NATCAN WEEKLY MARKER

March 6, 2008

WHEN INSURANCE CREATES UNCERTAINTY

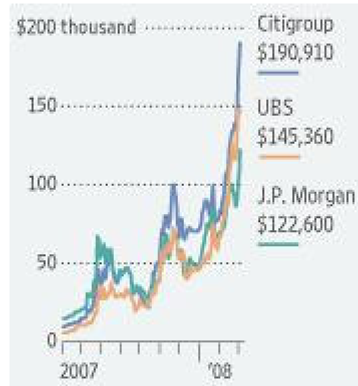
TWO OF TWO

A significant share of recent market volatility can be explained by news flow affecting monoline bond insurers. In this week's Marker, we pursue our analysis of the dynamics affecting the bond insurance industry.

WHY THE FOCUS IS ON BOND INSURANCE

Recent estimates peg the value of insured bonds at $2.4 trillion. Of this amount, reports indicate over $1 trillion of insurance contracts pertain to non-municipal debt. Therein lies the answer to the importance accorded to bond insurers by regulators and investors. Over $1 trillion in debt is valued and traded on markets based on an explicit insurance against defaults with this insurance rated AA or AAA by major rating agencies. The loss of such financial guarantee could translate into hundreds of billions of insured debt having to be written down or in some cases sold on the market under difficult circumstances. Ironically, the very segments of outstanding paper likely to be most hard hit are the so-called super senior tranches of the structured credit world. Designed to be the safest and best protected against credit default losses, these tranches were aggressively insured by banks and hedge funds in an effort to gain beneficial accounting treatment and even more generous financing terms. The investments deemed the safest, and issued in the largest amounts, are therefore at risk of being hit the hardest should a large insurer fail to maintain its financial strength. Investors have taken note. As illustrated in the accompanying chart, the cost of insuring against a default by one of the leading banks has increased 3 to 5 times in the last year. Reports indicate that Citigroup and UBS have the largest amounts insured with Ambac, the number two monoline insurer.

Annual Cost of Insuring $10M of Debt against Default



Source: Markit

BAILOUT ATTEMPTS MULTIPLY

Early in January, the New York State regulator of insurance called on several major banks to find means of injecting capital in the leading bond insurers so as to avoid disruption of municipal financing markets. The banks proved leery of working with competitors, and refused to help. Warren Buffet offered to bail out the healthy segment of the industry by re-insuring municipal debt issues *if* insurers agreed to pay 1.5 times what they collected from their clients; an offer insurers were quick to dismiss! It is interesting that for all the interventions by regulatory and other public sector players, the true solutions appear to be provided by private sector players. Mr. Buffet created a brand new municipal bond debt insurer, and secured licenses in mere weeks instead of the usual several months required. Ambac and MBIA are in the process of raising significant amounts of capital, and secure a stay of further downgrades by the key rating agencies. The immediate threat appears to be in the process of being addressed, that is if credit does not deteriorate further and if other classes of credit such as commercial real estate and corporate debt avoid the difficulties experienced by sub-prime residential borrowers.

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Bond insurance companies have rocked financial markets in a way few investors had foreseen. Key steps have been taken to shore up capital, and new players are entering the market, thereby indicating past excesses are not likely to continue. One must nonetheless question why weakened entities should be given a clean bill of health in the form of AA/AAA ratings when it is most likely that the dubious underwriting practices that landed them in trouble in the first place were applied in other sectors where defaults have yet to spike. The final chapter is unlikely to have been written, and only the most aggressive speculators will consider bond insurers or the assets they guarantee attractive at this stage.

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FINANCIAL MARKETS

RETURNS AS AT FEBRUARY 29, 2008 (%)	MTD	QTD	YTD
S&P/TSX	3.45	-1.43	-1.43
S&P 500	-5.12	-9.92	-9.92
S&P/TSX Small Cap	5.81	-1.38	-1.38
Russell 2000	-5.57	-11.13	-11.13
MSCI EAFE	-1.47	-8.64	-8.64
MSCI World	-3.42	-8.88	-8.88
DEX Universe Bond	1.34	1.97	1.97

	RATES AS AT FEBRUARY 29, 2008
CAD/USD	0.98
CAD/Euro	1.49
US Treasuries yield 10-yr/30-yr	3.53/4.55
GOC bond yield 10-yr/30-yr	3.64/4.09
Fed Fund Rate (target)	3.00

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.