

Subprime Mortgages, Financial Guarantors and Municipal Bonds

During the past several months there has been much turmoil in the credit markets focusing mainly on structured investments related to mortgages, and in particular, subprime mortgages. Mortgages are often packaged into pools and securitized in the form of RMBS (Residential Mortgage Backed Securities), which may be packaged into pools in the form of CDOs (Collateralized Debt Obligations). These securities are stratified into tranches with each tranche being assigned a hierarchy or priority in the capital structure of the pool. The most senior tranches are rated AAA by the rating agencies and have first claim to all interest and principal payments. The more junior tranches absorb first losses or missed payments based on their assigned priority in the capital structure of the pool. Many of these asset pools contain both high quality credits (prime risk) as well as midprime and subprime credit risk (lower credit qualities).

Financial guarantee insurance companies such as AMBAC and MBIA have historically provided credit enhancement to various forms of debt obligations including municipal bonds and structured investments such as RMBS and CDOs. CDOs may contain mortgage pools and/or other obligations (e.g., credit card debt and leasing transactions). The financial guarantors agree to assume the obligation for any payments of interest and principal that are in default by the primary obligor. In other words, they enhance the credit of the primary obligor by standing behind them with their own AAA credit status. To protect their credit status, the financial guarantors have historically maintained strict credit and underwriting requirements. These requirements provide that the primary obligor generally be an investment grade credit and that there is sufficient collateral in the event of a default. Because of their sound underwriting, the financial guarantors for the most part have not experienced substantial cash losses, although some cash losses have occurred and future cash losses are anticipated.

In recent years, the financial guarantee insurance companies have provided credit enhancement insurance to RMBS and CDOs containing subprime mortgages. Applying their underwriting criteria to these securities, they have predominantly insured the highest rated (AAA) tranches of these structured investment pools. The support for the AAA tranche of these securities (absent the credit enhancement insurance) is a combination of some high credit quality mortgages and the subordination of the lower tier tranches of each pool. RMBS are constructed with this subordination feature and CDOs are also constructed with similar subordination provisions. Consequently each insured CDO or RMBS tranche has a high degree of coverage and subordination supporting the tranche that is insured by the financial guarantors.

Over the last several weeks, the share price of AMBAC and MBIA has declined significantly due to the concerns of the potential contagion of credit market risks to the financial guarantors. Additionally, AMBAC has reported large unrealized losses resulting from marking to market its derivative credit contracts (credit default swaps or CDS). A CDS is a derivative product that the financial guarantors utilize to create a credit enhancement that is similar in effect to an insurance policy. However, the accounting rules related to these instruments differ from an insurance contract in that generally accepted accounting principles (GAAP) require a mark to market of CDS contracts. A reduction in market value of a CDS occurs where collateral supporting the subordinate tranches has eroded. These losses are not cash out-of-pocket losses and are more akin to a reserve in anticipation of future loss. However they do result in the recognition of a loss on the financial statements. Importantly, the CDS contracts entered into by the financial guarantors are not subject to the collateral requirements and acceleration provisions that apply to many other CDS contracts. Therefore, the rating agencies have concluded that, for their purposes, they operate the same as the standard credit enhancement insurance policy to which the marked to market rules do not apply.

We have reviewed the latest available data for the four largest financial guarantors that are rated AAA. The portion of their insured portfolio that reflects RMBS and CDOs containing subprime exposure is less than 10%. In addition, as of this writing, the major rating agencies have all reviewed capital adequacy and portfolio credit quality and have reaffirmed their comfort level, and have maintained their AAA rating.

Nevertheless, we think it important to consider what would happen if the financial guarantors lost their AAA status. In such a case it is likely that municipal bonds which are not AAA rated of their own accord would trade and be valued based on their underlying credit rating and the downgraded credit rating of the insurer resulting in a decline in market value. However, we do not at this point believe it is necessary to reposition client municipal bond portfolios. This is because the quality of bonds purchased by KLS and held in client portfolios are investment grade on their own accord apart from credit enhancement insurance. Most of these bonds are either general obligation bonds backed by the full taxing authority of the issuer, or are bonds that are backed by critical service revenues (e.g., electricity, water etc.). Further, most client portfolios have a short average maturity, further reducing risk.

We will continue to monitor developments, and we encourage you to speak with your KLS Managing Director if you wish to discuss these or other investment portfolio issues.

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