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Credit Opinion: National Public Finance Guarantee Corporation

Global Credit Research - 29 May 2015

Illinois, United States

Ratings

Category	Moody's Rating
Rating Outlook	NEG
Insurance Financial Strength	A3
MBIA Inc.	
Rating Outlook	NEG
Senior Unsecured	Ba1

Contacts

Analyst	Phone
Brandan Holmes/New York City	1.212.553.1653
James Eck/New York City	
Stanislas Rouyer/New York City	
Roman Harutyunyan/New York City	

Key Indicators

National Public Finance Guarantee Corporation

	2014	2013	2012	2011	2010
As Reported (U.S. Dollar Millions)					
Gross Par Written	343	-	-	-	-
Present Value Premiums (PVP)	N/A	-	-	-	-
Net Income	238	256	416	478	409
Gross Premiums Written	13	12	-	-	109
Net Par Outstanding [1]	217,248	271,105	330,845	398,602	468,555
Regulatory Capital [2]	3,266	3,258	3,248	2,809	2,381
Portfolio Leverage of Regulatory Capital [2]	66.5x	83.2x	101.9x	141.9x	196.8x
Claims Paying Resources (Moody's adjusted)	4,896	5,196	5,605	5,631	5,670
Portfolio Leverage of Claims Paying Resources	44.4x	52.2x	59.0x	70.8x	82.6x
Coverage of Moody's Capital Charge at the A3 Level	1.23x	1.29x	--	--	--
PV Premiums divided by gross par written (bps)	N/A	--	--	--	--
% Of Industry Gross Par Written	1.6%	-	-	-	-
% Par Reinsured	2.3%	2.1%	1.9%	2.9%	2.9%
Underwriting Margin (1 yr)	56%	61%	64%	82%	68%
Return on Capital (1 yr)	7.3%	7.9%	13.7%	18.4%	18.7%
Sharpe Ratio of ROC (5 yr)	268.5%	66.7%	--	--	--
Financial Leverage [3]	42.9%	45.6%	44.6%	45.9%	47.2%
Total Leverage [3]	47.0%	50.6%	50.8%	55.2%	58.2%
Cashflow Coverage (1 yr) [4]	4.8x	5.4x	3.0x	0.0x	0.0x
Earnings Coverage (1 yr) [3][5]	1.5x	-0.6x	-1.2x	-0.8x	0.6x

[1] Net Par Outstanding is based on GAAP reported amounts [2] Regulatory capital defined as U.S. Statutory Qualified Statutory Capital for U.S. guarantors [3] Based on MBIA Inc. consolidated results [4] Based on holding company data; Cashflow coverage for 2014 and 2013 includes tax escrow release [5] Includes GAAP accured interest on MBIA Corp. surplus note that is note being paid accrued for statutory purposes

Opinion

SUMMARY RATING RATIONALE

National Public Finance Guarantee Corporation's (National) A3 insurance financial strength (IFS) rating, with negative outlook, reflects the insurer's substantial stand-alone capital resources, the meaningful delinking from its weaker affiliates, steady amortization of its legacy book, and its ongoing efforts to reestablish its franchise in the primary and secondary US municipal debt markets. National has substantial exposure to below investment grade credits, which represent approximately 3.0% of its insured book and 192% of qualified statutory capital at March 31, 2015, including approximately $4.5 billion gross exposure to debt issued by Puerto Rico and its public enterprises. National's exposure to Puerto Rico is approximately $4.9 billion when including accreted interest on insured zero-coupon, or capital appreciation bonds. In addition, National, like its peers, faces significant headwinds from weak fundamentals in the sector, including still depressed levels of insurance usage, moderate prospective profitability and meaningful legacy risk.

The B2 insurance financial strength (IFS) rating of MBIA Insurance Corporation (MBIA Corp.), with negative outlook, reflects the company's weak capitalization relative to its remaining insured exposures, and its modest liquidity position. Recent transactions, including significant commutations of insured exposures, and the settlement of RMBS put-back claims, have improved the firm's capital adequacy and liquidity profile such that a restructuring or insolvency is no longer the most likely scenario. The majority of MBIA Corp.'s structured finance book is expected to run off within the next five years, freeing up capital resources. However, MBIA Corp.'s capital adequacy and liquidity positions are highly sensitive to the levels of excess-spread recovery on its insured portfolio of second-lien RMBS. In addition, the company remains exposed to a number of large structured transactions, including the material Zohar CLO notes that are currently the subject of restructuring discussions, that could cause significant stress, including insolvency, in the event of default.

MBIA Inc.'s Ba1, negative, senior unsecured debt rating is four notches lower than the IFS rating of its lead insurance subsidiary, National. This is wider than the typical three notches for insurance groups, reflecting MBIA's high leverage, and significantly weaker credit profile of MBIA Corp., its other substantial subsidiary. The negative outlook on MBIA Inc.'s rating, reflects the heightened risk of losses on National's Puerto Rico exposures, and the adverse effect it could have on its liquidity, given its reliance on the future release of tax escrow funds and dividends from National to pay debt service. In addition, the firm's high debt burden and meaningful asset risks, a large share of which reside in its wind-down operations, remain a distinct weakness.

Credit Strengths

- Generally high quality and fairly diversified municipal insurance portfolio;

- Substantial claims-paying resources;

- The group's experienced management team.

Credit Challenges

- Difficult market environment characterized by low interest rates and limited demand for bond insurance;

- Large single risk exposures, including below investment grade rated Puerto Rico related obligations;

- Part of a group comprising significantly weaker affiliates.

Rating Outlook

The negative outlook on National's rating, reflects the heightened risk of losses on National's Puerto Rico-related exposures; the size of those exposures relative to capital and claims paying resources; and the meaningful level of uncertainty about the possible losses in the event of a default or restructuring. In addition, National has substantial exposure to weaker municipal credits, most notably approximately $2.45 billion gross par exposure to the City of Chicago and its related credits, that were recently downgraded to below investment grade.

What to Watch For:

- Growth in new business production;

- Credit deterioration related to Puerto Rico exposures, with a near-term focus on the Enterprise credits, notably the Puerto Rico Electric Power Authority (Caa3 negative) which has a debt service payment due in July;

- Developments related to large single risk exposures.

What Could Change the Rating - Up

A substantial reduction in National's exposure to Puerto Rico, or of the range of possible losses relative to National's claims paying resources could lead to a return to a stable outlook. The following factors could lead to an upgrade of National's rating:

- The successful, long-term resolution of Puerto Rico's funding and solvency issues;

- The reestablishment of National's financial guaranty franchise in the US municipal market.

What Could Change the Rating - Down

- Substantial credit erosion of insured risks, including meaningful impairments of its Puerto Rico exposure;

- A meaningful withdrawal of capital absent a significant reduction in the uncertainty around its Puerto Rico exposures;

- Provision of material support to weaker affiliates;

- A material decrease in profitability;

- Significant diversification into higher risk businesses.

DETAILED RATING CONSIDERATIONS

Moody's rates National A3 for insurance financial strength, which is one notch higher than the Baa1 rating produced by Moody's unadjusted rating scorecard, and primarily a result of the steady amortization of the company's insured portfolio, and its ongoing efforts to resume writing new business.

Insurance Financial Strength Rating

The key factors currently influencing the rating and outlook are as follows:

MARKET ENVIRONMENT AND PRODUCT STRATEGY: Baa - EFFORTS TO GROW PRODUCTION FACE HEADWINDS FROM DEPRESSED INSURANCE USAGE AND LEGACY EXPOSURES

The Baa score reflects National's ongoing efforts to reestablish its franchise in the primary and secondary US municipal debt markets, having resolved restructuring litigation and significantly reduced intercompany linkages. In addition, market prices on National wrapped debt, in some cases, indicate an element of value for the wrap. However, National is currently not writing any material new business, and like its peers, faces significant headwinds from weak fundamentals in the sector, including a dramatic reduction in insurance usage, moderate prospective profitability and still-meaningful legacy risk. We also believe that National will have to contend with risk-concentration overhang including, notably, its exposure to Puerto Rico, in achieving broad market acceptance of its insurance. In addition, persistent, low interest rates exacerbate an already challenging business environment. It remains to be seen whether the company will successfully establish a market presence, marked by its ability to underwrite policies at attractive risk-adjusted pricing.

PORTFOLIO CHARACTERISTICS AND CAPITAL ADEQUACY: A - SUBSTANTIAL CAPITAL RESOURCES TEMPERED BY RISK CONCENTRATIONS AND LARGE BELOW INVESTMENT GRADE EXPOSURES

The single-A range capital adequacy score reflects the company's substantial capital resources relative to its predominately low-risk, municipal-focused portfolio. As of March 31, 2015, National reported claims paying resources of $4.9 billion, and qualified statutory capital of $3.3 billion. While its statutory capital and claims paying resources are substantial and the public finance portfolio is, for the most part, of high credit quality, National's capital adequacy score is negatively impacted by its exposure to certain large below investment grade (BIG) credits.

The average credit quality of National's insured portfolio is strong, with the majority of the insured risks rated double-A or single-A. However, single risk concentration and relatively large BIG exposures are notable

weaknesses. As of March 31, 2015, National reported BIG exposure of approximately 3.0% of its insured book and 192% of qualified statutory capital (QSC). National's BIG exposure includes approximately $4.5 billion of total gross par exposure to the Commonwealth of Puerto Rico and its public enterprises ($4.9 billion when including accreted interest on insured zero-coupon, or capital appreciation bonds). This amounts to approximately 136% of its QSC. Gross par exposure to Puerto Rico's public enterprises was approximately $2.3 billion at March 31, 2015, or 70% of QSC. Given the various linkages of the individual Puerto Rico obligors and their reliance on the same local economy to support revenues, we view National's exposures to Puerto Rico to be more highly correlated than is typical across public sector obligors. Single risk concentrations such as these exposures to Puerto Rico can meaningfully increase risk, because they can define the "weakest link" in a chain of enterprise financial strength.

National has substantial exposure to weaker municipal credits, most notably the cities of Chicago and Detroit. National's gross par exposure to the City of Chicago is approximately $2.45 billion, including $1.04 billion to the city's general obligation bonds, and $1.11 billion to the city's board of education, both of which were recently downgraded to below investment grade. The vast majority of the company's exposure to the City of Detroit is comprised of approximately $1.6 billion of Detroit Water and Sewer bonds (Ba2/ Ba3) which have a secure lien on revenues from those systems and are were outside of the reach of the city's bankruptcy. MBIA, and other creditors reached a settlement with the City regarding the Unlimited Tax GO bonds, at a recovery rate of 74%.

In addition, deterioration at MBIA Corp., due to either liquidity stress or weaker performance of the insured portfolio, could have a negative impact on National, because it would increase the risk of a contingent call on National's resources. However, the likelihood of National providing support to MBIA Corp. has declined significantly because of the effective separation of National and MBIA Corp., and stabilization of MBIA Corp.'s credit profile.

PROFITABILITY: A - STRONG EMBEDDED EARNINGS MODERATED BY VULNERABILITY TO CREDIT IMPAIRMENTS

National has not written any material new business since 2008, but is earning substantial revenues from its existing insurance portfolio through recognition in earnings of the unearned premium reserve, municipal refunding, and investment income. This ability to generate earnings absent new business flow is a powerful characteristic of the business model, and affords National some leeway as it works to reestablish its business. That said, refunding premiums earned are expected to continue to decline, as the refinancing wave tapers off, and there is a meaningful degree of uncertainty as to the level of new business National will be able to generate.

Included in National's 2014 gross par written of $343 million is $300 million of Detroit Water and Sewer debt issued as part of a tender offer to existing holders in September 2014. This signals a measure of franchise value, however, based on a single, below investment grade issue, it's too early to draw broad conclusions about future market demand from investors for National's insurance on the Baa and A investment grade credits that are now the company's primary target market. For the quarter ended March 31, 2015, National insured an additional $38 million in net par. A lack of new business flow would eventually cause a decline in reported profitability as the company's legacy exposures amortize, and investment income declines on a dwindling asset base. In addition, National's large exposure to BIG municipal credits, Puerto Rico in particular, could result in earnings volatility.

FINANCIAL FLEXIBILITY: Ba - NO CAPITAL ACCESS SINCE EARLY 2008

The group has not demonstrated access to capital markets since 2008, however, in our view its financial flexibility has improved over the past few years, as it has redeemed debt and earnings in its underlying insurance operations have lead to an increase in consolidated shareholders' equity. The group's total adjusted leverage (excluding VIE liabilities) was approximately 47.0% at December 31, 2014, an improvement from 50.6% and 50.8% at year-ends 2013 and 2012, respectively. The group's GAAP-basis earnings coverage was 1.5x for 2014, however this includes interest on MBIA Corp.'s surplus notes that is not currently being paid, or accrued on a statutory basis. Excluding the impact of MBIA Corp. and the interest on its surplus notes, 2014 earnings coverage was approximately 3.5x. In addition, liquidity at MBIA Inc., the holding company, has strengthened with the resumption of dividend payments from National in October 2013, and a steady release of funds from the tax escrow account. At March 31, 2015, the holding company had unencumbered cash and liquid investments of $567 million. We expect the group's financial flexibility and MBIA Inc.'s liquidity to continue to strengthen, however, the heightened risk of losses on National's Puerto Rico exposures could affect future levels of tax escrow funds to be released, as well as dividends from National.

While liquidity has strengthened, the holding company remains dependent on dividends from National and funds from the tax escrow account to service its obligations. As at March 31, 2015, the holding company reported debt

(including investment agreements, long-term debt and medium-term note liabilities) of $2.5 billion, and cash and invested assets of $1.86 billion. The company expects to address the shortfall in cash and invested assets over time, through distributions from National and releases from the tax escrow.

MBIA Corp.'s liquidity position has improved as a results of RMBS settlements and recoveries on put-back claims, such that a restructuring or insolvency is no longer the most likely scenario. RMBS excess-spread recoveries, recovery of the Credit Suisse put-back claim and possible future dividends from MBIA UK would further improve the company's liquidity. However, MBIA Corp.'s liquidity position remains exposed to uncertain outcomes of these factors, and is very sensitive to minor deviations from the expected path, including larger than anticipated claim payments related to Zohar. Given its legal separation from the group, and limited embedded economic value, we do not anticipate that the group would provide any meaningful financial support to MBIA Corp, currently, the weakest subsidiary in the group.

MBIA Inc. is required to meet collateral posting requirements under terms of its derivatives and investment agreements. In order to secure access to eligible assets to post as collateral, MBIA Inc. entered into simultaneous repurchase and reverse repurchase agreements (Asset Swap) with National, whereby MBIA Inc. borrows government securities from National, in-turn, collateralized with investment grade assets, from MBIA Inc. A haircut, which varies according to mark-to-market adjustments, is applied to the assets posted by MBIA Inc. While the Asset Swap facility is limited to $2 billion, as of March 31, 2015, $385 million was outstanding under the facility.

Rating Factors

National Public Finance Guarantee Corporation

Financial Strength Rating Scorecard [1][2]	Aa	A	Baa	Ba	B	Caa and lower	Score	Adjusted Score
Business Profile								
Market Environment and Product Strategy (25%)							Ba	Baa
Industry Environment				x				
Market Position and Product Strategy				x				
Financial Profile								
Portfolio Characteristics and Capital Adequacy (40%)							A	A
Risk-adjusted capital coverage		x						
Profitability (20%)							Aa	A
Underwriting Margin (5 yr average)	66%							
Return on Capital (5 yr average)	13%							
Sharpe Ratio of ROC (5 yr)		269%						
Financial Flexibility (15%)							Baa	Ba
Financial Policy			x					
Ease of Access to Capital				x				
Operating Environment							Aaa - A	Aaa - A
Aggregate Profile							Baa1	A3

[1] Financial information based on US Statutory financial statements [2] The Scorecard rating is an important component of the company's published rating, reflecting the stand-alone financial strength before other considerations (discussed above) are incorporated into the analysis

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