Article Title: ARCHIVE | Criteria | Insurance | Bond: Emerging Market Bond Insurance Criteria Data: (EDITOR'S NOTE: —This criteria article is no longer current. It has been superseded by the article titled "Bond Insurance Industry Overview And Analytical Focus," published June 29, 2006.) Incremental risks associated with rating start-up (de novo) bond insurers domiciled and operating in emerging markets limit their financial strength rating to 'A' or less. From the perspective of a company's ability to write financial guaranty business, the need for larger and more efficient fixed-income capital markets to finance projects and infrastructure in emerging markets, such as Asia and Latin America, is undeniable. Clearly, a financial guaranty insurance vehicle comparable to the bond insurance companies now operating in the U.S. would facilitate the evolution of such markets. However, attainment of the highest ratings is precluded by the fact that insured transactions will be subject to greater risks. The insured portfolio will be susceptible to business and economic cycles that have potential for greater volatility than insured deals in the U.S. In addition, the legal and regulatory frameworks within the emerging market countries are at various stages of development. Operating performance also is clouded in many cases by limited track records for some insured asset classes or projects. Country risk and currency risk also add to the risk of the insured portfolio. Standard & Poor's would be unlikely to rate a de novo bond insurer with a business plan that incorporated the insurance of a majority of noninvestment-grade transactions. Alternatively, a business plan focusing on only two countries probably would be unacceptable in view of the concentration of country risk. Risk Profile Comparison From a bond insurer's perspective, all investment-grade or near-investment-grade credits are not created equal. Whereas a Standard & Poor's debt rating expresses an opinion or confidence level with respect to the timeliness of debt service payment, it does not address the severity of the loss in the event of a default. On the other hand, capital charges, which are designed to capture all elements of risk in a worst-case context, must take into account the frequency and severity of a loss. For example, the capital charge for an 'A' rated city in the U.S. is about 70 basis points, expressed as percentage of par. Alternatively, the capital charge on an 'A' rated corporation is 5.3%. Two factors account for the difference: First, in terms of the severity of the loss, a defaulting city has no choice but to reorganize and resume debt service payments. In contrast, a company could cease to exist, leaving the bondholder with a creditor's claim on assets of a liquidating corporation. Second, as documented by Standard & Poor's and J.J. Kenny Co. Inc.'s default studies, the frequency of default for a domestic investment-grade corporation is greater than that of an investment-grade municipality. In determining the appropriate level of capital necessary to support an 'A' category emerging market bond insurer, Standard & Poor's will continue to use its capital adequacy model, modified to accommodate the different risks associated with emerging market insurance. Within the model, the most important component is the capital charge. The capital charge is applied to the insured portfolio to establish a theoretical worst-case level of losses. Based on the expectations of Standard & Poor's project finance and asset-backed analysts located in the region, insured target-market transactions will exhibit greater credit volatility and loss severity than those insured within the U.S. As a result, for capital adequacy modeling purposes, Standard & Poor's has assumed that capital charges will be 2 times (x) to 3x greater, depending on the sector and the level of first-loss protection, than those in force and within corresponding sectors for the domestic 'AAA' bond insurers. Insurance Portfolio Risks Emerging market underwriting and risk management are far more difficult, compared to domestic underwriting. Underwriting risks that are minimal in the U.S. are significant and crucial with respect to the viability of the emerging market start-up insurer's overall business plan. For example, both domestic and emerging market bond insurers share the risk that claims can occur simply because an investment-grade, insured transaction defaults. Obviously, this risk is intensified if the insured transaction is of noninvestment grade. However, Standard & Poor's expects the severity of loss to be higher in emerging markets. For example, it is possible that all outstanding principal and interest would be lost if a single-site infrastructure project defaulted within an emerging market. Likewise, in the asset-backed area, loss severity is assumed to be greater as collateral performance is less certain. Performance track records for many of the asset classes may be short or nonexistent. Also contributing to a climate of overall higher capital charges relative to those assessed domestically is the fact that local companies and issuers may be operating in economies that are smaller and more concentrated. These economies, therefore, are more prone to volatility and greater cyclicality. An additional consideration relates to accounting and disclosure standards for many emerging market issuers that can be less stringent than domestic market requirements. In terms of operating differences relative to the domestic 'AAA' industry, the nature and degree, or lack of regulatory oversight for a bond insurer domiciled outside of the U.S., is a variable that may increase the de novo's insured-risk profile. Specifically, the U.S. bond insurers must be licensed in their state of domicile and all other states in which they do business. Insurance regulations (for both the holding company and financial guaranty company) protect policyholders and address such issues as financial statement filing, quality of investments, change of ownership or control, reinsurance eligibility, intercompany asset transfers, single-risk limits, and dividend restrictions. Industry Risk Comparison FACTOR EVALUATED 'AAA' MONOLINE EMERGING MARKET DE NOVO BOND INSURER Cyclicality Developed countries' business and economic cycles among most stable Business and economic cycles have potential for greater volatility Barriers to entry and exit Difficult entry; exit assumed to be difficult, but untested Difficult barrier to entry could be offset by prospect of higher returns; barriers to exit untested Legal and regulatory considerations Tested, well-established legal and regulatory infrastructure Framework for and within emerging market countries is at various stages of development Potential for major loss Extremely limited, except under extreme economic circumstances; currency risk and country risk are not significant factors Moderate because a noninvestment-grade business component, greater overall insured transaction volatility, country risks, and currency risk contribute to higher-than-expected capital charges Threat of substitute products or services Low for public finance; high for asset-backed Low initially, moderate longer term Overall risk Low Moderate For de novo bond insurers operating in an emerging market, policyholders may be exposed to greater regulatory risk. Specifics associated with this greater risk include the absence of a regulatory track record or uncertainty with respect to how newly adopted financial guaranty regulations will be interpreted—if any are adopted at all. Currency risk is another incremental emerging market risk that can inflate claim payments. While domestic bond insurers are enjoying growing success in insuring international transactions, overall currency risk remains modest. For the emerging market de novo, generating revenues and paying expenses in multiple currencies represents, at best, an incremental cost of doing business. This risk, if improperly managed, can be catastrophic. In terms of the degree and types of currency risk exposure, Standard & Poor's probably would not rate a de novo that was willing, as part of its business plan, to accept risk of impairment of collateral or security cash flow due to fluctuations between the currency of the security and that of the collateral. Thus, deal-specific structural safeguards, such as currency swaps, reserve funds, overcollateralization, or indexing mechanisms, must be put into place. In other words, currency risk should come into play only in the event of the default of an insured transaction. At the company level, the de novo would be expected to manage currency risk through deal-specific and overall risk portfolio guidelines, and would likely eventually use investments as hedges and obtain local currency lines of credit as well. The underwriting process to a zero-loss standard should also work to minimize currency-related losses. For the de novo bond insurer, foreign exchange risk management includes the management of country risks. These risks go beyond relative currency valuation concerns to include transfer or cross-border risk (a moratorium on payments imposed by a country). Under such a scenario, timely payment would not be possible, even though the insured debtor remained creditworthy. Convertibility risk management addresses the possibility that one currency might not be exchanged into another. In addition, political and sovereign risk adds to the potential volatility of the insured portfolio. In the extreme, assassinations, coups, and other unsavory forms of affecting political control are not unknown in emerging-market countries.

Business-environment stability is also at issue in countries ruled by military dictatorships. Even economies in democratic countries can be influenced by their greater sensitivity to political and social unrest. Likewise, there is a greater risk of economic policy changes that could be unfavorable to foreign investors. These policy changes can range from expropriation of foreign assets to currency controls and tax revisions. Finally, in terms of the legal environment, successful risk management for the asset-backed product line is contingent on the ability to secure a true sale without recourse to perfect security interest and to enforce claims. This sort of legislation is at various stages of development in emerging markets. The lack of such legal provisions, or uncertainty with respect to interpretation, can increase losses associated with asset-backed insurance. In view of these added considerations relative to domestic bond insurance, the portfolio and risk-management functions are a more dynamic, multivariable strategic exercise. For example, the concept of single-risk management is broadened, as Standard & Poor's expects that country limits will be established. Management must rationalize the established limit within the context of the company's rating being able to withstand worst-case country losses. Obviously, less capacity should be available to a noninvestment-grade country than a country rated 'AAA'. In addition, within the country risk limit, Standard & Poor's would expect sublimits to be in evidence for cross-border or transfer risks. Term limits by maturity could be another sublimit within the country category. In defining country risk and determining appropriate insured portfolio limitations, Standard & Poor's believes that certain countries demonstrate such a strong positive correlation in terms of political and macroeconomic variables that treatment as independent entities is not appropriate. Owners of the emerging market bond insurers have an important risk-management role to play. Whereas ownership responsibilities in the U.S. typically involve corporate governance and strategic planning and capital planning, appropriate ownership and owner involvement in risk management are crucial for an emerging markets insurer. For example, some of the owners of ASIA Ltd. are American International Assurance Co. Ltd. (an American International Group unit), Asian Development Bank, a subsidiary of the Government of Singapore Investment Corp. Pte Ltd., and Employees Provident Fund Board of Malaysia. Management will benefit strategically from their market insights and strong local knowledge. ASIA Ltd. has chosen its shareholders in a way it believes these shareholders—either by their presence or through direct contact—might inhibit or prevent a country or issuer from taking adverse action. The Asian Development Bank (ADB) is probably the most prominent of the shareholders in this regard. In particular, ADB is such a vital source of credit and liquidity within the region that defaulting on an ADB affiliate would represent, in some instances, an option of last resort for insured obligors or other related parties. Asian Turmoil Highlights Risks The Asian turmoil that began in the fall of 1997 and largely subsided in 1999 vividly portrays certain risks borne by emerging market bond insurers. Even though ASIA Ltd has experienced modest claims in its portfolio through May 1, 2002, the underlying credit quality of many of the insured transactions has been negatively affected. At the height of the turmoil, noninvestment grade-rated transactions, nearly half of which were rated 'B', represented about 40% of the risk portfolio. Many of the downgrades reflected a deterioration in sovereign credit quality. Short of a widespread incidence of defaults, the scenario of wholesale downgrades precipitated by lowered sovereign credit quality is perhaps the most difficult for emerging market bond insurers to protect themselves against. Diversification across a wide number of transactions representing a variety of sectors cannot insulate the insurer against this risk due to the constraint the sovereign rating places on other ratings within the country. Diversification across countries helps, but there are simply not enough countries to diversify across to achieve sufficient insulation from sovereign rating downgrades, particularly if several sovereign ratings are under stress at the same time. Standard & Poor's bond insurer rating criteria are established with the dual focus of fostering rating stability over normal economic cycles and measuring solvency during severe economic stress. The criteria is not set to assure that an insurer can emerge from severe economic stress with its initial rating intact. Nor was it crafted to completely immunize an insurer from the dramatic effect of multiple sovereign rating downgrades. Although it produced limited claims to date, the Asian experience of 1997-1999 was indeed stressful. Rating downgrades significantly exceeded the level and magnitude contemplated over a normal economic cycle. Thus, such a scenario could be viewed as an additional stress test that measures significant portfolio deterioration without significant claims. Capital and Operating Standards In the context of an 'A' financial strength rating, the capital and operating standards that have applied to domestic de novo 'AAA' bond insurers will, with few exceptions, apply to de novo emerging market bond insurers. With the crucial assumption that a well-qualified management team is in place, some of the other more important standards are summarized in the following sections. Initial capitalization A minimum of $300 million of capital is required. Of this total amount, $200 million can take the form of hard capital, and the remaining $100 million can be committed capital. Reinsurance and committed capital providers must be rated no lower than the bond insurer. Capital adequacy modeling To receive an 'A' rating, a company's assets and insured portfolio will be subjected to a worst-case stress test similar to that established for the 'AAA' monolines. Standard & Poor's capital adequacy model for startups assumes five years of aggressive growth followed by a four-year depression. Until an actual portfolio-based weighted average capital charge is established, modeling capital charges are assumed to be 2x to 3x higher than those compiled by the 'AAA' monolines for respective sectors. In terms of Standard & Poor's stress test criteria, requirements for 'AAA' rated monolines specify a minimum capital-adequacy margin of safety of 1.25x. Domestic 'AA' monolines (which may insure up to 15% in noninvestment-grade business) are required to have a margin of safety of at least 1.0x. Emerging market bond insurers rated 'A' must maintain a margin of safety no lower than 0.80x. Investment management For all bond insurers, it is most prudent to contain the risks of the business, to the greatest extent possible, to the liability side of a company's balance sheet. Investment portfolios, therefore, should consist exclusively of fixed-income investments with a 'AA' weighted average credit rating and five- to seven-year durations. Single risk The foundation of Standard & Poor's single-risk analysis is the standard that a single worst-case default by any one issuer should not be so severe that it would result in a rating change. For example, for single-risk compliance with respect to individual asset-backed transactions, the full credit gap cannot exceed 30% of policyholders surplus, plus contingency reserves, plus capital on call. The credit gap is equal to the theoretical worst-case loss for a pool of assets, less the first loss protection provided within the transaction. For infrastructure transactions, net par exposure cannot exceed 30% of policyholders' surplus, plus contingency reserves, plus capital on call. Ownership The impact and potential risk to the de novo from the holding company during its start-up phase should be negligible: No dividend should be budgeted for the first five years of operation; During the first five years of operations, there should be no plans for debt issuance; Exit strategies should be a very low priority issue for owners; and Owner credit quality should be no lower than the rated operating company in cases where committed capital support is provided and generally no lower than 'BBB' in all other cases. Underwriting In the context of an 'A' rating, the area of greatest difference and latitude relative to 'AAA' standards is found in the area of underwriting. Up to 25% of the insured portfolio may be rated in the 'BB' category. While underlying ratings may change over time, which could lead to some underlying ratings dropping below 'BB', all transactions at the time of insurance should meet the 'BB' minimum rating criteria. Partly because of this element, however, Standard & Poor's surveillance of bond insurers operating in emerging markets will include a preclosing review and shadow rating for all insured transactions. Further, annual surveillance reviews of all closed transactions will be the norm. Targeted underlying credit quality ranges should be adjusted to reflect the performance of the outstanding portfolio. To the extent outstanding transactions have deteriorated, the insurer should raise its underlying rating target for new transactions to keep a proper credit quality balance in the risk portfolio.