

## WHEN INSURANCE CREATES UNCERTAINTY

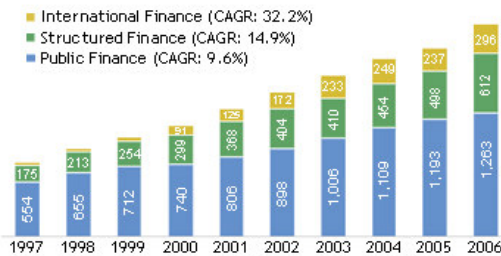
FIRST OF TWO

Financial sector investors experienced great uncertainty in recent weeks. This volatility has been exacerbated by the difficulties of a group of players active in a formerly obscure area of the debt financing world: credit insurers. This week's Marker is the first of a two-part series in which we review recent events related to credit insurance in order to better understand the risk and potential impact on financial markets.

### WELCOME TO THE WORLD OF BOND INSURANCE

The first bond insurance policy is said to have been written in 1971. Termed financial guarantee policies these contracts guarantee the timely payment of principal and interest in the event of a borrower default. Demand for these guarantees is very significant; an estimated \$5.8 trillion in policies has been written over the years. Borrowers and investors derive benefits from financial guarantees. The former cuts borrowing costs significantly thanks to higher ratings while investors rely on the guarantee - issued by AAA-rated entities - to facilitate their credit analysis. A broader group of borrowers can purchase the debt, which translates into more efficient markets. After all, how many pension and insurance fund bond analysts are capable or willing to inspect water treatment plants in western Florida in order to properly assess their value as collateral?

### Industry Growth in Net Par Outstanding



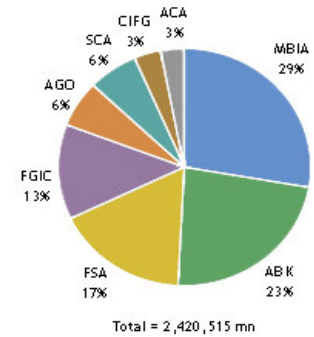
Sources: JP Morgan, AFGI

credit default swaps on over \$200 billion in complex mortgage securities. While a CDO or other structured debt issue may be insured, it is not immune from market forces, and the value of the underlying collateral will fluctuate with circumstances.

### RATING AGENCIES JOIN THE PARTY

Given large recent drops in the values of CDO's acting as collateral for debt issues, rating agencies moved to pressure insurers to raise capital or risk losing their vaunted AAA ratings. The loss of a AAA rating is essentially a death knell for any financial insurer. It would have very serious effects on those holding insured debt, leading to write-downs and forced sales. Investors already experienced a small preview of these effects when CIBC and Merrill Lynch had to take multi-billion dollar write-downs related to exposure to downgraded insurer SCA Capital at the end of 2007. Rating agencies have since been applying great pressure on the leading insurers, such as AMBAC and MBIA, to shore up their capital. Regulators have attempted to formulate bailouts on the insurers by the banks, and highly respected investors like Warren Buffet and Wilbur Ross are considering entering this industry as it faces the most difficult period of its history.

### Market Share in Net Par Outstanding



Source: JP Morgan

### IN SEARCH OF FASTER GROWTH, INSURERS VENTURE INTO NEW AREAS

While critically important, the world of municipal finance is not the fastest growing. Somewhat predictably, insurers looked to enhance their growth prospects by moving into related areas. The answer came in the form of insurance on structured credit instruments (CDO's). The concept is no different: an insurer guarantees timely payment of interest and principal. The distinction lies in the underlying collateral, which foregoes water treatment plants and airports to focus on sub-prime, Alt-A, and commercial mortgage-backed securities. Though the first guarantee of this type was written in the mid-1980's, the business really began to boom in 2005, when technical issues between insurers and Wall Street got resolved. From that point on, bond insurers underwrote modified

## NATCAN WEEKLY MARKER

Bond insurance has grown strongly over three decades; it has extended its reach to the center stage of the current credit crisis. By broadening their activities to guaranteed structured credit debt, insurers now face very difficult circumstances, and rating agencies and regulators are seeking ways of restructuring so as to avoid a cascade of losses. In the second part of this series, we will examine the potential impacts on financial markets as well as proposed solutions to the issues created by current market circumstances.

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## FINANCIAL MARKETS

| RETURNS AS AT FEBRUARY 22, 2008 (%) | MTD   | QTD   | YTD   | RATES AS AT FEBRUARY 22, 2008   |
|-------------------------------------|-------|-------|-------|---------------------------------|
| S&P/TSX                             | 3.34  | -1.53 | -1.53 | CAD/USD                         |
| S&P 500                             | -0.85 | -5.87 | -5.87 | CAD/Euro                        |
| S&P/TSX Small Cap                   | 4.63  | -2.49 | -2.49 | US Treasuries yield 10-yr/30-yr |
| Russell 2000                        | -1.64 | -7.44 | -7.44 | GOC bond yield 10-yr/30-yr      |
| MSCI EAFE                           | -0.37 | -7.63 | -7.63 | Fed Fund Rate (target)          |
| MSCI World                          | -0.57 | -6.19 | -6.19 |                                 |
| DEX Universe Bond                   | 0.02  | 0.64  | 0.64  |                                 |

Note: Returns in Canadian dollars, London 4h exchange rates. Source: Datastream, PC Bond, MSCI-Barra, and Bloomberg. PC-Bond, a business unit of TSX Inc. Copyright © TSX Inc. All rights reserved.

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