

December 10, 2008

**Research Update:**

**Customer Asset Protection Co. Rtg  
Lowered To 'BB' From 'A+'; Rtg  
Remain On Credit Watch Neg**

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## Research Update:

# Customer Asset Protection Co. Rtg's Lowered To 'BB' From 'A+'; Rtg's Remain On CreditWatch Neg

## Rationale

On Dec. 10, 2008, Standard & Poor's Ratings Services lowered its counterparty credit and financial strength ratings on Customer Asset Protection Insurance Co. (CAPCO) to 'BB' from 'A+'. The ratings remain on CreditWatch with negative implications, where they were placed on Sept. 16, 2008.

The downgrade reflects Standard & Poor's reassessment of the probability of CAPCO incurring a significant claim due to the liquidation of Lehman Brothers International (Europe) (LBIE). We placed CAPCO on CreditWatch after the bankruptcy of Lehman Brothers Holdings Inc. (Lehman), the parent of three broker dealers that are members of CAPCO including LBIE. Initially, Standard & Poor's did not expect CAPCO to incur a material claim from Lehman's bankruptcy because there is no evidence that any clients' assets were misappropriated. Although there is still tremendous uncertainty surrounding the administration of LBIE, Standard & Poor's now believes the decision by some clients to permit the rehypothecation of some of their assets increases the risk of a claim on CAPCO. The clients' claims on rehypothecated assets are expected to have the same status as general creditors of LBIE, which exposes CAPCO to heightened risk of claims. Based on the limited availability of information from the liquidator, it is not possible to calculate the magnitude of CAPCO's ultimate losses, but the ultimate insolvency of the company is possible.

Standard & Poor's primary concern regarding CAPCO is clearly the potential for a claim related to those clients of LBIE that opted to rehypothecate their assets to LBIE. We believe the administrator of the liquidation has segregated those clients who did not rehypothecate their assets. These clients may still endure long delays in obtaining access to their assets, but Standard & Poor's does not expect CAPCO will incur a significant liability from insuring these accounts. CAPCO's insurance does not reimburse clients for a decline in the market value of their securities or adverse circumstances that may arise from being unable to access or trade their securities.

Standard & Poor's believes there is only a remote chance that clients of CAPCO's other members will need coverage from CAPCO. Our opinion reflects the members' financial strength and the short time remaining on CAPCO's policies, which provide coverage on an occurrence basis. Many of CAPCO's members are still rated in the 'A' category or higher despite the very challenging environment for financial institutions. We believe CAPCO's members will decide to obtain excess SIPC coverage from another carrier when all of the members' policies expire in mid February. Therefore, a claim would not be eligible for coverage from CAPCO unless the liquidation of one of its members began in the next three months. Some of CAPCO's members have encountered financial stress,

but there has been no indication that clients' assets were misappropriated, meaning that claims on CAPCO's insurance policies under the U.S. contracts are expected to be minimal.

Rehypothecation has exposed CAPCO to potential losses from changes in LBIE. Rehypothecation is the practice of a client allowing its broker/dealer to pledge the client's assets as collateral for the broker/dealer's loans. The administrator in the liquidation of LBIE has stated that most of the clients who rehypothecated their assets will rank *pari passu* with the broker/dealer's general creditor. If LBIE's liabilities exceed its assets, the administrator will assign a percentage of that loss to the pool, and this loss will be allocated by account size. The pool will also bear the broker/dealer's cost of distributing remaining assets to the pool. Various reports state that clients rehypothecated approximately \$22 billion of Lehman Brother International (Europe)'s total client assets of \$40 billion.

Despite the uncertainty surrounding the liquidation of LBIE, Standard & Poor's believes clients could sustain a material loss and this insurable event under CAPCO's policy. The administrator is still in the process of reconciling LBIE's accounts, but it has estimated the assets and liabilities at \$500 billion each. The administrator also stated that it believes creditors will suffer some loss; however, the amount will not be known for quite some time.

CAPCO's claims paying resources are modest relative to the size of the pool; therefore, allocating even a small percentage loss to the pool could threaten CAPCO. CAPCO's claims paying resources include its own investment portfolio, which consists mostly of short-term obligations of the U.S. government, and reinsurance coverage from financial guarantors. If CAPCO incurs a claim related to the liquidation of LBIE, In the event of a sizeable loss, CAPCO would benefit from approximately \$200 million of reinsurance from two highly rated reinsurers.

LBIE's ability to offset its liabilities with assets due from the same counterparty could result in a material reduction in the size of CAPCO's potential claim. Standard & Poor's believes that many clients allowed LBIE to rehypothecate their assets in exchange for obtaining attractive pricing on a bank loan or line of credit from a Lehman affiliate. If LBIE is able to deduct the outstanding balance of this debt from the client's assets, Standard & Poor's believes the loss potential would decrease significantly. Furthermore, the value of the client assets may have decreased in recent months due to trends in the financial markets. During this time, the value of outstanding loans probably increased due to the accrual of interest. However, the administrator has identified the right of offset and transactions among Lehman affiliates as two issues that are making the liquidation process complicated.

The challenging landscape for financial institutions has created difficulties for some of CAPCO's members, but the potential for a claim from these members is significantly less than it is for a claim from LBIE. Bear Stearns faced some liquidity constraints in March, but it was acquired by JPMorgan Chase (AA-/Negative/A-1+), which guaranteed all of Bear Stearns counterparty agreements. Lehman has two U.S. broker dealers - Neuberger Berman LLC (Neuberger Berman) and Lehman Brothers Inc. (Lehman US). Neuberger Berman's clients' accounts have already been transferred without Securities Investor Protection Corp. (SIPC) initiating a liquidation proceeding. SIPC has initiated a liquidation proceeding for Lehman US, but there has been no

indication that clients' funds were misappropriated.

In the U.S., CAPCO provides excess SIPC coverage for its members, which are broker/dealers. Broker/dealers are regulated entities where customer assets are required to be segregated from the firm's assets and may not be used in the ongoing business of the firm or affected by a broker/dealer's own trading losses. For an excess SIPC claim to occur, all of the following must happen: a broker/dealer must be deemed insolvent; client assets must be found to be missing, lost or stolen; and customer property, SIPC advances, fidelity bond proceeds, if any, and distributions from the general estate of the member, if any, to customers are insufficient to satisfy customer account obligations. Neither SIPC nor excess SIPC cover a decline in the market value of a client's investments. Because of these conditions, any losses to CAPCO relating to U.S.-based Lehman units are not expected to be material.

## Ratings List

### Downgraded

	To	From
Customer Asset Protection Co.		
Counterparty Credit Rating		
Local Currency	BB/Watch Neg/--	A+/Watch Neg/--
Financial Strength Rating		
Local Currency	BB/Watch Neg/--	A+/Watch Neg/--

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