based on Standard & Poor's belief that FGIC's owners will not allow the company's capital to fall below minimum requirements. We also expect continued prudent underwriting and risk management in the context of planned growth and expansion.

Management And Corporate Strategy

In 2005, FGIC drew much closer to its goal of being a global, full-service financial guaranty provider to municipal and structured finance issuers and investors. This goal is an outgrowth of a change in ownership and related strategic direction. In December 2003, GECC sold FGIC Corp., the parent of FGIC, to a group of investors led by the PMI Group. As of Dec. 31, 2005, the PMI Group owns about 42% of FGIC Corp., while financial investors the Blackstone Group L.P., Cypress Group LLC, and CIVC Partners L.P. own 23%, 23%, and 7%, respectively; GECC retained roughly 5% ownership. The

financial investors are expected to divest in the near-to-intermediate term. PMI is viewed as a strategic, long-term investor motivated by greater diversification of its earnings and increased participation in the credit enhancement market overall.

Business activity under GECC ownership was not diversified; instead, it was largely focused on essential-use public finance sectors such as general obligation, water and sewer, sales and excise tax, and transportation. In the asset-backed market, FGIC selectively participated in the mortgage and home equity loan sectors. The new owners approved the change in strategic direction that has resulted in a staffing increase from about 100 employees at the time of the sale to 189 as of Dec. 31, 2005. The company expects to have a staff of about 230 by year-end, at which time staffing growth is expected to level off. The new plan and larger staff are responsible for the increase in adjusted gross premiums written to \$637.9 million for 2005, up from \$273.6 million in 2003. The new plan has also resulted in policies issued in the previously inactive sectors of auto loans, CDOs, and future-flow securitizations. Sectors that were re-entered in 2004 after a long absence included leasing, health care, municipal electric, investor-owned utilities, housing, and student loans.

FGIC's senior management team is very experienced and well regarded in the industry. CEO Frank Bivona, who joined management at the time of the company's sale, leads the team. Mr. Bivona had been with Ambac Assurance Corp. (Ambac) for 18 years and was most recently that company's vice chairman and CFO. Also joining Mr. Bivona from Ambac is Howard Pfeffer, who has assumed the role of FGIC president. Mr. Pfeffer was with Ambac for 14 years, having had responsibilities in both

the public finance and structured finance areas; his last position at Ambac was vice chairman. Jeff Fried joined FGIC after eight years at Ambac, where he was general counsel for its public finance division. Mr. Freed is running FGIC's public finance group. In addition, Tom Adams, formerly with Ambac for seven years, is heading the consumer asset area. These Ambac alumni join veteran FGIC senior managers Donna Blank, CFO, and Ed Turi, general counsel. Most recently, in 2005, former Ambac manager Alessandra D' Imperio was hired to fill the role of CCO, while another former Ambac manager, Donna Troia, has become a managing director and head of the surveillance group.

The change in ownership and new management has also brought greater pricing discipline to the underwriting process. Greater diversification has allowed the

company to participate in more profitable business sectors. Correspondingly, capital charges—Standard & Poor's principal measurement of insured portfolio risk—have not increased materially and in some cases have decreased during the underwriting expansion.

As the financial investors are expected to divest in the near-to-intermediate term, improving ROE has been a key goal to facilitate that exit strategy. ROE has increased to 9.5% in 2005 from 8.6% in 2004, with comparable increases expected over the next couple of years. While part of the gain is due to fundamental business increase and pricing improvements, a more aggressive capital plan also contributes to the ROE improvements. Capital for FGIC, as measured by the Standard & Poor's capital adequacy model, is in compliance

with the minimum margin of safety requirement of 1.25x, although by a rather thin margin. The holding company is also an above-average user of debt and preferred stock. In view of the desired IPO and maximizing their ROI, the investors would prefer not to have excess capital.

International expansion is also a key element of the business plan. Tim Travers, who was at Ambac for 20 years, is heading FGIC's international efforts. In addition, Eric Rosensweig, previously a managing director at MBIA, was hired in June 2005 to head FGIC's emerging markets effort. In connection with the company's international expansion, affiliate FGIC UK Ltd. was established in December 2004. FGIC UK Ltd.'s 'AAA' rating is based on the close strategic, operational, and financial ties of the company with its parent, FGIC. These ties include financial support in the form of quota share and excess-of-loss reinsurance agreements and a net-worth maintenance agreement, along with consolidated underwriting and risk management. The strategic importance of the subsidiary, combined with the scope of the support, has resulted in FGIC UK Ltd. being designated a "core" subsidiary. Core subsidiaries are seen as integral to the parent's operations and future strategy, and in Standard & Poor's view would be supported by the parent under any foreseeable circumstances. As a U.K.-licensed and domiciled company, FGIC UK Ltd. is authorized to conduct financial guaranty insurance business in other European Economic Area jurisdictions on a passported basis.

The risk-management function for FGIC includes the new issue credit review and approval process, which is headed by the CCO, and the portfolio risk-management function. This surveillance function was realigned in 2005 and now reports to Ed Turi, general counsel. Under GECC ownership, given the limited number of sectors, surveillance was not a separate operating area; rather, it was mostly a function of the underwriting and origination groups. This has changed as the now-separate portfolio risk-management group

Table 1 Financial Guaranty Insurance Co. Business Statistics

(Mil \$)	—Year ended Dec. 31—				
	2005	2004	2003	2002	2001
Net par exposure	275,327.0	236,776.9	206,744.7	187,918.0	172,505.5
Adjusted Gross Premiums Written*					
U.S. public finance	371.0	306.5	224.3	198.3	124.5
U.S. asset-backed and other	195.2	120.1	49.3	30.3	40.5
U.S. total	566.2	426.6	273.6	228.6	165.0
International public finance	32.3	1.0	0.0	0.0	0.0
International asset-backed and other	39.4	0.0	0.0	0.0	0.0
International total	71.7	1.0	0.0	0.0	0.0
Total adjusted gross premiums written	637.9	427.6	273.6	228.6	165.0
Net premiums written	381.1	313.9	266.0	206.0	136.0
Gross Par Written					
U.S. public finance	41,660.5	33,128.5	33,461.0	38,918.3	32,587.1
U.S. asset-backed and other	36,044.6	26,229.1	8,894.1	9,006.8	7,819.3
U.S. total	77,705.1	59,357.6	42,355.1	47,925.1	40,406.4
International public finance	2,587.5	155.4	0.0	0.0	0.0
International asset-backed and other	3,738.0	0.0	0.0	22.0	0.0
International total	6,325.5	155.4	0.0	22.0	0.0
Total gross par written	84,030.6	59,513.0	42,355.1	47,947.1	40,406.4
Net par written	81,416.6	58,116.6	41,523.5	43,974.7	36,029.2

*Adjusted gross premiums written include up-front and present value of installment premiums.

expands to cover new assets. Currently there are five public finance surveillance analysts and five structured finance analysts. Four to five new hires for the group are expected in 2006. A senior credit committee including the CEO, president, general counsel, CCO, and other senior managers meets daily to review individual transactions. Monthly, the CEO, president, general counsel, CCO, head of surveillance, and other senior managers meet to review portfolio risk limits, policies and procedures, sector trends, and underwriting criteria. The credit and investment committee of the board meets quarterly and provides additional risk-management oversight.

In November 2005, Thomas C. Wajnert joined the company as independent, nonexecutive chairman of FGIC Corp.'s board of directors. Mr. Wajnert founded AT&T Capital Corp. in 1985 and was its chairman and CEO. The board of directors reflects the ownership mix of the company and the senior management of FGIC Corp., and exercises oversight through its audit, credit and investment, and compensation committees.

Business Review

Diversification success and the evolution toward a full-service business platform are apparent in a review of business written in 2005. Underwriting in new sectors contributed to gross par written for the year of \$84 billion, up 41.1% compared with 2004. Likewise, total adjusted gross premiums written equaled \$637.9 million in 2005, up 49% from 2004. This somewhat stronger growth is due to the production of more structured finance business and corresponding annual payment structures.

Even more dramatically, international business written in 2005 reached \$6.3 billion. In 2003, FGIC did not have the infrastructure to underwrite international business, and therefore there was no volume in this sector. International production was mainly in the future-flow and utility sectors. The company also expects some private finance initiative volume in 2006, as it has won several mandates in this sector.

In the U.S. asset-backed sector, gross par insured in 2005 was \$36 billion, a 37.4% increase over 2004 and a 300% increase over 2003 U.S. structured finance results. Adjusted gross premiums in this sector totaled \$195.2 billion in 2005, a 62.5% increase over 2004 due to mix of business changes. In 2004, more than 90% of the company's production was in

the mortgage sector, which also includes home equity loans; mortgage and home equity loans made up 52.5% of structured production that year. The difference was made up by about \$10.1 billion of CDO production, representing 28% of par written in the U.S. structured sector in 2005. Also, the production in the other asset-backed sectors was \$8.2 billion in 2005

Table 2 Financial Guaranty Insurance Co. Portfolio Statistics

(Mil \$)	—Year ended Dec. 31—					
	2005 industry average % of par	2005 % of par	2005 par	2004 par	2003 par	2002 par
Public Finance						
GO	21.9	34.0	93,570.0	96,618.0	97,456.7	88,127.3
Utility	9.7	10.7	29,478.0	31,472.0	32,276.9	30,755.3
Tax-backed	8.8	15.0	41,192.0	34,093.0	27,812.0	22,230.4
Health care	4.7	1.5	4,216.0	1,722.0	1,043.8	1,414.6
Transportation	5.4	9.1	24,956.0	23,715.0	21,883.4	21,443.5
Colleges and universities	3.2	3.8	10,361.0	10,058.0	7,980.2	5,945.2
Investor-owned utilities	1.6	1.7	4,728.0	2,242.0	397.2	341.2
Housing	1.8	0.4	1,234.0	377.0	128.1	229.8
Special revenue	0.6	0.0	0.0	0.0	0.0	0.0
Other	3.3	2.0	5,384.0	2,439.0	350.9	609.6
Total	61.2	78.1	215,119.0	202,736.0	189,329.2	171,096.9
Leases contained in above	4.7	4.1	15,129.0	9,745.0	5,652.3	3,725.3
Domestic Asset-Backed and Corporate Finance						
MBS	4.5	5.9	16,180.0	13,761.0	2,882.9	5,246.8
Home equity loan	2.9	7.2	19,841.0	17,387.0	12,094.5	8,475.4
Auto loan	1.8	1.0	2,690.0	102.0	0.0	0.0
Other consumer asset-backed	1.5	0.2	684.0	931.0	811.7	1,137.7
Commercial asset-backed	7.0	1.6	4,354.0	963.0	0.0	37.4
Bank/financial institutions	0.3	0.0	0.0	4.9	129.1	354.2
Other	7.6	3.8	10,513.0	581.0	1,328.7	1,411.1
Total	25.6	19.7	54,262.0	33,729.9	17,246.9	16,662.6
International						
Public finance	3.4	0.5	1,287.0	311.0	168.6	158.8
Asset-backed	9.5	1.7	4,659.0	0.0	0.0	0.0
Other	0.4	0.0	0.0	0.0	0.0	0.0
Total	13.3	2.2	5,946.0	311.0	168.6	158.8
Total net par outstanding	100.0	100.0	275,327.0	236,776.9	206,744.7	187,918.3

compared with \$1.6 billion in 2004. This included auto loan, Regulation XXX structured insurance, and a pooled aircraft lease transaction.

Production was also robust in the U.S. public finance sector, again aided by broader sector opportunities. Gross par written was \$41.7 billion in 2005, a 26% increase over 2004 U.S. public finance production. Growth was also aided by record new-issue volume in the municipal market in 2005 of \$407 billion. Of that amount, \$228.4 billion was insured, and FGIC's share of the insured market was 17.5%. Sectors that have been re-entered since the company's sale in 2003 include health care, lease finance, municipal electric, investor-owned utilities, housing, student loans, and structured municipal.

Notwithstanding the more diversified business written over the past two years, FGIC's book of business lags the overall

industry in terms of diversification.

FGIC's total public finance par insured as of Dec. 31, 2005, was \$215.1 billion, or 78.1% of the total insured portfolio compared with the 2005 industry average of 61.2%. Notable variations within public finance are FGIC's health care portfolio of 1.5% compared with the 2005 industry average of 4.7%. Likewise, GO exposure was 34% for FGIC versus 21.9% for the industry. Also, FGIC's total asset-backed insured book of business was \$54.3 billion, or 19.7% of the total insured portfolio compared with the 2005 industry average of 25.6%. International business for FGIC was 2.2% of the total insured portfolio of \$275 billion. The 2005 industry average was 13.3%.

FGIC is a below-average user of reinsurance, although this could change going forward. Only about 7.7% of the gross insured par book of business of \$298.4

billion has been reinsured. The company currently cedes reinsurance primarily through a facultative arrangement.

The risk profile of FGIC's insured book of business remains very low. The company's internal ratings profile indicates a low 0.5% of ratings in the speculative-grade category. The average capital charge on the company's municipal book of business is 6.9%, well below the 2005 industry average of 11.7%. As expected, the capital charge on the 2005 book of insured municipal business was higher than the historical weighted average at 8.8%, reflecting the diversification efforts. The insured structured financial portfolio has a weighted average capital charge of 1.30% as of year-end 2005. This is down substantially from 2.50% a year earlier and below the 2005 average asset-backed capital charge of 1.83%. The decline is again attributable to diversification efforts, especially in the CDO area, where most of the business was credit-estimated in the 'AAA' category with correspondingly low capital charges.

Finances

Progress has been made with respect to the key goal of improving the ROE measurement for holding company FGIC Corp. For 2005, ROE was 9.5%, up from 8.6% in 2004. FGIC remains burdened by its pre-2004, GECC legacy book of generally under-priced municipal business. FGIC Corp. returns trail the lower-to mid-teen ROEs posted by several of the company's 'AAA' competitors. Nevertheless, FGIC expects strong improvement over the next several years as older business runs off and is replaced by insured debt that is better priced and more diversified. A trading value disparity is not an issue for the company.

In terms of the profitability of business written in 2005, the public finance profitability index (weighted average premium rated divided by weighted average capital charge) was 5.7%, down from 6.5% in 2004 but still well above the 4.7% index of the FGIC 2002 book of business. The profitability index for the U.S. asset-backed book of business written in 2005 was 7.41% compared

Table 3 Financial Guaranty Insurance Co. Financial Statistics

(Mil \$)	—Year ended Dec. 31—				
	2005	2004	2003	2002	2001
Insurance Company*					
Total assets	3,504.1	3,115.7	2,740.7	2,931.1	2,751.3
Cash + invested assets	3,437.5	3,076.5	2,700.6	2,898.0	2,719.4
Unearned premiums	1,239.1	1,047.6	879.8	759.9	693.9
Statutory capital	2,198.3	2,011.1	1,834.7	2,048.6	1,939.7
Net premiums earned	183.3	146.1	146.1	139.9	96.0
Losses and LAE	22.2	2.0	(3.0)	7.2	2.1
Underwriting expense	65.7	68.8	59.3	28.2	26.0
Investment income including gains	126.0	112.2	148.2	188.1	202.0
Net income	192.0	144.1	178.4	205.4	206.9
Loss ratio (%)	2.1	1.4	(2.1)	5.1	2.2
Underwriting profitability ratio (%)¶	52.1	51.5	61.5	74.7	70.7
Holding Company (FGIC Corp.)§					
Total assets	3,748.0	3,421.9	2,981.1	6,187.3	6,339.7
Stockholders' equity	2,079.0	1,918.0	1,743.1	1,928.9	2,085.0
Debt and preferred/capitalization (%)	24.7	25.7	23.4	N/A	N/A
Return on average equity (%)	9.5	8.6	9.7	10.1	10.6

*Statutory basis of accounting. ¶(Net earned premiums - underwriting expenses and losses)/net earned premiums. §GAAP basis of accounting. N/A—Not applicable.

with a 6.3% profitability index for the company for the 2004 book of U.S. asset-backed business.

Strong growth in premiums earned and investment income, not withstanding Hurricane Katrina losses, generated statutory net income of \$192 million in 2005, a 33.2% increase over 2004 results. Net premiums earned in 2005 totaled \$183.3 million, a 25.4% increase over 2004. The strong growth in net premiums earned reflected correspondingly strong growth in production, higher premium rates in place for the past several years, and municipal refundings of \$66.1 million for 2005 compared with \$63.4 million in 2004.

Underwriting expenses in 2005 totaled \$65.7 million, well above the high of \$28.2 million underwriting expenses before the sale. The principal driver of the increase is salaries and benefits related to the company's growing staff. Losses and loss adjustment increased sharply in 2005 to \$22.2 million, up from \$2 mil-

lion in 2004. Most of the increase is attributable to reserves established for Hurricane Katrina. The losses contributed to a loss ratio of 12.1% for 2005 compared with 1.4% for 2004.

Statutory investment income was also up strongly in 2005 to \$126 million compared with \$112.2 million in 2004. Contributing to this gain was 13.2% growth in the investment portfolio to \$3.4 billion, fueled by strong operating cash flow and higher premium rates. The company's unearned premium reserve increased by 18.3% in 2005 to \$1.2 billion. An increase in book yield to 4.1% in 2005 from 3.9% in 2004 also contributed to the gain. The credit quality of the investment portfolio remained very strong, with 74% of the insured portfolio invested in 'AAA' rated debt, 23% in 'AA' category rated debt, and 3% in 'A' category rated debt. The tax-exempt sector continues to dominate the investment portfolio at 80% of the total portfolio. Taxable bonds comprise 15% of the total, while short-term

investments represent 5%. Within the tax-exempt portfolio, 44% of investments are insured by other 'AAA' rated bond insurers. FGIC does not invest in its own insured bonds.

In March 2006, David Dowden joined the company as CIO, and eventually will bring the investment management function in-house. Mr. Dowden was previously with Alliance Capital Management for 10 years as a senior vice president and portfolio manager.

Capitalization

Strong insurance production is putting pressure on FGIC's capital position. This situation is in contrast with some of FGIC's competitors, where unattractive market conditions are constraining growth, but is having a positive effect on capital modeling. While the company's margin of safety remains in the range of 1.3x-1.4x, it has fallen to the lower end of the range. Compared with net insured portfolio growth of 16.2% to \$275.3 bil-

Table 4 **Financial Guaranty Insurance Co. Capital Statistics**

(Mil \$)	—Year ended Dec. 31—				
	2005	2004	2003	2002	2001
Portfolio Risk					
Municipal insurance weighted average capital charge (% of average annual debt service)	6.9	6.9	7.3	7.2	7.5
Asset-backed capital charge (% of par)	1.3	2.5	2.5	2.9	2.6
Claims-Paying Resources					
Statutory capital	2,198.3	2,011.2	1,834.7	2,048.6	1,939.7
Letters/lines of credit	0.0	0.0	0.0	0.0	0.0
Contingent capital	300.0	300.0	0.0	0.0	0.0
Owner capital commitment	0.0	0.0	300.0	300.0	300.0
Stop-loss treaty	0.0	0.0	0.0	0.0	0.0
Unearned premiums	1,239.1	1,047.6	879.8	759.9	693.9
Present value of annual premiums	393.1	192.0	111.1	100.2	105.7
Total	4,130.5	3,550.8	3,125.6	3,208.7	3,039.3
Capital Adequacy					
Capital remaining at end of depression test	1,200-1,250	1,300-1,350	1,100-1,150	1,650-1,700	1,050-1,100
Margin of safety (x)	1.3-1.4	1.3-1.4	1.3-1.4	1.5-1.6	1.3-1.4
Reliance on soft capital (%)	12.4	13.4	15.5	18.5	20.5

Table 5 Financial Guaranty Insurance Co. Liquidity Analysis

Assets/Resources as of Dec. 31, 2005	Haircut (%)	Adjusted (mil \$)
Cash and short-term investments	0.0	204.4
Treasury and government agency fixed-income securities	10.0	261.6
Corporate and ABS/MBS bonds	50.0	92.5
Bank lines of credit	0.0	250.0
Adjusted cash resources		808.5
Municipal bonds (informational/back-up only)		2,777.8
Potential Uses (Occurring in the Full Year 2006)		
Largest net total payments in 2006 associated with a municipal obligor default		139.2
Largest net bullet maturity default (potentially includes IOUs, international, or "guaranteed" maturity bonds)		100.7
Largest debt service reserve draw		178.7
90 days of payments associated with the largest servicer default		184.8
Largest financial service obligations such as largest unscheduled draw on a municipal investment contract		0.0
Largest individual "single name" credit default swap or single name in a defaulted synthetic structure		0.0
Holding company debt and dividend servicing needs		19.5
Total usage		622.0
Liquidity ratio (x)		1.3

lion as of Dec. 31, 2005, corresponding statutory capital grew just 9.3%. The margin of safety is the ratio of losses paid plus ending capital in the Standard & Poor's capital adequacy model to losses paid.

Losses in the model for the municipal insured portfolio increased due to both the larger size of the insured portfolio

and an expected slightly higher risk profile for the municipal book of business. A capital charge of 7.5% is assumed for municipal modeling purposes in anticipation of the insurance of somewhat higher risk business going forward. For the company's structured insured portfolio, strong growth of about 74% in

2005, to \$58.8 billion, contributed to the capital adequacy dynamic. Against theoretical losses, in addition to statutory capital of \$2.2 billion, other claims-paying resources include unearned premium reserves of \$1.2 billion and the present value of annual premiums of \$393.1 million. These accounts increased by 18.3% and 105%, respectively, in association with the strong production recorded by the company.

To help boost its ROE measure, FGIC is an above-average user of nonequity capital at the holding company. FGIC Corp. has \$323.3 million of 6% senior notes outstanding due Jan. 15, 2034. The company also has \$268.8 million of senior participating mandatory convertible preferred stock. Debt and preferred stock as a percent of total capitalization is 24.7%.

In assessing a bond insurer's liquidity profile, focus is placed on investments that are readily eligible as collateral for potential reverse repurchase agreements. These include Treasury and government agency securities as well as corporate and structured bonds, but not municipal bonds. FGIC's ratio of discounted cash resources relative to theoretical payments is acceptable at 130%, unchanged compared with 2004 results. Theoretical payments assume the largest potential cash obligation in the upcoming year in the asset-backed and municipal sectors, plus other operational requirements as appropriate. ■

Financial Security Assurance Inc.

Analysts: Robert E Green, New York (1) 212-438-2013; Richard P Smith, New York (1) 212-438-2095

AFFIRMED

CREDIT PROFILE

Fincl strength rtg	AAA
Fincl enhancement rtg	AAA

OUTLOOK: **STABLE**

Rationale

The 'AAA' financial strength and financial enhancement ratings on Financial Security Assurance Inc. and its related intercompany pool members (FSA Insurance Co. and FSA International Ltd., together known as FSA) reflect the company's:

- Strong capital position,
- Conservative underwriting and risk-management standard, and
- Flexibility associated with a global business operating in all financial guaranty sectors.

FSA's capital adequacy margin of safety currently falls in the range of 1.6x-1.7x, which is above the industry average and well above the minimum 'AAA' requirement of 1.25x. Historically, FSA has taken the capital planning approach of operating with a comfortable cushion above the minimum capital requirement. FSA also uses its capital adequacy margin of safety results to differentiate itself in the marketplace. Underwriting and risk-management standards are likewise conservative. The seasoned management team has fostered a culture of both pricing and underwriting discipline. Risk measurements such as capital charges are generally below the industry average. In the asset-backed sector, the company has historically had the lowest capital charge in the industry. Although business written for the company in 2005 was not priced as well as the two prior years' books of business due to tight spreads and intense competition, management reports that the company still met its hurdle-rate requirements. Standard & Poor's Ratings Ser-

vices' expectation, supported by FSA's first-quarter 2006 results, is that the company will reduce volume rather than approve mispriced business. Dexia S.A., the company's strategic owner, fully endorses management's conservative approach to capital planning, pricing, and underwriting. Dexia S.A. has approved, if necessary, a slow-growth response to the difficult pricing environment. To mitigate to the greatest extent possible the current competitive conditions, FSA is active in a number of global markets, offering a full menu of financial guarantee and credit default swap products, which allows management to deploy capital in those markets where credit and economic opportunities are best.

Outlook

The outlook is stable based on FSA's investment-grade underwriting, prudent risk management, conservative investment policy, and strong capital adequacy.

Management And Corporate Strategy

Continuity and experience are key characteristics of FSA's well-regarded management team. Robert P. Cochran remains chairman and CEO; Sean W. McCarthy is president and COO. Other senior managers include Russell B. Brewer II, managing director and chief risk management officer; Bruce E. Stern, general counsel and secretary; and CFO Joseph W. Simon.

Expectations for a continued competitive environment and reduced volume in some sectors are principal considerations in shaping FSA's near-term strategic plan. With tight credit spreads, intensive competition, and strong investor demand for mezzanine securities, management views underwriting discipline as the most appropriate response. Rather than approving unacceptably priced business, FSA and

parent company Dexia S.A. are prepared to accept lower volume, if necessary. Near term, ROEs and revenue growth could also decline as well.

Management has cultivated a conservative underwriting, risk-management, and capital planning culture for many years. Standard & Poor's expectation is that, notwithstanding current competitive pressures, these corporate characteristics will remain in place. FSA has the lowest risk book of asset-backed business in the industry as measured by our capital charge statistics. Profitability index trends confirm good pricing discipline and capitalization, as measured by Standard & Poor's capital adequacy margin of safety, which is usually above the average of the company's industry peers.

FSA's parent company Dexia S.A. ultimately owns about 99% of FSA Holdings Ltd. Dexia S.A. (and key operating subsidiary Dexia Credit Local, rated 'AA') is among the largest banking groups in Europe and the region's leading public finance lender.

FSA benefits in several ways from the relationship. Name recognition in Europe gives FSA UK Ltd. increased visibility in Europe. Synergies exist to the extent that about 40% of all European transactions closed in 2005 involved Dexia acting in some capacity (typically a funding or liquidity provider) along with FSA. Dexia also provides a source of capital independent from the public market.

Dexia and FSA share a similar, conservative credit culture, so Dexia endorses the company's slower growth response to the difficult pricing environment. With respect to governance, Dexia has assured Standard & Poor's that maintaining the 'AAA' rating for FSA is of paramount importance, and to that end FSA is allowed to operate as an "independent"

company. The FSA board totals 12 directors and includes four independent members, two FSA senior executives, and six Dexia members. Dexia has also integrated several FSA executives into a number of risk-management and operating committees, benefiting both organizations.

Management's mandate with respect to the difficult operating environment is for the staff to be as creative as possible in terms of developing business. In the public finance market, FSA is attempting to adapt European infrastructure public finance technology for use in the U.S., and has moved employees to the U.S. from Europe to aid in the development of this market. The Chicago Skyway toll bridge system concession, where the city of Chicago entered into a 99-year lease for the operation of that system with a

private entity, is an example of a new possible area of business. Water projects, as well as roads, could also fit this model. Parent company Dexia provided a swap in the Skyway transaction and is expected to play a critical role in the development of this market. In the more traditional public finance market, management will attempt to counter the competitive pressure by targeting smaller, less-visible deals.

In the asset-backed market, FSA hopes to selectively expand its product line to include such products as insurance securitizations, aircraft pooled lease transactions, pooled leases, and future-flow transactions. To that end, John Dare has joined FSA as managing director of asset finance in the corporate finance group. He was previously with MBIA Insurance Corp., where he

was a managing director and head of the global financial institutions group.

Internationally, FSA's response to the challenging environment is expansion. Longer term, FSA views the Asian market as a significant source of growth. To enhance its position in the region, Kazuhiko Shiotani, formerly managing director and yen product manager for Nikko Citigroup, has recently been hired to head FSA's Japanese office and take charge of the Asia region. In addition, FSA's insurance-licensing application with the Japanese insurance authorities has been submitted and is now in process. Management believes that Japan will eventually develop a municipal market. Likewise, good growth potential for certain sectors such as asset-backed and public infrastructure transactions is expected in Latin America. Eduardo Ramos de la Cajiga, formerly managing director for Casa de Bolsa Banorte, has joined FSA as managing director for Latin America. He will be based in FSA's new Mexico City representative office, which is the company's first local office in Latin America.

FSA is an above-average industry user of reinsurance. The company uses facultative and its auto-facultative programs mostly to increase single-risk capacity (exposure to individual credits), especially for large project finance transactions in Europe. It also uses traditional quota-share treaties, mostly in the public finance market. In some cases FSA will reinsure project finance or asset-backed transactions using its "layered loss" product or first-loss reinsurance. This has been very beneficial to FSA in terms of insured portfolio management, as well as economically in that the treaty is generally structured so, in contrast to a quota-share arrangement, the reinsurer is assuming somewhat higher risk in exchange for higher premiums.

Business Review

Tight credit spreads, a competitive environment, and investor demand for senior subordinated structures were especially detrimental in the area of asset-backed production and book of business profitability for FSA in 2005. Gross U.S. asset-backed par insured in 2005 was \$33

Table 1 Financial Security Assurance Inc. Consolidated Business Statistics

(Mil \$)	—Year ended Dec. 31—				
	2005	2004	2003	2002	2001
Net par exposure	351,398.0	325,808.5	294,389.6	265,700.4	217,110.8
Adjusted Gross Premiums Written*					
U.S. public finance	485.0	433.5	483.1	420.7	222.3
U.S. asset-backed and other	195.4	234.2	177.6	196.1	351.7
U.S. total	680.4	667.7	660.7	616.8	574.0
International public finance	185.0	127.5	129.4	124.4	23.0
International asset-backed and other	56.0	58.3	60.4	74.9	97.3
International total	241.0	185.8	189.8	199.3	120.3
Total adjusted gross premiums written	921.4	853.5	850.5	816.1	694.3
Net premiums written	608.3	615.8	624.5	523.3	459.4
Gross Par Written†					
U.S. public finance	64,805.9	48,983.6	54,862.6	51,622.3	36,451.6
U.S. asset-backed and other	33,027.4	54,725.9	19,205.5	38,351.3	56,689.0
U.S. total	97,833.3	103,709.5	74,068.1	89,973.6	93,140.6
International public finance	7,421.0	2,718.9	2,529.1	2,351.0	1,035.5
International asset-backed and other	6,637.0	7,472.7	7,735.3	17,403.3	20,048.4
International total	14,058.0	10,191.6	10,264.4	19,754.3	21,083.9
Total gross par written	111,891.1	113,901.1	84,332.5	109,727.9	114,224.5
Net par written	90,002.0	92,436.6	68,084.7	84,493.1	91,447.5

*Adjusted gross premiums written include up-front and present value of installment premiums and exclude guaranteed investment contract business. †Gross par written includes guaranteed investment contract business.

billion, a 39.6% decline from 2004. The present value of premiums written for the 2005 U.S. asset-backed book of business was \$195.4 million, a lesser, 16.6% decline compared with the 2004 book of business. Most notably, residential mortgage production was \$28.8 billion in 2004, but declined to \$8.3 billion in 2005 as tight spreads have been especially problematic with respect to residential mort-

gage net interest margin business. A shift in the mix of asset-backed business to longer duration business moderated the decline in the present value of premiums.

Market conditions also contributed to deterioration in the profitability of the 2005 book of asset-backed business relative to prior years' books of business. Mostly reflecting the mix of business changes and greater volatility for those

asset classes, the gross capital charge for the period was 1.71% compared with 0.97% for the 2004 book of business. The associated weighted average premium rate failed to keep pace with the incremental risk. The 2005 weighted average premium rate for U.S. asset-backed business was 0.19% compared with 0.18% in 2004. The profitability index—the ratio of premium rate to capital charge—is a

Table 2 Financial Security Assurance Inc. Consolidated Insurance Portfolio Statistics

(Mil \$)	2005 industry average % of par	2005 % of par	—Year ended Dec. 31—			
			2005 par	2004 par	2003 par	2002 par
Public Finance						
GO	21.9	25.3	88,922.0	76,081.0	65,221.7	52,786.0
Utility	9.7	10.6	37,245.0	33,544.3	30,024.6	23,442.2
Tax-backed	8.8	11.6	40,622.0	36,631.0	33,835.1	27,556.2
Hospitals	4.7	3.4	11,789.0	9,261.1	7,051.2	5,969.8
Transportation	5.4	4.2	14,695.0	12,834.4	10,744.2	7,640.2
Colleges and universities	3.2	1.2	4,065.0	3,248.5	2,896.2	2,219.1
Investor-owned utilities	1.6	0.0	94.0	174.1	406.4	468.4
Housing	1.8	2.2	7,585.0	7,628.3	7,597.0	5,833.4
Special revenue	0.6	0.0	0.0	0.0	0.0	0.0
Other	3.3	2.8	9,890.0	7,830.4	7,422.8	7,084.8
Total	61.2	61.2	214,907.0	187,233.1	165,199.0	133,000.1
Domestic Asset-Backed and Corporate Finance						
MBS	4.5	3.8	13,473.0	25,144.8	14,527.5	20,276.1
Home equity loan	2.9	1.4	4,990.0	1,987.0	288.9	1,327.9
Auto loan	1.8	1.9	6,773.0	7,810.0	11,692.1	17,128.6
Other consumer asset-backed	1.5	0.4	1,378.0	1,407.3	1,488.0	1,284.4
Commercial asset-backed	7.0	0.0	9.0	10.2	12.1	12.1
Bank/financial institutions	0.3	0.0	0.0	0.0	0.0	0.0
Other	7.6	19.5	68,388.0	61,413.0	57,489.2	54,158.8
Total	25.6	27.0	95,011.0	97,772.3	85,497.8	94,187.9
International						
Public finance	3.4	3.5	12,357.0	8,450.2	6,145.2	4,645.4
Asset-backed	9.5	8.3	29,123.0	32,352.2	37,547.6	33,867.0
Other	0.4	0.0	0.0	0.0	0.0	0.0
Total	13.3	11.8	41,480.0	40,802.4	43,692.8	38,512.4
Total net par outstanding	100.0	100	351,398.0	325,808.5	294,389.6	265,700.4

risk-adjusted pricing measure that shows how much premium has been collected per unit of risk. The profitability index for the FSA's 2005 U.S. asset-backed book of business was 11.22% compared with 18.2% in 2004.

The story was much the same in the international asset-backed sector. About \$6.6 billion of international asset-backed par was insured in 2005 compared with \$7.5 billion in 2004. For the 2004 book, the weighted average premium rate and weighted average capital charges were 0.11% and 0.17%, respectively. For the 2005 book of international asset-backed business, the weighted average premium rate and weighted average capital charges were 0.17% and 0.51%, respectively. The profitability index for the 2005 international asset-backed book of business was 33.54%, down from 69.3% a year earlier.

The news was mixed in the U.S. public finance market for FSA, as increased volume was generated but with lower profitability characteristics than those recently generated. Record new issue volume of \$408 billion, supported by continued low rates and strong refundings, contributed to record FSA gross municipal par insured of \$64.8 billion, a 32% increase over 2004 gross municipal par production. With new issue production of \$60 billion, FSA had a leading municipal market share position (26.3%). There was a mix shift in U.S. public finance in 2005 as well. Insured GO par in 2004 accounted for 45% of total U.S. public finance production. In 2005 it fell to 39% of total U.S. public finance production. Making greater contributions to the mix in 2005 were the tax-supported, utility, and health care sectors.

While the risk profile of the 2005 book stayed about the same as 2004 with

weighted average capital charges of 7.48% and 7.42%, respectively, competition resulted in a modest decline in respective weighted average premium rates (0.44% for 2005 compared with 0.52% for 2004). The profitability index for the 2005 book of U.S. public finance business was 5.92%, down from 7.05% in 2004.

Overall, the international public finance sector exhibited a similar combination of growth and economic deterioration. Strong volume in the U.K. infrastructure sector contributed to \$14.1 billion of international public finance par insured, up 37.9% from 2005. From a risk profile perspective, the weighted average capital charge for the 2005 book was 13.9%, down from 16.0% in 2004. The average premium rate for the 2005 book of business was 1.34%, down from 1.70% in 2004. Overall, 2005's public finance international profitability index was 9.7%, down from 10.8% in 2004.

In 2001 FSA began its guaranteed investment contract business to further diversify its sources of revenue and to provide additional services for its financial guaranty customers. As of Dec. 31, 2005, \$13.4 billion of assets were under management, generating a net interest margin of \$22.8 million for the year. The company measures business results by calculating a present value of future net interest margin that was \$92.6 million in 2005, compared with \$73.7 for the prior year. FSA does a good job of measuring and managing the risk relating to its spread lending business. It synthetically cash-matches the assets and liabilities (that is, it uses interest-rate swaps to convert both sides to floating to eliminate most first-order market risk). The majority of the assets it is funding are 'AAA' rated ABS: roughly 92% and 7% of the portfolio is rated in the 'AAA' and 'AA' categories, respectively. Liabilities are composed of both guaranteed investment contracts written on municipal transactions and funding agreements relating to structured transactions.

Current business conditions have also had an effect on the sector mix for the overall portfolio. The softness in the mortgage sector, combined with the run-

Table 3 Financial Security Assurance Inc. Consolidated Financial Statistics

(Mil \$)	—Year ended Dec. 31—				
	2005	2004	2003	2002	2001
Insurance Company*					
Total assets	4,640.0	4,253.0	3,754.3	3,229.6	2,592.3
Cash + invested assets	4,499.0	4,134.0	3,634.1	3,104.7	2,547.6
Unearned premiums	1,850.4	1,649.2	1,356.4	1,055.3	810.9
Statutory capital	2,417.5	2,280.9	2,104.3	1,876.1	1,593.6
Net premiums earned	386.7	335.7	338.7	298.5	214.6
Losses and LAE	8.1	16.7	12.7	45.0	8.6
Underwriting expense	174.0	165.5	142.3	119.4	124.5
Investment income including gains	204.0	174.7	177.3	175.2	142.0
Net income	292.9	242.0	262.9	195.1	173.1
Loss ratio (%)	14.1	5.0	3.7	15.1	4.0
Holding Company (Financial Security Assurance Holdings Ltd.)†					
Total assets	22,002.0	17,080.8	12,409.8	7,027.5	4,306.9
Stockholders' equity	2,823.0	2,550.0	2,168.4	1,868.4	1,636.0
Net income	326.0	363.8	290.6	181.1	209.5
Debt/capitalization (%)	13.2	14.4	16.5	18.7	16.8
Return on average equity (%)	12.0	15.6	14.5	11.1	13.3

*Statutory basis of accounting. †GAAP basis of accounting.

off of existing business, has contributed to a reduction in the amount of total asset-backed business insured. For the total insured portfolio, par exposure in the U.S. mortgage sector declined to \$13.5 billion as of Dec. 31, 2005, down from \$25.1 billion as of Dec. 31, 2004. Mostly as a result, overall insured U.S. asset-backed par exposure was \$95 billion as of year-end 2005, down from \$97.8 billion a year earlier. Whereas U.S. asset-backed business represented 30% of total insurance in 2004, it has declined to 27% in 2005 with U.S. municipals accounting for 61.2% and the international sector accounting for 11.8%.

From an overall credit quality perspective, the insured book of business remains very sound. Based on FSA ratings, about 0.5% of the insured portfolios is speculative grade—a low number for a mature company. For the total insured portfolio, the public finance capital charge declined modestly to 8.1% as of Dec. 31, 2005, from 8.3% as of Dec. 31, 2004—well

below the 2005 industry average of 11.7%. Likewise, the overall asset-backed capital charge for the entire book of business declined slightly to 0.8% from 0.9%. This weighted average portfolio charge is the lowest in the industry.

At this time last year, FSA Holdings indirectly owned a 34% stake in the parent company for Select Portfolio Servicing, formerly known as Fairbanks Capital Corp., a company specializing in sub-prime mortgage-servicing portfolios. FSA sold its stake in the company in 2005. FSA's only other material strategic investment is its 13% investment in preferred shares of bond reinsurer XL Financial Assurance Ltd.

Finances

Net income for holding company FSA Holdings Ltd. fell by 13.9% in 2005 to \$326.1 million. However, that result was influenced by fair-value adjustments for insured credit default swaps and economic interest-rate hedges. These adjust-

ments add substantial volatility to FSA financial statements but are not really reflective of fundamental changes to credit risk or economics. Operating earnings, which exclude credit default swaps and economic interest-rate hedges, were \$333.9 million for 2005, which is 3.1% higher than in 2004.

Lower asset-backed volume and the business mix shift from short-life mortgage net interest margin product to longer life CDO and asset finance contributed to relatively flat GAAP earned premium in 2005. Also, slower growth in earned and written premium is a function of more municipal business in the total insured portfolio with characteristics of lower premium rates and longer maturities. Total net premium earned in 2005 was \$401 million, up just 2.2% from 2004 levels. This slow earnings growth dynamic is expected to remain in the near term. Excluding incremental refunding gains, net earned premiums were flat. Refundings will

Table 4 Financial Security Assurance Inc. Consolidated Capital Statistics

(Mil \$)	—Year ended Dec. 31—				
	2005	2004	2003	2002	2001
Portfolio Risk					
Municipal insurance weighted average capital charge (% of average annual debt service)	8.1	8.3	8.4	8.9	9.3
Asset-backed capital charge (% of par)	0.8	0.9	1.0	0.8	0.9
Claims-Paying Resources					
Statutory capital	2,417.5	2,280.9	2,104.3	1,876.1	1,593.6
Contingent capital	200.0	200.0	200.0	0.0	0.0
Letters/lines of credit	350.0	325.0	325.0	240.0	240.0
Stop-loss treaty	0.0	0.0	0.0	0.0	0.0
Unearned premiums	1,850.4	1,649.2	1,356.4	1,055.3	810.9
Present value of annual premiums	803.0	727.3	607.1	589.7	556.4
Loss reserves	54.2	48.1	64.9	58.0	16.5
Total	5,675.1	5,230.5	4,657.7	3,819.1	3,217.3
Capital Adequacy					
Capital remaining at end of depression test	2,100-2,150	1,900-1,950	1,950-2,000	1,450-1,500	1,150-1,200
Margin of safety (x)	1.6-1.7	1.5-1.6	1.6-1.7	1.5-1.6	1.4-1.5
Reliance on soft capital (%)	13.8	16.7	17.0	16.4	23.1

likely be down in 2006. Net written premium in 2005 was \$577.7 million, down from \$587.8 million in 2004.

With respect to GAAP expenses, the provisions for losses and loss-adjustment expenses were \$25.4 million in 2005 compared with \$20.6 million in 2004. FSA loss reserves include both case-basis and nonspecific reserves. Case reserves increased modestly by \$8.3 million due to deterioration of existing CDO exposure. As of the first quarter of 2006, FSA had not received any notice of payment default on any exposures related to Hurricane Katrina and has not established any related case-specific reserves. Policy acquisition costs increased by 9.8% in connection with related compensation levels and the increased staff. Excluding deferred compensation-related expenses, which are offset in other income and have no effect on net income, other oper-

ating expenses totaled \$91.4 million in 2005—a 13% increase over 2004 operating expenses. This increase was primarily related to increased personnel costs and increases in premises and equipment expense as a result of the move to the company's new headquarters.

FSA's financial products segment made a positive contribution to FSA Holdings' revenue growth. Due to the larger book of guaranteed investment contracts under management, the net interest margin for 2005 for this business was \$40.5 million compared with \$23.5 million in 2004.

Return on average equity for the company was, compared with historical results, a relatively low 12.0%, but return on average equity using operating earnings was 13.5%. These results should be viewed in the context of the company being in a somewhat excess-capital situation and having some additional debt

leverage capacity at the holding company's 'AA' senior debt level.

The quality of FSA's balance sheet remains very strong. Statutory assets and statutory invested assets totaled \$4.6 billion and \$4.5 billion, respectively, as of Dec. 31, 2005; statutory net investment income was \$199 million. Investment management responsibilities are about evenly split between FSA and BlackRock Inc. FSA's principal investment goal is growth in adjusted book value through the generation of an optimal level of after-tax investment income while preserving capital and maintaining adequate liquidity. Credit quality management guidelines specify that the almost exclusively fixed-income portfolio will have an average credit rating of at least 'AA-', and generally all securities will be rated 'A-' or higher. About 75% of FSA's investment portfolio is tax exempt, with 17% taxable and 8% short term. In terms of credit quality, 70% of the portfolio is rated 'AAA', 18% is in the 'AA' category, 4% is in the 'A' category, and 8% is rated 'A-1+'. In the municipal portfolio, 46% of that total is insured, including 6% insured by FSA. The SEC is currently reviewing the accounting treatment for investments in insured bonds wrapped by the insuring company for the entire bond insurance industry.

In addition to emphasizing present-value premiums as the optimal way to measure top-line growth, management focuses on adjusted book value in measuring the intrinsic value of the company because it includes, on a present-value basis, deferred income less related expenses. It also excludes mark to market adjustments for credit default swaps and one-sided accounting for economic interest-rate hedges. The adjusted GAAP holding company book value was \$3.9 billion as of Dec. 31, 2005, up 11.5% from the prior year; corresponding GAAP equity was \$2.8 billion.

Excluding consolidated debt of the financial services company and variable interest entities, FSA Holdings has \$430 million of debt in its capital structure. This represents financial leverage of 13.9%. Historically, leverage has been as low as

Table 5 Financial Security Assurance Inc. Liquidity Analysis

Assets/Resources as of Dec. 31, 2005	Haircut (%)	Adjusted (mil \$)
Cash and short-term investments	0.0	374.2
Treasury and government agency fixed-income securities	10.0	173.0
Municipal repo line	N/A	189.5
Corporate and ABS/MBS bonds	50.0	233.6
Bank lines of credit	0.0	250.0
Total		1,220.3
Potential Uses (Occurring in the Full Year 2006)		
Largest net total payments in 2006 associated with a municipal obligor default		181.7
Largest net bullet maturity default (potentially includes IOUs, international, or "guaranteed" maturity bonds)		108.6
Largest debt service reserve draw		83.3
90 days of payments associated with the largest servicer default		47.9
Largest financial service obligations, such as largest unscheduled draw on a municipal investment contract		0.0
Largest individual "single name" credit default swap or single name in a defaulted synthetic structure		0.0
Holding company debt and dividend servicing needs		28.3
Total usage		449.8
Net (assets - usage)		770.5
Liquidity ratio (x)		2.7
N/A—Not applicable.		

13% and as high as 19%. This is consistent with 'AA' senior debt rating standards.

Capitalization

FSA's capital position remains very strong in the context of 'AAA' bond insurance criteria. Total claims-paying resources increased by 8.5% to \$5.7 billion as of Dec. 31, 2005. Within this category, qualified statutory capital was \$2.4 billion at year-end 2005, a 6% increase over year-end 2004 results. Due to strong municipal volume, FSA's unearned premium reserve account increased by 12.2% to \$1.8 billion as of year-end 2005.

For "catastrophic" claims protection, in addition to the company's statutory capital and future earnings, FSA has both a bank line of credit and a contingent capital facility. The bank line of credit is an irrevocable, nonrecourse facility of a group of highly rated banks, maturing April 30, 2015, that covers the municipal portfolio for up to \$350 million in losses, subject to FSA's first-loss obligation. The contingent capital resource of \$200 million is funded by the sale of auction-rate debt issued under the name of Sutton Capital Trusts I-IV, and invested in pools of short-term, highly rated instruments that are available to fund the purchase of FSA preferred stock at management's discretion. Standard & Poor's believes that the preferred stock would only be put to the trust in a serious claims-paying environment.

Against these claims-paying resources and the future earnings of the company, a

theoretical worst-case level of losses is assumed in Standard & Poor's capital adequacy model. An assessment of the capital charges against the current and prospective books of business generates the losses. Business ceded to reinsurers is adjusted to take into consideration the credit quality of the reinsurer, and investments are discounted to account for credit losses and possible market value losses. Standard & Poor's key capital adequacy measurement is the margin of safety. This is the ratio of losses incurred during the theoretical period of stress plus ending capital, divided by losses incurred. FSA's margin of safety as of Dec. 31, 2005, was in the lower end of the 1.6x-1.7x range. This is up from 1.5x-1.6x in the previous year and is well in excess of the minimum Standard & Poor's requirement of 1.25x. The improvement is due to the smaller in-force book of asset-backed business combined with business plan expectations for less asset-backed business written in 2006. Somewhat lower capital charges also contributed to the improving margin of safety. Additional improvement was moderated by an \$87 million dividend in 2005 and the expectation for greater dividends during the stress-test period relative to the prior year.

FSA's liquidity profile is in compliance with Standard & Poor's requirements. The company's liquid assets, cash, and other resources, discounted as appropriate, total \$1.2 billion as of Dec. 31, 2005. Discounted credit is given only for those financial instruments that are readily eligible as col-

lateral for reverse-repurchase (repo) transactions. The increase from last year's liquid asset total of \$809.8 million is mostly due to the establishment of a municipal repo line of \$189.5 million. In addition to financial assets of \$780.8 million, FSA has \$250 million in bank lines of credit. Measured against those resources are, theoretically, the largest individual claims or other cash usages for each of the company's various product lines or risk categories as well as holding company dividend requirements. These theoretical cash usages potentially totaled \$449.8 million, yielding a ratio of sources to uses of 2.7x.

Given the company's smaller size relative to some other major competitors, FSA is a major user of reinsurance. In our capital model it is assumed that FSA's reinsurer obligations comprise about 26% of FSA's total capital from all sources. However, FSA benefits from the establishment of collateral placed in trust by several of its principal reinsurers. Collateral increases internal FSA single-risk limits and allows 'AAA' modeling treatment for the reinsurer if the collateral and trust are appropriately structured. The company gets full 'AAA' credit for the \$29 billion of par that it has ceded to The Tokio Marine and Nichido Fire Insurance Co. Ltd. ('AA-' financial strength rating, positive outlook) as a result of \$394 million in short-term 'AAA' assets placed in trust for the benefit of FSA. When factoring this collateral into the calculation, FSA's reliance-on-soft-capital ratio adjusts to 13.8%. ■

MBIA Insurance Corp.

Analysts: David Veno, New York (1) 212-438-2108; Richard P Smith, New York (1) 212-438-2095

AFFIRMED

CREDIT PROFILE

Fincl strength rtg	AAA
Fincl enhancement rtg	AAA

OUTLOOK: **STABLE**

Rationale

The 'AAA' financial strength and financial enhancement ratings on MBIA Insurance Corp. (MBIA) reflect a strong capital position, diverse underwriting in a number of global markets, and sound investment-grade underwriting and risk-management standards. As of Dec. 31, 2005, the company's margin of safety was in the higher end of the 1.4x-1.5x range, which is well above Standard & Poor's Ratings Services' minimum 'AAA' requirement of 1.25x. Through the years, the company's capital position has been effectively managed with a balance between maintaining a strong capital position to support business growth and providing acceptable returns to shareholders. Because the company has long been active in a number of global markets, management is able to deploy capital in those markets that offer the best growth opportunities. In the current competitive financial guarantee business environment, this underwriting strategy could serve the company well. The soundness of the company's underwriting is evident in its long history of minimal losses on its insured portfolio. However, the company has a large speculative-grade exposure, whether expressed as a percent of its insured portfolio or as a multiple of its statutory surplus.

Outlook

The stable outlook reflects MBIA's currently strong capital and claims-paying resources relative to risk exposure, as well as its investment-grade underwriting standards. The outlook also reflects

Standard & Poor's expectation that the firm's financial standing will not be impaired once the settlement to the regulatory investigations is finalized. The rating and outlook would be reassessed in the event MBIA's speculative-grade exposure deteriorates further and results in an increase in significant actual losses, which, to date, have not materialized.

Management And Corporate Strategy

In the current underwriting environment of heightened competition and tight credit spreads, it could be difficult for MBIA to achieve its business production goals. From a capital adequacy perspective, less business underwritten is less of a strain on capital. However, management is faced with the challenge of producing acceptable returns for shareholders while not sacrificing underwriting credit quality. By prudently underwriting business that produces acceptable risk-return pricing, controlling expenses, and managing its capital resources, management believes it can improve shareholder returns. In terms of underwriting, management continues to be committed to investment-grade underwriting and risk-management guidelines that have produced an insured portfolio in which 81% of the obligors are rated 'A' or better as of Dec. 31, 2005. In 2004, MBIA strengthened its insured portfolio management function, and it continues to be the mission of this expanded group to prevent and mitigate loss through proactive remedial measures.

Management's financial guarantee business plan is focused on strengthening its global franchise. This is an attempt to capitalize on international growth opportunities that might be greater than opportunities in the U.S. based on growing international markets and increased acceptance of the financial guarantee

product by international investors. Notwithstanding the increase in competition in the international markets from within the industry, as well as competition from banks, management remains optimistic about future international business prospects. The ongoing development of global capital markets is expected to facilitate expansion for public infrastructure financings and ABS. In many of these markets, MBIA has conducted business for many years and has the staff in these regions to capitalize on any potential business opportunities.

There are no new initiatives planned in the U.S. public finance or U.S. structured finance market. Public finance is viewed as a mature market with modest growth opportunities, although providing steady business volume. Management's outlook on the structured finance market is muted due to narrower credit spreads, increasing investor appetite for uninsured bonds, and increased competition. Competition is sector-specific, as less-seasoned financial guarantors, or mature insurers with expanded underwriting initiatives, target specific sectors. Because of this, MBIA began to examine other sectors for underwriting opportunities and to look more closely at one-off transactions as a source of business volume.

Operationally, senior management is led by Gary C. Dunton, CEO and president of MBIA Inc.; Neil G. Budnick, president of MBIA Insurance Corp.; and C. Edward Chaplin, CFO. Christopher Weeks is head of international business, Mark S. Zucker is head of structured finance, and Tom McLoughlin is head of public finance. Ruth M. Whaley is the chief risk officer, and Mitchell I. Sonkin is head of insured portfolio management.

As previously reported, in November 2004 MBIA received subpoenas relating

to nontraditional reinsurance arrangements, including the Allegheny Health, Education, and Research Foundation (AHERF) reinsurance transactions. On March 30, 2005, MBIA announced that it received additional requests for information that supplement the subpoenas received in November. The information request covered the company's methodology for determining loss reserves and case reserves; its accounting treatment of advisory fees; instances of purchase of credit default protection on itself; and documents relating to Channel Reinsurance Ltd., of which MBIA is part-owner. Last April we answered a number of investor questions we had received relating to the effect of the subpoenas on MBIA's rating and the subsequent request for additional information (see "Credit FAQ: MBIA Insurance Corp. and MBIA Inc.," published April 6, 2005, on RatingsDirect, Standard & Poor's Web-based credit research and analysis system).

In November 2005 MBIA announced a restatement of its financial results, made in connection with potential settlements of investigations by the SEC, the New York State attorney general's office, and the New York State Insurance Department (NYSID) relating to the accounting treatment of reinsurance agreements MBIA entered into in 1998 with Muenchener Rueckversicherungs-Gesellschaft (Munich Re) and AXA Re Finance S.A. (AXA Re). The company also announced that it established a reserve of \$75 million as its estimate for what it will reportedly pay in connection with any settlements of the investigations. With regard to the estimated \$75 million, there are sufficient resources at MBIA Inc. to pay this amount; therefore, there should be no material reduction in MBIA's statutory capital. As of Dec. 31, 2005, the \$75 million estimated payment represented 1.1% of GAAP equity and 45.4% of holding company cash and invested assets.

Business Review

MBIA reported a 3% decline in adjusted gross premiums written for 2005 and a 13% increase in gross par written. The decline in premiums is understandable given

the increased competition and tight credit spreads the company experienced in all business lines. Also contributing to the decline in premiums is management's willingness to walk away from transactions due to pricing and credit terms. Reflective of the current challenging business environment, for the first quarter of 2006 the company reported a 63% decline in adjusted gross premiums to \$116 million and a 57% decline in gross par insured to \$13.8 billion.

An 8% increase in U.S. structured finance gross par written was due to greater opportunities in the auto and pooled corporate sectors, particularly auto fleet and aircraft leasing. Insured pooled corporate credit par almost doubled to \$8.6 billion, and the auto sector par written rose 9%. Offsetting these positives was a 20% decrease in consumer MBS par insured. Consumer MBS still represents the majority of U.S. structured finance par written, but concerns by management with seller/servicer risk and pricing factored into a lessening of this sector's contribution to total par written. Adjusted gross premiums written for U.S. structured finance matched the rise in par written, rising by 9%, owing to a 16% rise in the weighted average premium rate for the period to 22 basis points from 19 basis points in 2004. This rise in premium rates was due to a lesser amount of high-quality, but low-premium, mortgage transactions written during 2005. Growth in the auto and auto fleet business, coupled with a large aircraft-related transaction, led to higher capital charges. But the most significant effect on the weighted average capital charge for 2005 was the lowering of a large rental car securitization to speculative grade immediately after closing. The U.S. structured finance weighted average per-period capital charge rose 33% in 2005 to 3.34% from 2.51% in 2004. With the greater rise in the per-period weighted average capital charge compared with the rise in the weighted average premium rate, MBIA's U.S. structured finance profitability index for 2005 declined 11% to 6.65%. The index would have been 7.35% if the original capital charge assessed to MBIA for the large rental car securitization was

used to determine a per-period weighted average capital charge.

In the first three months of 2006, the company insured only \$1.5 billion of U.S. structured finance par, compared with \$11.2 billion for the same time period in 2005. Adjusted gross premiums written for the period fell by 89% from the prior-year period to \$15.8 million, whereas the amount of par written declined by 87%. To date in 2006, a greater amount of higher capital charge business, which typically leads to higher premiums, has been written than in 2005. However, the greater decline in adjusted gross premiums written than the decline in par written indicates that pricing pressure is still present for the industry.

Within the U.S. public finance business line, adjusted gross premiums written rose 7% and gross par written rose by 11%. In 2005, there was a change in MBIA's mix of business underwritten. Par written volume was weighted toward the lower risk GO and tax-backed sectors in 2004, whereas in 2005 business written was weighted more toward utilities, transportation, and higher education, which tend to have higher capital charges. An examination of the components of MBIA's public finance profitability index illustrates the economic impact of insuring elevated levels of moderately higher risk business in 2005 and the effects of competition on pricing. For 2005, the company reported a 20% increase in the gross per-period public finance weighted average capital charge to 8.8%, and a 6.0% decrease in the implied average premium rate to 45 basis points. The negative divergent movements in the components of the profitability index led to a 22% decline in the U.S. public finance profitability index to 5.7%. In theory, movements in capital charges and premium rates should move in tandem in a world of rational pricing; however, competition and narrowing credit spreads greatly influence pricing, as they did in 2005.

For the first quarter of 2006, insured U.S. public finance par volume was down significantly, and there does not appear to be a rebound in volume for the balance of 2006. While gross par insured was down

48%, adjusted gross premiums were down 66%. For the company, underwriting discipline will be the key to the future for this business line.

Total international gross par written rose by 13%, with structured finance par written increasing 31% and public finance par written rising 2%. In 2005, MBIA's international par written shifted from Europe and Latin America to almost entirely Europe, with the U.K. and Germany representing the lion's share of direct business written. Approximately \$15 billion of par written represented internationally diversified exposure, principally CDOs. International public finance transactions were infrastructure projects. For the first three months of 2006, MBIA's international par written was solely CDO transactions. As for other sectors, the project finance sector

is developing much more slowly than expected, and some structured finance transactions are becoming so large that they become "club deals," with two or three bond insurers providing a guaranty.

For the international business lines, the profitability results diverged. Within the structured finance business line, the weighted average premium rate and the weighted average capital charge rose by 8% and 9%, respectively, leading to a 1.8% increase in the profitability index. In the public finance line of business, the implied premium rate and the weighted average capital charge declined by 60% and 56%, respectively, leading to a 10% decline in the profitability index. Notwithstanding the negative movement in the international public finance business line, this index, at 16.6%, was approximately three times higher than the

U.S. public finance profitability index. The 12.2% profitability index for the international structured finance business line was well over one and a half times that of the U.S. structured finance business line.

Through the years, the international business lines have proven to be more profitable for the company than the equivalent U.S. business lines. However, due to pressure by the expanded underwriting initiatives at other bond insurers in Europe and banking activity in PPP and PFI transactions, the success of MBIA's international underwriting activity might depend on the company's ability to target other less-competitive global markets.

With regard to the declines in MBIA's profitability indices, it is important to view these results in terms of the company's historical profitability indices. While they are not as high as the peak years of 2001 through 2003, they are far greater than what the company produced in the mid-to-late 1990s, when the industry saw sound pricing take a back seat to market share and volume. The profitability indices measure the economics of business written in a given year. Therefore, with the company's par written down substantially it could be better to experience declines in the profitability indices at this time rather than when the amount of insured par is growing.

As of March 31, 2006, MBIA had \$6.5 billion of public finance speculative-grade net par exposure and \$5.7 billion of structured finance speculative-grade net par exposure. It is important to note that at the time MBIA insured these transactions they were investment grade, and have migrated to speculative grade over time. The total amount of speculative-grade exposure represents 2.1% of MBIA's insured net par. MBIA had case reserves of \$353 million based on SAP. In determining the capital adequacy of a bond insurer, the adequacy of the claims-paying resources relative to the risk of the insured portfolio is the principal factor in evaluating the financial strength of a financial guarantor. Based on Standard & Poor's capital adequacy test, MBIA's total claims-paying resources are sufficient to meet its insured financial obligations.

Table 1 MBIA Insurance Corp. Business Statistics

(Mil \$)	—Year ended Dec. 31—				
	2005	2004	2003	2002	2001
Net par exposure	585,003.0	585,574.5	541,026.0	497,344.6	452,409.0
Adjusted Gross Premiums Written*					
U.S. public finance	487.6	457.4	627.0	451.5	419.2
U.S. asset-backed and other	311.2	285.0	341.8	389.3	290.7
U.S. total	798.8	742.4	968.8	840.8	709.9
International public finance	97.8	258.2	435.9	207.6	239.0
International asset-backed and other	211.3	142.6	258.0	161.9	104.3
International total	309.1	400.8	693.9	369.5	343.3
Total adjusted gross premiums written	1,107.9	1,143.2	1,662.7	1,210.3	1,053.2
Net premiums written	857.8	958.1	1,050.0	753.4	629.9
Gross Par Written					
U.S. public finance	63,337.0	57,285.0	63,927.0	55,085.0	42,228.0
U.S. asset-backed and other	35,227.0	32,758.0	26,462.0	56,259.0	62,103.0
U.S. total	98,564.0	90,043.0	90,389.0	111,344.0	104,331.0
International public finance	4,034.0	3,942.0	10,810.0	5,671.0	5,201.0
International asset-backed and other	24,051.0	18,326.0	21,110.0	22,714.0	12,364.0
International total	28,085.0	22,268.0	31,920.0	28,385.0	17,565.0
Total gross par written	126,649.0	112,311.0	122,309.0	139,729.0	121,896.0
Net par written	110,858.0	107,570.0	108,800.0	112,636.0	103,679.0

*Adjusted gross premiums written include up-front and present value of installment premiums.

Affiliates

MBIA's affiliate financial services business lines include money management services, investment agreements, and customized and pooled investment products offered through:

- MBIA Municipal Investors Service Corp. (MBIA-MISC): an SEC-registered investment advisor that provides investment management programs for state and local governments, with total assets under management of \$12.4 billion as of Dec. 31, 2005;
- MBIA Investment Management Corp. (IMC): a provider of customized investments for bond proceeds, other public funds, and funds related to asset-backed or structured product issuance, with \$9.5 billion outstanding in investment agreements as of Dec. 31, 2005; and
- MBIA Capital Management Corp.: an SEC-registered investment advisor and NASD member firm specializing in fixed-income management for institutional funds, with total third-party assets outstanding of \$5.5 billion as of Dec. 31, 2005.

While these businesses benefit from solid management and conservative risk-management systems and procedures, they nonetheless produce higher capital charges than MBIA's traditional financial guarantee business. This occurs because the principal risk of worst-case market value declines is more severe relative to worst-case credit default scenarios for investment-grade credits in MBIA's insured portfolio. Some of the funds managed by MBIA-MISC are rated 'AAAm' on a stand-alone basis and are not assessed a capital charge. While the financial services businesses are not the company's primary source of revenue, the profits generated by this business are accretive to MBIA Inc.'s ROE.

MBIA Inc. has a number of special-purpose entities that are set up to provide an alternate source of funding for its clients. These vehicles purchase transactions with funds provided by the issuance of medium-term notes or CP. MBIA insures the transactions that are purchased by the vehicles, and may insure securities issued by the vehicles to fund the transactions. Standard & Poor's reviews each transac-

tion that goes into the special-purpose entity and assesses a capital charge to MBIA for capital adequacy testing purposes.

Finances

In 2005, statutory premiums earned were little changed from the prior year at \$735.3 million, as were premiums earned from refundings at \$195 million. Premi-

ums relating to the large U.S. public finance insured book of business represented 46% of earned premiums, followed by the U.S. structured finance book of business at 27%. The lack of growth in earned premiums can be linked to the lack of meaningful growth in the structured finance business. Because premiums are generally written on an installment basis

Table 2 MBIA Insurance Corp. Portfolio Statistics

(Mil \$)	2005 industry average % par	2005 % of par	—Year ended Dec. 31—			
			2005 par	2004 par	2003 par	2002 par
Public Finance						
GO	21.9	26.9	157,225.2	146,751.3	126,264.0	112,603.0
Utility	9.7	11.7	68,431.4	63,905.7	57,681.0	51,861.0
Tax-backed	8.8	6.1	35,948.4	33,716.3	28,573.0	24,606.0
Health care	4.7	5.3	30,775.3	33,351.6	34,038.0	35,266.0
Transportation	5.4	5.5	32,122.8	29,945.9	27,740.0	26,286.0
Colleges and universities	3.2	3.7	21,745.7	19,257.2	17,897.0	18,029.0
Investor-owned utilities	1.6	0.8	4,951.1	5,474.3	6,875.0	7,167.0
Housing	1.8	2.6	15,012.4	15,413.0	15,542.0	14,709.0
Special revenue	0.6	1.1	6,509.5	6,183.8	16,273.0	15,394.0
Other	3.3	0.8	4,425.7	13,234.5	6,230.0	7,937.0
Total	61.2	64.5	377,147.5	367,233.6	337,113.0	313,858.0
Leases contained in above	4.7	5.7	33,413.0	34,111.0	33,382.1	29,558.0
Domestic Asset-Backed and Corporate Finance						
MBS	4.5	1.5	8,906.0	10,557.5	13,018.9	13,469.6
Home equity loan	2.9	2.9	17,205.4	16,284.1	13,500.4	18,862.8
Auto loan	1.8	1.6	9,261.6	10,792.2	13,970.5	15,111.3
Other consumer asset-backed	1.5	0.8	4,397.4	7,935.0	9,678.0	13,696.7
Commercial asset-backed	7.0	7.8	45,819.6	60,654.6	54,672.7	49,785.3
Bank/financial institutions	0.3	0.2	1,277.3	1,371.9	1,917.2	4,065.0
Other	7.6	4.6	26,952.2	5,809.2	6,166.3	5,691.0
Total	25.6	19.5	113,819.4	113,404.4	112,924.0	120,681.6
International						
Public finance	3.4	4.5	26,190.4	27,625.4	22,812.0	11,849.0
Asset-backed	9.5	11.6	67,845.7	77,311.1	68,177.0	49,764.0
Other	0.4	0.0	0.0	0.0	0.0	1,192.0
Total	13.3	16.1	94,036.1	104,936.5	90,989.0	62,805.0
Total net par outstanding	100.0	100.0	585,003.0	585,574.5	541,026.0	497,344.6

for this line of business and earned in the year in which they are written, changes, or lack thereof, in the amount of par written and premiums earned on that business could have a great effect on earned premiums in any one year. The U.S. public finance business, on the other hand, adds a degree of stability to earned premiums. For this business, premiums are written on an up-front basis with a portion being earned in the year it was written and the balance booked as unearned premiums. As of year-end 2005, MBIA's statutory unearned premium reserve totaled \$3.5 billion and will be earned over the life of the underlying transactions, thus creating an annuity-like stream of revenue.

For 2005, the company reported a 20% decrease in statutory underwriting income to \$366 million. Factors that led to the decrease in underwriting income included

a doubling of incurred losses, a credit for loss expenses, and a 12% increase in underwriting expenses. The greater amount of underwriting expenses, coupled with the decline in new premiums written, led to a 17% rise in the statutory expense ratio to 22.2%. A decrease in advisory fees and ceding commissions received, which are netted within underwriting expenses, led to a deceptive increase in underwriting expenses. The drivers of the \$106 million increase to losses incurred over the prior year were the establishment of case reserves for the EETC and consumer mortgage sectors, as well as additional case reserves for prior transactions within the consumer mortgage sector and tax-lien portfolios. As for what appears to be a loss-adjustment expense (LAE) recovery of \$15 million on the statutory income statement, this was

due to a change in methodology required by an NYSID audit recommendation. Prior to the most recent NYSID examination, MBIA did not segregate loss reserves and LAE reserves on the statutory balance sheet. Following the NYSID recommendation, MBIA segregated the LAE reserve and reported it separately in 2005. This produced a benefit in loss expenses incurred for the year because the change in LAE reserves in 2005 reflected a net reduction due to salvage reserves that exceeded LAEs paid during the year.

MBIA's stream of net investment income remains secure as the high-quality, \$10.8 billion investment portfolio is conservatively invested in fixed-income assets. The company has begun to benefit from the strategy it implemented in 2003 of shortening the duration of the investment portfolio. This was done to protect the company's capital from unrealized losses in a rising interest-rate environment. Because the investment portfolio has remained relatively liquid over the past few years, the company is well poised to benefit from the recent rise in interest rates. With the rise in rates, the company can extend the maturity of the portfolio and improve its yield. For 2005, investment income, excluding capital gains, rose 6.0% on a 6.9% rise in invested assets. The mix of MBIA's investment portfolio became more weighted toward municipal securities that could provide a lower yield and lower investment income, but there is a tax benefit to the company. As of Dec. 31, 2005, the investment portfolio had an average duration of 5.28 years and a yield of 5.02%, compared with 5.27 years and 4.84%, respectively, as of year-end 2004. The investment portfolio included \$1.5 billion of investments for which MBIA is the financial guarantor.

For 2005, MBIA reported statutory net income of \$633 million, down 18%. In 2004, miscellaneous expenses entries were recorded in aggregate write-ins for miscellaneous income due to the reclassification of the AHERF contracts in that year. The 2005 miscellaneous income balance of \$4.8 million includes a gain recorded as a result of the implementation of deposit accounting related to the reclassification. Excluding

Table 3 MBIA Insurance Corp. Financial Statistics

(Mil \$)	—Year ended Dec. 31—				
	2005	2004	2003	2002	2001
Insurance Company*					
Total assets	11,036.2	10,342.3	9,985.0	9,211.6	8,545.5
Cash + invested assets	10,786.5	10,091.5	9,799.1	9,018.1	8,369.3
Unearned premiums	3,508.1	3,390.8	3,066.6	2,774.1	2,607.2
Statutory capital	6,569.4	5,985.4	6,083.2	5,434.8	4,939.5
Net premiums earned	735.3	746.0	677.5	548.5	476.0
Losses and LAE	188.8	126.6	63.3	51.6	44.4
Underwriting expense	180.4	161.4	124.7	119.8	85.4
Investment income including gains	474.4	536.8	445.0	448.3	422.6
Net income	633.0	768.5	661.5	622.4	561.2
Loss ratio (%)	25.7	17.0	9.2	9.4	9.3
Underwriting profitability ratio (%)¶	49.9	61.7	72.4	68.8	72.7
Holding Company (MBIA Inc.)§					
Total assets	34,561.4	33,036.3	30,324.3	18,835.4	16,210.0
Stockholders' equity	6,591.6	6,558.8	6,202.2	5,434.2	4,723.4
Net income	711.0	843.0	815.9	579.1	567.6
Debt/capitalization (%)	15.5	16.8	14.1	16.0	14.6
Return on average equity (%)§	10.8	13.2	14.0	11.4	12.8

*Statutory basis of accounting. ¶(Net earned premiums - underwriting expenses and losses)/net earned premiums. §GAAP basis of accounting.

these restatement entries, annual miscellaneous income on a combined basis has historically ranged from a loss of \$2.5 million to income of \$2 million, and is immaterial to MBIA's statutory financial results.

For 2005, MBIA Inc. reported GAAP financial guarantee pretax income of \$1.1 billion, down 13% from \$1.2 billion in 2004. The financial guarantee business continues to be the primary source of pretax income from continuing operations. With regard to the investment services component of MBIA Inc.'s pretax income, the company reported investment services pretax operating income of \$130.6 million, a roughly threefold increase from \$47.6 million in 2004. The municipal services business unit is the smallest contributor to consolidated earnings, generating \$2.1 million of pretax income in 2005.

MBIA Inc. reported GAAP earnings of \$711 million in 2005, 16% lower than what was reported for 2004. This level of earnings produced a 10.8% ROE, down

from 13.2% in 2004. The \$75 million accrual estimate for what the company anticipates paying in connection with any settlements of the regulatory investigations had the greatest effect on the ROE calculation. Adjusting earnings for the accrual of the ROE would be approximately 12%. For the three months ended March 31, 2006, although MBIA Inc. reported a 63% decrease in adjusted gross premiums written, financial guarantee operating income was little changed at \$265.8 million. This dynamic illustrates the annuity-like stream of revenue generated by the in-force book of business. Net income of \$199 million for the first three months of 2006 produced an annualized ROE of approximately 12%.

Capitalization

In 2005, regulators and investors raised questions about the appropriateness of all the bond insurers' unallocated reserves and when case reserves are set. In Standard &

Poor's experience, methodologies for determining losses in this industry are subjective, in part because losses have been extremely limited as a result of investment-grade underwriting standards. In general, when the financial strength of the financial guarantors is evaluated, the financial statements prepared under SAP are used. Under this accounting method, reserves are booked when a loss is incurred or imminent. In addition, in determining the capital adequacy of a bond insurer, theoretical losses in a severely stressful economic environment, which could be greater than current losses, are projected to evaluate the adequacy of the claims-paying resources of the bond insurer.

As of Dec. 31, 2005, through the use of Standard & Poor's capital adequacy test, MBIA's margin of safety was in the 1.4x-1.5x range. Although the reported range is unchanged from year-end 2004, the actual margin of safety improved in this year's test, and is at the higher end of the

Table 4 MBIA Insurance Corp. Capital Statistics

(Mil \$)	—Year ended Dec. 31—				
	2005	2004	2003	2002	2001
Portfolio Risk					
Municipal insurance weighted average capital charge (% of average annual debt service)	12.3	12.6	12.9	12.8	12.8
Asset-backed capital charge (% of par)	2.0	1.8	2.2	2.2	2.1
Claims-Paying Resources					
Statutory capital	6,569.4	5,985.4	6,083.2	5,434.8	4,939.5
Contingent capital	400.0	400.0	400.0	200.0	0.0
Letters/lines of credit	450.0	700.0	700.0	700.0	900.0
Owner capital commitment	0.0	0.0	0.0	0.0	0.0
Stop-loss treaty	0.0	0.0	35.7	210.7	210.7
Unearned premiums	3,508.1	3,390.8	3,066.6	2,774.1	2,607.2
Present value of annual premiums	2,171.0	2,103.0	2,052.9	1,300.1	1,068.4
Other	0.0	0.0	100.0	150.0	150.0
Total	13,098.5	12,579.2	12,438.4	10,769.7	9,875.8
Capital Adequacy					
Capital remaining at end of depression test	3,550-3,600	3,100-3,150	4,100-4,150	2,350-2,400	2,850-2,900
Margin of safety (x)	1.4-1.5	1.4-1.5	1.5-1.6	1.3-1.4	1.4-1.5
Reliance on soft capital (%)	11.1	19.2	17.2	15.3	27.5

Table 5 MBIA Insurance Corp. Liquidity Analysis

Assets/Resources as of Dec. 31, 2005	Haircut (%)	Adjusted (mil \$)
Cash and short-term investments	0.0	432.4
Treasury and government agency fixed-income securities	10.0	224.1
Corporate and ABS/MBS bonds	50.0	1,578.3
Bank lines of credit	0.0	500.0
Other (non-U.S. government securities)	10.0	289.9
Total		3,024.6
Municipal bonds (informational only)		5,268.0
Potential Uses (Occurring in the Full Year 2006)		
Largest net total payments in 2006 associated with a municipal obligor default		128.8
Largest net bullet maturity default		150.0
Largest debt service reserve draw		151.9
90 days of payments associated with the largest servicer default		241.1
Largest unscheduled draw on a municipal investment contract		166.2
Largest individual "single name" credit default swap		0.0
Holding company debt and dividend servicing needs		246.3
Total		1,084.3
Liquidity ratio (x)		2.8

range. The margin of safety expresses the relationship between theoretical losses generated by the capital adequacy model and capital remaining at the end of a theoretical economic depression. MBIA's margin of safety satisfactorily exceeds Standard & Poor's 1.25x minimum requirement for an 'AAA' rated company. MBIA was also in compliance with the alternative margin of safety test. From a worst-case sensitivity analysis perspective, should the single largest soft capital provider fail to perform (in MBIA's case Channel Reinsurance Ltd.) an 'AAA' bond insurer must achieve an alternative margin of safety of at least 1.20x.

The greatest effect on MBIA's margin of safety for 2005 was in the assumption for lower business production during the growth years of the capital adequacy test given the current financial guarantee environment. Also helping to improve the company's margin of safety is the absence of a special dividend. At the beginning of 2005, it was management's intention to upstream a special dividend to the holding company. For

last year's capital adequacy test, it was assumed that this dividend would be paid in 2005. However, the dividend was never paid. Therefore, MBIA's beginning statutory capital was higher for capital adequacy testing.

The take-back of ceded exposure relating to reinsurance arrangements put in place in connection with the AHERF loss had no effect on MBIA's capital adequacy. In 2002, Standard & Poor's revised its criteria for credit given to financial guarantors who have reinsurance arrangements with reinsurers that do not have a financial enhancement rating. As a result of this change, beginning with the year-end 2002 capital adequacy test, MBIA has not received any credit for cessions relating to the AHERF transaction. In effect, from a capital adequacy and rating perspective, Standard & Poor's has treated the risk as part of MBIA's insured portfolio.

In the aftermath of Hurricane Katrina, many investor concerns were raised about MBIA's exposure to the region and the effects that potential claims and

insured portfolio credit deterioration could have on the company. At the time, Standard & Poor's modeled two stress-case scenarios that measured the effect of Hurricane Katrina. The first scenario measured the immediate effect of any near-term potential claims on each company's margin of safety and, of more significance, on their liquidity resources. The second scenario highlighted the long-term effect that downgrades have on a bond insurer's capital adequacy. MBIA withstood both modeled stress scenarios. Immediately following the hurricane, MBIA did make debt service payments in instances where the issuer could not make these payments due to business interruption in the devastated region, and has been reimbursed for these payments. A payment was made by MBIA in 2006 relating to the Louisiana Regional Transit Authority for which the company has not been repaid to date. As for the long-term effect on MBIA, the underlying ratings on some bond issues have been lowered and capital charges increased. While the damage from Katrina will be felt for months, if not years, to come, from a capital stress perspective it does not appear that the severe hypothetical stress scenario we used to measure the long-term effect of downgrades on the bond insurers capital adequacy will materialize.

Standard & Poor's reviews a bond insurer's cash position and its ability to raise additional cash against conservatively defined theoretical payments associated with a company's various product lines. The approach to this analysis is that there might be unexpected liquidity demands on an insurer in periods of economic tranquility as well as stress. Liquidity resources and potential liquidity demands are examined for the current year and several subsequent years. MBIA's conservative investment and liquidity strategies and single-risk management standards produce a 2.79x liquidity analysis ratio, well in excess of the 1.0x thought to be prudent. Available liquid resources totaled \$3 billion as of year-end 2005. Of this, \$500 million is an existing line of credit. Against these resources, MBIA has theoretical payments totaling \$1.1 billion. ■

Radian Asset Assurance Inc.

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OUTLOOK REVISED

CREDIT PROFILE

	TO	FROM
	Stable	Negative
AFFIRMED		
Fincl strength rtg		AA
Fincl enhancement rtg		AA

Rationale

The outlook revision on Radian Asset Assurance Inc.'s (Radian Asset) 'AA' counterparty credit and financial strength ratings to stable from negative reflects enhancements the company has made to its underwriting and risk-management areas. The outlook revision also reflects Radian Asset's appropriate capitalization and supportive parent company Radian Group Inc.

Radian Asset has improved almost all of its risk-management functions, including its credit committee process, underwriting approval, portfolio risk management, surveillance, and transactional economic analysis. Key management positions were also upgraded in 2005. A more focused business plan and marketing effort led to better business results in 2005, with net par written totaling \$24.6 billion, a 72% increase from the prior year. Radian Asset has \$2.5 billion of claims-paying resources, including \$1.3 billion of statutory capital. The company's capital adequacy margin of safety ranges from 1.1x-1.2x, which is somewhat in excess of the 'AA' financial strength rating minimum requirement of 1.0x. Radian Group Inc. is committed to maintaining adequate capital at the company and has been very supportive in the past in terms of providing capital to Radian Asset when necessary.

The problematic "legacy" book of business generated a \$67 million statutory loss in 2006, and there could be several

threatening transactions left over in the portfolio. However, we believe these transactions have been identified and quantified, and although they might generate losses, they are not expected to impair capital sufficiently enough to threaten the rating.

Outlook

The stable outlook is reflective of a corporate culture at Radian Asset that now more appropriately aligns business and risk-management interests. It is expected that improvement to risk-management functions and staff will continue. The outlook is also based on a conservative investment strategy and appropriate capital strategy. However, should the company's legacy book of business, which was not consistently well underwritten, generate losses beyond what is currently anticipated, the rating outlook would be re-evaluated.

Management And Corporate Strategy

Noteworthy positive changes have occurred at Radian Asset over the past year in the areas of personnel, process, and organizational structure. In particular, the company's previously suspect underwriting and risk-management functions have been comprehensively upgraded, and their significance within the organization elevated.

S.A. Ibrahim joined Radian in May 2005, replacing Frank Filippis as CEO of parent company Radian Group Inc. Mr. Ibrahim was previously president and CEO of GreenPoint Mortgage Funding Inc. from 1999 through April 2005. Shortly following Mr. Ibrahim's arrival, Stephen Cooke became president of Radian Asset. Mr. Cooke is a seasoned financial guaranty executive, having worked for Ambac Assurance Corp. for 17 years, mostly as a managing director and general

counsel. Mr. Cooke replaced previous president Martin Kamarck. Another addition to the senior management team was Suzanne Hammett, to the newly created position of executive vice president and chief risk officer of Radian Group Inc. in July 2005. Ms. Hammett is responsible for maintaining the company's credit function and enterprise risk-management strategies across all business units at Radian Group Inc. Ms. Hammett was most recently executive vice president and chief credit policy officer with J.P. Morgan Chase and Co.

While the Radian Group's commitment to the financial guaranty business has not diminished in terms of its pledge to maintain sufficient capital in the context of an 'AA' financial strength rating, Radian Asset's strategic role in the organization has changed. Previously, financial guaranty was viewed as the growth engine of the group, in contrast with the relatively mature mortgage insurance line of business underwritten by a Radian Asset sister company. Now, Radian Asset is viewed as an important source of group revenue and risk diversification. It also provides the group with expertise in the area of structured finance technology. The parent's consolidated strategy is also shaped by expectations for the convergence of the financial guaranty and mortgage insurance sectors. Management's business outlook for the financial guaranty sector is for reasonable, longer term growth prospects and eventual double-digit ROE.

In January 2004, Standard & Poor's Ratings Services revised its outlook on Radian Asset's financial strength rating to negative from stable, due in part to concerns about the company's underwriting and risk-management functions. The rating action coincided with the company's

loss of \$111 million on an insured Con-seco manufactured housing transaction. This loss was symptomatic of broader weakness with respect to the company's controls and risk-management process. This problematic "legacy" book of business resurfaced again in 2006 when an inadequately underwritten managed CDO transaction generated a \$67 million statutory loss. Radian has no remaining risk associated with this transaction. While there could be several threatening transactions left over in the portfolio, we believe these have been identified and quantified. Also, while these transactions might depress earnings, they are not expected to impair capital sufficiently enough to threaten the rating.

Standard & Poor's attributes some of the historical problems to the fact that business at times outweighed the underwriting and risk-management functions.

These and other weaknesses have been reasonably addressed in a relatively short period of time. Risk management now has corporatewide autonomy, and a risk-management culture is being developed, with the chief risk officer reporting directly to the Radian Group CEO.

From a business perspective, the company's niche public finance product line is most sensitive to the negative outlook and competitive marketplace. The niche focus remains on smaller transactions and certain out-of-favor sectors such as health care and certain areas within the higher education sector. Because of business conditions, some of the less-established 'AAA' companies are underwriting business in niches that historically have been the province of Radian Asset.

Competition is less severe in the structured market, where investors, especially in the CDO sector, are less sensitive to the

'AA' rating. Radian's underwriting plan in sectors like the CDO market is to attach its guaranty at 'AA' or 'AAA' levels that are below the super-senior 'AAA' policy attachment levels typical of the 'AAA' bond insurers. The global structured product group also focuses on smaller, less-liquid issuers and sectors in the MBS and ABS markets, which are underserved by the 'AAA' companies.

Reinsurance remains a third financial guaranty product where the company opportunistically offers both treaty and facultative coverage. This product benefits the company not only in terms of incremental volume and earnings but also as a source of diversification, as reinsurance assumed from the 'AAA' companies is broader in terms of sector mix and geographic diversification.

Finally, Radian Asset decided to exit the trade credit business and placed it into runoff. This business line had been written by the company's U.K. subsidiary. Management felt the loss volatility and earnings characteristics of the business were not compatible with the financial guaranty line.

Enhancements have been made to almost all underwriting and risk-management functions. The company's committee structure has been modified, with a new products committee established in 2005. This committee establishes standards and limits for new asset classes. Previously, the company's credit committee undertook this function. Process and procedures were also modified for the company's credit committee. In order for pricing discipline to be better maintained, credit committees' presentations now require uniform information relating to capital at risk and to the return on risk adjusted capital for each transaction under consideration. Credit committee procedures have also been refined. Risk management is now represented on the credit committee and, along with legal representation, has transaction veto power. All members of the credit committee are now standing members with no delegates allowed. At the board level, in support of groupwide risk-management initiatives, a new

Table 1 Radian Asset Assurance Inc. Business Statistics

(Mil \$)	—Year ended Dec. 31—				
	2005	2004	2003	2002	2001
Net par exposure	76,574.0	66,751.1	76,997.0	15,266.0	10,044.0
Adjusted Gross Premiums Written					
U.S. public finance	148.3	109.7	149.7	64.0	38.2
U.S. asset-backed and other	98.0	79.7	151.0	125.0	31.3
U.S. total	246.3	189.4	300.7	189.0	69.5
International public finance	20.1	2.8	10.0	0.0	0.0
International asset-backed and other	26.2	20.6	9.9	45.0	33.0
International total	46.3	23.4	19.9	45.0	33.0
Total adjusted gross premiums written	292.6	212.8	320.6	234.0	102.5
Net premiums written	226.2	211.3	372.4	170.9	72.0
Gross Par Written					
U.S. public finance	9,226.8	7,010.2	8,106.7	2,154.0	1,433.0
U.S. asset-backed and other	12,112.7	6,183.6	9,099.3	6,391.0	1,632.0
U.S. total	21,339.5	13,193.8	17,206.0	8,545.0	3,065.0
International public finance	554.1	282.1	677.6	30.0	0.0
International asset-backed and other	2,820.9	839.8	1,788.0	516.0	435.0
International total	3,375.0	1,121.9	2,465.6	546.0	435.0
Total gross par written	24,714.5	14,315.7	19,671.7	9,091.0	3,500.0
Net par written	24,583.4	14,313.3	18,812.8	6,615.0	2,531.0

board of director credit committee was formed in 2005. The board committee is involved on both the deal level for large or unusual transactions and also in terms of providing a higher level portfolio review and guidance.

From a portfolio management perspective, the risk analytics group of Radian Asset now evaluates—based on a Monte Carlo analysis and probability-of-loss distribution—the economic capital exposure (capital at risk) to the overall portfolio as well as to sectors and individual transactions. This information is used to analyze sector and single-risk exposures and limits. It was also used to establish a new internal rating system where ratings are a function of probability of loss and remaining term of exposure. In the area of surveillance, new analytical and technological tools have been introduced, and there has been a general improvement with respect to surveillance personal. Surveillance has also been included in the underwriting decision process. The surveillance group is headed by Betty Cohen, previously with Financial Guaranty Insurance Co. and GreenPoint Financial Corp. Most of Radian Asset's information technology budget in 2005 was earmarked for further risk-management system development.

Business Review

In June 2004 Radian Reinsurance Inc. (Radian Re) and Radian Asset Assurance Inc. merged, with Radian Asset Assurance Inc. the surviving entity. Radian Re had been a stand-alone financial guarantee reinsurance company, but adverse selection of business by the primary companies caused management to view reinsurance in a secondary position relative to direct business in terms of growth opportunities. This merger has allowed Radian Asset to refocus reinsurance as a product line within its portfolio of products rather than as a stand-alone strategy.

Business results for the company were mixed with good production offset by lower premium rates charged for business written in 2005. For the company's direct public finance product line, gross par written increased by 63% to \$3 billion.

However, the profitability of the 2005 public finance book of business fell due to competitive pressures. The average premium rate was 1.48%, off by 3% compared with the 2004 book of business. Likewise, the risk profile of the 2005 book of public finance business was greater, with a weighted average capital charge of 35.9% compared with 27.1% a year earlier. Radian's market niche

includes smaller and infrequent borrowers rated 'BBB' and 'BBB-'. Predominant sectors include health care, higher education, senior living, and some smaller GO and tax-backed issuers.

In the U.S. structured finance market, direct gross par increased substantially to \$10.2 billion written in 2005 compared with \$5.2 billion written in 2004. The company's weighted average premium

Table 2 Radian Asset Assurance Inc. Portfolio Statistics

(Mil \$)	—Year ended Dec. 31—				
	2005 industry average % of par	2005 % of par	2005 par	2004 par	2003 par
Public Finance					
GO	21.9	19.2	14,712.0	12,981.6	13,676.0
Utility	9.7	7.3	5,568.0	5,861.9	7,702.0
Tax-backed	8.8	6.0	4,573.0	4,519.1	4,466.0
Health care	4.7	13.1	10,025.0	9,229.9	9,943.0
Transportation	5.4	2.4	1,863.0	1,843.8	2,823.0
Colleges and universities	3.2	4.6	3,510.0	3,595.8	3,805.0
Investor-owned utilities	1.6	1.3	1,025.0	1,231.6	1,740.0
Housing	1.8	0.8	618.0	693.3	1,141.0
Special revenue	0.6	4.5	3,408.0	3,639.2	4,418.0
Other	3.3	0.0	0.0	861.7	887.0
Total	61.1	59.2	45,302.0	44,457.9	50,601.0
Domestic Asset-Backed and Corporate Finance					
MBS	4.5	1.6	1,188.0	1,334.8	1,768.0
Home equity loan	2.9	0.3	263.0	453.5	1,432.0
Auto loan	1.8	0.2	182.0	404.1	1,116.0
Other consumer asset-backed	1.5	1.4	1,045.0	1,347.1	3,515.0
Commercial asset-backed	7.0	25.8	19,781.0	12,680.8	10,357.0
Bank/financial institutions	0.3	1.1	843.0	788.9	1,097.0
Other	7.6	2.2	1,721.0	512.8	497.0
Total	25.6	32.7	25,023.0	17,522.0	19,782.0
International					
Public finance	3.4	1.8	1,367.0	1,913.9	2,817.0
Asset-backed	9.5	6.4	4,882.0	2,857.4	3,797.0
Other	0.4	0.0	0.0	0.0	0.0
Total	13.3	8.2	6,249.0	4,771.3	6,614.0
Total net par outstanding	100.0	100.0	76,574.0	66,751.1	76,997.0

rate for the 2005 book of business was 0.19%, down from 0.33% in 2004. The weighted average capital charge for the 2005 asset-backed book of business was 1.17% compared with 1.16% for the 2004 book of business. While the profitability ratio (weighted average premium rated divided by weighted average capital charge) declined to 16.2% for the 2005 book of U.S. asset-backed business compared with 28.8% for the comparable 2004 book, the outcome is superior to that posted by the 'AAA' companies in 2005 of 8.29%. Internationally, direct gross par written in 2005 was \$2.3 billion compared with about \$800 million written in 2004.

Radian's reinsurance business also recorded good growth in 2005. Reinsurance assumed (par) in 2005 was \$9.2 billion, a 29% increase over par assumed in 2004 (excluding MBIA Insurance Corp.

and Ambac Assurance Corp. clawbacks in 2004 and 2005). Radian is making progress with respect to its goal of increasing facultative (deal-by-deal approvals) cessions as opposed to treaty transactions. This is also consistent with the needs of the 'AAA' ceding companies, assuming reinsurance in this way also gives the company better control with respect to pricing and credit quality. In 2005, 46% of reinsurance assumed by Radian was facultative compared with just 28% in 2003. Reinsurance assumed is of incremental value to the company because ceding companies provide access to transactions that Radian, due to its niche business platform, could not otherwise underwrite, thereby providing greater sector and geographic diversification. The profitability index for public finance reinsurance assumed in 2005 was 7.2%, and for asset-backed reinsurance assumed was 8.1%.

With respect to the insured portfolio, total net par outstanding was \$76.6 billion as of Dec. 31, 2005. Total net par insured as of Dec. 31, 2004, was \$66.7 billion, down from \$77 billion a year earlier. The reason for the decline in 2004 and constrained growth in 2005 was the recapturing of reinsurance business (clawback) by two 'AAA' ceding companies in 2004 and 2005. The 2004 recapture was triggered by Standard & Poor's lowering of its rating of Radian Reinsurance Inc. to 'AA' from 'AAA' in October 2002. The 2005 recapture was triggered by the rating action of another rating agency. Radian Asset believes that, while the recapture was disruptive, newer business will eventually prove to be more profitable than the business returned to the ceding companies.

The quality and diversification of Radian's insured portfolio reflects the company's niche strategy. About 3.1% of the portfolio is rated in the speculative-grade category or unrated. For the 'AAA' companies, the typical range of speculative-grade business is 0.5%-2.0%. Another indicator of the somewhat higher risk insured portfolio is reflected in the company's capital charges. Capital charges are the worst-case default and loss estimates assigned by Standard & Poor's to determine losses in our capital model. The capital charge for the total public finance book of business (direct and reinsured) as of Dec. 31, 2005, is 17.7%, well above the 'AAA' average of 11.7%. Likewise, Radian's total asset-backed book of business capital charge is 2.2% as of Dec. 31, 2005, compared with the 'AAA' industry average of 1.8%. However, the current 2.2% asset-backed capital charge is substantially below the prior year's capital charge of 4.1% due to a combination of new low-risk CDO business being written combined with the run-off of the company's high-risk, high capital charge mezzanine deals.

The company's niche strategy is also reflected in the sector composition of its insured portfolio. In the public finance sector, health care represents 13.1% of Radian's insured book of business compared with 4.7% for the industry aver-

Table 3 Radian Asset Assurance Inc. Financial Statistics

(Mil \$)	—Year ended Dec. 31—				
	2005	2004	2003	2002	2001
Insurance Company*					
Total assets	2,084.1	2,070.0	1,969.8	657.4	381.5
Cash + invested assets	2,025.0	2,012.4	1,913.2	622.5	360.2
Unearned premiums	732.1	694.6	710.4	233.7	156.9
Statutory capital	1,266.4	1,255.4	1,144.3	348.7	169.8
Net premiums earned	150.1	169.5	245.9	94.1	49.0
Losses and LAE	(1.5)	125.5	62.2	32.1	25.6
Underwriting expense	89.9	69.0	116.3	44.2	30.7
Investment income including gains	93.7	92.3	89.1	27.2	19.8
Net income	117.0	42.4	139.4	33.4	10.6
Loss ratio (%)	(1.0)	74.0	25.3	34.1	52.3
Holding Company (Radian Group)†					
Total assets	7,230.6	7,000.8	6,445.8	5,393.0	4,406.0
Stockholders' equity	3,662.9	3,689.1	3,225.8	2,753.0	2,306.0
Net income	522.9	518.7	385.9	427.0	360.0
Debt/capitalization (%)	16.9	16.3	18.2	19.8	15.8
Return on average equity (%)	14.7	15.0	12.9	16.9	19.6

Note: Radian Asset statutory results for 2003 and 2004 have been restated to address the merger of Radian Asset and Radian Re. *Statutory basis of accounting. †Radian Group has been the holding company since 2003. GAAP basis of accounting.

age. Higher education exposure, at 4.6%, is also in excess of the industry average of 3.2%, while special revenue exposure, at 4.5%, is above the industry average of 0.6%. Alternatively, GO debt is 19.2% compared with the industry average of 21.9%, and transportation exposure for Radian Asset is 2.4% versus 5.4% for the industry. In the asset-backed sector, insured CDO debt dominates the category. International and domestic CDO exposure is \$22.7 billion, representing 29.1% of the total portfolio. Mature 'AAA' company CDO exposure ranges from 10%-15%.

Finances

Over the past few years the statutory balance sheet and income statement for Radian Asset has been considerably affected by uncommon events. The company's unearned premium reserve at Dec. 31, 2005, was \$732.1 million, a modest 5% increase from the prior year. About \$54 million was returned to a ceding company in 2005 in connection with the clawback of previously reinsured business. Total assets were \$2.1 billion at year-end 2005, unchanged from the prior year. A dividend payment of \$100 million from Radian Asset to the parent company essentially offset net income for the year.

Net earned premiums for Radian Asset in 2005 were \$150.1 million compared with \$169.5 million in 2004. The decline is due to incremental earned premium from new financial guaranty business being offset by rapidly declining trade credit earned premium as well as the absence of premiums earned in 2005 associated with the clawback book of business. There was an underwriting expense recovery of \$1.5 million in 2005 compared with a loss of \$125.5 million in 2004. Included within the 2004 loss expense is the Conseco reserve as well as losses associated with the trade credit business. Underwriting expenses were \$89.9 million in 2005 compared with \$69.0 million in 2004. A large ceding commission recovery in 2004 largely contributed to the difference. Higher salary expense in 2005 in connection with the

staffing changes and the expensing of stock options also played a role in the differential between years. Investment income was essentially flat in 2005 at \$93.7 million due to relative stability in both yields and the size of the investment portfolio, which totaled \$2 billion as of Dec. 31, 2005. With \$117 million in net income in 2005, return on average total statutory capital for the company was 9.4%. For comparison, some of the mature 'AAA' financial guarantors report returns on average total statutory capital in the range of 13%-15%.

The goal of Radian Asset's investment strategy is to optimize after-tax total returns in the context of satisfying rating agency and regulatory requirements as well as management's views with respect to risk and liquidity. Some key portfolio guidelines and limitations include the following: 95% of investments must be in investment-grade fixed-income assets, 50% or more of the portfolio must be rated 'AAA', and no more than 6% of

the portfolio can be invested in the securities of a single issuer (excluding Treasury and agency securities). As of year-end 2005, 67% of the investment portfolio was rated 'AAA', 10% was rated in the 'AA' category, 8% was rated in the 'A' category, and 6% was in the 'BBB' category. There were no equity investments, nor were there any investments in speculative-grade bonds. About 73% of the investment portfolio is in municipal bonds, with the balance in taxable, convertible, and short-term instruments. About 38% of the municipal bond portfolio is insured. Investments guaranteed by Radian Asset total about \$15.5 million, or 0.7% of the total investment portfolio.

Capitalization

Radian Asset's capitalization profile is acceptable for an 'AA' rated financial guarantor. Total claims-paying resources equaled \$2.5 billion as of Dec. 31, 2005. Within this category, statutory capital was

Table 4 Radian Asset Assurance Inc. Capital Statistics

(Mil \$)	—Year ended Dec. 31—				
	2005	2004	2003	2002	2001
Portfolio Risk					
Public finance insurance weighted average capital charge (% of average annual debt service)	17.7	17.7	17.5	29.5	28.3
Asset-backed capital charge (% of par)	2.2	4.1	4.6	4.3	9.1
Claims-Paying Resources					
Statutory capital	1,266.4	1,225.4	1,144.3	348.7	169.8
Line of credit	0.0	0.0	125.0	0.0	10.5
Contingent trust preferred security	150.0	150.0	150.0	0.0	0.0
Other soft capital	0.0	0.0	0.0	0.0	25.0
Unearned premiums	732.1	694.6	710.4	233.7	156.9
Present value of annual premiums	301.7	245.0	444.3	151.0	71.8
Total	2,450.2	2,315.0	2,574.0	733.4	434.0
Capital Adequacy					
Capital remaining at end of depression test	250-300	600-650	100-150	50-100	50-100
Margin of safety (x)	1.1-1.2	1.3-1.4	1.1-1.2	1.0-1.1	1.0-1.1
Reliance on soft capital (%)	8.4	11.0	14.5	9.4	10.9

Note: 2003 is restated to include Radian Re, which merged with Radian Asset in 2004.

\$1.3 billion, unearned premium reserves were \$732.1 million, and the present value of annual premiums was \$301.7 million. Another capital resource is the company's \$150 million Market Street Custodial Trusts contingent preferred stock facility. The trusts have entered into agreements that allow Radian Asset to put its pre-

ferred stock to the trusts, at which time holders of the trust securities will become holders of Radian Asset preferred stock. The trusts are rated 'A', which reflects the rating that would be applied to preferred stock of Radian Asset. The put option would likely be exercised only in a severe claims-paying environment. The trust

assets are viewed as a claims-paying resource for the company. Because of dividends paid to the parent company as well as unearned premiums returned to the ceding company due to the clawback in 2005, total claims-paying resources increased by a modest 4.5% in 2005.

Standard & Poor's models a bond insurer's claims-paying resources against a theoretical worst-case loss environment. Claims-paying resources were relatively flat in 2005, but new business written was strong and is expected to aggressively grow during the initial portion of the modeling time frame. As a result, Radian Asset's margin of safety declined in 2005 to a range of 1.1x-1.2x. The margin of safety is defined as a ratio of theoretical losses occurring in the Standard & Poor's capital adequacy model plus the company's ending capital position divided by theoretical losses. The 2005 margin of safety is down from the 1.3x-1.4x range as of Dec. 31, 2004. This strong number from one year earlier reflects the fact that the two clawbacks removed \$22.8 billion of par exposure (and related claims) from the modeling exercise. Radian is now beginning to replace this business with direct business and new reinsurance business written.

Liquidity for the company is mostly a function of its highly rated investment portfolio. The total of short-term investments plus longer term fixed-income securities that are readily available for a reverse-repurchase transaction is \$258.7 million after appropriate haircuts have been applied. Theoretical cash needs in 2006, assuming a default in each business line by the largest obligor or servicer in that sector, total \$162.3 million with a resulting liquidity ratio of 1.59%. ■

Table 5 Radian Asset Assurance Inc. Liquidity Analysis

Assets/Resources as of Dec. 31, 2005	Haircut (%)	Amount (mil \$)
Cash and short-term investments	0.0	32.2
Treasury and government agency fixed-income securities	10.0	71.0
Corporate and ABS/MBS bonds	50.0	325.2
Bank lines of credit*	0.0	0.0
Other	0.0	0.0
Total		428.4
Adjusted cash totals after haircut		258.7
Municipal bonds (informational/back-up only)		1,476.0
Potential Uses (Occurring in the Full Year 2006)		
Largest net total payments in 2006 associated with a municipal obligor default		55.2
Largest net bullet maturity default (potentially includes IOUs, international, or "guaranteed" maturity bonds)		50.0
Largest debt service reserve draw		0.0
90 days of payments associated with the largest servicer default		6.8
Largest financial service obligations, such as largest unscheduled draw on a municipal investment contract		0.0
Largest individual "single name" credit default swap or single name in a defaulted synthetic structure		10.0
Holding company debt and dividend servicing needs		16.3
Other		24.0
Total usage		162.3
Net (assets - usage)		96.4
Liquidity ratio (x)		1.6

*The Radian Group has a liquidity line in the amount of \$400 million.

RAM Reinsurance Co. Ltd.

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OUTLOOK REVISED

CREDIT PROFILE

	TO	FROM
	Negative	Stable
AFFIRMED		
Fincl strength rtg		AAA
Fincl enhancement rtg		AAA

Rationale

The outlook revision on RAM Reinsurance Co. Ltd.'s (RAM Re) 'AAA' financial strength rating to negative from stable reflects the below-average earnings and ROE earned by the company over the past several years, coupled with concerns regarding the level and pace of improvement in the near to intermediate future.

The affirmed 'AAA' financial strength and financial enhancement ratings reflect RAM Re's sound capital position, well-managed reinsurance strategy, and strong reinsurance relationships, coupled with Standard & Poor's Ratings Services' expectation that RAM Re will make progress toward improving its historically below-average ROE. The company's capital adequacy margin of safety was 1.3x-1.4x, which exceeds Standard & Poor's 'AAA' requirement of 1.25x. RAM Re has added \$54 million to its capital resources in 2006 with a new \$40 million bank soft-capital facility and \$14 million from the proceeds of an IPO completed in early May. Management's well-executed capital-raising efforts that began in 2003 have enabled the company to further enhance its business position by increasing its treaty participations, taking advantage of facultative cessions, and by increasing the capacity of the company to insure larger transactions. With regard to underwriting, management has selectively assumed business through the years and has done a good job protecting the company from adverse selection issues that can arise in

the financial guarantee industry. Despite the changes in ownership as a result of the IPO, Standard & Poor's does not expect management to abandon a strategy that has served it well through the years. RAM Re has earned below-average returns over the past several years operating under a variety of impediments, including higher expenses in anticipation of, and to execute, an IPO; extraordinary legal and personnel expenses; regular capital infusions; and, more recently, growing losses and loss-reserve accruals. Particularly now that RAM Re has a significant component of public ownership, it needs to show progress toward producing competitive shareholder returns. Management's plans for the company in 2006 include strategies designed to improve its earnings and ROE.

Outlook

The negative outlook reflects concerns relating to RAM Re's consistently below-average earnings and ROE over the past several years, coupled with uncertainty as to whether the company can show significant improvement in the near to intermediate term. While RAM Re's plans include strategies for improvement in these important measures of financial health, the company's recent history dictates that it will have to demonstrate these improvements before the outlook could be returned to stable. If RAM Re fails to demonstrate significant improvement, the 'AAA' ratings could be pressured.

Management And Corporate Strategy

RAM Re's strategy centers on maximizing market opportunities as the only independent 'AAA' rated financial guarantee reinsurance company. To this end,

the company has no plans to diversify its business model, but will focus on its core business and increasing its treaty participation with the 'AAA' primary financial guarantors. RAM Re has had treaties with Ambac Assurance Corp. (Ambac), MBIA Insurance Corp. (MBIA), and Financial Security Assurance Inc. (FSA) for a number of years, and in early 2006 added a treaty with XL Financial Assurance Ltd. (XLFA) retroactive to the first of the year. Over the past few years the company has been successful in increasing its treaty participation rates with each of its major ceding companies. These increases have been facilitated by RAM Re making significant increases to its capital base through the sale of both new equity and debt. RAM Re has also been aided by a declining availability of high-quality financial guarantee reinsurance. Facultative business is conducted both with the seasoned 'AAA' rated primaries and with the newer 'AAA' rated primaries as well. Par written on a facultative basis from Financial Guaranty Insurance Co. (FGIC), XL Capital Assurance Inc. (XLCA), XLFA, and the CIFG Companies—four insurers that RAM Re did not have treaty relationships with—represented 6.4% of total 2005 par written. Facultative business is pursued to diversify sources of business and to fill in treaty gaps.

To prepare the company for the growth in business and the possibility of an IPO, beginning in 2003 internal policies and procedures were strengthened and additions to the finance and legal staff were made to facilitate the improvement and expansion of financial and regulatory reporting as well as corporate governance practices. Additional risk-management and underwriting

Table 1 RAM Reinsurance Co. Ltd. Business Statistics

(Mil \$)	—Year ended Dec. 31—				
	2005	2004	2003	2002	2001
Net par exposure	27,054.3	22,153.8	19,775.0	15,860.0	12,803.2
Adjusted Gross Premiums Written*					
U.S. public finance	38.3	28.3	37.7	23.3	15.4
U.S. asset-backed and other	30.4	22.5	16.8	14.4	11.4
U.S. total	68.7	50.8	54.4	37.7	26.8
International public finance	20.9	25.2	30.0	6.7	4.0
International asset-backed and other	14.9	12.6	12.2	9.4	8.0
International total	35.8	37.8	42.2	16.1	12.0
Total adjusted gross premiums written	104.5	88.6	96.6	53.8	38.8
Net premiums written	68.1	66.0	67.9	36.0	26.5
Gross Par Written					
U.S. public finance	3,402.0	3,144.0	2,330.4	2,150.2	2,214.9
U.S. asset-backed and other	3,173.0	3,391.0	1,959.9	1,732.3	1,239.7
U.S. total	6,575.0	6,531.0	4,290.3	3,882.5	3,454.6
International public finance	503.0	507.0	771.9	182.6	87.5
International asset-backed and other	1,323.0	1,019.0	1,102.2	679.5	448.4
International total	1,826.0	1,526.0	1,874.1	862.1	535.9
Total gross par written	8,401.0	8,061.0	6,164.4	4,744.6	3,990.5
Net par written	8,401.0	8,061.0	6,164.4	4,744.6	3,990.5

*Adjusted gross premiums written include up-front and present value of installment premiums.

resources will be added as and when needed to address the growing book of in-force par as well as a greater amount of par written volume. While these additional resources have been a near-term drag on earnings, in the long run they are needed to maintain strong surveillance and risk-management practices.

RAM Re is a Bermuda-based, wholly owned subsidiary of RAM Holdings Ltd., whose largest shareholder is The PMI Group Inc. (23.7%). There are no other subsidiaries or holding companies. The PMI Group Inc. (A/Stable/—) is a holding company that, through its subsidiaries, provides mortgage insurance, title insurance, financial guarantee insurance, and various services and products for the home mortgage industry. Other major institutional shareholders include:

- Greenwich Street Capital Partners (11.9%), a direct equity investment fund;
- Transatlantic Reinsurance Co. (10.8%), a partially owned subsidiary of AIG Inc.;
- High Ridge Capital Partners LP (9.0%), a direct equity investment fund; and
- CIVC Partners (4.8%), an independent venture capital fund formerly a subsidiary of Bank of America and managing funds on its behalf.

The balance of the shares is held by the public (39.7%) and certain members of management (less than 0.1%).

Changes to the ownership list as a result of the IPO include the elimination of MBIA and three other small institutional shareholders and reductions in holdings by Transatlantic Reinsurance Co. and CIVC Partners. At this point, RAM Re's strategic ownership consists of The PMI Group Inc. and Transatlantic Reinsur-

Table 2 RAM Reinsurance Co. Ltd. Net Par By Source

Year Ended Dec. 31, 2005		
(Mil \$)	Net par in force	Net par written
Ambac	5,461.1	1,938.0
FGIC	2,047.3	175.0
FSA	10,138.9	2,132.0
MBIA	8,525.1	3,793.0
XLCA/XLFA	609.6	247.0
Other	272.2	116.0
Total	27,054.3	8,401.0

ance Co., together representing 34% of ownership. The loss of MBIA as a strategic investor should have no material effect on the company. MBIA provides a significant percent of RAM Re's reinsurance volumes through both treaty and facultative arrangements, and this relationship is not expected to change.

The financial investors, including CIVC Partners, Greenwich Street Capital Partners, and High Ridge Capital Partners LP, have placed RAM Re shares in funds that they manage. These funds typically have an expiration date when the fund is to be liquidated. The earliest expiration date is 2008. Having shares of the company trade in a public market should facilitate an orderly liquidation of shares held by these funds.

The board of directors is made up of 11 individuals, including one management representative and four unaffiliated directors. Two of the unaffiliated directors were added in 2004 as part of the company's efforts to become compliant with public company requirements in anticipation of an IPO; a third was added in 2005 and the fourth joined in 2006.

Like all reinsurers, the company has a thin staff. Operationally, senior management is led by Vernon Endo, who came on board as CEO in 2003. Steven Tynan is chairman, and Richard Lutenski is CFO. Underwriting is led by James Gerry, head of public finance, and Mary Ellen Pavlovsky, head of structured finance. David Steel joined the company

in 2005 to become the chief risk manager. This position was created in 2005 as a replacement for the vacated position of CUO to place more emphasis on risk management and surveillance. The former CUO, one of the original employees of the company, left as of June 30, 2005, upon the expiration of his employment contract. Victoria Guest joined the company in January 2006 as general counsel.

Business Review

Total par reinsured in 2005 was \$8.4 billion, 4% above the prior year's net par written, led by a 30% increase in non-U.S. structured finance volume and despite a 6% decline in U.S. asset-backed par written. Treaty business accounted for 86% of gross par written in 2005, up from 83% in 2004. The company hopes to increase treaty business over time to drive expense ratios down by leveraging the existing infrastructure and staff. From a business economics perspective, results in 2005 reflect a changing mix of business toward the higher premium, more profitable segments, particularly international asset-backed, offset to a degree by the effect of lower premium rates. The result was that adjusted gross premiums written were up 18% from 2004, well above the 4% increase in gross par written.

RAM Re's underwriting activities have been greatly influenced by the needs of the primary companies. The three ceding companies that the company has had long-standing treaty relationships with produce a significant percent of its total new business. In 2005, MBIA ceded 45% of the net par written, followed by FSA (25%) and Ambac (23%). For the par outstanding as of Dec. 31, 2005, FSA was the ceding company for 37% of the in-force par, followed by MBIA at 32% and Ambac at 20%. RAM Re is seeking to diversify its sources of business; the new treaty with XLFA and growing facultative volumes from other primary insurers are early examples of the success of this strategy.

For business written in 2005, RAM Re appears to have done an excellent

job managing adverse selection from across all segments of the business. For the U.S. and international public finance segments, RAM Re had moderately higher capital charges but disproportionately higher premium rates. This resulted in profitability indexes (premium rate divided by capital charge) that, at 6.32% and 15.56%, respectively,

were a respective 14% and 49% higher than the 'AAA' rated primary company average. For U.S. asset-backed transactions, the same pattern prevailed, leading to a profitability index of 8.54% that was just 3% higher than the 'AAA' rated primary company average. In the non-U.S. asset-backed arena, lower capital charge business was accompanied by

Table 3 RAM Reinsurance Co. Ltd. Portfolio Statistics

(Mil \$)	2005 industry average % of par	2005 % of par	—Year ended Dec. 31—			
			2005 par	2004 par	2003 par	2002 par
Public Finance						
GO	21.9	19.5	5,281.9	4,737.9	3,688.0	3,363.4
Utility	9.7	9.8	2,649.4	2,486.3	2,335.0	1,995.4
Tax-backed	8.8	7.3	1,984.3	1,482.1	1,278.0	1,085.1
Health care	4.7	6.7	1,823.9	1,509.5	1,361.0	1,053.0
Transportation	5.4	8.9	2,398.8	2,095.7	1,969.0	1,567.2
Colleges and universities	3.2	1.2	328.2	232.5	192.0	158.6
Investor-owned utilities	1.6	1.9	524.5	440.6	467.0	485.2
Housing	1.8	1.2	337.1	253.9	242.0	205.5
Special revenue	0.6	0.3	74.4	83.5	110.0	209.3
Other	3.3	0.0	9.0	20.1	34.0	28.0
Total	61.2	57.0	15,411.6	13,342.1	11,676.0	10,150.8
Leases contained in above	4.7	4.4	1,188.0	1,258.9	945.0	828.0
Domestic Asset-Backed and Corporate Finance						
MBS	4.5	1.6	429.4	683.9	531.0	461.0
Home equity loan	2.9	5.9	1,589.5	1,046.8	787.0	839.9
Auto loan	1.8	2.3	626.2	448.8	580.0	453.8
Other consumer asset-backed	1.5	1.8	481.2	531.5	519.0	460.5
Commercial asset-backed	7.0	11.6	3,144.2	1,867.5	1,943.0	1,663.4
Bank/financial institutions	0.3	0.3	77.9	46.1	82.0	45.6
Other	7.6	0.1	25.2	42.8	35.0	29.4
Total	25.6	23.6	6,373.6	4,667.4	4,477.0	3,953.7
International						
Public finance	3.4	5.4	1,472.1	1,378.6	1,460.0	407.1
Asset-backed	9.5	12.1	3,268.0	2,532.9	2,159.0	1,189.4
Other	0.4	2.0	529.0	232.8	3.0	158.0
Total	13.3	19.5	5,269.1	4,144.3	3,622.0	1,754.5
Total net par outstanding	100.0	100.0	27,054.3	22,153.8	19,775.0	15,860.0

higher premium rates, leading to a profitability index of 14.62%, which was 19% better than the 'AAA' rated primary company average.

Because primary insurers use reinsurers to help manage their larger exposures, reinsurers have found that a disproportionate amount of business ceded to them has been large exposures. While the reinsurers have been able to keep these exposures at or below Standard & Poor's guidelines, this dynamic has resulted in reinsurers having greater individual exposures relative to their capital than the primary insurers. RAM Re has not been immune to this dynamic, but has not raised its single-risk limits as much as new capital additions would have allowed. This practice should result in lowering the largest exposures as a percent of capital.

Speculative-grade exposure as of Dec. 31, 2005, was \$315 million, or 111% of statutory capital, comparable in percent terms with other 'AAA' rated insurers. Par outstanding on public finance exposure in the area affected by Hurricane Katrina was \$119.4 million, of which RAM believes \$29.2 million is most at risk to potential claims. No reserves have been established against this exposure. RAM Re has paid four claims on its Katrina exposure so far, totaling \$13,000, all of which has been reimbursed. The other significant component of RAM Re's speculative-grade exposure is \$118.7 million of enhanced equipment trust certificate transactions. The majority of these are still performing, and no material losses are expected.

Table 4 RAM Reinsurance Co. Ltd. Financial Statistics

(Mil \$)	—Year ended Dec. 31—				
	2005	2004	2003	2002	2001
Insurance Company*					
Total assets	490.7	445.4	367.7	226.4	197.7
Cash + invested assets	480.5	438.2	352.3	215.2	190.4
Unearned premiums	189.1	160.3	131.4	85.6	64.3
Statutory capital	284.8	274.6	230.3	135.3	131.4
Net premiums earned	39.3	25.7	22.0	14.9	11.8
Losses and LAE	7.2	4.1	1.3	2.7	0.1
Underwriting expense	34.6	29.9	29.7	19.2	16.1
Investment income including gains	16.6	17.3	14.9	14.1	11.8
Net income	14.1	9.0	6.0	7.1	7.5
Loss ratio (%)	18.3	15.9	5.8	16.1	0.4
Underwriting profitability ratio (%)¶	(6.3)	(32.3)	(40.6)	(47.1)	(36.5)
Holding Company (RAM Re Group of Companies)§					
Total assets	553.6	510.8	426.3	277.1	234.6
Stockholders' equity	322.7	311.5	289.3	185.6	169.0
Net income	19.6	24.7	21.2	14.3	15.0
Debt/capitalization (%)	11.0	11.4	0.0	0.0	0.0
Return on average equity (%)	6.2	8.2	9.2	8.4	9.6
*Statutory basis of accounting. ¶(Net earned premiums - underwriting expenses and losses)/net earned premiums. §GAAP basis of accounting.					

Finances

In 2005, on a U.S. GAAP basis, net premiums earned were up 23%, reflecting the dramatic growth in the insured portfolio over the past couple of years. RAM Re's operating income was \$8.3 million, up 23% from \$6.7 million in 2004. Despite a 101% increase in losses and loss-adjustment expenses, primarily relating to a defaulted aircraft enhanced equipment trust certificate transaction, total expenses were up 23%. Operating efficiency improved, evidenced by a 64% expense ratio, which was nearly seven percentage points lower than last year. RAM Re is managing its expense base to benefit from a growing book of business that should yield improved economies of scale.

With regard to its other earnings component, RAM Re reported \$14.1 million in investment income, including realized losses of \$1.6 million and unrealized losses on credit derivatives of \$2.5 million, a decline of 30% from 2004. Excluding realized and unrealized gains, investment income was \$18.2 million, up 8%, reflecting the growth in invested assets. The \$474.4 million investment portfolio, managed by MBIA Capital, has a 'AAA' average credit quality and includes U.S. government securities, corporate obligations, MBS, and other consumer ABS. RAM Re has no other source of earnings. The lower investment income offset the growth in operating income, leading to a 21% decline in earnings to \$19.6 million in 2005. The return on average equity in 2005 was 6.2%.

Capitalization

There have been significant changes to RAM Re's claims-paying resources since year-end 2002. In addition to raising \$182 million in equity capital, contingent capital, and debt in 2003 and 2004, the company also increased its bank soft-capital facilities by \$40 million in February 2006. Substantially all the proceeds from the IPO in May 2006 were invested in the operating company, increasing capital by another \$14 million. RAM Re has raised capital several times since 2002 to support its ability to respond to growth opportunities. Equity capital raised in

2003 was originally undertaken to support expected normal business growth. However, being the only 'AAA' reinsurer solely dedicated to reinsuring the financial guarantee industry, the company's business opportunities grew beyond expectations. The effect was that the equity capital raised in 2003 was needed to support special cessions and increased treaty business and was not available to support further facultative business growth. Had the additional claims-paying resources not been created later in the year, RAM Re would not have been able to accept facultative cessions without placing stress on the company's capital position. With the successful completion of the IPO, the company has better positioned itself to augment its capital through the issuance of additional equity.

RAM Re's existing capital resources, future earnings, and cash flow generated a satisfactory margin of safety when stressed in Standard & Poor's capital adequacy model. As of Dec. 31, 2005, the

company's margin of safety was in the 1.3x-1.4x range, down from the 1.4x-1.5x range reported as of year-end 2004. The year-to-year decline is primarily the result of higher projected business volumes and higher municipal capital charges, net of the benefits of the added \$40 million nonrecourse bank line. The benefits of the capital added as a result of the IPO were not included in the 2005 result. The margin of safety expresses the relationship between theoretical losses generated in the capital adequacy model and capital remaining at the end of a theoretical depression. RAM Re's margin of safety comfortably exceeds Standard & Poor's 1.25x minimum requirement for an 'AAA' rated company.

RAM Re makes greater use of nonrecourse bank lines of credit and committed capital facilities (collectively "soft capital") than does the average bond insurer. In 2005, RAM Re had a 28.9% reliance on soft capital, up from 25.1% in 2004. This ratio expresses the percent of claims-

Table 5 RAM Reinsurance Co. Ltd. Capital Statistics

(Mil \$)	—Year ended Dec. 31—				
	2005	2004	2003	2002	2001
Portfolio Risk					
Municipal insurance weighted average capital charge (% of average annual debt service)	12.0	11.5	11.9	10.6	10.9
Asset-backed capital charge (% of par)	2.3	2.4	2.5	2.8	3.0
Claims-Paying Resources					
Statutory capital	284.8	274.6	230.3	135.3	131.4
Contingent capital	50.0	50.0	50.0	0.0	0.0
Letters/lines of credit	130.0	90.0	90.0	70.0	70.0
Owner capital commitment	0.0	0.0	0.0	0.0	0.0
Stop-loss treaty	0.0	0.0	0.0	0.0	0.0
Unearned premiums	189.1	160.3	131.4	85.6	64.3
Present value of annual premiums	84.8	59.5	55.6	34.5	24.2
Total	738.8	634.4	557.3	325.4	289.9
Capital Adequacy					
Capital remaining at end of depression test	100-150	150-200	100-150	50-100	50-100
Margin of safety (x)	1.3-1.4	1.4-1.5	1.3-1.4	1.3-1.4	1.3-1.4
Reliance on soft capital (%)	28.9	25.1	22.6	15.5	21.3

Table 6 RAM Reinsurance Co. Ltd. Liquidity Analysis

Assets/Resources as of Dec. 31, 2005	Haircut (%)	Amount (mil \$)
Cash and short-term investments	0.0	6.1
Treasury and government agency fixed-income securities	10.0	129.1
Corporate and ABS/MBS bonds	50.0	328.2
Bank lines of credit	0.0	0.0
Other		0.0
Total		463.3
Adjusted cash totals after haircut		286.3
Municipal bonds (informational/back-up only)		12.7
Potential Uses (Occurring in the Full Year 2006)		
Largest net total payments in 2006 associated with a municipal obligor default		28.3
Largest net bullet maturity default (potentially includes IOUs, international, or "guaranteed" maturity bonds)		10.1
Largest debt service reserve draw		12.9
90 days of payments associated with the largest servicer default		38.2
Largest financial service obligations, such as largest unscheduled draw on a municipal investment contract		0.0
Largest individual "single name" credit default swap or single name in a defaulted synthetic structure		16.3
Holding company debt and dividend servicing needs		2.8
Other		0.0
Total		108.6
Net (assets-usage)		177.7
Liquidity ratio (x)		2.6

paying resources available in the capital adequacy model that was supplied by third parties. Standard & Poor's criteria generally place a 33% limit on soft capital. RAM Re's soft capital includes \$130 million of nonrecourse bank lines and \$50 million of committed capital. The committed capital facility is known as Blue Water Trust I and provides a \$50 million pool of funds that is available to RAM Re at its discretion in return for the issuance of preferred stock to the trust. The assets of the trust are invested in high-quality, short-term securities.

Standard & Poor's reviews a bond insurer's cash position and its ability to raise additional cash against conservatively defined theoretical payments associated with a company's various product lines. The approach to this analysis is that there could be unexpected liquidity demands on an insurer in periods of economic tranquility as well as stress. Liquidity resources and potential liquidity demands are examined for the current year and several subsequent years. RAM Re's liquidity ratio as of Dec. 31, 2005, was 2.64x, well in excess of what is considered adequate for a bond insurer. Liquid resources totaled \$286.3 million available at year-end 2005. Against these resources, RAM Re has theoretical payments in 2006 totaling \$108.6 million. ■

XL Capital Assurance Inc.

Analysts: David Veno, New York (1) 212-438-2108; Richard P Smith, New York (1) 212-438-2095

AFFIRMED

CREDIT PROFILE

Fincl strength rtg	AAA
Fincl enhancement rtg	AAA

OUTLOOK: **STABLE**

Rationale

The 'AAA' financial strength and financial enhancement ratings on XL Capital Assurance Inc. (XLCA) are based on the reinsurance support provided by 'AAA' rated affiliate XL Financial Assurance Ltd. (XLFA), conservative and disciplined underwriting, and a satisfactory margin of safety. As of Dec. 31, 2005, XLCA's margin of safety was in the 1.2x-1.3x range, meeting Standard & Poor's Ratings Services' 'AAA' requirement. Management's conservative approach to underwriting and growth is evident in that underwriting quality has not suffered as the company's market share has increased. The company has benefited from a supportive parent in XL Capital Ltd. (XLC, A-/Stable), which views XLCA and XLFA as key in providing a diversified, largely noncorrelated earnings stream that offsets some of the volatility associated with its traditional property/casualty insurance earnings. However with the downgrade of XLC's core property/casualty operating companies, steps have been taken to improve the operating independence and ownership structure of its financial guaranty subsidiaries. Principal among these steps is the formation of Security Capital Assurance Ltd. (SCA), a holding company with at least 35% public ownership that will own 100% of XLCA and 87% of XLFA.

Outlook

The stable outlook reflects support from XLFA through the reinsurance agreement,

an acceptable capital position relative to retained risk, and a steadily growing financial guarantee franchise. The outlook also reflects Standard & Poor's strong expectation that the formation of SCA will proceed as planned. The outlook would be revised to negative in the event that XLC does not prove successful in the formation of SCA.

Management And Corporate Strategy

XLCA is a New York-domiciled financial guarantee company owned by XL Reinsurance America Inc. (XL Reinsurance), an indirect subsidiary of XLC. Operationally, XLCA cedes the majority of its premium and par volume through its arms-length quota-share reinsurance agreement with XLFA. Under the quota-share reinsurance agreement, up to 90% of XLCA's business written can be ceded to XLFA. From a holding company perspective, the financial guarantee operations of XLCA and XLFA provide a diversified, largely noncorrelated earnings stream that offsets some of the volatility associated with XLC's traditional property/casualty insurance earnings.

With the downgrade of XLC's core operating companies—which included XL Reinsurance—to 'A+' from 'AA-' in November 2005, Standard & Poor's expressed concern regarding the operating independence and ownership structure of XLC's financial guaranty subsidiaries. On April 7, 2006, XLC announced its planned sale of approximately 35% of its shares of SCA in an IPO. SCA is a newly created holding company for XLCA and XLFA. SCA's recent S-1 filing outlines the following key points designed to improve XLCA's and XLFA's operating independence:

- A board of directors whose majority will be independent,
- A nonexecutive chairman of the board,

- Public ownership of approximately 35% of SCA,
- Appropriate governance and financial control practices in the key areas of audit and board oversight, and
- A dividend policy generally restricting the payment of cash from SCA's insurance operating companies other than nominal dividends.

While the steps identified above should insulate XLCA's and XLFA's ratings from rating actions relating to their current owners' principal insurance and reinsurance operations, Standard & Poor's will monitor the progress that is being made in implementing such steps. Reportedly, there will be no change in the underwriting strategy or senior management under the new ownership structure.

Management maintains a conservative growth strategy, having developed an established franchise value with a focus on profitable credit exposures. The insured portfolio has grown through disciplined investment-grade underwriting, and management is willing to cede market share if competition is viewed as not being rational. Market share is currently used as a gauge of market acceptance, but the company is not market share-driven. In 2004, a strategy was implemented to expand RMBS underwriting efforts into related sectors. In addition, efforts were undertaken prior to 2005 to become a more active insurer in non-U.S. markets, with an emphasis on Europe. Participating in more markets should provide the company with underwriting alternatives, thereby reducing susceptibility to changing conditions in any one market.

Management has made good progress in achieving trading value parity and liquidity of XLCA insured bonds across most lines of business. There still exists a slight trading value discrepancy in a limited number

of U.S. public finance sectors. Much of management's efforts to ensure visibility and liquidity in XLCA insured paper have been in the U.S. public finance market, where the company has focused on the lower risk GO and tax-backed sectors to help build a presence. With the formation of SCA, the trading value and liquidity of XLCA-insured bonds might not be susceptible to "rating noise" that can be created by XLC's property/casualty operations.

For the structured finance business line, the company has gained trading parity in ABS, CDO, and other single-risk businesses. This business line seems to have not been affected by the downgrade of XLC's core businesses. Within ABS, the company targets sub-prime auto loan securitizations and RMBS, and is evaluating operating asset-backed securitizations such as ship

lease finance, cell tower leases, and rail car securitizations. As for international business, whole business securitization in the U.K. is a sector the company has entered and infrastructure/PFI transactions have provided a good opportunity to expand its presence overseas.

Senior management is led by Edward Hubbard, president and COO, and Elizabeth Keys, CFO. Business generation is led by Cassie Lau, senior managing director of consumer asset backed; Steven Czark, senior managing director of commercial asset backed; Wynne Morris, senior managing director of structured single risk; Sohail Rasul, senior managing director of structured investment products; and Tom Randazzo, senior managing director of public finance. Richard Heberton, senior managing director, is the CCO.

Business Review

For 2005, adjusted gross premiums written increased 28% to \$342 million while gross par written was little changed at \$33.1 billion. The U.S. public finance business line was the principal driver of the increase in adjusted gross premiums written, as this business line was the only one to record a meaningful increase in premiums written. The same can be said of U.S. public finance par written.

U.S. public finance adjusted gross premiums written rose 76% to \$148.4 million, representing 43% of total adjusted gross premiums written. Gross par written for the business line rose by 84% to \$18.1 billion. Management attributes the strong growth in premiums and par written to efforts to build relationships with smaller issuers and financial advisors. Although XLCA-insured par represented approximately 6% of the industry's U.S. public finance insured par, by management's estimates XLCA accounted for 14% of the total number of transactions insured. The company experienced growth in all sectors and is able to cycle in and out of sectors as opportunities present themselves. This greater sector participation did have an effect on the company's profitability for this business line. Higher capital charges attributable to more structured credits, such as special revenue bonds, pushed the weighted average capital charge on U.S. public finance business written in 2005 to 9.54%, compared with 9.05% in 2004. Because the implied premium rate for 2005 was unchanged at 55 basis points, the 5.4% increase in the weighted average capital charge led directly to a 5.3% decrease in the U.S. public finance profitability index for 2005 to 5.77%.

In the U.S. structured finance line of business, total par written was down 56% to \$9.7 billion, with par written in the consumer and commercial sectors down 77% and 69%, respectively; however, par written in the CDO sector was three times greater than in 2004. The decline in par written for the consumer sector had more to do with what XLCA insured in 2004 than a decline in volume in 2005. In the fourth quarter of 2004,

Table 1 XL Capital Assurance Inc. Business Statistics

(Mil \$)	—Year ended Dec. 31—				
	2005	2004	2003	2002	2001
Net par exposure	8,303.0	6,707.4	4,292.7	2,049.9	665.2
Adjusted Gross Premiums Written*					
U.S. public finance	148.4	84.4	144.6	55.6	22.9
U.S. asset-backed and other	47.8	119.4	105.3	132.7	39.6
U.S. total	196.1	203.8	249.9	188.3	62.5
International public finance	81.1	0.0	0.0	0.0	1.0
International asset-backed and other	64.8	62.9	57.2	72.8	67.3
International total	145.9	62.9	57.2	72.8	68.3
Total adjusted gross premiums written	342.0	266.7	307.2	261.1	130.8
Net premiums written	21.9	29.5	23.9	11.6	3.4
Gross Par Written					
U.S. public finance	18,055.0	9,815.9	9,734.3	4,516.0	1,824.1
U.S. asset-backed and other	9,749.0	22,388.8	11,799.9	9,553.0	5,466.4
U.S. total	27,804.0	32,204.7	21,534.2	14,069.0	7,290.5
International public finance	2,387.0	0.0	0.0	0.0	99.4
International asset-backed and other	2,917.0	1,450.2	1,726.4	2,545.0	1,831.4
International total	5,034.0	1,450.2	1,726.4	2,545.0	1,930.8
Total gross par written	33,108.0	33,654.9	23,260.6	16,614.0	9,221.3
Net par written	3,370.0	3,079.0	2,420.0	1,487.0	766.2

*Adjusted gross premiums written include up-front and present value of installment premiums.

the company insured several large 'AAA' transactions in the MBS market. These were one-off transactions not expected to repeat in future years. As for the decline in the commercial sectors, competition within these sectors resulted in structures for which XLCA was not willing to provide credit enhancement. Much of the growth in CDOs was in synthetic structures in which the company has had limited participation in the past.

For the U.S. structured finance business line, adjusted gross premiums were down 60%, compared with the 56% decline in par written. With more low-premium, high-quality CDO business written in 2005, the greater decline in premiums could be understood. However, the company's profitability index for this business line does not support the notion that CDO business produced lower adjusted gross premiums written, although based on extremely low capital charges, the business is very profitable. For 2005, the company produced a profitability index of 7.93%, 30% lower than in 2004, on a 12% decline in the per-period weighted average premium rate and 25% increase in the per period weighted average capital charge.

Within international markets, deal flow for the industry is inconsistent and XLCA's international par written figures illustrate this characteristic. The good news for the company is that none of the more seasoned bond insurers that participate in the international markets have established themselves as the market leader in providing financial guarantees. In 2005, for the first time, international par written included a meaningful amount of public finance par written. These were infrastructure transactions on the European continent and U.K. PFI deals. These are sectors that are most attractive to management. For this business line, the profitability index, at 13.7%, was two and one-third times greater than the U.S. public finance profitability index.

International structured finance par written of \$5.3 billion was primarily future-flow, MBS, and whole business securitization transactions, and did not

include any CDO exposure. It is interesting to note that the portion of XLCA's insured portfolio that represents international exposure is lower than the industry average even though XLCA began operations at a time when the international business has grown significantly for the industry. This is evidence of management's cautious approach to underwriting and the company's ability

to conduct business in the U.S. and on a global scale. The effect of no CDO business being written in 2005 is evident in the company's international structured finance profitability index. On a 39% rise in the per-period weighted average capital charge and a 30% decline in the weighted average per period premium rate, the profitability index fell 49% to 6.94%.

Table 2 XL Capital Assurance Inc. Portfolio Statistics

(Mil \$)	2005 industry average % of par	2005 % of par	—Year ended Dec. 31—			
			2005 par	2004 par	2003 par	2002 par
Public Finance						
GO	21.9	19.1	1,585.3	981.0	652.5	148.4
Utility	9.7	11.2	927.5	644.9	462.0	208.4
Tax-backed	8.8	5.2	428.0	309.2	101.6	6.0
Health care	4.7	0.0	0.0	0.0	0.0	0.0
Transportation	5.4	6.0	497.1	318.2	180.1	63.7
Colleges and universities	3.2	4.3	353.6	190.7	158.1	79.2
Investor-owned utilities	1.6	4.9	410.1	463.6	248.0	84.5
Housing	1.8	0.0	0.0	0.0	31.3	0.0
Special revenue	0.6	0.4	35.5	35.5	36.0	0.5
Other	3.3	4.4	367.5	341.2	0.0	0.0
Total	61.2	55.5	4,604.6	3,284.3	1,869.6	590.7
Leases contained in above	4.7	0.0	0.0	0.0	58.0	0.0
Domestic Asset-Backed and Corporate Finance						
MBS	4.5	8.6	714.8	1,056.4	195.5	200.4
Home equity loan	2.9	0.0	0.0	0.0	0.0	0.0
Auto loan	1.8	2.7	221.3	282.0	252.4	86.2
Other consumer asset-backed	1.5	0.7	54.5	58.3	54.5	10.3
Commercial asset-backed	7.0	2.8	232.4	364.0	296.7	88.0
Bank/financial institutions	0.3	1.1	94.7	90.0	119.9	45.4
Other	7.6	18.9	1,571.9	959.2	974.6	741.5
Total	25.6	34.8	2,889.6	2,809.9	1,893.6	1,171.8
International						
Public finance	3.4	0.6	53.6	9.9	9.9	9.9
Asset-backed	9.5	0.5	37.8	45.6	89.5	63.1
Other	0.4	8.6	717.2	557.7	430.1	214.4
Total	13.3	9.7	808.6	613.2	529.5	287.4
Total net par outstanding	100.0	100.0	8,303.0	6,707.4	4,292.7	2,049.9

Table 3 XL Capital Assurance Inc. Financial Statistics

(Mil \$)	—Year ended Dec. 31—				
	2005	2004	2003	2002	2001
Insurance Company*					
Total assets	328.3	341.9	329.7	180.9	158.4
Cash + invested assets	308.4	328.5	322.2	175.9	154.8
Unearned premiums	55.8	47.2	28.3	11.4	3.2
Statutory capital	201.8	205.0	211.5	123.4	109.7
Net premiums earned	13.2	10.6	7.0	3.5	0.2
Losses and LAE	3.6	0.6	0.0	0.0	0.0
Underwriting expense	21.6	21.0	18.4	18.9	18.0
Investment income including gains	12.1	9.6	5.6	7.6	7.7
Net income	(0.4)	(6.4)	(11.0)	(7.8)	(8.3)
Loss ratio (%)	27.3	5.7	0.0	0.0	0.0
Holding Company (XL Capital Ltd.)†‡					
Total assets	58,454.9	49,014.6	40,764.2	35,647.4	27,963.0
Stockholders' equity	8,546.7	7,738.7	6,936.9	6,569.6	5,437.2
Net income	(1,243.8)	1,126.3	371.7	396.0	(576.1)
Debt/capitalization (%)	28.5	26.0	21.5	22.2	22.8
Return on average equity (%)	(15.3)	15.6	5.5	6.6	(10.5)

*Statutory basis of accounting. †GAAP basis of accounting.

Table 4 XL Capital Assurance Inc. Capital Statistics

(Mil \$)	—Year ended Dec. 31—				
	2005	2004	2003	2002	2001
Portfolio Risk					
Municipal insurance weighted average capital charge (% of average annual debt service)	9.3	9.1	8.9	11.8	8.9
Asset-backed capital charge (% of par)	2.4	2.2	2.7	3.0	2.9
Claims-Paying Resources					
Statutory capital	201.8	205.0	211.5	123.4	109.7
Contingent capital	0.0	0.0	0.0	0.0	0.0
Letters/lines of credit	0.0	0.0	0.0	0.0	0.0
Owner capital commitment	0.0	0.0	0.0	0.0	0.0
Stop-loss treaty	0.0	0.0	0.0	0.0	0.0
Unearned premiums	55.8	47.2	28.3	11.4	3.2
Present value of annual premiums	132.2	117.7	94.5	63.1	32.0
Total	389.9	369.9	334.3	197.9	144.9
Capital Adequacy					
Capital remaining at end of depression test	50-100	100-150	200-250	100-150	0-50
Margin of safety (x)	1.2-1.3	1.7-1.8	1.8-1.9	1.3-1.4	1.3-1.4

For the three months ended March 31, 2006, XLCA reported \$97 million in adjusted gross premiums written, a two and half times increase from the same period in 2005, and a 90% increase in gross par written to \$70.8 million. Gross par insured totaled \$10.2 billion, representing a 57% increase for the period. U.S. structured finance accounted for 47% of gross par written, while U.S. public finance accounted for 44% of gross par written.

Finances

For 2005, on a statutory accounting basis, XLCA reported a net operating loss of \$12 million; this level of net operating loss was 8% higher than 2004. At the beginning of 2005, it was expected that the company would report a steady decline in net operating losses in the near term. This is because as more public finance premiums are written and booked as future earned premiums, combined with a growing book of installment structured finance premiums, the company should begin to experience the benefit of the annuity-like earnings power of a larger insured portfolio. Earned premiums did rise 25% to \$13.2 million, but \$3.7 million of case-base loss reserves taken more than offset the rise in earned premiums. XLCA has \$84.6 million of net par exposure to three problem credits for which it has taken case reserves.

Underwriting expenses were little changed in 2005 at \$21.6 million. However, the expected improvement in the statutory underwriting expense ratio did not materialize, as this ratio rose from 71% in 2004 to 98% in 2005—well above the industry average. The expected improvement in the underwriting expense ratio was based on the theory that, as annual installment premiums relating to a growing amount of insured par were booked with little underwriting expense associated with these premiums, the ratio would begin to show steady improvement. With an overall decline in the amount of par written, the amount of net premiums written, representing the denominator in the ratio, fell 26% to

\$21.8 million. The portion of XLCA's insured portfolio comprising installment premium business may not be yet of sufficient size to offset the ebb and flow of new business written. However, the fact remains that, as the structured finance book of business grows, XLCA should benefit from its earnings power relative to expenses incurred.

With regard to its other earnings component, XLCA reported \$12.1 million in investment income, including realized gain of \$58,507. Investments and liquidity are viewed as extremely strong through a conservative investment strategy and good asset allocation that should produce strong operating cash flows. The \$308.4 million investment portfolio has an 'AA+' average credit quality and includes corporate obligations, U.S. government securities, and ABS. There are no bonds insured by XLCA in the investment portfolio. As the investment portfolio grows, it will continue to be the principal source of earnings. For 2005, XLCA reported a statutory loss of \$426,182.

On a GAAP basis, XLCA reported a pretax loss of \$3.4 million in 2005 compared with the pretax loss of \$2.5 million reported in 2004. As in the SAP

financial statements, an increase in losses was the factor leading to the rise in the pretax operating loss. A net loss totaling \$3.1 million was reported by the company for 2005. For the three months ended March 31, 2006, XLCA reported an underwriting loss of \$3.8 million and a net loss of \$700,000.

Capitalization

As of Dec. 31, 2005, XLCA's margin of safety was in the 1.2x-1.3x range. This is down from year-end 2004 but meets Standard & Poor's 'AAA' minimum requirement. The margin of safety expresses the relationship between theoretical losses generated in the capital adequacy model and capital remaining at the end of the theoretical depression period. The minimum requirement for an 'AAA' rated company is 1.25x. However, it should be noted that the strength of XLCA's margin of safety is closely tied to the strength of XLFA.

XLFA provides XLCA up to 90% quota-share reinsurance protection covering all of the company's financial guaranty policies. As of year-end 2005, XLFA's margin of safety, as estimated by Standard & Poor's capital adequacy

model, was in the 1.4x-1.5x range. XLCA is largely insulated from the financial leverage decisions made by XLC, and it is not considered a source of prospective dividend capacity. It is expected that a majority of the SCA IPO proceeds will be downstreamed to XLFA.

The factors that led to the decline in the margin of safety were the business volume assumption and a slight change in the quality of the insured portfolio. The overall amount of business assumed to be written in the first year of the model is 40% greater than what was assumed last year. The assumption for structured finance is 44% higher, and this is business that has higher capital charges. The company's ability to generate internal capital was affected by premium rates that are 14% and 3% lower for the public finance and structured finance business lines, respectively. Finally, a greater amount of theoretical losses is assumed relative to the size of the insured portfolio due to an increase in the weighted average capital charges. For the public finance business line, the weighted average capital charge increased 2%, and the weighted average capital charge for the structured finance business line rose 8%. ■

XL Financial Assurance Ltd.

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AFFIRMED

CREDIT PROFILE

Fincl strength rtg	AAA
Fincl enhancement rtg	AAA

OUTLOOK: **STABLE**

Rationale

The 'AAA' financial strength and financial enhancement ratings on XL Financial Assurance Ltd. (XLFA) are based on the company's strong margin of safety and strategic relationship with 'AAA' rated affiliate company XL Capital Assurance Inc. (XLCA). As of Dec. 31, 2005, the margin of safety was in the 1.4x-1.5x range, well above Standard & Poor's Ratings Services' 'AAA' requirement. The company has benefited from a supportive parent in XL Capital Ltd. (XLC, A-/Stable), which views XLCA and XLFA as key in providing a diversified, largely noncorrelated earnings stream that offsets some of the volatility associated with its traditional property/casualty insurance earnings. However, with the downgrade of XLC's core property/casualty operating companies, steps have been taken to improve the operating independence and ownership structure of its financial guaranty subsidiaries. Principal among these steps is the formation of Security Capital Assurance Ltd. (SCA), a holding company with at least 35% public ownership that will own 100% of XLCA and 87% of XLFA.

Outlook

The stable outlook reflects XLFA's strong capital position and claims-paying resources and strategic relationship with XLCA and Financial Security Assurance Inc. (FSA), coupled with a steadily growing financial guarantee franchise for XLCA and XLFA. The out-

look also reflects Standard & Poor's strong expectation that the formation of SCA will proceed as planned. The outlook would be revised to negative in the event that XLC does not prove successful in the formation of SCA.

Management And Corporate Strategy

XLFA is a Bermuda-domiciled financial guarantee reinsurance company owned by XL Insurance (Bermuda) Ltd. (XLI, 87%) and FSA Holdings (13%). XLI is a wholly owned subsidiary of XLC. XLFA assumes the majority of its premium and par volume through its arms-length quota-share reinsurance agreement with XLCA, which is directly owned by XL Reinsurance America Inc. Under the quota-share reinsurance agreement, up to 90% of XLCA's business written can be ceded to XLFA. The company also assumes a limited amount of par from 'AAA' rated FSA. XLFA has been strategically important to XLC and is a core component of XLCA's financial strength. The financial guarantee operations provide a diversified, largely noncorrelated earnings stream that offsets some of the volatility associated with XLC's traditional property/casualty reinsurance earnings.

With the downgrade of XLC's core operating companies—which included XLI—to 'A+' from 'AA-' in November 2005, Standard & Poor's expressed concerns regarding the operating independence and ownership structure of XLC's financial guaranty subsidiaries. On April 7, 2006, XLC announced its planned sale of approximately 35% of its shares of SCA in an IPO. SCA is a newly created holding company for XLCA and XLFA; FSA will retain its 13% ownership in XLFA. SCA's recent S-1 filing outlines the following key points

designed to improve XLCA's and XLFA's operating independence:

- A board of directors whose majority will be independent,
- A nonexecutive chairman of the board,
- Public ownership of approximately 35% of SCA,
- Appropriate governance and financial control practices in the key areas of audit and board oversight, and
- A dividend policy generally restricting the payment of cash from SCA's insurance operating companies.

While the steps that management has identified in the S-1 should insulate XLCA's and XLFA's ratings from rating actions relating to its current owners' principal insurance and reinsurance operations, Standard & Poor's will monitor the progress that is being made in implementing such steps. Management has reported that there will be no material change in the business strategy or senior management under the new ownership structure.

Although XLCA is the main source of cessions for the company, in addition to FSA, XLFA does have reinsurance relationships with other 'AAA' rated primary insurers. All business with such other primary companies is done entirely through facultative agreements. The reason for entering into the facultative cessions is to provide diversification to the XLCA assumed portfolio. Management, however, will assume business from other primaries only if the transactions meet appropriate risk-adjusted return hurdles. It is not expected that these cessions from parties other than XLCA and FSA will become a meaningful component of XLFA's business. Cessions with FSA represent the dominant component of non-XLCA assumed par with cessions from FSA accounting for approximately

7.5% of insured net par outstanding as of Dec. 31, 2005.

Senior management is led by Michael E. Rego, executive vice president, COO, and deputy chairman; as well as Sean A. Symons, CFO. Underwriting is led by Tom W. Currie, CUO; and Sylvia C. Tavares, managing director. Melodie Wakefield, managing director, handles retrocession business.

Business Review

For business originated in 2005, XLCA was the source of 90% of XLFA's adjusted gross premiums written, and cessions from FSA represented a majority of the balance of adjusted gross premiums written. Although there were a small number of transactions with other financial guarantors, XLFA's insured par principally mirrors XLCA's business. Therefore, as with XLCA, the U.S. public finance business line was the driver of the 40% increase in adjusted gross premiums written, as this business line was the only one to record a meaningful increase in premiums written. XLCA management attributes the strong growth in premiums and par written to efforts to build relationships with smaller issuers and financial advisors.

Most of these cessions from other primary companies were international transactions. These cessions are typically \$100 million in size and do not include esoteric asset classes. It is likely that most international business ceded from other primary companies will represent Western European issuers. This is supported by statements made by senior management at the primary companies as they have identified their greatest need for reinsurance as being in the international markets. Therefore, a missed opportunity in the international markets by XLCA could still find its way to XLFA in the form of reinsurance.

As of Dec. 31, 2005, XLFA's net par outstanding totaled \$73.5 billion and had a weighted average rating of 'A+'. Approximately 3% of the portfolio was composed of business assumed from primaries other than XLCA and FSA. The distribution of XLFA's insured portfolio

largely reflects the type of business the industry has underwritten in recent years. As the company assumes more U.S. public finance business, the sector distribution of its insured portfolio should begin to more closely mirror the industry average. This is because the U.S. public finance transactions have a longer average maturity than structured finance and international transactions. As more long-tenor U.S. public finance business is assumed, these sectors will become a more dominant component of the insured portfolio. A larger U.S. public finance book of business will have a positive effect on the company with the annuity earnings power of this business creating a predictable source of revenue and a steady increase in capital.

Table 1 **XL Financial Assurance Ltd. Business Statistics**

(Mil \$)	—Year ended Dec. 31—				
	2005	2004	2003	2002	2001
Net par exposure	73,650.0	60,206.6	38,582.3	24,452.0	6,369.0
Adjusted Gross Premiums Written*					
U.S. public finance	134.6	98.2	154.3	85.0	44.0
U.S. asset-backed and other	68.8	84.5	101.3	57.0	87.0
U.S. total	203.5	182.7	255.5	142.0	131.0
International public finance	73.2	7.2	0.0	8.0	1.0
International asset-backed and other	85.0	53.8	58.8	63.0	50.0
International total	158.2	61.0	58.8	71.0	51.0
Total adjusted gross premiums written	361.6	243.7	314.4	213.0	182.0
Net premiums written	341.5	223.7	210.9	159.0	65.0
Gross Par Written					
U.S. public finance	16,467.0	9,417.0	10,587.0	4,201.0	2,026.0
U.S. asset-backed and other	9,664.0	17,789.0	10,228.2	10,429.0	6,621.0
U.S. total	29,131.0	27,206.0	20,815.2	14,630.0	8,647.0
International public finance	2,148.0	70.0	94.5	153.0	106.0
International asset-backed and other	3,286.0	1,483.0	1,676.0	2,462.0	1,838.0
International total	5,434.0	1,553.0	1,770.5	2,615.0	1,944.0
Total gross par written	31,565.0	28,759.0	22,585.6	17,245.0	10,591.0
Net par written	29,450.0	27,071.1	19,895.6	13,291.0	9,202.0

*Adjusted gross premiums written include up-front and present value of installment premiums.

Finances

For 2005, on a GAAP basis, XLFA reported a 55% increase in underwriting income to \$76.9 million on a 30% rise in premiums earned of \$134.9 million. A 20% reduction in losses and loss expenses offset a 24% increase in acquisition cost to help hold total underwriting expenses to a 2% increase. Ongoing expenditure management remains a key component to the company's prospective earnings stability and financial strength. As the structured finance component of the insured portfolio grows and generates annual premiums with minimal incremental expense, underwriting income should continue to steadily rise. The benefit associated with a growing book of installment business is evident in XLFA's statutory expense ratios, which dropped from 21% in 2004 to 11% in 2005.

Investments and liquidity are viewed as extremely strong due to a conservative investment strategy and good asset allocation, which should produce solid operating cash flows. Investment guidelines are considered prudent, with XLFA's fixed-income securities invested primarily in 'AAA' rated issues. In 2005, the company reported \$34.9 million in investment income, including a realized loss of \$3.2 million. Investment income increased by 53% due to an increase in the investment portfolio and an improvement in interest rates. From year-end 2004 the investment portfolio increased 20% to \$1.1 billion million as of Dec.31, 2005. For 2005, XLFA reported net income of \$98.3 million, up 29% from 2004.

Capitalization

As of Dec. 31, 2005, XLFA's margin of safety, as estimated by Standard & Poor's capital adequacy model, was in the 1.4x-1.5x range. This margin of safety exceeds Standard & Poor's 1.25x requirement for an 'AAA' rated company. XLFA modeling results benefit from a contingent capital facility that is drawn down in the first year of the depression in the capital adequacy test. In December 2004, Twin Reefs Pass-

Table 2 XL Financial Assurance Ltd. Portfolio Statistics

(Mil \$)	2005 industry average % of par	2005 % of par	—Year ended Dec. 31—			
			2005 par	2004 par	2003 par	2002 par
Public Finance						
GO	21.9	18.0	13,241.0	8,234.0	6,069.8	2,295.0
Utility	9.7	7.1	5,259.0	4,577.6	2,505.8	1,471.0
Tax-backed	8.8	4.2	3,087.0	2,039.0	0.0	0.0
Health care	4.7	0.0	0.0	0.0	0.0	0.0
Transportation	5.4	4.6	3,394.0	3,072.0	1,711.8	389.0
Colleges and universities	3.2	4.6	3,416.0	1,951.0	1,383.0	507.0
Investor-owned utilities	1.6	4.2	3,084.0	3,264.0	1,692.3	670.0
Housing	1.8	0.0	0.0	1.0	283.6	2.0
Special revenue	0.6	0.4	261.0	261.0	162.5	4.0
Other	3.3	0.4	311.0	805.0	662.0	586.0
Total	61.2	43.5	32,053.0	24,204.6	14,470.8	5,924.0
Leases contained in above	4.7	0.0	0.0	0.0	0.0	0.0
Domestic Asset-Backed and Corporate Finance						
MBS	4.5	5.3	3,908.7	8,772.0	1,049.0	1,676.0
Home equity loan	2.9	2.3	1,700.3	0.0	0.0	0.0
Auto loan	1.8	3.1	2,306.0	3,371.0	2,975.0	2,036.0
Other consumer asset-backed	1.5	0.7	490.0	525.0	490.5	41.0
Commercial asset-backed	7.0	1.2	894.0	3,479.0	1,722.7	987.0
Bank/financial institutions	0.3	0.4	325.0	1,131.0	797.2	549.0
Other	7.6	29.2	21,485.0	11,434.0	10,884.0	7,909.0
Total	25.6	42.2	31,109.0	28,712.0	17,918.4	13,198.0
International						
Public finance	3.4	0.8	603.5	450.0	688.5	732.0
Asset-backed	9.5	0.5	347.4	733.0	2,350.0	4,598.0
Other	0.4	12.9	9,537.1	6,107.0	3,154.6	0.0
Total	13.3	14.2	10,488.0	7,290.0	6,193.1	5,330.0
Total net par outstanding	100.0	100.0	73,650.0	60,206.6	38,582.3	24,452.0

Through Trust was established, the formation of which created a \$200 million pool of funds that is available to XLFA at its discretion in return for the issuance of preferred stock to the trust. XLI continues to provide support through a small reinsurance agreement for single-risk limits, and a small capital commitment is assumed in the year-end 2005 capital adequacy test.

The factors that led to the decline in the margin of safety from 2004 to 2005 were business volume actually written in 2005 and assumed for 2006, as well as a slight change in the quality of the insured portfolio. The actual amount of U.S. public finance business written in 2005 was greater than the amount assumed in last year's model. For this year's test, the beginning U.S. public finance in-force exposure is 43% greater than it was in last year's capital adequacy test. In terms of business written assumptions, the amount of structured finance par written is 68% higher than last year's assumption, and this is business that has higher capital charges. The

Table 3 XL Financial Assurance Ltd. Financial Statistics

(Mil \$)	—Year ended Dec. 31—				
	2005	2004	2003	2002	2001
Insurance Company*					
Total assets	1,394.1	1,183.5	831.8	613.2	544.0
Cash + invested assets	1,082.4	893.8	610.3	480.5	367.0
Unearned premiums	371.3	301.3	199.2	98.0	57.2
Statutory capital	690.1	614.8	430.6	366.0	299.0
Net premiums earned	134.9	83.9	77.6	40.8	16.9
Losses and LAE	16.8	17.0	17.8	4.3	4.3
Underwriting expense	41.2	43.4	36.8	18.4	10.0
Investment income including gains	34.9	25.3	18.1	28.7	29.9
Net income	98.4	76.2	76.2	69.4	22.2
Loss ratio (%)	12.5	20.3	22.9	10.5	25.4
Underwriting profitability ratio (%)¶	57.0	28.0	29.6	44.4	15.4
Holding Company (XL Capital Ltd.)*					
Total assets	58,454.9	49,014.6	40,764.2	35,647.4	27,963.0
Stockholders' equity	8,546.7	7,738.7	6,936.9	6,569.6	5,437.2
Net income	(1,243.8)	1,126.3	371.7	396.0	(576.1)
Debt/capitalization (%)	28.5	26.0	21.5	22.2	22.8
Return on average equity (%)	(15.3)	15.6	5.5	6.6	(10.5)

*GAAP basis of accounting. ¶(Net earned premiums - underwriting expenses and losses)/net earned premiums.

Table 4 XL Financial Assurance Ltd. Capital Statistics

(Mil \$)	—Year ended Dec. 31—				
	2005	2004	2003	2002	2001
Portfolio Risk					
Municipal insurance weighted average capital charge (% of average annual debt service)	8.5	9.1	8.9	9.4	7.4
Asset-backed capital charge (% of par)	2.8	2.0	2.8	2.4	2.7
Claims-Paying Resources					
Statutory capital	690.1	614.8	430.6	366.0	299.0
Contingent capital	200.0	200.0	0.0	0.0	0.0
Letters/lines of credit	0.0	0.0	0.0	0.0	0.0
Owner capital commitment	0.0	0.0	0.0	0.0	0.0
Stop-loss treaty	0.0	0.0	0.0	0.0	100.0
Unearned premiums	371.3	301.3	199.2	98.0	57.6
Present value of annual premiums	332.0	186.0	156.3	111.0	49.0
Total	1,593.4	1,305.1	786.1	575.0	505.6
Capital Adequacy					
Capital remaining at end of depression test	800-850	900-950	450-500	550-600	400-450
Margin of safety (x)	1.4-1.5	1.6-1.7	1.2-1.3	1.3-1.4	1.2-1.3
Reliance on soft capital (%)	14.6	16.3	28.1	30.0	30.0

Table 5 XL Financial Assurance Ltd. Liquidity Analysis

Assets/Resources as of Dec. 31, 2005	Haircut (%)	Adjusted (mil \$)
Cash and short-term investments	0.0	23.0
Treasury and government agency fixed-income securities	10.0	505.8
Corporate and ABS/MBS bonds	50.0	253.5
Bank lines of credit	0.0	500.0
Adjusted cash totals after haircut		1,282.3
Municipal bonds (informational only)		0.0
Potential Uses (Occurring in the Full Year 2006)		
Largest net total payments in 2006 associated with a municipal obligor default		137.7
Largest net bullet maturity default (potentially includes IOUs, international, or "guaranteed" maturity bonds)		0.0
Largest debt service reserve draw		2.4
90 days of payments associated with the largest servicer default		40.8
Largest financial service obligations such as largest unscheduled draw on a municipal investment contract		36.3
Largest individual "single name" credit default swap or single name in a defaulted synthetic structure		0.0
Holding company debt and dividend servicing needs		0.0
Other		0.0
Total		217.2
Liquidity ratio (x)		5.9

company's ability to generate internal capital is somewhat better in this year's capital adequacy test, as the structured finance weighted average premium rate is 26% above last year's assumed weighted average premium rate. However, this benefit is more than offset by a 38% increase in the structured finance weighted average capital charge.

Standard & Poor's reviews a bond insurer's cash position and its ability to raise additional cash against conservatively defined theoretical payments associated with a company's various product lines. The approach to this analysis is that there could be unexpected liquidity demands on an insurer in periods of economic tranquility as well as stress. Liquidity resources and potential liquidity demands are examined for the current year and several subsequent years. XLFA's conservative investment and liquidity strategies produce an acceptable 5.9x liquidity ratio. Liquid resources totaled \$1.3 billion available as of year-end 2005. Against these resources, XLFA has theoretical payments totaling \$217 million. ■