

ASSOCIATION REPORT ON EXAMINATION

OF THE

MBIA INSURANCE CORPORATION

AS OF

DECEMBER 31, 2003

ZONES  
REPRESENTED

I  
II  
IV

STATES  
PARTICIPATING

NEW YORK  
MISSISSIPPI  
NEVADA

EXAMINERS

JAMES MURPHY  
VINCENT RAPACCIUOLO  
TIMOTHY GADLER



STATE OF NEW YORK  
INSURANCE DEPARTMENT  
25 BEAVER STREET  
NEW YORK, NEW YORK 10004

September 21, 2005

Honorable Diane Koken  
NAIC President  
Commissioner of Insurance  
State of Pennsylvania

Honorable Kevin McCarty  
Chairman, Southeastern Zone  
Director of Insurance Regulation  
State of Florida

Honorable Howard Mills  
Superintendent of Insurance  
State of New York

Honorable Mike Kreidler  
Chairman, Western Zone  
State of Washington

Sirs:

Pursuant to your instructions an examination has been made into the condition and affairs of the MBIA Insurance Corporation, hereinafter referred to as "the Company" or "MBIA Corp.", at its home office located at 113 King Street, Armonk, New York 10504.

The examination was conducted by the New York State Insurance Department, hereinafter referred to as "the Department" with participation from the State of Mississippi representing the Southeastern Zone and participation from the State of Nevada representing the Western Zone.

The report on examination is respectfully submitted.

REPORT ON EXAMINATION

OF THE

MBIA INSURANCE CORPORATION

AS OF

DECEMBER 31, 2003

DATE OF REPORT

SEPTEMBER 21, 2005

EXAMINER

JAMES MURPHY

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STATE OF NEW YORK  
INSURANCE DEPARTMENT  
25 BEAVER STREET  
NEW YORK, NEW YORK 10004

September 21, 2005

Honorable Howard Mills  
Superintendent of Insurance  
Albany, New York 12257

Sir:

Pursuant to the requirements of the New York Insurance Law, and in compliance with the instructions contained in Appointment Number 22396 dated August 8, 2005 attached hereto, I have made an examination into the condition and affairs of MBIA Insurance Corporation as of December 31, 2003, and submit the following report thereon.

Wherever the designations “the Company” or “MBIA Corp.” appear herein without qualification, they should be understood to indicate the MBIA Insurance Corporation.

Wherever the term “Department” appears herein without qualification, it should be understood to mean the New York Insurance Department.

The examination was conducted at the Company’s home office located at 113 King Street, Armonk, New York, 10504.

## 1. SCOPE OF EXAMINATION

The previous examination was conducted as of December 31, 1999. This examination covered the four-year period from January 1, 2000 through December 31, 2003. Transactions occurring subsequent to this period were reviewed where deemed appropriate by the examiner.

The examination comprised a complete verification of assets and liabilities as of December 31, 2003. The examination included a review of income, disbursements and company records deemed necessary to accomplish such analysis or verification and utilized, to the extent considered appropriate, work performed by the Company's independent public accountants. A review or audit was also made of the following items as called for in the Examiners Handbook of the National Association of Insurance Commissioners ("NAIC"):

- History of Company
- Management and control
- Corporate records
- Fidelity bond and other insurance
- Territory and plan of operation
- Growth of Company
- Business in force by states
- Loss experience
- Reinsurance
- Accounts and records
- Financial statements

A review was also made to ascertain what action was taken by the Company with regard to comments and recommendations contained in the prior report on examination.

This report on examination is confined to financial statements and comments on those matters, which involve departures from laws, regulations or rules, or which are deemed to require explanation or description.

## 2. DESCRIPTION OF COMPANY

The Company was incorporated as the National Bonding and Accident Insurance Company under the laws of the State of New York in March 1968. In December 1982, the MBL Holding Corporation, a wholly-owned subsidiary of the Mutual Benefit Life Insurance Company, Newark, New Jersey, purchased all of the outstanding capital stock of National Bonding and Accident Insurance Company. In December 1986, the Company was sold to MBIA Inc. adopting the name of Municipal Bond Investors Assurance Corporation. In April 1995, the Company changed its name to MBIA Insurance Corporation.

MBIA Insurance Corporation is the successor to the business of the Municipal Bond Insurance Association (“Association”), a consortium of five multi-line insurers, which began writing municipal bond insurance in 1974. Four of the five member companies, the Aetna Casualty and Surety Company, Fireman’s Fund Insurance Company, Aetna Insurance Company and the Continental Insurance Company, participated in the formation of the Company. The Travelers Indemnity Company, the fifth member elected not to join. MBIA Insurance Corporation assumed the four predecessor member companies’ entire outstanding municipal bond insurance portfolio. In 1993, MBIA Insurance Corporation assumed the remaining business from the fifth member of the Association.

On February 17, 1998, MBIA Inc. completed a merger with CapMac Holdings, Inc., the parent company of Capital Markets Assurance Corporation (“CapMac”). On March 19, 1998, the board of directors of MBIA Inc. voted to contribute the common stock of CapMac to MBIA Insurance Corporation. Then, effective April 1, 1998, CapMac became a wholly-owned subsidiary of MBIA Insurance Corporation.

The Company is the parent of MBIA Insurance Corp. of Illinois (“MBIA Illinois”) and Capital Markets Assurance Corporation (“CapMac”). The Company also owns MBIA Assurance S.A., a

French insurance company, which writes financial guarantee insurance in the member countries of the European Union, and MBIA UK (Holdings) Ltd.

Capital paid in is \$15,000,000 consisting of 100,000 shares of common stock of \$150 par value per share. Gross paid in and contributed surplus is \$1,228,021,579. Gross paid in and contributed surplus paid in increased by \$121,962,898 during the examination period, as follows:

<u>Year</u>	<u>Description</u>	<u>Amount</u>
2000	Beginning gross paid in and contributed surplus	\$1,106,058,681
2000	Surplus contribution	\$ 26,056,518
2001	Surplus contribution	27,407,934
2002	Surplus contribution	42,696,157
2003	Surplus contribution	<u>25,802,289</u>
	Total Surplus Contributions	<u>121,962,898</u>
2003	Ending gross paid in and contributed surplus	<u>\$1,228,021,579</u>

A. Management

Pursuant to the Company's charter and by-laws, management of the Company is vested in a board of directors consisting of not less than thirteen nor more than twenty-five members. At December 31, 2003, the board of directors was comprised of the following fifteen members:

<u>Name and Residence</u>	<u>Principal Business Affiliation</u>
Joseph W. Brown Bedford Corners, NY	Chairman and Chief Executive Officer, MBIA Insurance Corporation
W. Thacher Brown Devon, PA	Managing Director, MBIA Insurance Corporation
Neil G. Budnick New Canaan, CT	Vice Chairman and Chief Financial Officer, MBIA Insurance Corporation
John B. Caouette Pound Ridge, NY	Vice Chairman, MBIA Insurance Corporation
Clifford D. Corso Katonah, NY	Managing Director and Chief Investment Officer, MBIA Insurance Corporation

<u>Name and Residence</u>	<u>Principal Business Affiliation</u>
Gary C. Dunton Ridgefield, CT	President and Chief Operating Officer, MBIA Insurance Corporation
Douglas C. Hamilton Armonk, NY	Managing Director and Controller, MBIA Insurance Corporation
John S. Pizzarelli Pleasantville, NY	Managing Director and Head of Public Finance, MBIA Insurance Corporation
Joseph L. Sevely Manhasset, NY	Managing Director and Treasurer, MBIA Insurance Corporation
Kevin D. Silva Manhasset, NY	Managing Director and Chief Administrative Officer, MBIA Insurance Corporation
Richard L. Weill Mt. Kisco, NY	Vice Chairman and Secretary, MBIA Insurance Corporation
Ram D. Wertheim Westport, CT	Managing Director, General Counsel and Assistant Secretary, MBIA Insurance Corporation
Ruth M. Whaley Scarsdale, NY	Managing Director and Chief Risk Officer, MBIA Insurance Corporation
Robert T. Wheeler Waccabuc, NY	Managing Director and Chief Technology Officer, MBIA Insurance Corporation
Mark S. Zucker Westport, CT	Managing Director and Head of Structured Finance, MBIA Insurance Corporation

The board met four times during each calendar year. A review of the minutes of the board of directors' meetings held during the examination period indicated that the meetings were generally well attended and each board member has an acceptable record of attendance.

As of December 31, 2003, the principal officers of the Company were as follows:

<u>Name</u>	<u>Title</u>
Joseph W. Brown	Chairman and Chief Executive Officer
Gary C. Dunton	President and Chief Operating Officer
Neil G. Budnick	Vice Chairman and Chief Financial Officer
Richard L. Weill	Vice Chairman and Secretary
John B. Caouette	Vice Chairman
Joseph L. Sevely	Managing Director and Treasurer
Ram D. Wertheim	Managing Director, General Counsel and Assistant Secretary
Douglas C. Hamilton	Managing Director and Controller

B. Territory and Plan of Operation

As of December 31, 2003, the Company was licensed to write business in all fifty states, the District of Columbia, Guam, the Northern Mariana Islands, Puerto Rico and the U.S. Virgin Islands, France and Spain. The Company also writes business in Latin America, Asia and Europe.

As of the examination date, the Company was authorized to transact the kinds of insurance as defined in the following numbered paragraphs of Section 1113(a) of the New York Insurance Law:

<u>Paragraph</u>	<u>Line of Business</u>
16	Fidelity and surety
17	Credit
25	Financial guaranty

Based on the lines of business for which the Company is licensed and the Company's current capital structure, and pursuant to the requirements of Articles 13, 41 and 69 of the New York Insurance Law, the Company is required to maintain a minimum surplus to policyholders in the amount of \$66,400,000.

The following schedule shows the direct premiums written by the Company both in total and in New York for the period under examination:

<u>Calendar Year</u>	<u>New York State</u>	<u>Total United States</u>	<u>Premiums Written in New York State as a Percentage of United States Premium</u>
2000	\$223,297,714	\$ 567,747,170	39.33%
2001	\$306,653,000	\$ 776,349,831	39.50%
2002	\$344,766,498	\$ 833,027,984	41.39%
2003	\$353,369,468	\$1,143,286,895	30.91%

C. Reinsurance

Assumed

The Company assumes a relatively minor volume of business as compared to its direct writings. In 2003, the Company's assumed premiums represented approximately 3.4% of its total book of business for the year. Approximately 41% of assumed premiums were assumed from affiliates.

Ceded

The Company's Schedule F data as reported in its annual statements filed with this Department during the exam period did not accurately reflect its reinsurance transactions. As discussed further herein, the Company's "Special Risk Facilities" should have been accounted for using deposit accounting. Additionally, the Company did not properly report reinsurance associated with a US Air transaction, as described in Section 4 herein. It is recommended that the Company correctly report all transactions with its reinsurers on Schedule F in all future financial statements filed with the Department.

The examiner reviewed all ceded reinsurance contracts in effect at December 31, 2003. The contracts all contained the required standard clauses including insolvency clauses meeting the requirements of Section 1308 of the New York Insurance Law.

The following is a description of the Company's ceded reinsurance program in effect at December 31, 2003:

### Comprehensive Automatic Treaty Reinsurance Agreement

MBIA Corp. entered into the 2003 comprehensive automatic treaty with six reinsurers. Under the terms of the treaty, a variable percentage of risk over a minimum par value is ceded on domestic and international business, subject to a maximum percentage specified in such treaty. Reinsurance ceded under the treaty is for the full term of the underlying policy.

The Company may cede a minimum of 10% to a maximum of 70% (80% in some instances) of par value of an insured issue which par value exceeds \$75,000,000 but the pro-rata share of par amount can not exceed various single issue limits established by each reinsurer.

Business ceded is categorized into six classifications: Organization for Economic Cooperation and Development (“OECD”) Public Finance, OECD Structured Finance, Non-OECD Public and Structured Finance, Future Flow, Healthcare & Investor Owned Utilities, and CDOs. Reinsurer participation and limits are set within each of these categories and negotiated prior to the treaty’s effective date. Most of the Company’s reinsurers in this program are unauthorized.

### Stop Loss Reinsurance Agreement

As of January 1, 2003, the Company maintained \$211 million of annually renewable stop-loss reinsurance coverage with three reinsurers. At the end of the third quarter, the Company elected not to renew two of the facilities with \$175 million of coverage due to the rating downgrades of the stop-loss providers. As of December 31, 2003, the Company had \$35.7 million of stop-loss coverage in effect with an authorized reinsurer. In addition, at the end of 2003, MBIA Corp. elected not to renew the remaining \$35.7 million of stop-loss reinsurance coverage effective January 1, 2004, also due to the rating downgrade of the stop loss reinsurer.

### Facultative Reinsurance Agreements:

MBIA Corp. has also entered into facultative reinsurance arrangements with mostly unauthorized reinsurers to address those transactions when reinsurance needs can not be fulfilled by the treaty alone. Under these facultative arrangements, portions of MBIA Corp.'s liabilities are ceded on an issue-by-issue basis. MBIA Corp. may also use facultative arrangements as a means of managing its exposure to single issuers or counterparties to comply with regulatory and rating agency requirements, as well as internal underwriting and portfolio management criteria.

### First Loss Facultative Cessions

Under these contracts, MBIA Corp. cedes policy specific exposure facultatively on a first dollar of loss basis to mostly unauthorized reinsurers. These cessions relate to insured obligations backed by diversified pools of receivables with very low loss severity expectations. The Company's objective in entering into these facultative cessions is to increase the credit quality of its net exposure retained to meet internal underwriting guidelines.

### Special Risk Facility

The Company entered into three "Special Risk Facilities" with the three reinsurers who provided coverage under the loss portfolio transfer described further herein. Pursuant to the terms of the "Special Risk Facilities" the Company was required to cede a certain amount of premium over a maximum six year period. The agreements provided the following reinsurance protection to the Company:

<u>Reinsurer</u>	<u>Treaty</u>	<u>Cession</u>	<u>Effective Dates</u>
Zurich Reinsurance (North America), Inc. (now Converium)	Quota Share Treaty	Premium ceded equals 70% of \$145,100,000, losses proportional.	10/1/1998 To 10/1/2004
Muenchener Rueckversicherungs-Gesellschaft (Munich Re)	Third Special Risk Facility	Premium ceded must equal \$28,000,000 over 1 <sup>st</sup> 3 months, losses proportional. Ceding commission is 32.5%.	10/1/1998 To 1/1/1999
Muenchener Rueckversicherungs-Gesellschaft (Munich Re)	Second Special Risk Facility	\$70,000,000 over 6 years, 19% share assumed, losses proportional to the reinsurance cession. Ceding commission is 32.5%.	1/1/1999 To 1/1/2005
Axa Re Finance S.A. (Axa Re)	Special Semiautomatic Facultative Treaty	Premium ceded must equal \$37,000,000 over 1 <sup>st</sup> six years, losses proportional. Ceding commission is 32.5%.	10/1/1998 To 1/1/1999
Axa Re Finance S.A. (Axa Re)	Second Special Risk Facility	\$60,000,000 over 6 years, 19% share assumed, losses proportional to reinsurance cession. Ceding commission is 32.5%.	8/1/1998 To 8/1/2004

The Company fulfilled its obligations to Munich Re and AXA Re prior to December 31, 2003. The remaining facility (“Converium”) was in effect at December 31, 2003. The Company’s fulfilled its obligations under this facility in 2004.

#### Loss Portfolio Transfer

During the third quarter of 1998, MBIA Corp. incurred a significant loss caused by the bankruptcy of Allegheny Health, Education and Research Foundation (“AHERF”). The Company gross, undiscounted exposure for the AHERF bond issue was \$497.1 million. While the Company’s expected loss was partially mitigated by quota share reinsurance, the Company entered into a loss portfolio transfer

with three reinsurers to cover its net remaining exposure for the loss, pursuant to the terms of “Special Per Occurrence Excess of Loss Reinsurance Agreements”. The agreements called for the loss portfolio reinsurers to pay the Company \$170,000,000 at the inception of the agreement, which represented the discounted value of MBIA Corp’s expected net loss, in return for a consideration of \$3,500,000. In addition, the Company agreed to cede future business to the loss portfolio transfer reinsurers over the next six years under the terms of the “Special Risk Facility” (“SRF”) described above. Subsequent to the examination date, in 2004, the AXA SRF was cancelled and the Company and was reimbursed for the remaining unearned premium.

The Company reported the transaction as a loss portfolio transfer in its 1998 filed annual statement, pursuant to the reporting requirements set forth in Department Regulation 108. However, it appears that it should have been treated as a non-complying loss portfolio transfer under Department Regulation 108.

Part 112.5(e) of Department Regulation 108 provides as follows:

“The agreement shall constitute the entire contract between the parties, and must provide no guarantees of any kind to the transferee by or on behalf of the transferer, whether directly, by side agreement, or otherwise”.

The agreement to cede future business under the terms of the “Special Risk Facility” over six years constitutes a side agreement to the loss portfolio transfer. It appears that the intent of the “Special Risk Facility” was to compensate the reinsurers with profitable business, on a going forward basis, for the \$170,000,000 in losses paid by the reinsurers at the inception of the loss portfolio transfer. Furthermore, the Company failed to disclose the full nature and extent of the agreements with its reinsurers in financial statements filed with this Department.

Part 112.7 of Department Regulation 108 provides that:

“Loss portfolio transfers executed or entered into after November 30, 1984 that do not comply with section 112.5 of this Part, shall be reported in annual and interim statements, filed in New York, so that the consideration paid by the transferer for any such transaction shall be recorded as a deposit and reported as a nonadmitted asset in exhibit 1 of the annual and interim statements, with no deduction made from loss and loss adjustment expense reserves”.

Thus, the Company should have accounted for this agreement as a non-complying loss portfolio transfer. Furthermore, it appears that the intent of the Special Risk Facilities was to generate a profit for losses sustained by the loss portfolio transfer reinsurers under the AHERF agreement. As such, it appears that these prospective agreements do not meet the risk transfer requirements for reinsurance agreements as set forth in Chapter 22 of the Accounting Practices and Procedures Manual published by the National Association of Insurance Commissioners.

The financial statements included in this report reflect the loss portfolio transfer as a non-complying loss portfolio transfer pursuant to the provisions of Part 112.7 of Department Regulation 108. The loss reimbursement received in advance by MBIA Corp. has been treated as a liability in this report to the extent it applies to the unpaid AHERF loss at December 31, 2003. Additionally, the “Special Risk Facilities” have been accounted for using deposit accounting. It is recommended that the Company account for the loss portfolio transfer in accordance with Part 112.7 of Department Regulation 108 and for the “Special Risk Facilities” using deposit accounting. Furthermore, it is recommended that the Company refile its December 31, 2004 annual statement with this Department and reflect the proper statutory accounting for both the loss portfolio transfer and the related “Special Risk Facilities”.

#### Unauthorized Reinsurance

The trust agreements and letters of credit obtained by the Company in order to take credit for cessions made to unauthorized reinsurers were reviewed for compliance with Department Regulations 114 and 133, respectively. No exceptions were noted.

D. Holding Company System

The Company is a wholly-owned subsidiary of MBIA Inc.

A review of the holding company registration statements filed with this Department indicated that such filings were complete and were filed in a timely manner pursuant to Article 15 of the New York Insurance Law and Department Regulation 52.

The chart of the holding company system at December 31, 2003, is attached to this report as Exhibit A.

At December 31, 2003, the Company was party to the following agreements with other members of its holding company system:

Tax Allocation Agreement

The Company participates in a tax allocation agreement with its parent company and members of its holding company group. A formal agreement was executed and submitted to the Department, pursuant to Department Circular Letter No. 33 (1979). The agreement was effective January 1, 1987, and was amended numerous times to add various participants and to change various terms and conditions.

Investment Management Agreement

The Company entered into an investment services agreement with MBIA Capital Management Corp. effective April 28, 1995. Pursuant to the terms of the agreement, MBIA Capital Management Corp. provides various services relative to the management of the Company's investment activities. The agreement was amended numerous times to change various terms and conditions. The agreement and all amendments were submitted to the Department pursuant to Section 1505 of the New York Insurance Law.

Repurchase Agreements between MBIA Corp., MBIA Inc and MBIA Investment Management Corp.

The Company entered into a simultaneous repurchase agreement and reverse repurchase agreement with MBIA Inc., its parent company and MBIA Investment Management Corp. effective June 25, 1996. The agreements were put in place to allow the Company to enter into transactions with MBIA Inc. or MBIA Investment Management Corp. for the sale of certain securities subject to the right of repurchase and the purchase of certain securities subject to the right of repurchase. The agreements were submitted to the Department pursuant to Section 1505 of the New York Insurance Law.

Management Agreement between MBIA Corp. and CapMac

The Company entered into a management agreement with CapMac effective January 31, 2000. Pursuant to the terms of the agreement, MBIA Corp. provides all administrative, production, accounting and claim services on behalf of CapMac. The agreement was submitted to the Department pursuant to Section 1505 of the New York Insurance Law.

Management Agreement between MBIA Corp. and MBIA Insurance Corp. of Illinois

The Company entered into a management agreement with MBIA Illinois effective January 31, 2000. Pursuant to the terms of the agreement, MBIA Corp. provides all administrative, production, accounting and claim services on behalf of MBIA Illinois. The agreement was submitted to the Department pursuant to Section 1505 of the New York Insurance Law.

Advances Agreement between MBIA Corp. and MBIA Inc.

Effective January 1, 2001 MBIA Corp. and MBIA Inc. and all affiliates entered into an advances agreement. Pursuant to the terms of the agreement, MBIA Corp. may make advances of funds to any affiliate. Any advanced funds are repayable on demand, together with any accrued interest. The agreement was filed with Department pursuant to Section 1505 of the New York Insurance Law.

Reinsurance Agreement with CapMac

Effective April 1, 1998, the Company entered into a reinsurance agreement with CapMac. Pursuant to the terms of the agreement, MBIA Corp. assumed 100% of CapMac's net insured exposure as well as its unearned premiums and contingency reserves. The agreement was filed with the Department pursuant to Section 1505 of the New York Insurance Law.

Reinsurance Agreement with MBIA Illinois

Effective January 1, 1999, the Company entered into a reinsurance agreement with MBIA Illinois. Pursuant to the terms of the agreement, MBIA Corp. assumed 100% of MBIA Illinois' net insured exposure as well as its unearned premiums and contingency reserves. The agreement was filed with the Department pursuant to Section 1505 of the New York Insurance Law.

E. Abandoned Property Law

Section 1316 of the New York Abandoned Property Law provides that amounts payable to a resident of this state from a policy of insurance, if unclaimed for three years, shall be deemed to be abandoned property. Such abandoned property shall be reported to the comptroller on or before the first day of April each year. Such filing is required of all insurers regardless of whether or not they have any abandoned property to report.

The Company's abandoned property reports for the period of this examination were all filed on a timely basis pursuant to the provisions of Section 1316 of the New York Abandoned Property Law.

F. Significant Operating Ratios

The following ratios have been computed as of December 31, 2003, based upon the results of this examination:

Net premiums written to surplus as regards policyholders	.279 to 1
Liabilities to liquid assets (cash and invested assets less investments in affiliates)	65.05%
Premiums in course of collection to surplus as regards policyholders	0.78%

All of the above ratios fall within the benchmark ranges set forth in the Insurance Regulatory Information System of the National Association of Insurance Commissioners.

The underwriting ratios presented below are on an earned/incurred basis and encompass the four-year period covered by this examination:

	<u>Amounts</u>	<u>Ratios</u>
Losses and loss adjustment expenses incurred	\$217,922,582	10.22%
Other underwriting expenses incurred	441,032,246	20.69
Net underwriting gain	<u>1,472,302,827</u>	<u>69.09</u>
Premiums earned	<u>\$2,131,257,655</u>	<u>100.00%</u>

G. Accounts and Records

Real Estate

Statements of Statutory Accounting Principles (“SSAP”) No. 40 of the NAIC Accounting Practices and Procedures Manual states, in part:

“...If market quotes are unavailable, estimates of fair value shall be determined by an appraisal (internal or third party), which is based upon an evaluation of all relevant data about the market...” As of May 5, 2003 the company’s home office was appraised at a value of \$68,550,000. On its 2003 annual statement the Company reported an asset for real estate in the amount of \$87,511,026. Accordingly, the real estate balance reported on the 2003 annual statement exceeded the appraised value by \$18,961,026.

It is recommended that the Company comply with SSAP No. 40 and properly record the value of its real estate on all future financial statements filed with this Department.

Subsequent to the examination date the Company's home office was reappraised. As of March 15, 2005, the value of the Company's home office was appraised at a value of \$88,000,000, which supports the book/adjusted carrying value of real estate of \$86,953,806, as reported on the March 31, 2005 quarterly statement.

#### Investment Accounting and Oversight

##### US Airways Pass Thru Certificates

MBIA incorrectly reported \$98,363,189 fair value of U.S. Airways pass-through certificates (CUSIP 90332UAN3) and sub-totaled them with "single class mortgage-backed/asset-backed securities - US government" in Schedule D-Part 1 of its 2003 annual statement. These securities are neither issued nor insured by the U.S. Government or any of its agencies.

The Company's explanation for the incorrect classification of U.S. Airways pass-through certificates (above) was that it was a "manual error" resulting from the name beginning with "US". (The Company had nine securities beginning with "US" in its 2003 Schedule D – Part 1). Although only one security, given the distressed nature of the credit and the Company's insured exposure to other U.S. Air-related debt, including losses sustained on US Airways 1998-1 Repackaging Trust, this explanation is inadequate.

The US Airways 1998-1 Repackaging Trust loss (described in further detail in section 4 herein) was represented to the examiners as an "investment". However, the Company was unable to provide any documentation or supporting arguments for such a representation.

In addition, the Company misclassified \$279 million of trust preferred and perpetual securities. While such securities are designed to arbitrage the separate regulatory, accounting, tax, and rating agency distinctions between “debt” and “capital”, the Company said the investment function was aware of the junior nature of these securities when acquired. However, the accounting function failed to classify them as such. Additionally, the Securities Valuation Office of the NAIC Practices and Procedures Manual and the NAIC Annual Statement Instructions provide that preferred trust securities be classified as preferred stocks and be reported in Schedule D-Part 2-Section 1 of all financial statements.

It is recommended that the Company report all preferred trust securities as preferred stocks and include them in Schedule D-Part 2-Section 1 of all future financial statements.

It is also recommended that the Company review and make improvements in its investment accounting, reporting, internal controls, and investment oversight practices and functions to prevent future misclassifications.

Separately, two lines or rows were used to describe each security in Schedule D-1. This format is neither necessary nor desirable. It is recommended that the Company avoid this presentation format in future hardcopy and electronic filings.

### 3. FINANCIAL STATEMENTS

The following compares the assets, liabilities and surplus to policyholders as determined by this examination to those reported by the Company in its December 31, 2003 filed annual statement.

<u>Assets</u>	<u>Assets</u>	<u>Examination</u> <u>Assets Not</u> <u>Admitted</u>	<u>Net Admitted</u> <u>Assets</u>	<u>Company</u> <u>Net Admitted</u> <u>Assets</u>	<u>Surplus</u> <u>Increase</u> <u>(Decrease)</u>
Bonds	\$7,851,103,417	\$0	\$7,851,103,417	\$7,851,103,417	\$
Preferred stocks	20,700,000		20,700,000	20,700,000	
Common stocks	522,818,905		522,818,905	522,818,905	
Properties occupied by the company	87,511,026		87,511,026	87,511,026	
Cash, cash equivalents and short-term investments	884,074,903		884,074,903	884,074,903	
Other invested assets	431,145,966	67,890,714	363,255,252	431,145,966	(67,890,714)
Receivable for securities	2,017,628	247,711	1,769,917	1,769,917	
Investment income due and accrued	119,637,496		119,637,496	119,637,496	
Uncollected premiums and agents' balances in the course of collection	18,868,586	8,914,034	9,954,552	9,954,552	
Amounts recoverable from reinsurers	2,285,650		2,285,650	2,285,650	
Electronic data processing equipment and software	12,694,870	10,296,789	2,398,081	2,398,081	
Furniture and equipment, including health care delivery assets	59,689	59,689			
Receivables from parent, subsidiaries and affiliates	43,235,244		43,235,244	43,235,244	
Premium deposits	207,034,745		207,034,745		207,034,745
Aggregate write-ins for other than invested assets	<u>12,264,762</u>	<u>3,859,616</u>	<u>8,405,146</u>	<u>8,405,146</u>	<u>0</u>
Total assets	<u>\$10,215,452,887</u>	<u>\$91,268,553</u>	<u>\$10,124,184,334</u>	<u>\$9,985,040,303</u>	<u>\$ 139,144,031</u>



B. Underwriting and Investment ExhibitStatement of IncomeUnderwriting Income

Premiums earned		\$2,131,257,655
Deductions:		
Losses incurred	\$182,961,185	
Loss adjustment expenses incurred	34,961,396	
Other underwriting expenses incurred	441,032,246	
Aggregate write-ins for underwriting deductions	<u>0</u>	
Total underwriting deductions		<u>658,954,827</u>
Net underwriting gain or (loss)		\$1,472,302,828

Investment Income

Net investment income earned	\$1,651,726,342	
Net realized capital gain	<u>103,280,749</u>	
Net investment gain or (loss)		<u>\$1,755,007,091</u>

Other Income

Net gain or (loss) from agents' or premium balances charged off	\$1,117	
Finance and service charges not included in premiums	0	
Aggregate write-ins for miscellaneous income	<u>4,729,916</u>	
Total other income		<u>\$4,731,033</u>
Net income before dividends to policyholders and before federal and foreign income taxes		\$3,232,040,952
Dividends to policyholders		<u>0</u>
Net income after dividends to policyholders but before federal and foreign income taxes		\$3,232,040,952
Federal and foreign income taxes incurred		<u>834,671,903</u>
Net Income		<u>\$2,397,369,049</u>



right to repay the notes and acquire them from the 1998-1 Repackaging Trust. At the same time, MBIA Corp. indicated to its reinsurers that it was making a loss payment and requested payment from its reinsurers for their proportional share of the cost of the notes. As such, it would appear that the cost of this investment is more appropriately reported as a loss settlement payment instead of an investment.

The examination change represents the reclassification of the carrying value of these notes as of December 31, 2003 from the captioned asset to a loss payment. It is recommended that the Company account for the costs associated with acquiring those securities for which it provides a financial guaranty as a loss payment.

## **5. DEPOSIT PREMIUMS**

The Company did not report an admitted asset under this caption as of December 31, 2003. This examination has established an admitted asset in the amount of \$207,034,745 for the captioned item, representing premiums ceded to certain of its reinsurers pursuant to the terms of agreements that, in the Department's view, were designed to compensate the reinsurers for losses sustained under a loss portfolio transfer. As described in Section 2C herein, it was concluded that the agreements did not meet the risk transfer requirements of Chapter 22 of the Accounting Practices and Procedures Manual ("Chapter 22") published by the National Association of Insurance Commissioners. Chapter 22, since superseded by Statement of Statutory Accounting Principals No. 62, was the authoritative accounting literature as of the effective date of the agreements.

Chapter 22 requires the following accounting for reinsurance contracts that do not qualify for reinsurance accounting (i.e., do not transfer insurance risk):

“At the outset of the reinsurance contract the net consideration paid by the ceding company (premiums less commissions or other allowances) shall be recorded as a deposit on the ceding company's books and as a liability on the assuming company's books. Throughout the life of the contract receipts and disbursements shall be recorded through the deposit/liability accounts. When the contract is completed, or when there is a loss payment in excess of the deposit, any difference between consideration and recoveries shall be recorded as other income or loss.

No deduction shall be made from the loss and loss adjustment expense reserves on the ceding company's balance sheet, schedules and exhibits”.

It is recommended that the Company account for these reinsurance agreements in accordance with Chapter 22 in future financial statements filed with this Department. This recommendation also applies to the examination adjustments set forth in items 6, 9 and 11 herein.

## **6. LOSSES**

The examination liability of \$201,051,955 is \$369,000 more than the \$200,682,955 reported by the Company as of December 31, 2003. The adjustment to the liability represents the amount of reinsurance credit reflected by the Company for losses ceded pursuant to certain prospective reinsurance agreements that were determined not to meet the risk transfer requirements for reinsurance accounting treatment. As such, the Company is not permitted to reduce any of its liabilities for cessions under these agreements, pursuant to the provisions of Chapter 22 of the Accounting Practices and Procedures Manual, as explained in Section 5 herein.

## **7. LOSS ADJUSTMENT EXPENSES**

Statement of Statutory Accounting Principles (“SSAP”) No. 55 of the NAIC Accounting Practices and Procedures Manual states, in part:

“...Liabilities shall be established for any unpaid claims and unpaid losses (loss reserves), unpaid loss/claim adjustment expenses (loss/claim adjustment expense reserves) ...”

Although the Statement of Actuarial Opinion for MBIA Insurance Corporation indicates that the Company's carried reserves make a reasonable provision for all unpaid loss and loss adjustment expense obligations of the Company under the terms of its contracts and agreements, the Company does not report any amount for loss adjustment expenses.

It is recommended that the Company comply with the provisions of SSAP No. 55 and allocate a portion of its loss reserves to loss adjustment expenses on all future filed financial statements.

Examination review indicated that while the Company allocated a portion of its overhead expenses to the loss adjustment function, it failed to report such allocation in Part 3 of the Underwriting and Investment Exhibit. It is recommended that the Company follow the guidelines set forth in the NAIC Annual Statement Instructions and properly complete all exhibits and schedules in all future financial statements.

## **8. OTHER EXPENSES**

The examination liability of \$89,282,020 is \$33,285,922 less than the \$122,567,942 reported by the Company in its filed 2003 annual statement. The examination decrease represents the anticipated salvage due to the Company's reinsurers for their share of the cost of the US Airways 1998-1 Repackaging Trust Notes.

Upon receipt from its reinsurers for their proportional share of the cost of the US Airways 1998-1 Repackaging Trust Notes, the Company, rather than reducing its cost of such notes, established a liability to the reinsurers for their share of future lease payments that would be made to MBIA Corp. by US Airways under the terms of such notes. Since the examination financial statements reflect the

reclassification of the cost of such notes as a loss payment, the recoveries received from the reinsurers have been classified as ceded loss payments.

#### **9. UNEARNED PREMIUMS**

The examination liability of \$3,241,148,071 is \$174,504,999 more than the \$3,066,643,072 reported for by the Company in its December 31, 2003 filed annual statement. The examination adjustment represents the unearned premium credit taken by the Company for certain reinsurance agreements that were determined not to transfer risk, as set forth in item 5 herein.

#### **10. CONTINGENCY RESERVES**

The examination liability of \$2,436,052,351 is \$67,828,786 more than the \$2,368,223,565 reported by the Company in its December 31, 2003, filed annual statement. The examination adjustment represents the contingency reserve credit taken by the Company for certain reinsurance agreements that were determined not to transfer risk, as set forth in item 6 herein.

#### **11. FUNDS HELD BY COMPANY UNDER NON-COMPLYING LOSS PORTFOLIO TRANSFER**

The Company did not report a liability under this caption as of the examination date. This examination has established the captioned liability in the amount of \$166,250,000.

As described in Section 2C herein, the Company was a party to a loss portfolio in which its discounted net loss liability under the AHERF transaction was transferred to a group of insurers for a consideration of \$3.5 million. Upon examination, it was determined that this agreement did not comply with the provisions of Department Regulation 108. As such, the agreement should have been accounted for as a non complying loss portfolio transfer. The examination adjustment represents the surplus benefit

taken by the Company for erroneously accounting for this agreement as a complying loss portfolio transfer.

## 12. MARKET CONDUCT ACTIVITIES

In the course of this examination, a review was made of the manner in which the Company conducts its business and fulfills its contractual obligations to policyholders and claimants. The review was general in nature and is not to be construed to encompass the more precise scope of a market conduct investigation, which is the responsibility of the Market Conduct Unit of the Property Bureau of this Department. The general review was directed at practices of the Company in the following areas:

- A. Sales and advertising
- B. Underwriting
- C. Rating
- D. Claims and complaint handling

No problem areas were encountered.

## 13. SUBSEQUENT EVENTS

### Salvage on Tax Liens

When MBIA takes title to the underlying collateral of an insured credit under subrogation or other rights related to a claim payment, the previously expected recovery is no longer recorded as a reduction to its case basis reserve but rather the collateral is recorded as an asset on the Company's balance sheet. During the third quarter of 2004, MBIA acquired \$42 million of tax liens and recorded them in other assets, which previously represented expected recoveries within the Company's case basis loss reserves. These tax liens were acquired as a result of payments made on policies related to the Philadelphia Authority for Industrial Development and the Capital Asset Research Funding Series 1997A and Series

1998A tax lien securitizations. The balance of these tax liens at December 31, 2004 was \$34.9 million which the Company expects to collect as a result of future redemptions.

The Company has recorded the right to receive the proceeds of the tax liens as if the proceeds were actually received. The Company's estimate of these proceeds were reported as salvage under the caption "Other assets". The Company also recorded this transaction in Schedule P as if all salvage was actually received in its 2004 filed annual statement.

Paragraph 12 of SSAP No. 55 states:

"If a reporting entity chooses to anticipate salvage and subrogation recoverables, the recoverables shall be deducted from the liability for unpaid claims or losses".

It is recommended that the Company comply with SSAP 55 and properly record salvage receivable as a reduction to loss reserves. Subsequent to the examination date, and beginning in its June 30, 2005 filed quarterly statement, the Company properly reclassified the salvage relating to the tax liens.

#### Hurricane Katrina Exposure

The Company's total Public Finance net exposure to the Federal Emergency Management Agency ("FEMA") designated counties and parishes in Alabama, Louisiana and Mississippi is approximately \$3.3 billion.

The Company's total Structured Finance net exposure for the states of Alabama, Louisiana and Mississippi is \$1.7 billion. It should be noted that adequate insurance coverage is required on all pool collateral in the Manufactured Housing sector and all Student Loans are guaranteed by the Department of Education as part of the Federal Family Education Loan Program.

#### 14. ASSURANCE OF DISCONTINUANCE AND STIPULATION

As part of the resolution of this examination, the Company and its parent, MBIA Inc., entered into an Assurance of Discontinuance with the Attorney General of the State of New York and a Stipulation with the New York State Insurance Department wherein management agreed to utilize the services of an independent consultant to review certain transactions and procedures that were not fully addressed during the course of this examination. This examination report does not include any findings of the consultant's review.

#### 15. COMPLIANCE WITH PRIOR REPORT ON EXAMINATION

The prior report on examination contained thirteen comments and recommendations as follows

(page numbers refer to the prior report):

<u>ITEM</u>	<u>PAGE NO.</u>
A. <u>Reinsurance</u>	
i. It is recommended that the Company restate its contingency reserve account to reflect the reinsurance credit taken on such liability in accordance with annual statement instructions, Schedule F – Part 8.	13
The Company has complied with this recommendation.	
B. <u>Holding Company System</u>	
<u>Tax Allocation Agreement</u>	
i. It is recommended that the Company comply with Sections 4(b) and (c) of its tax allocation agreement.	16
The Company has complied with this recommendation.	
ii. It is further recommended that the tax allocation agreement be revised to specifically indicate the names of all participating entities and their direct responsibilities.	16
The Company has complied with this recommendation.	
<u>Investment Management Agreement</u>	

<u>ITEM</u>	<u>PAGE NO.</u>
<p>i. It is recommended that the Company submit the revised fee for review and non-disapproval pursuant to Section 1505(d) (3) of the New York Insurance Law.</p> <p>The Company has complied with this recommendation.</p> <p><u>Advances to Parent</u></p>	17
<p>i. It is recommended that the Company formalize any and all agreements with members of its holding company system.</p> <p>The Company has complied with this recommendation.</p>	19
<p>ii. It is recommended that the Company be compensated for any lost investment income.</p> <p>The Company has complied with this recommendation.</p> <p><u>Settlement of Inter-Company Balances</u></p>	19
<p>i. It is recommended that the Company comply with Department Circular Letter 15 (1975).</p> <p>The Company has complied with this recommendation.</p>	19
<p>ii. It is recommended that all inter-company balances be settled in a timely manner.</p> <p>The Company has complied with this recommendation.</p>	19
<p>C. <u>Abandoned Property Law</u></p>	
<p>i. It is recommended that the Company annually submit abandoned property reports to the State Comptroller in accordance with Section 1316 of the Abandoned Property Law.</p> <p>The Company has complied with this recommendation.</p>	20
<p>D. <u>Accounts and Records</u></p>	
<p>i. <u>Loans to MBIA Inc.</u></p> <p>It is recommended that the Company comply with Section 1411(a) of the New York Insurance Law which requires that loans be approved and authorized by the Company's board of directors.</p> <p>The Company has complied with this recommendation.</p>	21

<u>ITEM</u>	<u>PAGE NO.</u>
E. <u>Disaster Recovery Plan</u>	
i. It should be noted that as reported in the report of the previous statutory examination, it was recommended that the Company formalize a plan but such recommendation was not given the required emphasis and importance it deserved. It is strongly recommended that the Company place high priority on this project and develop and establish a written plan that would enable its personnel to respond effectively to an incident that may disrupt normal business activities and system processings. Once this plan is established, the Company should perform periodic testing to ensure that formulated procedures will operate as intended.	21

The Company has complied with this recommendation.

F. <u>Loss Adjustment Expenses</u>	
i. It is recommended that the Company follow the guidelines set from NAIC Annual Statement Instructions and property complete all exhibits and schedules in all future financial statements.	28
ii. It is recommended that the Company allocate a percentage of its operating expenses that are associated with the handling, adjustment and recording of losses to its loss adjustment expense item account.	

The Company has not complied with this recommendation and the recommendation is repeated in this report.

## **16. SUMMARY OF COMMENTS AND RECOMMENDATIONS**

<u>ITEM</u>	<u>PAGE NO.</u>
A. <u>Reinsurance</u>	
i. It is recommended that the Company report all transactions with its reinsurers in Schedule F on all future financial statements filed with the Department.	7
ii. It is recommended that the Company account for the loss portfolio transfer in accordance with Part 112.7 of Department Regulation 108.	12
iii. It is further recommended that the Company account for the “Special Risk Facilities” using deposit accounting.	12
iv. It is recommended that the Company refile its December 31, 2004 annual statement with this Department and reflect the proper statutory accounting for both the loss portfolio transfer and the related “Special Risk Facilities”.	12

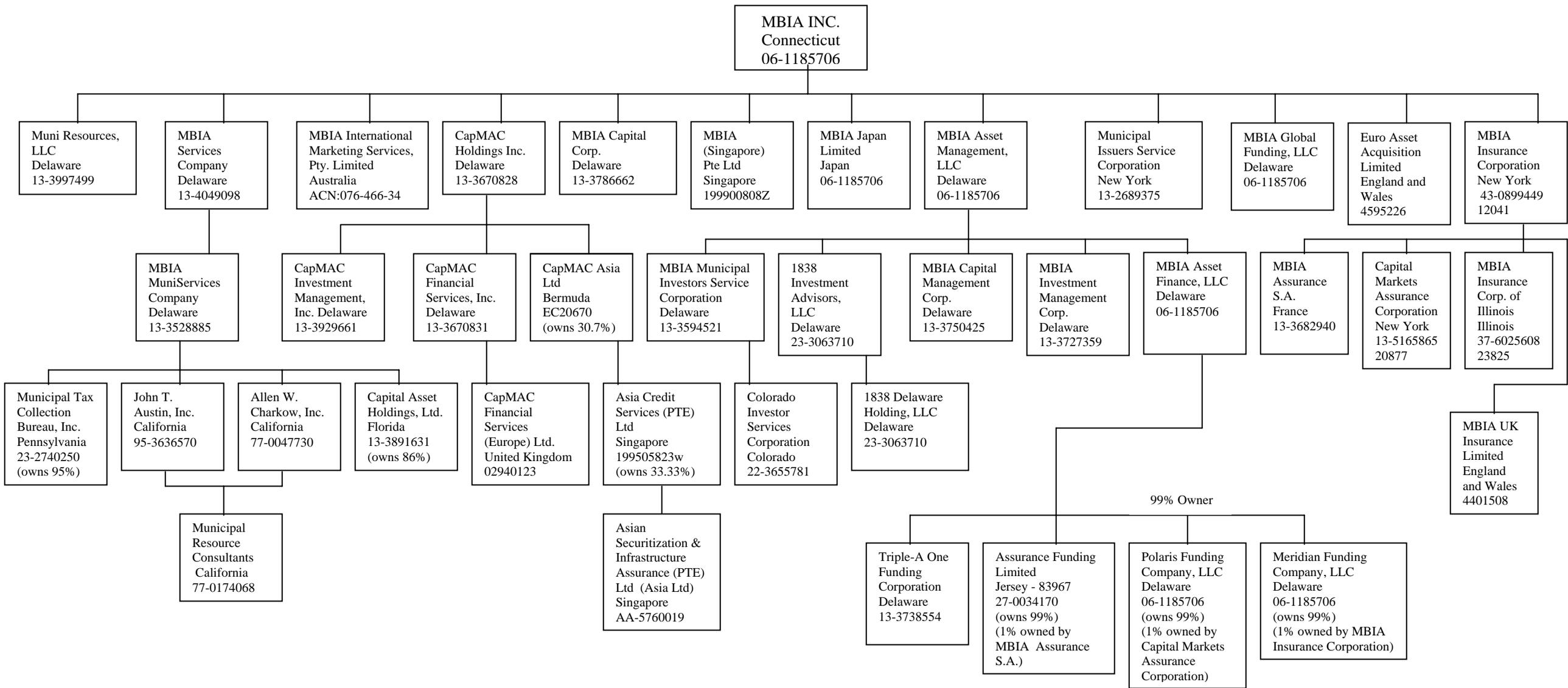
<u>ITEM</u>		<u>PAGE NO.</u>
B.	<u>Accounts and Records</u>	
	<u>Real Estate</u>	
i.	It is recommended that the Company comply with SSAP No. 40 and properly record the value of its real estate.	17
	<u>US Airways Pass Thru Certificates</u>	
i.	It is recommended that the Company report all preferred trust securities as preferred stocks and include them in Schedule D-Part2-Section 1 of all future financial statements.	18
ii.	It is also recommended that the Company review and make improvements in its investment accounting, reporting, internal controls, and investment oversight practices and functions to prevent future misclassifications.	18
iii.	Separately, two lines or rows were used to describe each security in Schedule D-1. This format is neither necessary nor desirable. It is recommended that the Company avoid this presentation format in future hardcopy and electronic filings.	18
C.	<u>Other Invested Assets</u>	
i.	It is recommended that the Company account for the costs associated with acquiring those securities for which it provides a financial guaranty as a loss payment.	23
D.	<u>Deposit Premiums</u>	
i.	It is recommended that the Company account for these reinsurance agreements in accordance with Chapter 22 in future financial statements filed with this Department. This recommendation also applies to the examination adjustments set forth in items 6, 9 and 11 herein.	24
E.	<u>Loss Adjustment Expenses</u>	
i.	It is recommended that the Company comply with the provisions of SSAP No. 55 and allocate a portion of its loss reserves to loss adjustment expenses on all future filed financial statements.	25
ii.	It is recommended that the Company follow the guidelines set forth in the NAIC Annual Statement Instructions and properly complete all exhibits and schedules in all future financial statements.	25

ITEMPAGE NO.F. Salvage on Tax Liens

It is recommended that the Company comply with SSAP 55 and properly record salvage receivable as a reduction to loss reserves.

28

Subsequent to the examination date, and beginning in its June 30, 2005 filed quarterly statement, the Company properly reclassified the salvage relating to the tax liens.



Respectfully submitted,

\_\_\_\_\_/S/  
James Murphy  
Associate Insurance Examiner

STATE OF NEW YORK    )  
                                  )SS:  
                                  )  
COUNTY OF NEW YORK )

James Murphy, being duly sworn, deposes and says that the foregoing report, subscribed to by him, is true to the best of his knowledge and belief.

\_\_\_\_\_/S/  
James Murphy

Subscribed and sworn to before me

this \_\_\_\_\_ day of \_\_\_\_\_, 2005.

State of \_\_\_\_\_  
County of \_\_\_\_\_

EXAMINER'S AFFIDAVIT AS TO STANDARDS AND PROCEDURES  
USED IN AN EXAMINATION

I, VINCENT RAPACCIUOLO, BEING DULY SWORN, STATES AS FOLLOWS:

1. I have authority to represent the State of Mississippi in the examination of MBIA Insurance Corporation.
2. Mississippi is accredited under the National Association of Insurance Commissioners Financial Regulation Accreditation Standards.
3. I have reviewed the examination work papers and examination report and the examination of MBIA Insurance Corporation was performed in a manner consistent with the standards and procedures required by the State of Mississippi.

The affiant says nothing further.

JS  
\_\_\_\_\_  
Examiner's Signature

Subscribed and sworn before me by JOSE GUESON on this 26<sup>th</sup> day of October 2005.

JS  
\_\_\_\_\_  
Notary Public

My commission expires \_\_\_\_\_

JOSE T. GUESON  
NOTARY PUBLIC, State of New York  
No. 01GU4951406  
Qualified in Queens County  
Commission Expires May 22, 2007

State of New York  
County of \_\_\_\_\_

EXAMINER'S AFFIDAVIT AS TO STANDARDS AND PROCEDURES  
USED IN AN EXAMINATION

I, TIMOTHY GADLER, BEING DULY SWORN, STATES AS FOLLOWS:

1. I have authority to represent the State of Nevada in the examination of MBIA Insurance Corporation.
2. Nevada is accredited under the National Association of Insurance Commissioners Financial Regulation Accreditation Standards.
3. I have reviewed the examination work papers and examination report and the examination of MBIA Insurance Corporation was performed in a manner consistent with the standards and procedures required by the State of Nevada.

The affiant says nothing further.

[Signature]  
Examiner's Signature

Subscribed and sworn before me by JOSE GUESON on this 26<sup>th</sup> day of OCTOBER 2005.

[Signature]  
Notary Public

My commission expires 5/22/07

JOSE T. GUESON  
NOTARY PUBLIC, State of New York  
No. 01GU4951406  
Qualified in Queens County  
Commission Expires May 22, 2007

Appointment No 22396

STATE OF NEW YORK  
INSURANCE DEPARTMENT

I, HOWARD MILLS, Superintendent of Insurance of the State of New York,  
pursuant to the provisions of the Insurance Law, do hereby appoint:

**James Murphy**

*as proper person to examine into the affairs of the*

**MBIA INSURANCE CORPORATION**

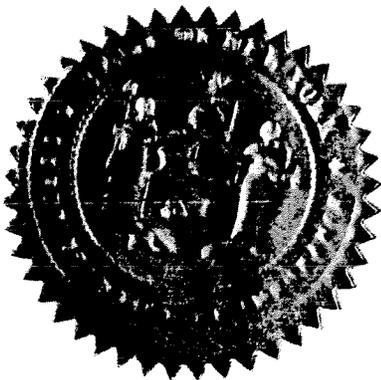
*and to make a report to me in writing of the condition of the said*

**Corporation**

*with such other information as she shall deem requisite.*

*In Witness Whereof, I have hereunto subscribed by the  
name and affixed the official Seal of this Department, at  
the City of New York,*

*this 8th day of August, 2005*



*Howard Mills*

HOWARD MILLS

Superintendent of Insurance