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February 5, 2008

The Honorable Ben S. Bernanke
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The Honorable Henry M. Paulson, Jr.
Secretary
Department of the Treasury
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The Honorable Timothy F. Geithner
President
The Federal Reserve Bank of New York
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The Honorable Robert K. Steel
Under Secretary for Domestic Finance
Department of the Treasury
1500 Pennsylvania Avenue, NW
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Re: Bond Insurer Bailout

Gentlemen:

As an active market participant, I have watched with dismay the spread of credit contagion that was born in the United States and exported to the rest of the world by grossly overstated credit ratings on residential mortgage-backed securities (RMBS), CDOs, and the bond insurance industry. As capital market participants have lost confidence in the principally American-based credit ratings of Moody's, Standard & Poor's, and Fitch (now owned by Fimulac, a French company), investors in the U.S. and abroad have taken a natural course of action. They have avoided the purchase of complex securities that cannot easily be deciphered and valued with a reasonable degree of due diligence.

Many banks are finding it difficult to isolate the extent of their own exposures and so understandably will not transact with institutions that own or are perceived to own these complex securities, or are believed to have counterparty exposure to institutions that have such exposures. Consequently, the interbank lending market has contracted forcing reserve banks around the world to provide hundreds of billions of dollars of funding to these institutions. Even without recent Federal Reserve interest rate reductions, the decline in the value of the dollar can be partially explained by the increasing loss of confidence in U.S. financial assets, particularly so-called Triple A rated CDO, RMBS, and other exposures guaranteed by MBIA, Ambac and the other nominally Triple A rated bond insurers, as our rating agencies have been initially discredited and then justifiably ignored.

While central bank actions can help provide some liquidity to the capital markets, we are of the belief that all will not be right with the global capital markets without a return to complete transparency for the benefit of all market participants. Unfortunately, recent press reports suggest that U.S. federal and state regulators' actions with respect to the bond insurance industry continue to promote a path that limits transparency, further increases risk in the banking system and the capital markets at large, and will likely prolong the term and severity of the recent credit contraction.

I have been invited by Representative Kanjorski to testify on February 14th before the House Financial Services Committee's Subcommittee on Capital Markets about the issues I will discuss in this letter. In light of the importance and timeliness of these issues, I have chosen to bring them to your attention in advance of that testimony. In this letter, I:

- Provide background information on the bond insurance industry's participation in credit default swaps and guarantees on CDOs,
- Explain that recent bailout attempts by banks which are counterparties to the bond insurers are ill advised, as they prolong the crisis by postponing the recognition of these banks' losses as the banks arbitrage the lower regulatory capital requirements for bond insurers and their overstated credit ratings,
- Explain why the banking industry led bailout of the bond insurers should be allowed to fail,
- Make recommendations as to how greater transparency can be provided while minimizing systemic risk to the marketplace,
- Describe the systematic overstatement of municipal bond ratings by the rating agencies and explain how systemic risk can be reduced by requiring the rating agencies to use their corporate rating scales for municipal issuers, and
- Explain our view that bailouts should only be implemented to address illiquidity and not insolvency.

The Bond Insurance Industry's Participation in Credit Default Swaps

While the bond insurers were once companies that performed due diligence on low-risk municipal bond issues in exchange for upfront fees, they have in recent years become credit default swap counterparties on hundreds of billions of dollars of exposure with financial institutions around the world. It is worth exploring how these institutions morphed from having credit risk exposure perhaps equivalent to that of title insurers to become among the largest credit derivative counterparties in the world with capital less than one-tenth of their banking industry counterparts (typical capitalization less than 1% equity to outstanding credit exposures).

While the bond insurers are regulated by state regulators like other insurance companies, in economic substance they are no different than banks in taking on credit risk, except that they provide funding through the provision of a guarantee to a bond issue which is funded in the capital markets. Furthermore, unlike banks that attempt to syndicate risk, bond insurers hold all of their exposures to maturity and do not hedge.

The bond insurers' ability to underwrite credit default swaps was caused by a breakdown of the state insurance regulatory oversight system that regulates the industry. According to a recent Wall Street Journal story, approximately 10 years ago, a junior employee in the property and casualty division of the New York State Insurance Department approved a side letter that permitted the bond insurance industry to guarantee credit derivatives indirectly. To be clear, guarantees of speculative derivatives were at the time (and still are) explicitly not permitted under New York statutory insurance law. In undoing the prohibitions of a state statute by way of a side letter, it is doubtful that this person understood the implications of his or her actions.

Other states apparently followed New York's lead in providing access to this loophole and approved "transformers" (special-purpose vehicles that circumvented the original bond insurance prohibition against speculative derivative exposures) that allowed the insurers to engineer their way around the law. Because the bond insurers were considered insurance companies, the Federal Reserve, Treasury Department, and the Comptroller of the Currency played no role in overseeing these institutions or approving this enormously material modification to bond insurance regulations. In fact, given the segmented regulatory environment which treats bond insurers as entities separate and apart from other bank and bank-like institutions, many market participants and regulatory authorities were likely unaware of the role these institutions played in the banking system until the events of recent months.

Fast forward ten years later and the industry has several hundred billion dollars of counterparty exposure to financial institutions around the world of which \$125 billion is for subprime related CDO structures. Unlike as is required for other derivative counterparties, the bond insurers have posted no collateral to secure their obligations to make payments to their counterparties. Relative to other market participants, this means that bond insurers do not have the market-driven discipline to set aside capital in the form of counterparty collateral as market conditions have turned against them, nor do their counterparties have protections against the failure of the insurers.

The Proposed Bailout of the Bond Insurance Industry

If recent press reports are correct, at the behest of U.S. state regulators and with Federal Reserve and Treasury Department tacit oversight, a consortium of U.S. and international banks – Citigroup, Wachovia, UBS AG, BNP Paribas, Société Générale, Royal Bank of Scotland Group, Barclays, and Dresdner Bank – are working on a bailout of Ambac Assurance Corporation, the second largest U.S. bond insurer. These banks likely have significant counterparty exposure to Ambac with respect to CDOs on their books.

This recent bailout approach is apparently part of a bond-insurer-by-bond-insurer bailout effort which contemplates infusing capital and/or providing credit lines or reinsurance so that the rating agencies will allow Ambac and other bond insurers to maintain Triple A ratings. In essence, the banks are attempting to take advantage of the arbitrage between (1) the relatively lax state regulatory capital and ratings agency standards for the bond insurers and (2) the appropriately stringent federal capital requirements for banks.

Rather than admit material impairment on assets that are currently “hedged” through uncollateralized protection from functionally insolvent bond insurers, it appears to us that banks are instead attempting to invest a fraction of the value of these impairments into the bond insurers to prop up (temporarily) their Triple-A ratings. In so doing, banks can continue the charade that their exposures are adequately hedged. The rating agencies to which regulators and the markets have historically turned to determine the solvency of the insurers are loathe to admit their gross miscalculations in recent years and continue to understate the ultimate losses from CDOs, RMBS, and other related securities.

Ultimately, a bailout led by bond insurers’ counterparties will only delay the inevitable at the expense of transparency in the international capital markets. The foreseeable losses in mortgage related securities will overwhelm the capital of the insurers (even after they raise new capital) and banks will be forced to take charges to recognize the inadequacy of insurance policies. Our capital markets will not regain stability until these exercises in obfuscation come to an end.

Furthermore, participants in any discussions to provide capital to bond insurers would be well served to undertake an exposure-by-exposure level due diligence within bond insurers’ books of “safe” municipal bonds. While traditional general obligations bonds are safe credits, these insurers’ municipal bond portfolios include many bonds that depend solely on project performance for repayment (such as toll roads, hospitals, prisons, and other public works that depend on operating revenue rather than tax payer support). We believe that a substantial number of these projects, which encompass material gross dollar amounts, are underwater and their related obligations will suffer losses. Historical remediation and refinancing practices that allowed insurers to hide or delay losses will be difficult in a new world where investors pay closer attention to the quality of the underlying credits.

We commend New York State Insurance Department Superintendent Eric Dinallo for being proactive in accelerating the entrance of new participants into the industry, of which Berkshire Hathaway is the first and most prominent example. We also highlight Superintendent Dinallo’s open-mindedness in acknowledging that the industry’s capital shortfall numbers in the many billions (if not tens of billions) of dollars. It is clear that the seeds for this crisis were planted years before his recent appointment and, therefore, he should bear no responsibility for its creation. That being said, while the Superintendent’s efforts to avoid a bond insurance industry failure under his watch are well intentioned, we believe that they will serve merely to forestall loss recognition and prolong the credit crisis.

Banks shifted risk to these insurers because the insurers were willing to take on risk at a fraction (often one-third or less) of the market spread for these risks. This allowed banks to profit on these transactions while avoiding disclosure of their growing CDO exposures because they could claim that these transactions had been hedged with Triple A rated counterparties.

The bond insurers actions were predicated on rating agency models which predicted that there would be no losses on these so-called “Super Senior” or better than Triple A exposures. The bond insurers effectively outsourced their credit analysis and due diligence to the rating agencies. Consistent with this view, the insurers took immaterial reserves (in the range of one to three basis points) against these risks. As such, the bond insurers’ nominal capital and enormous leverage allowed the below-market fees earned on their CDOs to appear to generate high returns on their capital.

Unfortunately, this was all a fiction. Bond insurers who were paid approximately 20 basis points per annum on these exposures now face thousands of basis points of losses on these risks. Based on our estimates, those recently published by investment banking analysts, and those of the New York State Insurance Department, the industry stands to lose billions of dollars on these exposures, destroying the entire industry’s capital base.

The risk transfer should never have been permitted in the first place. It occurred because of the differential regulatory, accounting, and rating agency regimes for the bond insurers versus their banking industry counterparts. These disparate regimes should not allow the banking and bond insurance industries to continue to mislead global capital markets as to where the actual risk lies.

While we understand that the banking industry counterparties to the bond insurers would prefer to avoid taking these CDO risks back on balance sheet – particularly at a time when their balance sheets are strained by subprime and other losses that have not been hedged – there are no such free lunches available in the capital markets.

Bond insurers have served a similar function to the banks as so-called Structured Investment Vehicles (or “SIVs”), conduits, and other off-balance sheet structures because insurers have enabled the banks to appear better capitalized than they are in reality. The banks’ CDO exposures were “kept” off-balance sheet in bond insurers with overstated credit ratings.

The Super SIV plan that you introduced was designed to address illiquidity that threatened to create losses due to technical selling pressure. It was abandoned when banks consolidated these assets, took write-downs, and took responsibility for managing the orderly liquidation of the assets over time. In contrast, the bond insurer bailout strategy appears to be aimed at propping up insolvent and falsely rated entities so that banks can defer judgment day to a time when they are better capitalized or their stock prices are higher and will suffer less dilution if further capital is required. The bond insurer industry bailout should fail if legitimate banks come out against the practice of propping up insolvent and falsely rated entities or when you and your international counterparts act to stop it.

The bond insurers' Triple A ratings are historical artifacts of their early years of lower risk municipal bond insurance, ratings that have been maintained to the present despite the gradual but dramatic change in their risk profiles. The rating agencies seem forcefully committed to their outdated bond insurance industry capital models despite the industry's enormous recent losses. If this continues to be the case, the ratings agencies' models may allow the insurers to retain their Triple A ratings even if they raise an economically insufficient, but rating agency approved, amount of additional capital.

It is bad practice to rely on the judgment of those whose misjudgments have caused the current crisis. Banks should not be allowed to rely on the overstated ratings of the bond insurers for the purpose of continued unsecured credit risk transfer. Rather, this situation calls for a fundamental, data-driven analysis, where regulators form an independent view of the risks and exposures at hand. Only then will an appropriate course of action present itself.

Our Recommendations

The losses that banks have incurred on CDOs exist whether or not the banks have entered into counterparty hedges with the bond insurers. We therefore make the following recommendations:

- Banks and bond insurers should be forced to disclose their CDO exposures in detail including the name and CUSIP of each of their CDOs, a quantification of the amount of their losses before considering hedges, and any additional information that will allow the market to independently assess these exposures. Any hedged exposures should identify the counterparty with which these hedges have been executed and the terms of the hedge.
- Banks should be required to hold capital against their CDO exposures based on Federal Reserve and Comptroller of the Currency's guidelines and assessments of these exposures that are not based solely on credit ratings. Our banking system can no longer outsource risk management to the rating agencies who have grievously failed in their analysis.
- Banks should write down the exposures they have hedged with the bond insurers today and raise sufficient capital on their own balance sheets so that they can continue their business in a safe and sound manner. Once the write-offs have been taken, transparency is restored, and investors can be comforted that there are no more SIVs, overstated CDO marks, undisclosed counterparty risks, or other surprises, the capital markets can function normally again.
- Federal regulators should work with their state counterparts to ensure that the bond insurers preserve as much of their capital as possible for the benefit of policyholders and bank counterparties. Dividends from regulated insurance subsidiaries to their holding companies should be suspended until it is determined that bond insurer capital is sufficient to meet current and future obligations.

- Transactions between bond insurer holding companies and their regulated insurance subsidiaries should be examined closely to determine whether such transactions are arm's length. Any non-arm's length transfers of value from these subsidiaries to holding companies should be reversed with interest and penalties where appropriate.
- Independent directors should be appointed to bond insurance subsidiary boards immediately and independent monitors should be appointed at each of the insurers to oversee their activities. Currently, substantially all directors of these insurance subsidiaries are executives of the holding companies and have historically received equity compensation based on holding company performance, creating a clear conflict of interest. With the recent declines in stock prices, management's out of the money options may engender risk seeking behavior that runs counter to the interests of policyholders and the insurers' derivative counterparties.

We respectfully urge you to consider these recommendations with the highest degree of care and seriousness. In the near term, you have the opportunity to restore the integrity of the U.S. capital markets. Our country's credibility in the global capital markets depends on it.

Avoiding Systemic Risk from a Downgrade of the Bond Insurers

There are some who believe that the failure of the bond insurers will create systemic risk issues for the capital markets. The potential for systemic risk appears not to be driven by CDO losses for the bond insurer counterparties (which have been recently estimated by Oppenheimer & Co. at \$40 to \$70 billion),¹ but rather due to the downgrade of approximately \$1.5 trillion of municipal bonds guaranteed by the bond insurers in the event the insurers lose their Triple A ratings.

Investors are particularly concerned about tender option bonds, variable-rate deposit obligations and other short-term municipal securities that are held by money market mutual funds which typically cannot own securities with lower than Double A ratings. While we are skeptical of the real risks of a bond insurer downgrade on the market – for these insured municipal issues have already experienced an effective downgrade as they are already trading as if they are uninsured with few identified systemic issues to show for it – we are cognizant that the potential for systemic risk may be difficult to accurately gauge in advance.

While the ratings of structured finance securities have been materially overstated by the rating agencies, it is not widely known that the ratings of municipal securities have been systematically understated by the rating agencies. In a March 2007 report, Moody's

¹ See Meredith Whitney, Industry Update – U.S. Banks, *The Big 'What If': \$40-\$70B In Est. Damage Caused By Monoline Downgrades*, Oppenheimer & Co. Inc. (Jan. 29, 2008). A copy of this report has been enclosed with this letter.

acknowledged the disparity between its municipal ratings scale and its “Global” or corporate ratings scale.

For reasons that we do not know, municipal ratings vastly overstate the probability of default when compared with corporate ratings. For example, a Triple B general obligation bond has one-fourth the probability of default of a Triple A corporate issue, and upon default yields higher recoveries for investors than corporate issues. We have enclosed with this letter a report entitled, “Corporate Ratings for Munis,” published by Municipal Market Advisors on January 17, 2008 which addresses this issue in detail.

As a result of the grade deflation of municipal ratings, most municipalities that are rated less than Double A would achieve Double or Triple A ratings on the rating agencies’ corporate rating scales. Despite their Triple A default risk, these municipal issuers’ less-than-Triple A ratings require them to purchase bond insurance for some or all of their bond issues because of the greater demand for Triple A rated, rather than lower-rated, municipal bonds. Leaving aside the issue of the tens of billions of dollars of taxpayer funds expended for bond insurance that was likely not needed, this systematic understatement of municipal ratings provides an opportunity to mitigate the potential for system-wide forced selling of insured municipal securities in the event of bond insurer downgrades if the understated ratings are corrected promptly.

As reported in the press, on January 12, 2008, the Connecticut Attorney General Richard Blumenthal expanded his investigation of the subprime crisis to include rating agency methodologies as they relate to municipal bond issuers and insurers. While we cannot predict the outcome of Attorney General Blumenthal’s investigation, we believe that it will ultimately lead the ratings agencies to grade municipal exposures on the same scale as they do all corporate issuers so that investors are not misled as to the creditworthiness of municipalities.

The ancillary benefit of such a requirement will be a large scale upgrading of all municipal issues and the significantly reduced cost of municipal borrowing nationwide. Using the corporate ratings scale as the sole standard across all types of credit instruments will have the important benefit of mitigating the impact of a downgrade of insured municipal issues and will likely reduce, if not eliminate, the need for certain funds to dispose of municipal issues that would not otherwise attain a Double A or higher rating.

If ratings agencies refuse to agree to use the corporate ratings scale as the uniform standard, federal regulators can achieve much of the benefit of such a move by clarifying Rule 2a-7 of the Investment Company Act of 1940. Under Rule 2a-7, money market funds are effectively required to hold assets that have a rating of no less than Double A. The rule does not differentiate between the municipal ratings scale and the corporate ratings scale. If the rule were clarified such that municipal bonds were rated on the corporate scale, the ratings on those bonds are likely to be high enough to avoid a sell down of insured municipal bonds in the event of a bond insurer failure. We believe that such a change would be appropriate in light of the grade deflation of municipal ratings under the current system.

Bailouts Should be Orchestrated to Address Illiquidity Not Insolvency

Experience has shown that attempts to bailout insolvent market participants have often failed while advancing moral hazard, whereas bailouts or regulatory-assisted intervention to address illiquidity can greatly benefit the capital markets. We believe that comparing the experience of Long Term Capital Management (“LTCM”) to that of the bond insurers is instructive.

After the Russian bond default, LTCM received a cascade of margin calls from its counterparties, which had insufficient transparency into the various exposures held by the firm. These events brought the firm to the brink of failure. Coordination by the Federal Reserve of a meeting of top counterparties led to an infusion of capital from private market participants that allowed LTCM to stabilize its exposures and complete an orderly liquidation, massively reducing global market risk. Warren Buffett and AIG were stalking horse bidders for the ultimate consortium that took over and liquidated the portfolio.

The LTCM rescue succeeded because LTCM suffered from illiquidity and margin calls, rather than insolvency. Its fixed income, merger, and other arbitrage exposures were fundamentally sound if they could be held to term. The capital infusion eliminated forced selling and preserved capital for all, except for the original equity holders of LTCM, who met their appropriate fate in the markets given their misjudgments.

In the case of the bond insurers, Mr. Buffett has already completed his review of the players and concluded that launching a new insurer to compete in the marketplace was a better course of action than investing in an existing insurer. According to press reports, Mr. Buffett chose to launch his own bond insurer rather than, as he said, “pick up the problems of the past.” His insurer has committed to guarantee only municipal issues and will likely take enormous market share as investors frown on guarantees from legacy bond insurers regardless of their capital replacement programs.

Apparently, AIG is also considering launching a competitive bond insurer and has declined to participate in funding any of the existing players. Yesterday, the Financial Times reported that Bain Capital, Carlyle Group, KKR, and TPG have also passed on investing in any of the existing bond insurers. If this were an issue of illiquidity rather than solvency, there would be competitive auctions among tens of private equity firms interested in pursuing such an opportunity. These private market assessments indicate that this is not simply a case of illiquidity or a lack of sufficient opportunistic capital in the market. Rather, the bond insurers suffer from insolvency caused by the combination of poor risk selection, enormous leverage, and the diminution in value of the real estate collateral that underlies some of their derivative exposures.

* * * * *

As the principal regulators of our financial markets, you can work proactively with state regulators and the bond insurers themselves to help restore confidence in the global

capital markets. Acknowledging the collateral damage caused by the mass outsourcing of judgment to the ratings agencies is the first step. Preserving capital in the beleaguered bond insurers, coupled with the detailed fundamental analysis of their exposures is the next step in wresting control of the situation and restoring confidence. Forcing banks to disclose and then reserve against their CDO exposures without reference to bond insurance are important steps to restoring transparency and confidence to the capital markets.

We would welcome the opportunity to discuss any of the above with you or any of your associates at any time. I will be in Washington next week on the 12th and the 14th for my Congressional testimony, but can otherwise be available at your or your colleagues' convenience. In the interest of transparency, we expect to make this letter generally available including, in particular, to Congressional staff.

Please note that Pershing Square manages funds that are in the business of trading – buying and selling – securities and credit default swaps. While Pershing Square currently maintains a net short position in MBIA Inc. and Ambac Financial Group Inc. (the holding companies of the two largest regulated bond insurers) and may have other positions in the industry, Pershing Square may change its position regarding the companies and possibly increase, decrease, dispose of, or change the form of its investment in the companies for any or no reason.

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Respectfully submitted,



William A. Ackman

Encl.

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