

## Q&A: What's Going on with the Monolines?

Background

March 7, 2008

### Q: What's the latest with the monolines and the rating agencies?

A: Of the two largest financial guarantors (MBIA and Ambac), MBIA seems to be out of the woods for now. Ambac is currently being reassessed. Both firms are still rated AAA by both Moody's and S&P.

S&P removed MBIA from CreditWatch after re-evaluating its subprime stress assumptions on Feb. 25th. Moody's confirmed MBIA's Aaa rating the next day (outlook is still negative from both firms). MBIA benefited from \$2.5 billion of new capital raised over the last several months, which the rating agencies now consider sufficient.

Ambac is still on CreditWatch by both agencies, but is being re-evaluated after having raised \$1.5 billion in new equity this week. Both agencies had signaled that they might be willing to affirm Ambac and remove it from CreditWatch after a successful capital raise.

### Q: Why were the markets so unfavorable for the monolines this week?

A: Ambac's equity offering is highly dilutive to current shareholders (shares outstanding more than doubled) and is similar to an equity offering the company tried to push through in early January (which was scrapped after the company's stock price plummeted). The markets were expecting a capital infusion of as much as \$3 billion, and the deal was rumored to have included a backstop by the banks as well as the potential inclusion of private equity capital (Cerberus was apparently considering a major commitment). Instead, Ambac came forth with a routine secondary. MBIA traded down in sympathy.

### Q: What happens now?

A: It is likely that Ambac already "pre-cleared" the scale of their capital raise with the two rating agencies, so hopefully the \$1.5 billion will be sufficient. Now that Ambac has actually come to the market, look for Moody's and S&P to possibly remove the firm from CreditWatch. If that happens, the markets should settle for the time being (or at least until first quarter earnings come out).

### Q: Is "it" over?

A: If Ambac is removed from CreditWatch, the monoline drama should wind down for at least the next month or so. Both agencies have the discretion to continually revise their capital adequacy models as the markets shift, but it seems as though there is a lot more comfort with fact that the monolines have ample time and liquidity to work through their current situations.

### Q: Are they in "run-off" now?

A: Technically, no. Practically, yes. "Run-off" is when the companies continue to pay existing claims but fail to write new business. Both Ambac and MBIA have temporary moratoriums on new structured finance business, and muni activity has slowed to a virtual stop as well. It's likely that neither firm will see material new business for at least the next several months. However, both firms will generate close to \$1 billion of additional capital this year just by allowing existing business to run off and investment income to accumulate. This would put both firms in a position to start pitching new business more aggressively by year-end.

### Q: Split or no split?

A: Ambac has announced that it intends to remain in one piece. MBIA's new CEO, Jay Brown, told shareholders that his firm will likely split its book at some point, but over the next several years. FGIC and SCA are also likely to split. The split process will be a long and laborious legal and regulatory morass that will take years to play out.

### Q: Is all this all good or bad?

A: Better. MBIA seems to be in the clear for now. Ambac, assuming the ratings agencies are satisfied, should stabilize as well. While existing equity shareholders are clearly going to suffer from the dilutive impact of recent capital raises, all this is good news from the perspective of a policy holder (both structured and muni). Look for the muni markets to start stabilizing soon. The structured products are in bigger trouble, but any capital addition to the monolines' claims paying ability is a positive development in the long term.

The monoline insurance companies risk losing their coveted AAA-rating status due to mark-to-market losses suffered on structured finance securities they insure. The AAA-rating is critical to monolines because it enables them to write insurance policies for municipal debt. The ratings are also crucial to the Wall Street firms that hold insured debt and would likely face further write-downs if ratings were lowered.

**Additional reading:** The *Financial Times* section on monolines available at: <http://www.ft.com/indepth/monolines>