FitchRatings

Statement of

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To

United States House of Representatives
Committee on Financial Services
Subcommittee on Capital Markets, Insurance
and Government Sponsored Enterprises

The State of the Bond Insurance Industry

February 14, 2008

Introduction

Fitch Ratings traces it roots to the Fitch Publishing Company established in 1913. In the 1920s, Fitch introduced the now familiar "AAA" to "D" rating scale. Fitch was one of the three rating agencies (together with Standard & Poor's ("S&P") and Moody's Investors Service ("Moody's")) first recognized as a nationally recognized statistical rating organization ("NRSRO") by the Securities and Exchanges Commission (the "Commission") in 1975.

Since 1989 when a new management team recapitalized Fitch, the company has experienced dramatic growth. In 1997, Fitch merged with IBCA Limited, another NRSRO headquartered in London, and became owned by Fimalac, a holding company that acquired IBCA in 1992. The merger of Fitch and IBCA represented the first step in our plan to respond to investors' needs for an alternative global, full-service rating agency capable of successfully competing with Moody's and S&P across all products and market segments.

The next step in building Fitch into a global competitor was our acquisition in April 2000 of Duff & Phelps Credit Rating Co., an NRSRO headquartered in Chicago, followed by the acquisition later that year of the rating business of Thomson BankWatch. These acquisitions especially strengthened our coverage in the financial instutions and insurance industries.

Fitch currently covers 6,000 banks, insurance companies and other financial institutions, 1,600 corporations, 103 sovereigns and 93,000 municipal offerings in the United States. In addition, we cover over 7,300 structured finance securities.

Testimony

Set forth below is a summary of our history and methodology of rating bond insurers, as well as a discussion of our recent rating actions.

Rating Coverage & History

Fitch commenced its ratings coverage of the bond insurance industry in 1991 when it assigned an ‘AAA’ insurer financial strength (IFS) rating to Financial Guaranty Insurance Company (FGIC). By 1997, Fitch covered all of the so-called “big four” bond insurers, which in addition to FGIC included Ambac Assurance Corp. (Ambac), Financial Security Assurance (FSA), and MBIA Insurance Corp. (MBIA), all of whom were initially assigned ‘AAA’ IFS ratings. Together, Fitch estimates these four bond insurers currently account for approximately 83% of the gross par insured in the industry.

In addition, Fitch currently rates four other smaller, yet still significant bond insurers – Assured Guaranty Ltd. (Assured), CIFG Guaranty (CIFG), Radian Asset Assurance (Radian) and Security Capital Assurance (SCA), the parent company of XL Capital Assurance Inc. (XLCA). All of these companies were initially assigned ‘AAA’ IFS ratings with the exception of Radian, which strategically operates on a niche basis with an IFS rating below ‘AAA’.

The following table summarizes the ratings status as of February 12, 2008 of the bond insurers currently rated by Fitch. The table summarizes each bond insurers’ current and prior IFS ratings, the date of any recent rating change (if applicable), the original year in which Fitch assigned a rating to the company, the current Rating Outlook/Rating Watch status, as well as the gross par insured by each company.

Table 1: Fitch Bond Insurer Ratings Summary

	IFS Rating		Date	Rated	Rating	Gross
Company	**Current**	**Prior**	**Changed**	**Since**	**Outlook/Watch**	**Par ($B) ***
Ambac Assurance Corp.	AA	AAA	1/18/08	1994	Negative Watch	$600
Assured Guaranty Ltd.	AAA	---	No change	2005	Stable Outlook	$146
CIFG Guaranty	AAA	---	No change	2002	Negative Watch	$87
Financial Guaranty Ins. Co.	AA	AAA	1/30/08	1991	Negative Watch	$349
Financial Security Assurance	AAA	---	No change	1997	Stable Outlook	$506
MBIA Insurance Corp.	AAA	---	No change	1995	Negative Watch	$731
Radian Asset Assurance	A+	AA	9/5/07	2001	Evolving Watch	$63
Security Capital Assurance	A	AAA	1/24/08	2000	Negative Watch	$153

* As of June 30, 2007

Source: Fitch Rating

We will discuss the rationale behind recent rating actions taken by Fitch later in this testimony.

Though not rated by Fitch since 2004, Fitch at one time maintained rating coverage on ACA Financial Guaranty Corp. (ACA), a niche bond insurer that strategically operated with an IFS rating below ‘AAA’. Based on concern with the company’s capitalization, strategic direction and risk management, Fitch downgraded its IFS rating of ACA to ‘BBB’ in 2004, and subsequently withdrew its rating after management ceased providing Fitch information necessary to maintain a rating.

Rating Methodology

The group within Fitch covering the bond insurers is a specialized team within our global insurance group. Because of the intensity of the analysis employed in rating and monitoring bond insurers, the ratio of companies rated relative to the number of analytical staff within the bond insurance team is the lowest within Fitch’s broader insurance and financial institutions group.

Fitch’s methodology for rating bond insurers is consistent with that used to rate other types of insurance companies, financial institutions and corporate entities, while also recognizing the unique attributes and risks within the bond insurance industry. Our methodology employs a mix of quantitative metrics and qualitative factors. Ratings are ultimately set judgmentally by a Rating Committee, consistent with Fitch policy that includes a mix of industry experts and independent members.

From a qualitative perspective, key factors analyzed include:

- Management
- Corporate Governance
- Ownership & Holding Companies
- Franchise Value
- Strategic Direction
- Ancillary Businesses

Fitch notes that in the current challenging environment facing bond insurers, the impact of these qualitative factors will take on extra importance in our analysis going forward. This will be especially true as we consider the ratings parameters for companies that formerly were rated ‘AAA’, but have been downgraded below ‘AAA’. We are currently considering the question as to the appropriate parameters for these bond insurers to return to ‘AAA’. For example, for a number of these companies Fitch believes franchise values may be materially impacted by the loss of investor confidence. We also have observed significant differences in how ownership has impacted financial flexibility, and we have seen material differences in how management has approached both capital raising strategies and the tradeoff between the interests of shareholders versus policyholders.

From the perspectives of quantitative analysis, key factors analyzed include:

- Capital Adequacy
- Risk Management
- Financial Performance
- Reinsurance
- Investment/Liquidity

Though all of the quantitative factors are important and can take on varying weighting within our analysis of a given bond insurer based on unique circumstances, the most important quantitative factor is typically capital adequacy.

Fitch introduced a new capital adequacy model in January of 2007. The model was developed over a two year period working with an outside consultant, and employed a significant investment by Fitch in both development costs and human resources. The model is a stochastic model employing Monte Carlo simulation techniques, and can produce over 500,000 scenarios. While Fitch recognizes that no model is a perfect indicator of future performance, Fitch believes its capital model has served it well during the current period in which subprime credit issues have been impacting the bond insurers.

In the most simple of terms, Fitch's capital model analyzes the relative risk of the various municipal, structured finance and infrastructure bonds insured by the financial guarantors, and based on that analysis indicates a minimum amount of capital the bond insurer should hold to meet what Fitch determines as its 'AAA' IFS rating standard. Generally speaking, the greater the risk assessed in the insured portfolio, the higher the amount of capital that will be indicated by the model. The model then compares this indicated amount of capital to the actual capital held by the bond insurer to judge adequacy.

One of the significant inputs into the model is the underlying credit ratings assigned to each of the bonds in the insured portfolio. Underlying ratings are simply the credit rating assigned to the bond based only on the credit quality of the issuer or structure, before giving any benefit to the ratings uplift from the bond insurance itself.

Fitch will take into account its own underlying ratings when they exist, and if not we monitor the lower of the underlying ratings assigned to the insured bonds by S&P and Moody's. It is important to note too that the credit staff within each bond insurer develops its own underlying ratings on the transactions they choose to insure, and they historically shared these underlying ratings with Fitch. In effect, each bond insurer employs its own internal credit rating process. Fitch's monitoring of these underlying ratings and the overall quality of the credit analysis and risk management process within each guarantor is a critical part of our ratings analysis.

For a variety of reasons that are beyond the scope of today's testimony, Fitch's market share of underlying ratings has historically been modest. For example, Fitch estimates that it rated less than 10% of the subprime-exposed collateralized debt obligations insured by the bond insurers that are now experiencing the highest degrees of downward ratings migration.

Ultimately, the ratings assigned by Fitch to bond insurers are based on a blending of the various qualitative and quantitative factors highlighted above. It is also important to note that it is generally Fitch's practice not to rate a bond insurer at a given rating, especially 'AAA', if it does not meet the capital adequacy guidelines for that rating. That said, simply meeting capital adequacy guidelines is not sufficient to achieve an 'AAA' rating if the insurer is deficient in other key areas within our methodology. In other words, the bond insurer must have both 'AAA' capital adequacy, and meet other 'AAA' standards, to be rated 'AAA'.

Insurer Financial Strength Ratings and Insured Ratings In Perspective

The ratings assigned to the bond insurers that are the most commonly referred to in the capital markets are IFS ratings. These ratings address the capacity of the bond insurer to meet its policyholder obligations, and it is the IFS rating that then becomes the rating on the insured bond. For example, assume an 'AAA' IFS rated bond insurer guarantees the municipal general obligation bonds issued by a mid-sized city, whose underlying rating is 'A'. Once bond insurance is put in place, those insured bonds will then be rated at 'AAA', based on the IFS rating of the bond insurer.

When the IFS rating of a bond insurer is downgraded, many of the bonds it insurers will also be downgraded to the revised IFS rating. The exception would be the case in which the underlying rating on the bond is higher than that of the IFS rating, in which case the bond would then be rated at its underlying ratings level.

It is important to note that IFS ratings indicate the likelihood that a bond insurer will fail, and become insolvent. The ratings do not provide, and were never intended to provide, any indication as to the likelihood that a bond insurer may be downgraded. In fact, with most financial institutions and insurance companies downgrades are common during periods of financial stress within a sector, and can be expected.

Ratings of 'AAA' have historically only been assigned at the regulated insurance company level within the bond insurance industry. Holding company-level debt ratings, which are most comparable to the credit ratings assigned to most corporations and financial institutions, have historically been in the 'AA' category. The ability to rate the regulated policyholder obligations via the IFS rating at 'AAA' has reflected the seniority afforded policyholder obligations via regulatory protections, and the historic business models of the bond insurers to place protection of policyholder interests far ahead of stakeholder interests, and to underwrite to a "zero loss" standard.

Downgrades among bond insurers have historically been infrequent due to their generally low risk strategies and management's stated commitment to maintain their 'AAA' ratings. However, downgrades have occurred, as indicated by Fitch's previously noted 2004 downgrade of ACA.

Fitch believes the current IFS rating downgrades experienced by and/or facing a number of bond insurers -- at their most basic level -- are due to the significant deterioration in the U.S. real estate market, particularly what is commonly known as the subprime sector, to which several of the bond insurers have significant exposure. The exposure to the subprime sector highlighted certain weaknesses within the insurers' risk management and underwriting practices, coupled with lower than expected financial flexibility and, in the case of some companies, an apparent unwillingness to dilute shareholder interests for the benefit of policyholder interests.

Recent Rating Actions: Phase 1

In the Second Quarter of 2007, it became clear to Fitch that the increasing deterioration in the U.S. subprime mortgage sector would lead to credit deterioration in securities with subprime exposures that were insured by many of the bond insurers. This deterioration in the credit quality of the bond insurers' insured portfolios would, in turn, increase the modeled capital requirements for the bond insurers. With potentially higher amounts of modeled capital indicated at the 'AAA' ratings threshold, it also became clear that the bond insurers could at some point experience capital shortfalls below our 'AAA' ratings standards, thus putting their 'AAA' IFS rating in jeopardy.

In many ways, the situation facing bond insurers today is not dissimilar to that which other types of insurance companies and financial institutions have faced in the past, such as the emergence of asbestos claims that caused property/casualty insurers' capital ratios to weaken in the latter part of the 1990s. As is well known, many property/casualty insurer ratings were ultimately downgraded as a result of emerging asbestos losses.

From a process perspective, Fitch approached the situation with the bond insurers as it would with any other type of insurance company or financial institution. We first conducted analyses which "stress tested" the impact of how hypothetical future downgrades of underlying ratings would impact the various bond insurers' capital adequacy, and published a report in early September 2007 with our findings.

Subsequently, as deterioration in subprime markets became even more pronounced, on November 5, 2007 Fitch issued a public commentary indicating that it was formally reviewing the 'AAA" rated bond insurers in light of credit deterioration in their insured portfolios, with a special focus on structured finance collateralized debt obligations (SF CDOs) that contained subprime collateral.

In this commentary, Fitch stated that if its updated analysis identified a capital shortfall below our 'AAA' standards for a given bond insurer, we would likely place the bond insurer on Rating Watch Negative. For those bond insurers placed on Rating Watch, we stated that we expected the bond insurer to raise capital or otherwise mitigate the risk (such as through reinsurance) to again meet 'AAA' capital standards within a four to six week time period. It was our expectation that a 'AAA' bond insurer ought to have the financial flexibility to raise the capital or mitigate the risk in such a period. If capital remained below our ‘AAA’ standards at the end of the four to six week period capital, we stated that we would expect to downgrade the IFS rating. After Fitch’s announcement on November 5, similar announcement were subsequently made by Moody’s and then S&P.

Fitch believed that the use of a stipulated time period to judge management’s ability and willingness to raise capital was important, because part of our historic rationale in assigning ‘AAA’ ratings to the bond insurers was based on managements’ unflinching representations that they would take any measure to maintain their ‘AAA’ ratings. We also thought that the time period needed to be realistic, but not unduly long because another historic rationale for assigning ‘AAA’ ratings was the assumption that bond insurers would benefit from ready access to capital and financial flexibility during periods of stress, as we would expect of any ‘AAA’ rated issuers. Thus, the ability of a bond insurer to execute quickly when facing a capital shortfall was viewed by Fitch as important to our rating conclusion from a qualitative perspective.

When we announced commencement of our review in November, we risk ranked the bond insurers based on their relative exposures to SF CDOs. Two insurers – Assured and FSA – were designated as having minimal exposure, and they are currently the only two ‘AAA’ bond insurers whose ratings have been affirmed and currently carry “Stable Rating Outlooks” from Fitch.

At the conclusion of our updated capital analysis, on various dates throughout late November through December, all of the remaining bond insurers were identified as having material capital shortfalls relative to our ‘AAA’ standards.

Two insurers – CIFG and MBIA – were able to secure sufficient capital commitments to avoid downgrades, and Fitch affirmed both companies’ IFS ratings. In the case of the other three ‘AAA’ bond insurers – Ambac, FGIC and SCA – capital was not raised within our stated timeframes, and their ratings were downgraded as reflected in the Table shown earlier in this testimony. In the case of Ambac and SCA both companies issued press releases just prior to Fitch’s downgrades stating they were postponing capital raising efforts until market conditions improved. In the case of FGIC, while management was still actively exploring capital raising plans at the time of the downgrade, Fitch lacked confidence in the company’s ability to execute on its plans in a reasonable timeframe. The three downgrades occurred at various dates in January of 2008, and the rating of each downgraded company was left on Rating Watch Negative.

Recognizing that Fitch originally rated less than 10% of the subprime SF CDOs insured by the bond insurers, Fitch’s CDO rating team developed Fitch ratings assessments on each of the SF CDOs previously unrated by Fitch. These assessments were used by Fitch’s bond insurance ratings team in its updated capital modeling. As of September 2007, bond insurers’ collective gross exposure to these SF CDOs totaled approximately $114 billion across approximately 130 transactions. In every case but one, the underlying rating of the various insured CDOs was ‘AAA’ at origination.

The following summarizes the ratings distribution of these 130 SF CDOs after Fitch completed its ratings assessments in November and December of 2007:

- 27 were assessed at AAA
- 29 were assessed at AA or A
- 25 were assessed at BBB
- 40 were assessed at BB or B
- 9 were assessed at CCC

In addition to providing assessments on these SF CDOs with material subprime exposure, Fitch also anticipated future downgrades of certain other sub-prime-exposed and mortgage-exposed securities insured by the bond insurers, and added additional modeling stresses to compensate for this risk.

<u>Recent Rating Actions: Phase 2</u>

In late January 2008, Fitch's Residential Mortgage Backed Securities (RMBS) ratings team announced that it had updated its loss estimates for subprime mortgages based on new default, housing and economic data, including significantly worse projections for the subprime sector. As a result of a prospective analysis using this data and other information, Fitch has more than doubled its loss estimates for 2006 and 2007 vintage subprime mortgages, and has announced that it will be reevaluating its ratings on impacted RMBS and SF CDO transactions during the month of February. Fitch believes that most RMBS tranches originally rated 'A' or lower may default with a 100% loss, and that a number of mezzanine subprime SF CDOs from this vintage, including tranches of the type insured by the bond insurers, may default with material losses. High grade SF CDOs should fair better, but will experience higher expected losses than previously assumed.

Though a material portion of the deterioration implied by Fitch's recently updated subprime loss projections was already factored into our bond insurer IFS rating through the conservatism of our SF CDO ratings assessments and use of other modeling stress factors, Fitch's bond insurance ratings team on February 5, 2008 announced a second phase of subprime analysis with respect the bond insurers. This decision reflects both the speed and magnitude at which the U.S. real estate market, and the subprime sector in particular, appear to be deteriorating, and recognizes that even our very conservative prior assumptions may now be under additional stress.

As part of our February 5 commentary, Fitch stated that it has increased concern as to whether an 'AAA' IFS rating would be appropriate for a bond insurer that has been recently downgraded, even if the bond insurer some day recapitalizes to meet 'AAA' capital standards. This in part reflects Fitch's concern that actual losses ultimately incurred by the bond insurers may prove to be quite significant, and inconsistent with ratings expectations. Fitch's view also reflects previously discussed concerns with respect to franchise values, financial flexibility and the alignment of shareholder and policyholder interests, and management's view with respect both constituencies. Thus, Fitch's newest phase of analysis not only includes an updated capital analysis, but close scrutiny of the escalation of expected losses and expected future claim payments, as well as various qualitative considerations.

Concurrent with the announcement of the second phase of our review, Fitch placed the IFS ratings of both CIFG and MBIA on Rating Watch Negative, while the ratings of Ambac, FGIC and SCA remained on Watch Negative. The IFS ratings of Assured and FSA remained Stable at 'AAA'.

Fitch has not yet defined its timetable for completion of this next phase of analysis, but we believe it will likely be completed relatively soon. Also, given both the materiality of the deterioration in capital positions we expect to see, together with a generally poor access to capital demonstrated by most of the bond insurers this past January, we will likely not afford capital raising "grace periods" if the analysis indicates that a downgrade be warranted.

Conclusions

Fitch believes the outlook for the bond insurance industry is highly uncertain, and that it is likely that several companies may ultimately exit the market via voluntary runoff. Others bond insurers that remain in business may be challenged to write new business for an extended period of time as they take steps to try and regain 'AAA' ratings and rebuild their franchises. As noted, Fitch is currently reviewing the parameters and timeframes under which a downgraded financial guarantor could potentially be upgraded, and expects to clarify this in the near future.

We also would not be surprised to see consolidation among some of the remaining players, as well as entry into the market of new market participants. Fitch believes too that given the declining confidence many in the capital markets have in the sector, the ultimate level of demand for the industry's product is unclear, especially recognizing that bond insurance may be a helpful, yet nonessential product for the economy.

Positively, at this stage, consistent with our original 'AAA' IFS ratings, Fitch does not envision solvency problems for the bond insurers even at the current level of high projected losses on subprime mortgage loans.