Bond Insurance Update

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Bond Insurance: Why Is it important?

• Monoline bond insurers have served the capital markets for 35 years. Currently insure approximately $3.0 trillion of public finance, project finance and asset-backed finance debt issued in domestic and international markets.

• Who benefits?
  
  Debt issuers- obtain higher credit ratings on bonds and market access
  Taxpayers- $40 billion in interest cost savings since inception (AFGI estimate)
  Investors- protection against default

• The product: Policies provide an unconditional, irrevocable guaranty to pay principal and interest when due should the bond obligor default. No insurer in this industry has ever failed to fulfill its payment obligations to investors when due.
Layers of Regulatory Oversight

- Strict risk-based capital standards and reserving requirements under NY Insurance Law. Other states have enacted similar legislation.
- Insurers must meet the requirements of every state in which they conduct business.
- Financial guaranty companies must be monoline; they cannot underwrite traditional property/casualty or life insurance.
- Publicly held companies are subject to SEC regulation; UK subsidiaries are regulated by UK Financial Services Authority.
- Most carry ratings from 3 rating agencies which closely monitor.
Loss Experience Has Historically Been Low

- Normally underwrite to a ‘remote loss’ standard
- Broadly have low probability/low severity of loss portfolios
- Approximately 95% of securities insured are rated investment grade before provision of insurance
- Collective claims paying resources now exceed $50 billion
- Reinsurance employed to spread risk
- Until recently, estimate the financial guarantor industry had only 3bps in losses on net debt service compared to banks, which had weighted average annual charge-offs on principal of 60bps in the 1992-2006 period
- Significant built-in structural strengths, control of remedies and active remediation have been important to mitigation of loss
The Monoline Bond Insurance Industry Now

• The monoline’s exposure to transactions with deteriorating domestic nonprime mortgage exposure in 2007-08 is the single biggest credit-related event to ever hit the bond insurance industry in its 35 year history.

• It will have far-reaching ramifications for the mix of insurers that will remain active players in this market as well as the mix and magnitude of business that they will underwrite in future years.

• For the companies that have meaningful subprime exposure, we are witnessing significant decline in business opportunity leading to forced ‘hibernation’.

• S&P is tracking closely the progression of this ongoing credit event and has been running the companies through a series of evolving stress test scenarios since March 2007. Five tests have been run to date.
# S&P Bond Insurer Ratings

## Primary Bond Insurers

<table>
<thead>
<tr>
<th>Company</th>
<th>Current Rating</th>
<th>Rating June 2007</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ambac Assurance Corp.</td>
<td>AAA/Negative Outlook</td>
<td>AAA/ Stable</td>
</tr>
<tr>
<td>Assured Guaranty Corp.</td>
<td>AAA/ Stable</td>
<td>AAA/ Stable</td>
</tr>
<tr>
<td>Berkshire Hathaway Assurance Corp.</td>
<td>AAA/ Stable</td>
<td>--</td>
</tr>
<tr>
<td>CIFG Financial Guaranty</td>
<td>A+/Negative Outlook</td>
<td>AAA/Negative Outlook</td>
</tr>
<tr>
<td>Financial Guaranty Insurance Co.</td>
<td>BB/Negative Outlook</td>
<td>AAA/ Stable</td>
</tr>
<tr>
<td>Financial Security Assurance Inc.</td>
<td>AAA/ Stable</td>
<td>AAA/ Stable</td>
</tr>
<tr>
<td>MBIA Insurance Corp.</td>
<td>AAA/Negative Outlook</td>
<td>AAA/ Stable</td>
</tr>
<tr>
<td>XL Capital Assurance Inc.</td>
<td>A-/CW Negative</td>
<td>AAA/ Stable</td>
</tr>
<tr>
<td>Radian Asset Assurance Inc.</td>
<td>AA/CW Negative</td>
<td>AA/ Stable</td>
</tr>
<tr>
<td>PMI Guaranty</td>
<td>A+/Negative Outlook</td>
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</tr>
<tr>
<td>ACA Financial Guaranty Corp.</td>
<td>CCC/CW Developing</td>
<td>A/ Stable</td>
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## Bond Reinsurers

<table>
<thead>
<tr>
<th>Company</th>
<th>Current Rating</th>
<th>Rating June 2007</th>
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</thead>
<tbody>
<tr>
<td>Channel Reinsurance Ltd.</td>
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<tr>
<td>RAM Reinsurance Ltd.</td>
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<td>XL Financial Assurance Ltd.</td>
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<td>AAA/ Stable</td>
</tr>
<tr>
<td>Assured Guaranty Re</td>
<td>AA/ Stable</td>
<td>AA/ Stable</td>
</tr>
<tr>
<td>BluePoint Re</td>
<td>AA/CW Negative</td>
<td>AA/ Stable</td>
</tr>
</tbody>
</table>

*To date, those companies that have responded in a timely and comprehensive way to the need for broader capitalization as identified in our stress testing of hypothetical projected losses, have seen their ratings affirmed, although we have adopted a negative Outlook for those companies with significant subprime exposure.

*Companies that have not been able to respond as effectively as needed have seen their credit ratings and outlooks adjusted accordingly.*
### Bond Insurers: Timeline

<table>
<thead>
<tr>
<th>Year</th>
<th>Company/Event</th>
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<tbody>
<tr>
<td>1975</td>
<td></td>
</tr>
<tr>
<td>1980</td>
<td></td>
</tr>
<tr>
<td>1985</td>
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<tr>
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</tr>
<tr>
<td>2008</td>
<td></td>
</tr>
<tr>
<td>2009</td>
<td></td>
</tr>
</tbody>
</table>

### Key Insurers:
- **Ambac Assurance Corp.** (1971 - )
- **Connie Lee** (1988 - 1997)
- **Assured Guaranty Corp.** (1988 - )
- **Berkshire Hathaway Assurance Corp.** (2008 - )
- **Financial Guaranty Insurance Co.** (1983 - )
- **Financial Security Assurance** (1985 - )
- **Capital Guaranty** (1986 - 1995)
- **CapMAC** (1985 - 1998)
- **MBIA Insurance Corp.** (1986 - )
- **PMI Guaranty** (2006 - )
- **Radian Asset Assurance Inc.** (1988 - )
- **Sompo Japan Financial Guarantee Insurance Co., Ltd.** (2001 - 2005)
- **XLCA** (2000 - )

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Bond Insurers: Current Status

- **Unaffected by current situation** - ratings and outlooks are stable; business prospects excellent and improving: FSA, AGC

- **Impaired to a moderate degree by current situation** - ratings maintained but hurt by Negative Outlook or CreditWatch: MBIA, Ambac, Radian

- **Seriously damaged by current situation** - ratings downgraded, outlook uncertain, capital adequacy in question: FGIC, XLCA, CIFG, ACA, PMI Guaranty

- **New entrants** - rating assigned, outlook stable, long-term role in market still uncertain: BHAC; other entities are expressing interest in entering this business.
Insurer Capital

• In our view, the following strategies for raising capital have been less effective:
  – Waiting for certainty of need (missed opportunities)
  – Commutation of risk
  – Splitting up company
  – Owner capital contribution

• We believe the following strategies have been more effective:
  – Slow down/stop new business origination
  – Owner capital contribution
  – New common equity
  – Reinsurance
  – Surplus notes
Insurer Capital (2)

• What might we see in the future?
  – New company formation appears to be more popular to investors than investments in tainted companies
  – Tainted companies may have to go split company route to attract capital
  – Reinsurance opportunities likely still exist
  – Companies forced to raise capital a second time may have difficulty attracting additional capital and may have to use risk modification strategies or simply ‘sit it out’ until internal capital generation, run off of existing risk, and greater clarity on potential losses combine to improve capital adequacy
Ability To Write Business In The Future

• We do not believe the basic business model of bond insurance is broken
• Recent troubles may present a significant impediment to new business activity
• History of temporarily impaired companies to regain investor acceptance is positive but it has taken time; will this time be different?
Potential Issues Related To Any Company Separation

• We believe execution risk is real
  • Availability of insurance ‘shell’ is not certain
  • Licensing of new entity may take time
  • How do you not disadvantage a class of policyholders?
• Is it possible to have disparately rated entities under the same holding company structure?
• Would a split company structure maximize capital efficiency and achieve the desired rating outcomes?
Regulatory Changes on the Way?

• Regulators may move away from a solvency standard
• Regulators likely to produce changes in regulations designed to limit insurers’ ability to engage in most egregious classes/types of business
• Can they successfully regulate the quality of business underwriting?
• Prospects for additional regulatory structures uncertain
Competition: From Outside Industry

• New Entrants – Startups
  – Experience ranges from long track record in the industry to initial entrant
  – Some backers are well known, others are less of a household name
  – Dabblers vs. long-term players

• Other Possible Enhancement Providers
  – State pension funds
  – Government-sponsored enterprises
  – Ability to pay vs. willingness to pay

• Derivative Product Companies
  – Quietly grown in numbers over the past few years, continue to grow
  – Focused on single-name obligors, such as corporates and asset-backed securities, or on tranched structured finance obligations.
  – Termination risk, liquidation vs. continuation
Competition: Market Situation and Strategies

• **U.S. Public Finance**
  – Insured volume off in general, but focus of underwriting strategies
  – Some issuers going to market without insurance, will trend continue
  – Competition is relatively light, pricing is strong, four main players

• **U.S. Structured Finance**
  – Very little insured volume, most insurers in hibernation
  – Still a part of business plans, but no longer the drivers of growth
  – Insurers have reworked their underwriting strategies, less CDO’s and CDS execution

• **International**
  – Expected to become a very small component of business volume
  – Historically, dominated by CDO’s, may be limited to PFI
  – Struggled to build acceptance prior to recent turmoil, will continue to struggle
Some Observations on Insurers

• There are clear “winners” and “losers”. The seriously damaged companies will find it hard to come back.

• Municipal market penetration rate will slowly recover to historic levels.

• Structured finance appetite will be permanently reduced or eliminated for some; there will be fewer insurers competing in this space as deals evolve into simpler/less-levered structures.

• ‘Hibernation’ almost across the board can be sustained temporarily; some are facing run-off.

• Among the companies that are moderately impaired, regaining former credibility with clients and investors will take some time.

• Financial guaranty industry may compress at same time that it reorganizes itself, seeks to further bolster its capital levels and changes its business model.

• Prospects for ‘Good Company/Bad Company’ model are very unclear; return to municipal-dominant business model seems likely as risk appetite is curbed.
Some Observations on Insurers (2)

• Ongoing regulatory and governmental interest in stabilizing the insurers could impact their structure and business models

• Prospective new entrants continue to express interest in this industry.

• Prescribed accounting standards may lead to confusion for investors as to the economics of the insurers and may increase investor skepticism

• Insurers will need to review risk management procedures

• Short of contractual agreements, ownership intentions or incentives may not materialize
Implications For Public Finance Market
Distribution of State Ratings as of 5/2/2008

State Rating Distribution

- AAA: 18%
- AA+: 24%
- A+: 2%
- A: 2%
- AA-: 8%
- AA: 46%
# Municipal Bond Issuance: First Quarter 2008

<table>
<thead>
<tr>
<th>Issuer Type</th>
<th>Number of Transactions</th>
<th>Total Issuance ($MM)</th>
<th>Number of Insured Transactions</th>
<th>Amount Insured ($MM)</th>
<th>Percent Insured Penetration of Par</th>
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<tr>
<td>STATE AUTH</td>
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<td>24,106.144</td>
<td>37</td>
<td>4,481.825</td>
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<tr>
<td>All Other</td>
<td>2030</td>
<td>50,741.082</td>
<td>719</td>
<td>16,733.997</td>
<td>33%</td>
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<tr>
<td><strong>Total</strong></td>
<td><strong>2356</strong></td>
<td><strong>83,609.806</strong></td>
<td><strong>759</strong></td>
<td><strong>22,263.942</strong></td>
<td><strong>26%</strong></td>
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</table>
Appendix: Overview of Primary Insurers
ACA Financial Guaranty Corp.

- Financial strength rating lowered from ‘A’ to ‘CCC’ on Dec. 19 (remains on CreditWatch negative. Modeled stress-test losses of $2.2 billion substantially in excess of capital cushion of $650 million.

- Issue ratings suspended - viewed as not adequately reflecting underlying credit characteristics that are likely higher.

- ACA is negotiating with swap counter-parties to commute swap obligation in favor of an equity interest in ACA Capital Holdings Inc. Forebearance period extended to May 30.
Ambac Assurance Corp.

• Rated ‘AAA’ negative outlook (revised from negative CreditWatch upon completion of equity raise.

• Raised $1.5 mm in new equity, of which $250mm was a mandatory convert note, on 3-6-08. (Earlier they withdrew a $1.0 billion equity raise because of unfavorable market conditions)

• Management is also no longer pursuing a plan of splitting the company into municipal and “structured” operations.

• For purposes of enhancing capital, Ambac ceased writing new structured business for six- months (from point of equity raise). Also, company plans to exit its financial products lines.

• Four CDO^2 deals wrapped in 2007 account for most of reserves and stress test losses.
Assured Guaranty Corp.

- One of two financial guarantors with a stable outlook for its ‘AAA’ rating.
- Relative to peers has proportionately less RMBS and CDO exposure due in part to the fact that they had a split rating during part of the 2005 to 2007 time frame and as such couldn’t compete in some markets. Sometimes it is better to be lucky than good.
- In 2006 did write direct RMBS but mostly with ‘AAA’ attachment points.
- On 12-17-07 raised about $300 million in common equity to support growth.
- On 3-3-08 Wilbur Ross purchased $250 million in common and holds an option for one year from AGL to purchase an additional $750 million.
Berkshire Hathaway Assurance Corp. (BHAC) is not a conventional monoline insurer. It has now been rated ‘AAA’ (4-11-08) via a guaranty from Berkshire’s Columbia Insurance Co.

Secondary market municipal transactions in excess of $5.0 billion par have already been wrapped by BHAC and are rated ‘AAA’ based on a contingent payment insurance policy and financial enhancement letter from Berkshire affiliate National Indemnity Co.

Public statements by management indicate that underwriting focus will be on the general obligation sector along with some essential services such as water and sewer bonds.

Approach to business is purely opportunistic; withdrawal from market is possible if current pricing dynamics reverse.
CIFG Companies

• Downgraded to A+/negative outlook on 3-12-08.

• Banque Populaire and CNCE provided $1.5 billion capital support on 12-21-07. It was $1.3 billion equity and $200 soft capital. This has resulted in a surplus capital cushion of about $250 million at 2-25-08.

• Nevertheless, the downgrade to A+ was prompted by our perception of impaired franchise value relating to scaled back underwriting activity, senior staff turnover, and concern about company’s ability to remain a viable competitor.

• CIFG had previously been on negative outlook since June 07 due to issues relating to governance, ownership, and earnings.
Financial Guaranty Insurance Co.

- Financial strength rating lowered to BB negative outlook on 3-28-08.
- At a disadvantage going into 2007; was operating very near the minimum ‘AAA’ capital requirement.
- A majority of owners are financial investors and were looking for FGIC to make return on equity improvement.
- 70% of RMBS exposure had BBB original ratings, more than any other company. Same credit disadvantage for CDOs in terms of collateral.
- Board and management have been among the least effective in terms of developing a strategy and raising capital. Whereas other have raised capital, painful though it might have been, FGIC is still in the planning stage.
- Only company still embracing the split company idea.
- Insured ratings suspended- viewed as not adequately reflecting underlying credit quality which is likely higher.
Financial Security Assurance Inc.

- Unqualified AAA makes FSA a market share leader in 2008.
- Conservative underwriting led to only one wrapped CDO of ABS.
- Most RMBS have ‘AAA’ underlying ratings.
- FSA guaranteed investment contract business is a spread lending business with about $18.0 billion in assets, of which about $8.6 billion are subprime (about $5.8 billion is subprime 06 and 07 vintage). The large majority of subprime exposure is ‘AAA’. The business is managed so that the weighted average life of assets is less than liabilities to avoid liquidity risk. Holding about $1.9 billion in cash to support unscheduled withdrawals.
- FSA raised $500 million (a contribution from the parent on 2-4-08) to support stronger business growth.
MBIA Insurance Corp.

- Rated ‘AAA’, negative outlook.
- Removal from CreditWatch (and return to negative outlook) based on successful capital raising of $2.6 billion. Reducing the dividend was also a positive statement by management. (A CreditWatch negative was placed on the rating on Jan 31, 2008 because only the $1.0 billion surplus note component of the capital plan had been completed to that point.)
- Capital is also being created by slower business growth. Structured business has been suspended for six months. Also, no longer insuring business via credit default swap execution.
- Backed off near-term restructuring (split of the company), but is something the company will consider over next 5 years.
PMI Guaranty Co.

- Downgraded to A+ with Negative Outlook on 4-8-08
- Company was launched in 2006 as a “AA” insurer but has failed to gain traction
- Niche business strategy was to: take advantage of mortgage-related opportunities in conjunction PMI, pursue structured finance transactions and provide reinsurance capacity to FGIC
Radian Asset Assurance Inc.

• ‘AA’ affirmed; CreditWatch Negative on 4-11-08 due to downgrade of parent.

• Limited CDO and RMBS exposure underlies rating stability.

• Nominal subprime RMBS exposure is about $700 million and total CDO of ABS exposure is $800 million.

• The company has not written any direct subprime RMBS since 2004.

• Concerns about credit deterioration at sister company Radian Insurance and parent the Radian Group underlies Radian Assets’ recent slowed business activity.
XLCA and XLFA

• Company was lowered to A- on 2-25-08 and remains on CreditWatch Negative.

• Stress test losses have resulted in about a $1.8 billion capital shortfall.

• Capital plan has execution and timing risk. Reinsurance and commutation are a big part of capital plan.

• On 1-23-08 they pulled the equity offering component of the capital raising plan due to market conditions.

• XLCA and XLFA are in “hibernation”, which will act to free-up capital; large portion of staff has been released.
Appendix 2: Facts Related To S&P’s Global Rating Scale
S&P Ratings Defined

“A Standard & Poor's issue credit rating is a current opinion of the creditworthiness of an obligor with respect to a specific financial obligation, a specific class of financial obligations, or a specific financial program.

It takes into consideration the creditworthiness of guarantors, insurers, or other forms of credit enhancement on the obligation and takes into account the currency in which the obligation is denominated.

The opinion evaluates the obligor’s **capacity** and **willingness** to meet its financial commitments as they come due, and may assess terms, such as collateral security and subordination, which could affect ultimate payment in the event of default.”
What A Rating Is Not

The issue credit rating is not a recommendation to purchase, sell, or hold a financial obligation, inasmuch as it does not comment as to market price or suitability for a particular investor.
Municipal Ratings on a Global Scale

• S&P's ratings opinions and analyses are designed to bring transparency to the global credit markets to help facilitate access to capital. Our ratings also help investors determine which bonds and issuers might meet their individual risk tolerance and investment objectives.

• The global credit markets benefit from standards and benchmarks that are understood by all, which is why we use the same scale across all sectors.
S&P Municipal Ratings and Default Rates

S&P has been systematically reviewing and upgrading a large number of U.S. public debt instruments over the last several years in response to their generally lower default rates. The result has been higher ratings for those bonds that truly deserve it.

- In 1986, only about 20% of municipal bonds rated by S&P held AAA or AA ratings; by 2007, more than 35% were rated that highly.
- More than 99% of rated municipal issuers are investment grade, compared with less than 20% of corporate issuers that S&P has rated in recent years.
# Standard and Poor’s Rating Distributions

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<thead>
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<th>Rating</th>
<th>Count</th>
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<tr>
<td>AA</td>
<td>3818</td>
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<tr>
<td>A</td>
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**US Public Finance Housing**

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Municipal Bonds Are Not Risk Free

Our recent municipal transition and default study shows 34 defaults by issuers rated by S&P between 1986 and 2006. And just recently, two municipal entities -- Jefferson County, Ala., and Vallejo, Calif. -- have been downgraded substantially due to increased financial uncertainty that they can meet their debt obligations.

Officials in Jefferson County recently stated that they could "provide no assurance that net revenues ... will be sufficient to permit the county to continue to meet its debt obligations," and revenue shortfalls in Vallejo have led that city to consider filing for bankruptcy.
Municipal Bonds Are Not Risk Free

- Municipal bond market tends to be self-selecting. Higher-risk municipalities that are more likely to default often choose not to have their bonds rated at all.
- During 2007, for example, S&P rated only about 40% of the municipal bonds coming to market.
- Information obtained by S&P Securities Evaluations confirms that there were more than 1,100 municipal issue defaults between 1986 and 2007, but only 167 of those -- about 15% -- were rated by any rating agency.
S&P Municipal Ratings Reflect Credit Strength

Municipal Rating Category Distribution

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S&P Ratings Continue to Evolve

• S&P will revise and refresh criteria as appropriate to best reflect rating performance.

• We anticipate further migration up the rating scale in the USPF sector, assuming that creditworthiness, particularly of governmental credits, remains strong.

• It is distinctly possible that, over time, much of the public finance-rated universe will be weighted to the 'A' category or better.

• We would not expect the same trend in housing, health care, toll roads, or other sectors that exhibit more risk characteristics.

• A more incremental understanding of the factors driving credit stability adds value to the market.
Contact Information

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