Assured Guaranty Corp. (AGC)

Analytical Contacts:

Paul Kwiatkoski, Managing Director
pkwiatkoski@kbra.com, (646) 731-2387

Karen Daly, Senior Managing Director
kdaly@kbra.com, (646) 731-2347

Peter Giacone, Senior Director
pgiacone@kbra.com, (646) 731-2407

Jack Morrison, Senior Analyst
jmorrison@kbra.com, (646) 731-2410

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KBRA KROLL BOND RATING AGENCY

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Executive Summary

Kroll Bond Rating Agency (KBRA) has assigned an insurance financial strength rating of AA with a Stable outlook to Assured Guaranty Corp. (AGC).

As a major part of our analysis, KBRA determined a level of stress losses to be applied to AGC's insured portfolio based upon assumptions that, in our opinion, are consistent with a AA rating for a large, diversified portfolio. In developing these higher than expected credit losses, KBRA used a Monte Carlo analysis for the majority of AGC's insured portfolio and a deterministic loss assessment for the company's exposures to residential mortgage backed securities, Puerto Rico, and a limited number of other distressed credits. KBRA tested AGC's ability to pay this stress level of claims, and other expenses, in a run-off scenario. AGC satisfied all claims in full and on time in this stress case scenario and their ability to do so supports this rating.

KBRA notes that significant uncertainty remains with respect to AGC's exposure to Puerto Rico. The financial position of the Commonwealth of Puerto Rico continues to be severely stressed as evidenced by numerous defaults by various Puerto Rican issuers, including virtually all general obligation debt service due on July 1, 2016. Despite extensive ongoing efforts by various stakeholders, including the passage of the Puerto Rico Oversight, Management, and Economic Stability Act (PROMESA) legislation at the end of June, the ultimate resolution for creditors remains uncertain. KBRA has endeavored to address this uncertainty by developing a conservative stress case for AGC's insured Puerto Rico exposures and assessing AGC's ability to pay all claims reflected in this scenario. Further detail on the Puerto Rico stress case is described later in this report.

AGC also has significant legacy exposure to structured finance although this segment of the company's insured portfolio has declined substantially since the credit crisis. Within this structured finance portfolio, the company has net exposure to $2.1 billion of residential mortgage backed securities, which is 4.9% of the total portfolio. This sector has produced the majority of the company's paid losses in recent years and represents a significant source of expected and stress case losses going forward. Therefore, it was a focal point of KBRA's analysis. In developing stress case losses for this sector, KBRA's RMBS analysts reviewed each exposure, applying assumptions based partially on the RMBS sub-sector (e.g. first lien, HELOC, CES). For a majority of the exposures from first-lien sub-sectors, KBRA applied stress assumptions which included a decline in property values of 40%. For HELOC or CES exposures, KBRA applied stress assumptions which included multiples to observed prepayment rates. Such assumptions produced estimated losses that, in KBRA's opinion, AGC should be able to withstand to achieve a AA rating.

Overall, AGC's financial operations have stabilized following the substantial losses incurred as a result of the credit crisis. Leverage ratios have continued to decline to historic lows as the company's insured portfolio has run off more rapidly than new business origination. The acquisitions of CIFG in 2016 and Radian Asset Assurance in 2015 slowed but did not reverse this trend despite the addition of the insured exposure from these two companies. Further detail is provided in the "Claims Paying Resources and Financial Profile" section.

KBRA also conducted a detailed review of AGC's corporate governance framework, credit and risk management processes and consider them strong and reflective of industry best practices. AGC has a proven management team and a well-developed governance framework.

This rating is based on KBRA's **Financial Guaranty Rating Methodology** dated December 18, 2015.

Key Rating Strengths
• Demonstrated ability to withstand KBRA's conservative stress case loss assumptions across the breadth of its insured portfolio.
• The substantial and continuing runoff in structured finance components of the company's portfolio should continue to moderate risk. Structured finance exposure is currently $13 billion, down nearly 75% from $50 billion at year end 2010.
• Mature and high-functioning operating platform supported by strong governance and risk management systems.
• Tested management team that, given their experience through the credit crisis, is well positioned to address future portfolio risk issues should they develop.
Key Rating Concerns
• The impaired components of AGC's portfolio could experience losses approaching or exceeding the levels of stress case losses that KBRA assumed in our rating analysis.
• Significant industry risks are characterized by narrow credit spreads, low interest rates, vigorous competition and the increased loss profile manifesting itself in the public finance market.
• Payment of dividends in recent years to its parent at the maximum regulatory level. This could place downward pressure on the rating if portfolio risk levels increase rapidly or if risks fail to emerge in time to limit management's deployment of capital it determines to be excess capital.

Rating Summary

A key element of KBRA's analysis of AGC is testing the company's ability to provide for all claims under conservative stress case assumptions. The table below summarizes how KBRA segmented AGC's portfolio and stressed each component. The portfolio segments were: (i) Puerto Rico, (ii) RMBS, (iii) distressed structured finance and other credits and, (iv) the balance of the insured portfolio (Monte Carlo simulation). The table below shows the net par outstanding of each of these segments and the assumed estimated stress losses on a future value basis incorporated within our analysis. These stress case losses do not represent KBRA's forecast of expected claims but were developed to reflect KBRA's best estimate of the level of losses that a AA rated entity should be able to withstand so that an investor holding a bond insured by AGC would not expect to suffer losses under these assumed conditions.

KBRA's Stress Loss Treatment by AGC Portfolio Segment ($ in millions)			
Portfolio segment	**Net Par (6/30/2016)**	**Financial Guaranty Stress Losses[1] (Future Value)**	**Comments**
Puerto Rico	$1,703	$819 (Stress Case I) $765 (Stress Case II)	**Stress Case I** - Severities range from 10% to 55% based upon the issuer, realized annually as debt service is due, includes incremental severities of 15% in the first three years **Stress Case II** – 5-year debt service moratorium (50% subsequent recovery) followed by severities of 7.5% to 30% based upon issuer
RMBS	$2,065	$396	RMBS individually analyzed under KBRA's RMBS methodology
Distressed structured finance and other credits	$995	$473	Includes below investment grade Trups CDOs, XXX insurance securitizations, small public finance credits and losses on Zohar II CDO bonds held as investments.
Balance of portfolio	$37,584	$916	Monte Carlo simulation losses
Totals	**$42,347**[2]	**$2,605 (Stress Case I) $2,550 (Stress Case II)**	**Aggregate stress losses incorporated in Bond Insurer Financial model**

[1] These are stress case loss assumptions that support an overall AA rating on the insured portfolio. KBRA is not forecasting this level of losses for AGC.
[2] Pro forma including CIFG exposure.

KBRA's Monte Carlo simulation model was an important tool for developing stress case losses across the majority (~90%) of AGC's insured portfolio. KBRA's public finance and structured finance analysts reviewed the components of AGC's insured portfolio on a sector by sector basis to assess its credit risk and adjusted AGC's internal ratings where appropriate for KBRA's modelling purposes. KBRA's Monte Carlo simulation model produces a series of 100,000 paths, each of which assesses the probability of future defaults for each credit in each year of its expected remaining life. If a credit defaults in a particular path, a sector-specific severity assumption is applied against the amount of debt outstanding at that point in time to calculate a loss amount. The model generates 100,000 paths to produce a broad distribution of results. We focus on the tail of this distribution to construct a stress analysis which is reflected in the table above.

In our opinion, the aggregate of stress losses shown above (approximately $2.6 billion on a future value basis) represents the level of losses that AGC would need to cover to achieve a AA financial strength rating. We assessed AGC's ability to meet these losses in the KBRA Bond Insurer Financial Model. The financial model begins with an asset base equal to AGC's claims paying resources according to KBRA's definition, which is $2.8 billion at June 30, 2016 (reflects pro forma impact of CIFG acquisition). These resources, plus a conservative estimate of installment premiums and interest earnings, must be sufficient to provide for the stress level claims and all other expenses in our modeled run-off scenario. Based upon KBRA's model assumptions, AGC was projected to be able to pay all claims and expenses in full and on time under this scenario with a comfortable balance remaining, which is an outcome consistent with a KBRA insurance financial strength rating of AA.

Outlook: Stable

KBRA's stress case loss analysis incorporates significant deterioration in the distressed sectors of AGC's portfolio from current performance, which should contribute to stability if ultimate losses do not approach or exceed these modeled levels.

In KBRA's view, the following factors may contribute to a rating upgrade:

- Significant increase in claims-paying resources, as defined by KBRA.
- Favorable developments related to distressed structured finance and Puerto Rico exposures.
- Reduction in overall risk profile of insured portfolio with limited losses relative to claims-paying resources when subjected to KBRA's stress loss simulation and financial run-off scenario.
- Market factors that include a more favorable interest rate environment, firmer pricing conditions, and sustainable profitability.

In KBRA's view, the following factors may contribute to a rating downgrade:

- Market-wide increases in municipal default and severity rates and deterioration in the default and severity rates expected by KBRA within AGC's insured portfolio.
- Significant changes in AGC's senior management team or business strategy.
- Levels of capital extraction or deployment that outpace the decrease in portfolio risk.
- Portfolio acquisitions or other strategic actions that, in KBRA's opinion, introduce excessive risk into AGC.
- Risk imbalances that could materialize should new business production accelerate.

Key Rating Determinants

Rating Determinant 1: Corporate Assessment

Background

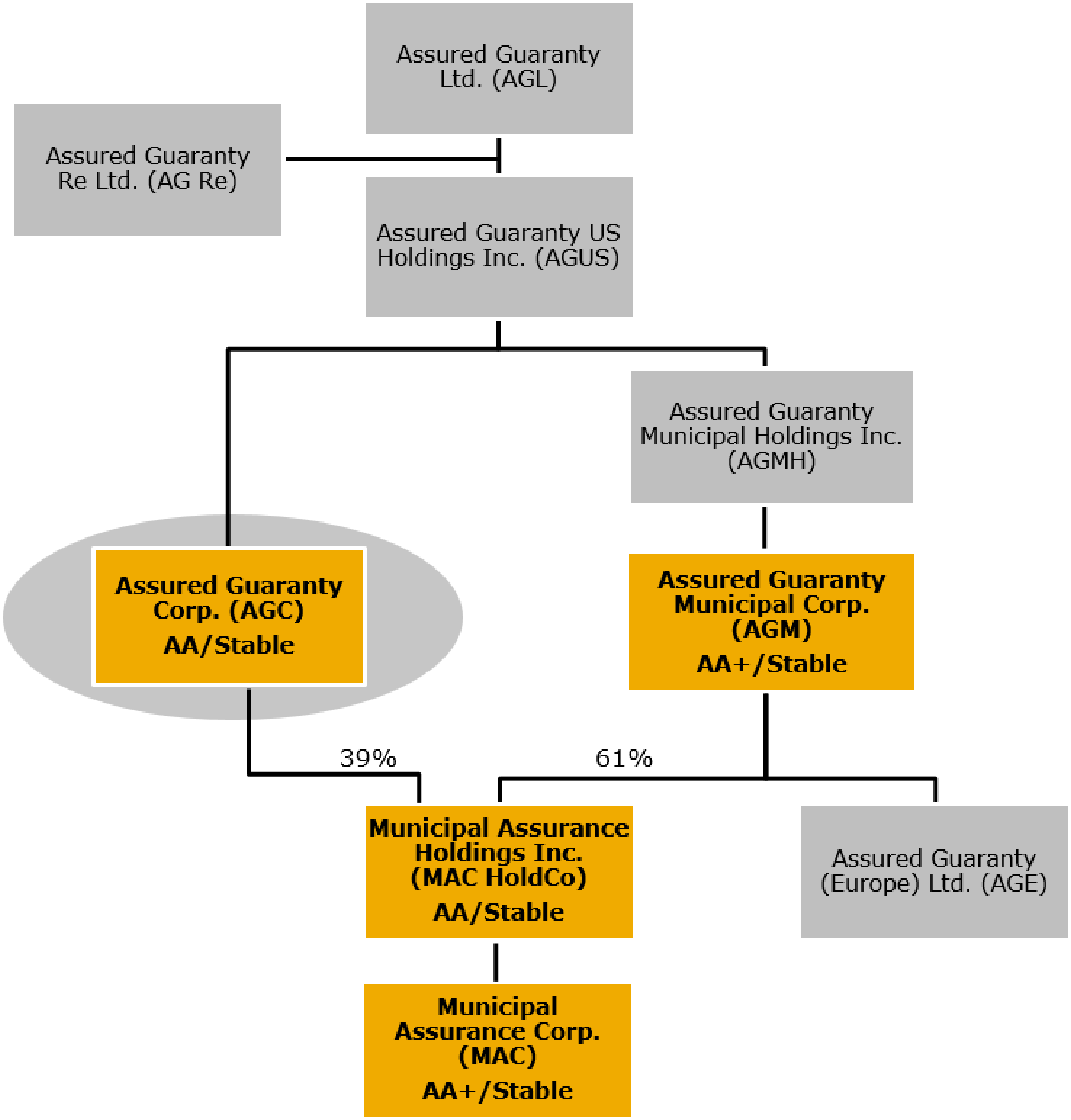
AGC's ultimate parent is Assured Guaranty Ltd. (AGL). AGL, together with its subsidiaries, Assured or Assured Guaranty, is a Bermuda-based holding company incorporated in 2003 that provides financial guaranty products to the U.S. and international public finance, infrastructure, and structured finance markets.

During 2007, the meltdown within the U.S. retail mortgage market spurred a worldwide financial crisis, a surge of rating downgrades and the subsequent collapse of the broader financial guaranty industry. By September 2008, most financial guarantors were no longer writing new insurance policies. Assured Guaranty, the lone industry survivor not subject to restructuring, continued to write new financial guaranty policies in the municipal market and, to a limited extent, in the structured finance market. Assured has been the most active provider of financial guaranty products in this market from 2008 to the present.

Ownership Structure

AGC is a wholly-owned subsidiary of Assured Guaranty US Holdings Inc. and a wholly-owned subsidiary of the ultimate parent company AGL. AGC was founded in 1988 (previously named Capital Reinsurance Company) and is domiciled in Maryland.

AGC also owns 39% of Municipal Assurance Holdings Inc., the intermediate holding company and parent of Municipal Assurance Corp. (MAC), while its affiliate, Assured Guaranty Municipal Corp. (AGM), owns the balance of 61%. MAC and AGM are both rated AA+/Stable by KBRA.



In the Q2 2015, AGC completed the purchase of Radian Asset Assurance for a cash price of $804.5 million, a 22% discount to Radian's year-end 2014 statutory surplus. The transaction added approximately $14 billion of net par outstanding to AGC's insured portfolio. On July 1, 2016, AGC completed the purchase of CIFG Holding Inc. for a cash price of $450 million, a 30% discount to CIFG's statutory surplus at March 31, 2016. AGC acquired approximately $4 billion of exposure as a result of the CIFG transaction.

Corporate Governance

The Board of Directors of AGL ("the Board") is responsible for the corporate governance of all of its subsidiaries, including AGC.

The AGL Board consists of 10 members following the appointment of Thomas W. Jones and Alan J. Kreczko in August 2015 and Mr. Stephen Cozen's retirement in May 2016. Mr. Jones and Mr. Kreczko both serve on the board's Audit and Finance Committees. Except for the CEO, who is a Board member, the Board considers all of the other directors to be independent according to the listing standards of the New York Stock Exchange. KBRA notes that all directors have extensive professional backgrounds and appropriate qualifications for the oversight of a financial institution of AGL's size and complexity.

In response to evolving regulatory requirements and market trends, over the last several years the Board has modified certain key aspects of AGL's governance framework (e.g. executive compensation) and taken discrete actions (e.g. soliciting input directly from major shareholders) to establish a robust structure for oversight of company management and operations.

The Board carries out its responsibilities through the operation of six committees: Audit, Compensation, Finance, Nominating and Governance, Risk Oversight, and Executive. The CEO sits only on the Executive Committee, which meets in between Board meetings exclusively in the event time sensitive matters arise that require Board deliberation and authority prior to the next scheduled meeting of the full Board. In 2015, all of the committees met at least 4 times, except for the Executive Committee which did not meet.

In KBRA's view, a Board level committee that focuses exclusively on risk, such as AGL's Risk Oversight Committee, better positions a company to maintain a high level of focus on this area, one that is critically important for a financial guaranty insurance company.

The Board is responsible for defining the business strategy for the overall group of companies, meets quarterly to review progress towards meeting operational objectives and conducts separate sessions to discuss current or emerging issues that might impact the business.

The roles of Chairman and Chief Executive Officer are separate. The Board members meet regularly without the presence of the CEO which, in KBRA's view, contributes to the Board's independence.

Since 2012, the Board eliminated all employment contracts with individual executives, instituted uniform severance and change of control policies covering all senior management and simplified the compensation program. In KBRA's view, this creates greater transparency with respect to overall management incentives.

AGC's Board of Directors is comprised of 10 members consisting of executive officers of AGC.

Risk Management

Assured has established a risk management framework under the supervision of the Board's Risk Oversight Committee ("ROC"). The Risk Management Department is responsible for the oversight of the framework under the supervision of the Chief Risk Officer ("CRO") and the Portfolio Risk Management Committee ("PRMC"). The PRMC is a management level committee that includes the CEO, CRO, Chief Surveillance Officer, Chief Credit Officer, General Counsel, CFO, President of Assured Guaranty Re ("AG Re"), and the Executive Officer.

The Risk Management Department is responsible for providing the PRMC with research and data used to establish, monitor and reassess policies and procedures on a regular basis. The Risk Department is also responsible for the execution of policies established by the PRMC. The PRMC meets at least four times a year to review the insured portfolio and market trends. All decisions made by the PRMC are reported to

AGL's Risk Oversight Committee. This ensures that representatives of Assured Guaranty's Board are adequately informed about risk positions and industry trends. These reporting mechanisms are intended to add discipline to the risk management process and enhance the ability of the Board and senior management to effectively execute company strategy.

The Risk Management Department prepares the Own Risk and Solvency Assessment ("ORSA"), the annual corporate-wide risk appetite statement, which incorporates AGC, and is also responsible for Enterprise Risk Management across Assured. The ORSA report includes an analysis of economic capital which in KBRA's view is a robust and useful review of AGC's risk profile.

Surveillance

AGC's surveillance of its insured risk is integrated with the surveillance process for all of Assured. Surveillance follows a set of priorities that determine how frequently credits are reviewed. Upon review each credit is assigned to one of six surveillance categories ranging from one to 6 that also determines the level of ongoing review. Category one and two credits are considered to be performing in accordance with expectations and are generally reviewed on an annual or semi-annual basis. Category three generally requires quarterly reviews. At Category four the intensity of review increases further and generally requires the creation of a team that includes legal resources. Categories five and six are considered impaired and generally require the establishment of loss reserves and are monitored by the Workout Committees.

Written credit reports document the surveillance review. KBRA reviewed the surveillance reports for a significant number of AGC credits in the three lowest surveillance categories (four, five, and six). In addition, for many sectors, Assured's entire exposure to the sector is reviewed in one sector-wide report.

KBRA views the surveillance reporting process as comprehensive and as providing a sufficient mechanism to inform senior management about the condition of the insured portfolio.

Business Strategy

AGC is focused on the structured finance market but has insured only a few new issuance transactions since the credit crisis. While currently writing a very limited amount of new business within the Assured platform, AGC supports AGL's overall corporate strategy by serving as the primary vehicle for acquisitions. Assured Guaranty recently announced the launch of a new business venture to evaluate alternative investments, such as acquiring collateralized loan obligation (CLO) managers. KBRA will continue to monitor the company's progress in building out this fee-based platform and any potential impacts on AGL's claims paying resources and/or risk profile.

Rating Determinant 2: Insured Portfolio and Modeling Analysis

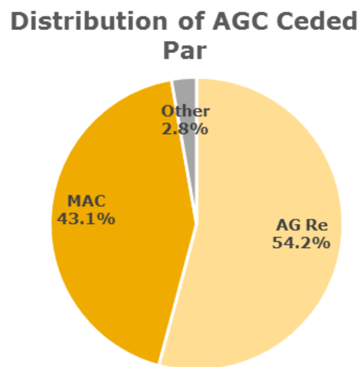
The following section contains a detailed review of AGC's insured portfolio followed by a discussion of KBRA's modeling and stress analysis of the portfolio. All par exposure numbers shown below are on a statutory basis as of June 30, 2016 and include the exposures acquired from CIFG on a pro forma basis (acquisition closed July 1, 2016). As previously stated, even with the two aforementioned acquisitions, AGC's book continues to run-off rapidly. Over the next ten years, nearly 55% of total net par is scheduled to mature.

Insured Portfolio, Gross and Net Par

The AGC insured portfolio has a total of $75.1 billion of gross par and $42.3 billion of net par outstanding. Although a substantial amount of gross par is reinsured ($32.9 billion or 43.8%), the bulk is to AGC's affiliates, MAC (AA+/Stable) and AG Re. AG Re has assumed $17.8 billion and MAC has assumed $14.2 billion of ceded par, respectively, or a total of 97.3% of total cessions.

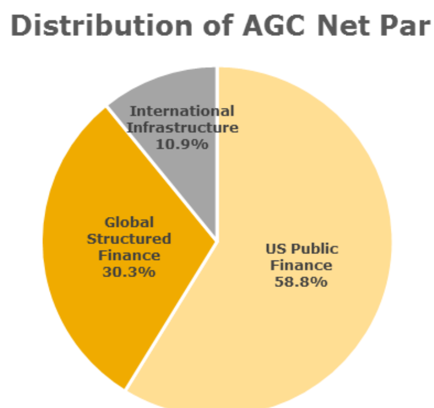
AGC Portfolio		
Par Outstanding ($ millions)		**6/30/2016**
Gross Par		$ 75,067
Ceded Par		
AG Re	$ 17,829	
MAC	14,182	
Other	906	
Total Ceded Par		32,917
Net Par		$ 42,347

Note: Excludes bond purchases.



Net Par Exposure by Type

The net retained insured portfolio consists of both public finance and structured finance obligations. As shown in the pie chart below, of total net par of $42.3 billion, 58.8% or $24.9 billion consists of U.S. public finance exposure, 30.3% or $12.8 billion consists of global structured finance exposure, and 10.9% or $4.6 billion consists of international infrastructure exposure (includes international public finance).



U.S. Public Finance

U.S. public finance is the largest segment of AGC's portfolio with a total of $24.9 billion in net par outstanding as of June 30, 2016. A breakout of the U.S. public finance exposure by sector and rating is shown below.

US Public Finance Sectors		
Net Par Outstanding ($ millions)	**6/30/2016**	
General Obligation	$ 5,879	23.62%
Tax-supported	5,665	22.76%
Health Care Revenue	3,858	15.50%
Transportation Revenue	2,975	11.95%
Municipal Utility Revenue	2,441	9.81%
Education/University	1,457	5.85%
Infrastructure Finance	1,297	5.21%
Other Public Finance	654	2.63%
Investor Owned Utilities	378	1.52%
Housing Revenue	286	1.15%
Total	$ 24,891	100.0%

US Public Finance Rating Category[1]		
NPO ($ millions)	**6/30/2016**	
AAA	$ 56	0.2%
AA	2,983	12.0%
A	11,222	45.1%
BBB	7,427	29.8%
BIG	3,203	12.9%
Total	$ 24,891	100.0%

[1] AGC Internal Rating

Structured Finance

AGC's structured finance portfolio has declined significantly in recent years. At year-end 2010, AGC had $50 billion of structured finance net par exposure and by June 30, 2016, it had declined to $12.8 billion, a reduction of nearly 75%. Additionally, nearly 70% of current structured finance net par is scheduled to run off in the next 5 years.

For analytical purposes, KBRA assessed the global structured finance portfolio in two components: RMBS and non-RMBS.

RMBS

The AGC internal rating and sector profile of the RMBS portfolio is shown below. The AGC internal ratings breakout reflects a substantial level of below investment grade (BIG) ratings.

RMBS Portfolio		
Net Par Outstanding ($ millions)	**6/30/2016**	
Subprime	$ 1.0	47.8%
Alt-A	0.5	23.9%
HELOCs	0.2	9.7%
Other	0.1	6.5%
Prime	0.1	5.6%
Option ARMs	0.1	3.7%
Closed-End Seconds	0.1	2.8%
Total	$ 2.1	100.0%

RMBS Portfolio Rating Category[1]		
NPO ($ millions)	**6/30/2016**	
AAA	$ 0.8	39.7%
AA	0.3	13.9%
A	0.0	2.4%
BBB	0.1	6.6%
BIG	0.8	37.4%
Total	$ 2.1	100.0%

[1] AGC Internal Rating

Non-RMBS

The non-RMBS portfolio is rated more highly and has performed better, although there are pockets of below investment grade exposures, particularly within the XXX insurance securitizations and Trust Preferred CDO's. The investment grade collateralized debt obligations (CDO), CLOs, and CMBS are more highly rated. Further, substantially all of the investment-grade CDOs and CLOs mature within the next 12-24 months.

The sector and risk profile of the non-RMBS portfolio is shown below.

Non-RMBS Portfolio		
Net Par Outstanding ($ millions)	**6/30/2016**	
Trust Preferred CDOs	$ 2,770	25.7%
IG Corp CDOs	2,189	20.3%
CLOs	2,045	19.0%
Private Student Loans	1,205	11.2%
Other	944	8.8%
Insurance Securitizations	736	6.8%
Aircraft Leases	431	4.0%
CMBS	328	3.0%
Manufactured Housing	133	1.2%
Total	$ 10,782	100.0%

Non-RMBS Portfolio Rating Category[(1)]		
NPO ($ millions)	**6/30/2016**	
AAA	$ 5.0	46.0%
AA	2.2	20.8%
A	1.8	16.9%
BBB	0.8	7.9%
BIG	0.9	8.4%
Total	$ 10.8	100.0%

(1) AGC Internal Rating

International Infrastructure

The international infrastructure portfolio has a diversity of sectors but also a significant concentration of AGC internal BBB rated credits (54%) and 8% of below investment grade exposures. This sector is also generally characterized by longer-dated maturities.

International Infrastructure Portfolio		
Net Par Outstanding ($ millions)	**6/30/2016**	
Infrastructure Finance	$ 2.0	44.1%
Regulated Utilities	1.5	32.6%
Pooled Infrastructure	0.8	16.5%
Other Public Finance	0.3	6.8%
Total	$ 4.6	100.0%

International Infrastructure Portfolio Rating Category[(1)]		
NPO ($ millions)	**6/30/2016**	
AAA	$ 0.1	1.7%
AA	1.1	23.6%
A	0.6	12.9%
BBB	2.5	53.8%
BIG	0.4	8.0%
Total	$ 4.6	100.0%

(1) AGC Internal Rating

Portfolio Stress Analysis

KBRA utilized several methods to develop a stress case forecast of losses across AGC's entire insured portfolio of $42.3 billion of net par outstanding. The methods used included a (i) Monte Carlo simulation and ii) deterministic analysis for the (a) insured RMBS, (b) Puerto Rico exposures, and (c) distressed structured finance and other exposures. Each of these approaches is discussed separately below.

Monte Carlo Simulation Model

KBRA uses a Monte Carlo simulation model to quantify the amount of stress scenario claims within the AGC insured portfolio. KBRA views this as the most appropriate approach for modeling loss expectations for large, diverse portfolios typical of the financial guaranty industry.

The model uses the assigned rating and sector of each insured credit to simulate default and severity performance over the remaining life of the portfolio. KBRA's public finance and structured finance analysts assessed AGC's internal ratings by sector and made various adjustments. In this process, KBRA selected a cross-section of credits to review from various sectors within AGC's insured portfolio including public finance, infrastructure, CMBS, CLOs, TRUPS CDOs, consumer ABS and commercial ABS. To conduct these reviews, KBRA obtained AGC's internal surveillance reports for each credit and supplemented them with independent information sources. In aggregate, KBRA reviewed 66 credits representing $4.6 billion of net par outstanding. As a result of these reviews, KBRA adjusted AGC's internal credit ratings upward on 9, downward on 7, and did not adjust the balance, all as inputs to the Monte Carlo simulation.

The Monte Carlo model produces a series of 100,000 paths where each path assesses the probability of future defaults for each credit in each year of its remaining life. If a credit defaults, a sector-specific severity assumption is applied against the amount of debt outstanding at that point in time to calculate loss amount. The model generates 100,000 paths to produce a broad distribution of results. We focus on the tail of this distribution to construct a stress analysis. For AGC, the aggregate of all annual loss payments at the 97.5% confidence level, or that level associated with a AA rating, was $916 million over the life of the portfolio on a future value basis compared to nearly $2.8 billion of current claims paying resources (reflects financial impact of CIFG acquisition).

The total loss amounts produced by the Monte Carlo model also incorporates, in KBRA's opinion, conservative assumptions for refunding activity in AGC's insured municipal portfolio.

Puerto Rico

AGC's portfolio includes significant exposure to Puerto Rico. As of June 30, 2016, AGC has approximately $1.7 billion in aggregate insured net par exposure to the Commonwealth of Puerto Rico across its various bond issuing entities, representing 4% of AGC's total portfolio. The two largest exposures are to the Highway and Transportation Authority and to the Commonwealth's General Obligation bonds, which total $623 million and $416 million, respectively. Currently, all of AGC's Puerto Rico exposure is rated internally by AGC below investment grade.

In light of the Commonwealth's significant financial strain that remains unresolved, KBRA applied stress losses to all of AGC's insurance of Puerto Rico debt. KBRA developed two conservative stress case scenarios for Puerto Rico exposures to assess the impact of different potential claims payment patterns and the varied insured debt profiles of the bond insurers that KBRA rates.

<u>Stress Case I:</u> KBRA applied severities ranging from 10% to 55% to different Commonwealth issuers and assumed the losses to AGC would be realized annually as insured principal and interest comes due. The stress loss severities for Case I include an incremental 15% severity in the first three years (through 2019).

Under these assumptions applied by KBRA, total net losses to AGC were $819 million on an undiscounted basis over the life of the insured Puerto Rico debt.

<u>Stress Case II:</u> KBRA also tested AGC's ability to withstand a modified stress that front-loaded a significant proportion of stress losses by assuming a complete moratorium on all debt service payments for the first five years. In this stress case, Puerto Rico makes *no* debt service payments over the first five years (through 2021) with recoveries on this foregone debt service limited to 50% received ratably by AGC over the subsequent five years (years 6 through 10). Further, severities on the balance of insured debt service coming due after the moratorium period (i.e. years 6 and beyond) ranged from 7.5% to 30%, which are lower than the severities applied in Stress Case I, providing somewhat of an offset from an analytical perspective in a scenario where there is complete nonpayment of debt service in the first five years. Nominally, the aggregate amount of unrecovered insured debt payments under the stress case was $765 million, slightly lower than Stress Case I losses of $819 million, although the financial effects to AGC are somewhat more onerous due to a larger proportion of nearer term losses.

The table below compares the assumed loss payout pattern for AGC for Stress Case I and Stress Case II in five-year increments. The negative "losses" in years 2022-2026 represent the net impact of 50% recoveries on claim payments made during the initial moratorium period of 2016-2021.

As the newly appointed PROMESA oversight board becomes fully operational and takes actions which change the credit profile for Puerto Rico debt, KBRA will review the assumptions within our stress cases.

Puerto Rico Stress Case Losses

	Years							
$ millions	**2016-21**	**2022-26**	**2027-31**	**2032-36**	**2037-41**	**2042-46**	**2047-51**	**Total**
Stress Case I	$269,945	$139,980	$132,432	$185,393	$52,271	$28,772	$9,946	$818,740
Stress Case II	743,988	(215,715)	39,169	133,400	38,230	19,352	6,630	765,054

Residential Mortgage Backed Securities

Substantially all of AGC's RMBS portfolio was analyzed on an individual transaction basis by KBRA's RMBS analytical team. KBRA obtained transaction detail at the CUSIP and insured tranche level from AGC which represented the individual insured positions outstanding as of June 30, 2016. For all insured, first-lien backed U.S. positions, the loan level data of the underlying collateral pool was updated and loan level losses were projected consistent with KBRA's **U.S. RMBS Rating Methodology**. Collateral pools supporting the majority of first-lien transactions were stressed by assuming economic conditions that included property value declines of 40% from current levels. KBRA's analysis applied these aggregated residential loan level losses to the insured tranches based on the waterfall provisions of the RMBS trusts and further allocated losses to AGC on those positions according to AGC's net exposure. Depending on each underlying transactions historical performance, stress assumptions for some first-lien exposures received further adjustments. HELOC and CES exposures were analyzed based on group level historical performance and losses were modeled based on stress multiples to historical prepayment rates for each transaction. The representation and warranty agreements AGC has with several financial institutions were factored into this analysis on a transaction level basis and served to decrease the ultimate losses to AGC.

This analytical approach imposes a uniform, simultaneous shock on each transaction within the RMBS portfolio that KBRA believes is a more appropriate approach than Monte Carlo analysis when considering a portfolio of largely distressed RMBS which has historically exhibited high-levels of intra-asset correlation. In KBRA's opinion, this level of stress losses applied to the RMBS portfolio of AGC is consistent with a AA rating level for a diversified portfolio.

The losses attributed to each insured RMBS position of AGC were aggregated by year. Over the term of the insured RMBS the total amount of aggregate losses assessed against this exposure was $396 million on a future value basis. This annual stream of loss payments was added to all other projected stress loss claims as part of the total annual cash outflows in the KBRA Bond Insurer Financial Model.

Distressed Structured Finance and Other Credits

KBRA estimated specific stress cases for several distressed structured finance exposures. These consisted of a $245 million investment in the Zohar II CDO, XXX insurance securitizations ($149 million of net par) and the below investment grade Trups CDO's ($441 million of net par). In each of these cases we assumed a loss with a severity of 50-90% and a loss profile consistent with the maturity dates and projected interest costs of the insured obligations. In addition, KBRA estimated discrete losses for a small number of defaulted or severely impaired public finance credits.

In the financial model, net outflows in these cases totaled approximately $473 million on a future value basis.

Bond Insurer Financial Model

KBRA assesses the ability of a financial guarantor to pay forecasted claims in a stress case scenario. The model uses AGC's Claims Paying Resources (defined in the "Claims Paying Resources" section below) as the beginning base of assets. These assets earn interest at rates adjusted downward by KBRA from the company's current yield levels. The model also incorporates the company's estimate of future installment premiums (after KBRA's haircut of 10%).

The model assesses the ability of the company with these defined resources to pay annual stress losses and other expenses as they come due through the 35 year forecast period. For AGC, the stress losses (all on a future value basis) were the sum of (i) the aggregate annual losses generated in the loss profile KBRA developed from the tail distribution of the Monte Carlo simulation model of $916 million, (ii) the RMBS stress losses of $396 million, (iii) Puerto Rico losses in Stress Case I and Stress Case II of $819 million and $765 million, respectively, and (iv) distressed structured finance and other credit outflows of $473 million.

Given the level of stress losses assumed in this analysis, the company is assumed by KBRA to go into run off immediately and expenses begin to decline after year 5.

Within the run-off scenario, KBRA incorporated an estimate of the financial risk to AGC associated with the litigation with Lehman Brothers International (Europe) (LBIE), which is in administration. As described in AGC's statutory financial statements, LBIE sued AG Financial Products Inc., an affiliate of AGC as to which AGC was the credit support provider, over the cancellation of over 20 credit default swap contracts following Lehman's bankruptcy in 2008. In addition, KBRA reflected the full pay down of surplus notes by affiliate company MAC (AA+/Stable) at the end of the second quarter 2016, which generated cash proceeds to AGC of approximately $118 million.

AGC is able to pay all claims and other expenses in this analysis with a comfortable amount of assets remaining at the end of the 35 year forecast period. In KBRA's opinion, this result is consistent with an insurance financial strength rating of AA.

Rating Determinant 3: Claims Paying Resources and Financial Profile

KBRA focuses its analysis of financial resources on statutory results as it is our opinion that statutory accounting principles provide the most appropriate standard for assessing an insurer's ability to meet policyholder obligations. Unless otherwise noted, all amounts are based on statutory reports as filed or reported by the company and, except for a pro-forma adjustment to Claims Paying Resources, exclude the impact of the CIFG acquisition which closed July 1, 2016.

Claims Paying Resources

To determine claims paying resources, KBRA begins with unearned premium reserves, loss and loss adjustment reserves, contingency reserves, and policyholder's surplus. For AGC, KBRA deducts AGC's investment in MAC because it is not considered liquid and is deeply subordinate to MAC's policyholders. KBRA also excludes some other illiquid admitted assets such as real estate.

The 2015 increase in unearned premium reserve, contingency reserve, policyholder's surplus, and net par outstanding reflects the Radian Asset Assurance acquisition. This acquisition did not increase leverage despite the addition of $14 billion of insured par because of these balance sheet effects and, in fact, the recent historical trend of declining leverage has continued as the outstanding portfolio runs off at a pace which exceeds new business origination.

Select AGC Statutory Balance Sheet Data				
$ Thousands	**6/30/2016**	**12/31/2015**	**12/31/2014†**	**12/31/2013†**
Claims paying resources:				
Unearned premium reserves	$416,206	$469,100	$417,219	$457,272
Loss & LAE reserves	164,481	209,816	82,298	153,280
Contingency reserve	795,514	795,018	716,381	1,025,174
Policyholder surplus	1,435,060	1,365,288	1,086,139	692,554
Adjustments*	(288,719)	(307,493)	(224,383)	(190,166)
Increase in statutory invested assets - CIFG	274,000	-	-	-
Total claims paying resources (KBRA definition)	**$2,796,542**	**$2,531,729**	**$2,077,652**	**$2,138,114**
Net statutory par outstanding (NPO) **	$42,346,738	$45,477,000	$45,724,000	$57,227,000
Net statutory debt service outstanding (NDSO) **	$62,295,463	$67,687,000	$67,794,000	$82,478,000
Leverage: NPO/Claims paying resources (X)	**15x**	**18x**	**22x**	**27x**
Leverage: NDSO/Claims paying resources (X)	**22x**	**27x**	**33x**	**39x**

Source: AGC statutory statements and financial supplements

† As previously reported by AGC. Amounts do not reflect impact of Radian acquisition.

** Reflects investment in MAC, assets in AGC's executive retirement fund, COLI, fair value of Stockton office building (since 2015) and actual Puerto Rico losses paid July 1, 2016.*

*** Amounts shown for 6/30/2016 include CIFG acquisition.*

Balance Sheet

The $805 million acquisition of Radian Asset Assurance closed in the second quarter of 2015 and caused a commensurate increase in the size of the AGC balance sheet from year end 2014. A similar effect on AGC's balance sheet will occur when the CIFG transaction is reflected in the September 30, 2016 financial statements. AGC issued $300 million of surplus notes to AGM in 2009, effectively a transfer of capital from its affiliate. (KBRA does not count the surplus notes in its calculation of AGM's claims paying resources.)

The large decline in unearned premium reserves from year end 2012 to year end 2013 was largely due to the cession of premium and risk to support the formation of affiliate company, MAC. The UPR balance continued to decline as the portfolio has diminished in size, reflecting the run-off of existing exposures at a faster rate than new business generation. The increase in UPR from year-end 2014 to year-end 2015 results from the Radian Asset Assurance acquisition. The increase in loss reserves from year-end 2014 to year-end 2015 was due to deterioration in AGC's Puerto Rico exposures.

Over the last few years, the balance of statutory contingency reserves has fluctuated. In 2013, in connection with AGC's cessions to affiliate company, AGC Re, AGC received permission from the Maryland insurance regulator to reassume, over a three-year period, $267 million of contingency reserves. In 2014 and 2015, AGC received permission from the Maryland insurance regulator to release contingency reserves of approximately $540 million and $134 million, respectively, into policyholder surplus due excess reserve balances. Total policyholder surplus and contingency reserves increased in 2015 due to the Radian acquisition.

AGC Statutory Balance Sheet				
$ Thousands	**6/30/2016**	**12/31/2015**	**12/31/2014†**	**12/31/2013†**
Bonds	$1,833,855	$2,333,570	$1,906,206	$1,893,329
Stocks (includes Investments in Affiliates)	280,938	392,083	352,144	323,864
Cash & short term investments	182,808	87,501	109,977	84,655
Derivatives, receivables, other invested assets	58,742	65,540	-	12,617
Total cash and invested assets, net admitted	**$2,356,344**	**$2,878,693**	**$2,368,327**	**$2,314,465**
Investment income due and accrued	17,384	21,914	18,605	17,517
Deferred tax asset	82,401	66,264	31,525	21,583
Receivable from parent	35,989	48,498	62,828	62,935
Other assets	530,637	51,554	57,960	87,925
Total Assets, net admitted	**$3,022,755**	**$3,066,922**	**$2,539,245**	**$2,504,425**
Loss and LAE Reserves	164,481	209,816	82,298	153,280
Unearned Premium Reserve	416,206	469,100	417,219	457,272
Contingency reserve	795,514	795,018	716,381	1,025,174
Other liabilities	211,494	227,701	237,209	176,145
Total Liabilities	**$1,587,695**	**$1,701,635**	**$1,453,106**	**$1,811,871**
Common capital stock	15,000	15,000	15,000	15,000
Surplus Notes	300,000	300,000	300,000	300,000
Gross paid-in and contributed surplus	923,534	924,198	924,164	922,774
Unassigned Funds	196,525	126,089	(153,026)	(545,221)
Policyholder Surplus	**$1,435,060**	**$1,365,288**	**$1,086,139**	**$692,554**
Total Liabilities and Policyholder Surplus	**$3,022,755**	**$3,066,922**	**$2,539,245**	**$2,504,425**
Cash & short term assets/Total assets (%)	6.0%	2.9%	4.3%	3.4%
Bonds/Total assets (%)	60.7%	76.1%	75.1%	75.6%

Source: AGC Statutory Statements

† As previously reported by AGC. Amounts do not reflect impact of Radian acquisition.

Investments

AGC has a high-quality investment portfolio comprised primarily of fixed income securities with an average rating of A (publicly available ratings, except internal ratings for loss mitigation purchases) and duration of 6 years. Approximately 15%, or $380 million, of the available-for-sale portfolio consists of below investment grade securities which reflect assets with a par value of $712 million purchased in connection with AGC's workout of distressed credits in its insured portfolio. KBRA notes that approximately 10%, or $223 million, of the investment portfolio is pledged as collateral to support AGC's credit default swap exposures. This collateral amount has declined from approximately $450 million at June 30, 2015, reflecting the cancellation of several credit default swap agreements.

AGC Investment Portfolio Composition (6/30/2016)				
$ Millions			**---Book Yields*---**	
Sector	**Amortized cost**	**% of portfolio**	**Pre-tax**	**After-tax**
State and Political Subdivisions	$1,237	57%	3.97%	3.55%
Insured State and Political Subdivision	45	2%	4.68%	3.78%
U.S Treasury Securities	69	3%	2.30%	1.50%
U.S Agency Obligations	33	2%	5.00%	3.25%
Corporate Securities	71	3%	3.61%	2.35%
RMBS	49	2%	6.32%	4.11%
CMBS	20	1%	3.37%	2.19%
Asset-backed securities	366	17%	1.14%	0.74%
Foreign Governments	91	4%	2.79%	1.81%
Total Fixed Maturities	**$1,981**	**91%**	**3.41%**	**2.84%**
Short term investments and cash	188	9%	0.02%	0.01%
Grand Total	**$2,169**	**100%**	**3.32%**	**2.76%**

Source: AGC financial supplement

** Cash excluded from total yield calculations.*

Income Statement

The decline in the company's insured portfolio is reflected in the decreasing net premiums written and net premiums earned over the past several years. The negative net premiums written of $186 million in 2013 resulted from the cession of $249 million of premium to MAC upon its formation. In 2014, favorable development trends caused revisions to AGC's estimates of expected claims resulting in a net reduction in loss reserves of $116 million. Financial results turned negative in 2015, primarily due to increases in loss and LAE reserves related to deterioration in AGC's Puerto Rico exposures.

Select AGC Statutory Income Data				
$ Thousands	**6/30/2016**	**12/31/2015**	**12/31/2014†**	**12/31/2013†**
Gross Premiums Written (GPW)	$31,921	$66,229	$67,368	$89,390
Net Premiums Written	20,908	45,237	42,498	(186,713)
Net premiums Earned (NPE)	72,190	160,706	82,330	108,450
Loss & loss adjustment expenses (L&LAE)	8,447	149,713	(116,672)	(41,664)
Other underwriting expenses	36,636	75,629	77,118	65,910
Total losses & operating expenses	45,083	225,341	(39,554)	24,246
Net underwriting gain (loss)	27,107	(64,635)	121,884	84,203
Net investment gain	46,552	92,497	52,267	71,878
Other income, net gain (loss)	13,069	(107,002)	10,755	4,442
Earnings Before Taxes	86,728	(79,139)	$184,906	$160,524
Net Income (Loss)	$67,078	($91,643)	$115,574	$211,158
Dividends Paid	$23,000	$89,800	$69,000	$67,000
Expense ratio (Underwriting exp. / GPW)	114.8%	114.2%	114.5%	73.7%
Loss ratio (L&LAE / NPE)	11.7%	93.2%	NM	NM
Combined ratio	126.5%	207.4%	NM	NM
Return on Surplus (ROS) Pre-tax basis *	12.4%	-6.5%	20.8%	20.1%
Return on Surplus (ROS) After-tax basis *	9.6%	-7.5%	13.0%	26.4%

Source: AGC statutory statements

** Return on Surplus was annualized for the 2Q 2016 by multiplying the earnings by 2.*

† As previously reported by AGC. Amounts do not reflect impact of Radian acquisition.

The low level of premium volume reflects the significant decline in production for the entire financial guaranty sector since the credit crisis. At current depressed new business levels, AGC's low gross premium written generates a reported expense ratio far above industry and historical benchmarks. While KBRA does not view AGC's expense ratio as a significant issue in the near term and also acknowledges the inherent lag between expense recognition and revenue generation, we will continue to monitor the company's efforts to manage its revenue/cost profile since KBRA views the current expense ratio as unsustainable in the long-term. For AGC, continued stagnation in the market for financial guaranty insurance combined with several recent corporate restructuring actions (establishment of MAC, purchase of Radian) have generated substantial volatility in the company's statutory earnings over the past several years.

Dividends

The distribution of dividends from AGC is governed by Maryland insurance law. In KBRA's opinion, while Maryland insurance regulations are marginally less stringent in certain respects relative to corresponding dividend restrictions within New York insurance law, Maryland requirements do provide significant limits on the flow of dividends from an insurer. Specifically, ordinary dividends cannot exceed the lesser of (i) 10% of policyholder's surplus or (ii) 100% of net investment income, excluding realized gains. With respect to the latter restriction based on investment income, Maryland insurance law grants insurers additional dividend capacity to the extent that dividends paid in the prior three years are less than the cumulative net investment income over the period, excluding realized gains.

AGC had negative unassigned funds through year end 2014. This would have precluded payment of ordinary dividends under NY insurance law, but has not restricted AGC because it is domiciled in Maryland which does not have a similar earned surplus provision in its insurance statutes.

Since January 1, 2014, excluding the pro forma impact of the Radian acquisition, the company has paid $181 million of dividends which is equal to the statutory maximum permitted over the period. The maximum amount distributable from AGC as ordinary dividends in 2016 is $79 million.

Reinsurance

AGC, jointly with AGM and MAC, benefits from an aggregate excess of loss reinsurance facility with a number of reinsurers rated no lower than AA- (publicly available ratings) or who have posted collateral. The current facility attaches when the group's aggregate combined net losses exceed $1.25 billion on investment grade U.S. public finance exposures as of September 30, 2015. The reinsurers cover $360 million of the next $400 million of losses in excess of the attachment point with AGC, AGM and MAC jointly retaining the remaining $40 million. The reinsurance agreement terminates on January 1, 2018 unless the Assured subsidiaries decide to extend it. Because of its joint nature and the potential for losses at AGM or MAC to limit the support available for AGC, this facility is not incorporated in KBRA's rating assessment of AGC.

In addition, AGC cedes approximately 25% of its exposures to affiliate company, AG Re, a Bermuda-based reinsurer. KBRA reviewed AG Re's claims paying ability and risk profile as part of its rating analysis of AGC.

Woodbourne Capital Trusts

In April 2005, AGC established a Pass Through Trust that issued $200 million of short term, floating rate securities (Pass Through Securities) and four Custodial Trusts ("Trusts") which each received from AGC $50 million of Committed Capital Securities (CCS). The Trusts invested the $200 million of transaction proceeds in highly rated commercial paper. AGC entered into an agreement with the Trusts whereby it retains the right to deliver its Preferred Stock to the Trusts in exchange for cash up to the $200 million held in the Custodial Trust.

Upon a failed auction in 2008, the CCS were distributed to the holders of the Pass Through Securities. The Trusts remain in place and continue to invest in highly rated commercial paper. The agreement also remains in place and has no scheduled maturity. AGC is obligated to pay a fee at an amount that, together with interest earnings on the commercial paper invested in the Trusts, equals the maximum contractual rate on the CCS of LIBOR plus 250 basis points.

A number of other financial guarantors successfully utilized similar capital support facilities during the credit crisis to augment their claims paying resources. In light of the very liquid investments in the Trusts and the associated robust funding mechanism, KBRA includes $200 million of capital support from the Trusts in its financial model analysis of AGC.

Conclusion

KBRA has assigned an insurance financial strength rating of AA with a Stable outlook to AGC. The company demonstrates an ability to withstand KBRA's conservative stress case loss assumptions and benefits from a tested management team supported by strong governance and risk management systems. The substantial and continuing runoff in the structured finance segments of the company's portfolio should continue to mitigate risk.

KBRA INSURANCE FINANCIAL STRENGTH RATING: AA
OUTLOOK: Stable

AGC Key Takeaways:

- KBRA developed stress losses for AGC's insured portfolio based upon assumptions that are consistent with a AA insurance financial strength rating
  - KBRA's total stress losses were $2.6 billion (future value) over a 35-year period
  - AGC satisfied all claims in full and on time in the KBRA stress case scenario with a comfortable asset balance remaining
- To develop the stress losses, AGC's total portfolio of $42.3 billion statutory net par as of June 30, 2016 (including CIFG exposure pro forma) was segmented into four components that were assessed separately as follows: (i) Puerto Rico, (ii) RMBS, (iii) distressed credits, and (iv) the balance of the portfolio.
- Assessed AGC's ability to meet these losses in the KBRA Bond Insurer Financial Model beginning with an asset base equal to AGC's claims paying resources, according to KBRA's definition, which is $2.8 billion at June 30, 2016 (reflects pro forma impact of CIFG acquisition).
- KBRA also conducted a detailed review of AGC's corporate governance framework, credit and risk management processes and consider them strong and reflective of industry best practices.

Key Rating Strengths
▪ Demonstrated ability to withstand KBRA's conservative stress case loss assumptions across the breadth of its insured portfolio.
▪ The substantial and continuing runoff in structured finance components of the company's portfolio should continue to moderate risk. Structured finance exposure is currently $13 billion, down nearly 75% from $50 billion at year end 2010.
▪ Mature and high-functioning operating platform supported by strong governance and risk management systems.
▪ Tested management team that, given their experience through the credit crisis, is well positioned to address future portfolio risk issues should they develop.
Key Rating Concerns
▪ The impaired components of AGC's portfolio could experience losses approaching or exceeding the levels of stress case losses that KBRA assumed in our rating analysis.
▪ Significant industry risks are characterized by narrow credit spreads, low interest rates, vigorous competition and the increased loss profile manifesting itself in the public finance market.
▪ Payment of dividends in recent years to its parent at the maximum regulatory level. This could place downward pressure on the rating if portfolio risk levels increase rapidly or if risks fail to emerge in time to limit management's deployment of capital it determines to be excess capital.

KBRA's Financial Guaranty Rating Methodology incorporates lessons learned from the collapse of the financial industry and utilizes an objective, rigorous rating approach. KBRA's assessment of a financial guarantor takes into consideration:

I. A company's ownership, management, competitive position, strategy, organization and operations;
II. The composition of the insured portfolio in terms of credit sectors, geography and underlying ratings, portfolio losses generated through KBRA's simulation modeling and the company's ability to weather portfolio losses while paying operating expenses and claims in run-off; and
III. The guarantor's financial profile.

Related Publications:
Financial Guaranty Rating Methodology, December 18, 2015

Analytical Contacts:

Paul Kwiatkoski, Managing Director
pkwiatkoski@kbra.com, (646) 731-2387

Peter Giacone, Senior Director
pgiacone@kbra.com, (646) 731-2407

Karen Daly, Senior Managing Director
kdaly@kbra.com, (646) 731-2347

Jack Morrison, Senior Analyst
jmorrison@kbra.com, (646) 731-2410