

ASSOCIATION REPORT ON EXAMINATION
OF THE
FINANCIAL GUARANTY INSURANCE COMPANY
AS OF
DECEMBER 31, 2004

ZONES
REPRESENTED

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STATES
PARTICIPATING

NEW YORK
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EXAMINERS

FE ROSALES
JAMES O'SULLIVAN



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

Honorable Mike Pickens
Chairman, Executive Committee
Commissioner of Insurance
State of Arkansas

November 10, 2005

Honorable Janie Miller
Chairman, Southeastern Zone
Commissioner of Insurance
State of Kentucky

Honorable Howard Mills
Superintendent of Insurance
State of New York

Honorable Mike Kreidler
Chairman, Western Zone
State of Washington

Sirs:

Pursuant to your instructions the examination has been made into the condition and affairs of the Financial Guaranty Insurance Company hereinafter referred to as "the Company", at its administrative office located at 125 Park Avenue, New York, NY 10017.

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

The report on examination is respectfully submitted.

REPORT ON EXAMINATION

OF THE

FINANCIAL GUARANTY INSURANCE COMPANY

AS OF

DECEMBER 31, 2004

DATE OF REPORT

NOVEMBER 10, 2005

EXAMINER

FE ROSALES, CFE

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

November 10, 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 22373 dated May 13, 2005 attached hereto, I have made an examination into the condition and affairs of Financial Guaranty Insurance Company as of December 31, 2004, and submit the following report thereon.

Wherever the designations "the Company" or "FGIC" appear herein without qualification, they should be understood to indicate Financial Guaranty Insurance Company.

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 125 Park Avenue, New York, New York 10017.

1. SCOPE OF EXAMINATION

The previous examination was conducted as of December 31, 1999. This examination covered the five-year period from January 1, 2000 through December 31, 2004. 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, 2004. 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

On April 10, 1972, Switzerland General Insurance Company of New York (“SGICNY”) was incorporated under the laws of New York to serve as the corporate vehicle in the domestication of the United States Branch of the Switzerland General Insurance Company, Ltd., Zurich, Switzerland, which had entered the United States through the State of New York in 1872. SGICNY was licensed on June 6, 1972, and the domestication became effective as of July 1, 1972.

In October 1982, Christiania General Insurance Corporation of New York obtained control of the Company. The Company’s name changed to Tarrytown Insurance Company (“Tarrytown”) on July 12, 1983.

On October 31, 1983, Christiania General Insurance Corporation of New York sold Tarrytown to FGIC Corporation, a Delaware domiciled holding company, which then changed the Company’s name to Financial Guaranty Insurance Company (“FGIC”).

On December 18, 2003, an investor group consisting of The PMI Group, Inc (“PMI”), affiliates of the Blackstone Group L.P. (“Blackstone”), affiliates of the Cypress Group, L.L.C (“Cypress”) and affiliates of CIVC Partners L.P. (“CIVC”) completed the acquisition of FGIC Corporation from a subsidiary of General Electric Capital Corporation. PMI is the largest stockholder of FGIC Corporation, owning approximately 42% of its common stock at December 31, 2004. Blackstone, Cypress and CIVC own approximately 23%, 23% and 7% of FGIC Corporation’s common stock, respectively, at December 31, 2004.

At December 31, 2004, the Company’s paid-in capital of \$15,000,000 consisted of 10,000 common shares at \$1,500 par value per share. All authorized shares are outstanding. Gross paid in and contributed surplus increased by \$25,000,000 during the examination period, as follows:

| <u>Year</u> | <u>Description</u> | <u>Amount</u> |
|-------------|---|----------------------|
| 1999 | Beginning gross paid in and contributed surplus | \$383,511,360 |
| 2004 | Surplus contribution | <u>25,000,000</u> |
| 2004 | Ending gross paid in and contributed surplus | <u>\$408,511,360</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-one members. The board met at least three times during each calendar year. At December 31, 2004, the board of directors was comprised of the following thirteen members:

| <u>Name and Residence</u> | <u>Principal Business Affiliation</u> |
|--|--|
| Jon M. Barnwell New York, NY | Principal, The Blackstone Group |
| Frank J. Bivona Franklin Lakes, NJ | Chief Executive Officer, Financial Guaranty Insurance Company |
| Chinh E. Chu Cold Spring Harbor, NY | Senior Managing Director, The Blackstone Group |
| W. Roger Haughton Alamo, CA | Chairman & Chief Executive Officer, The PMI Group, Inc. |
| Daniel G. Helle Kenilworth, IL | Partner, CIVC Partners LP |
| Jeffrey P. Hughes New York, NY | Vice Chairman, The Cypress Group LLC |
| Ann F. Kaplan New York, NY | Chairman, Circle Financial Group |
| Harold Philipps Miami, FL | Retired Managing Director, Donaldson, Lufkin and Jenrette |
| John D. Roach Dallas, TX | Chairman / Chief Executive Officer, Stonegate International |

| <u>Name and Residence</u> | <u>Principal Business Affiliation</u> |
|---|--|
| Steven L. Scheid Paradise Valley, AZ | Chairman / Chief Executive Officer, Janus |
| Bradley M. Schuster Piedmont, CA | President / Chief Executive Officer, The PMI Group, Inc. – PMI Capital Corporation |
| L. Stephen Smith Alamo, CA | President / Chief Executive Officer, The PMI Group, Inc. – PMI Mortgage Insurance Co. |
| William L. Spiegel New York, NY | Managing Director, The Cypress Group, Inc. |

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, 2004, the principal officers of the Company were as follows:

| <u>Name</u> | <u>Title</u> |
|--------------------|-------------------------|
| Frank J. Bivona | Chief Executive Officer |
| Howard C. Pfeffer | President |
| A. Edward Turi III | Secretary |
| Donna J. Blank | Treasurer |

i. Conflicts of Interest

The Company's procedure for the disclosure of conflicts of interest by its directors, officers and key employees as of the examination date was reviewed. It should be noted that the examiners did not receive copies of conflict of interest statements completed by FGIC's directors, as follows:

| <u>YEAR</u> | <u>NUMBER OF DIRECTORS</u> |
|-------------|----------------------------|
| 2000 | 9 |
| 2001 | 7 |
| 2002 | 10 |
| 2003 | 12 |
| 2004 | 12 |

It is recommended that the Company ensure that all directors, officers and key employees complete conflict of interest statements on a yearly basis.

B. Territory and Plan of Operation

As of December 31, 2004, the Company was licensed to write business in all fifty states, the District of Columbia, Puerto Rico, United Kingdom and France.

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 (C, D, E and F) | Fidelity and surety |
| 17(A) | 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 Premiums</u> |
|----------------------|-----------------------|----------------------------|---|
| 2000 | \$32,690,626 | \$102,323,364 | 31.95% |
| 2001 | \$42,623,617 | \$154,553,300 | 27.58% |
| 2002 | \$71,457,250 | \$232,578,828 | 30.72% |
| 2003 | \$60,852,161 | \$260,324,200 | 23.38% |
| 2004 | \$62,594,681 | \$323,574,515 | 19.34% |

The Company writes only financial guaranty insurance, guaranteeing the scheduled payments of principal and interest on issuers' obligations.

FGIC provides financial guaranty for public finance and structured finance obligations. For public finance obligations, FGIC provides credit enhancement solutions that enable state and local issuers to reduce their borrowing costs and enhance their access to the capital markets. For structured finance obligations, FGIC provides credit enhancement solutions for a broad range of global issuers in the structured finance market, including asset managers and financial institutions. FGIC's financial guaranty enables issuers to reduce their financing costs, helps investment bankers to structure and execute transactions more efficiently and effectively, and provides added liquidity for investors.

During 2004, approximately 75% of the Company's gross premiums written were for public finance obligations (municipal bonds). The remainder was principally for structured finance (mortgage backed and other asset-backed non-municipal bonds).

C. Reinsurance

Assumed

As of the examination date, the Company did not assume any reinsurance business. However, the Company entered into two assumed reinsurance agreements in 2004 with its affiliate FGIC UK Ltd. These quota share reinsurance and excess of loss reinsurance agreements became effective March 31, 2004. The Company indicated that there were no reinsurance transactions in 2004 that occurred under these two contracts. Refer to Section D – Holding Company System for the detailed write-up.

Ceded

The Schedule F data as contained in the Company's filed annual statement did not accurately reflect its reinsurance transactions. Reinsurance recoverable on paid losses reported in Schedule F – Part 3 as of December 31, 2004 in the amount of (\$136,554), was misstated due to charged-off items that were not booked as of year-end. Based on the supporting documentation provided by the Company, \$66,334 represents the amount that should have been reflected in Schedule F and on page 2, line 13.1 -Amounts recoverable from reinsurers - of the 2004 annual statement. Although this amount is immaterial to surplus and no balance sheet change will be made, the Company must reflect the correct balances in its annual statement filed with the Department.

It is recommended that the Company ensure that reconciliation of balances between reinsurers and the Company's books are performed and reviewed on a timely basis and that the Company reflect the correct account balances in its filed annual statement.

The examiner reviewed all ceded reinsurance contracts in effect at December 31, 2004. Except as noted herein, the contracts all contained the required standard clauses including insolvency clauses meeting the requirements of Section 1308 of the New York Insurance Law.

The Company's ceded reinsurance program in effect at December 31, 2004, consisted of facultative pro-rata reinsurance for municipal bonds and mortgage-backed and other asset-backed bonds issued that exceeded its aggregate and single risk limitations. Facultative cessions represented 100% of the Company's total premiums ceded of approximately \$9.7 million in 2004.

As of December 31, 2004, the Company had total gross bond par in force of \$261,170,432,846. Of this total, it had ceded bond par in force in the amount of \$24,393,667,577 or 9.3% of the portfolio. Out of the total ceded par, the reinsurers with the highest amounts of ceded par were the Assured

Guaranty Re International Ltd. with a total of \$9,687,125,183 and the Radian Asset Assurance, Inc. with \$8,256,125,627.

The Company also has two excess of loss agreements in force for health care and municipal electric utility exposures. These contracts were entered into in 1996. For health care exposures, the Company's retention is equal to the first \$135,000,000 in aggregate losses in excess of \$45,000,000 per hospital. For electric utility exposures, the Company's retention is equal to the first \$419,000,000 in aggregate losses. As of December 31, 2004, the total par in force insured by the health care excess of loss was \$425,133,894 and the total par in force insured by the electric utility excess of loss was \$808,461,437.

Since the prior examination, the Company did not enter into any quota share treaties. Additionally, as in the prior examination, in cases where the Company required reinsurance, facultative treaty reinsurance was obtained during the current examination period. There were no other major changes in the Company's reinsurance program since the prior examination.

Unauthorized Reinsurance

The trust agreements obtained by the Company in order to take credit for cessions made to unauthorized reinsurers were reviewed for compliance with Department Regulation 114. No exceptions were noted.

D. Holding Company System

As of December 31, 2004, the Company is a wholly-owned subsidiary of FGIC Corporation, a Delaware corporation, which in turn is owned by The PMI Group, Inc. (“PMI”).

During 2004, FGIC capitalized two wholly-owned subsidiaries, FGIC UK Ltd. and FGIC UK Services Ltd. FGIC UK Ltd. was licensed by the UK Financial Services Authority in November 2004 to write financial guaranty business in the United Kingdom and other European Union member countries. FGIC UK Services Ltd. will perform management services for both the UK branch and FGIC UK Ltd.

It is noted that FGIC has two reinsurance agreements with its affiliate FGIC UK Ltd: 1) quota share reinsurance agreement and 2) excess of loss reinsurance agreement effective March 31, 2004, which were submitted to this Department on April 8, 2004. The agreements were non-disapproved by letter dated November 3, 2004.

Section 1505(d)(2) of the New York Insurance Law states in part that:

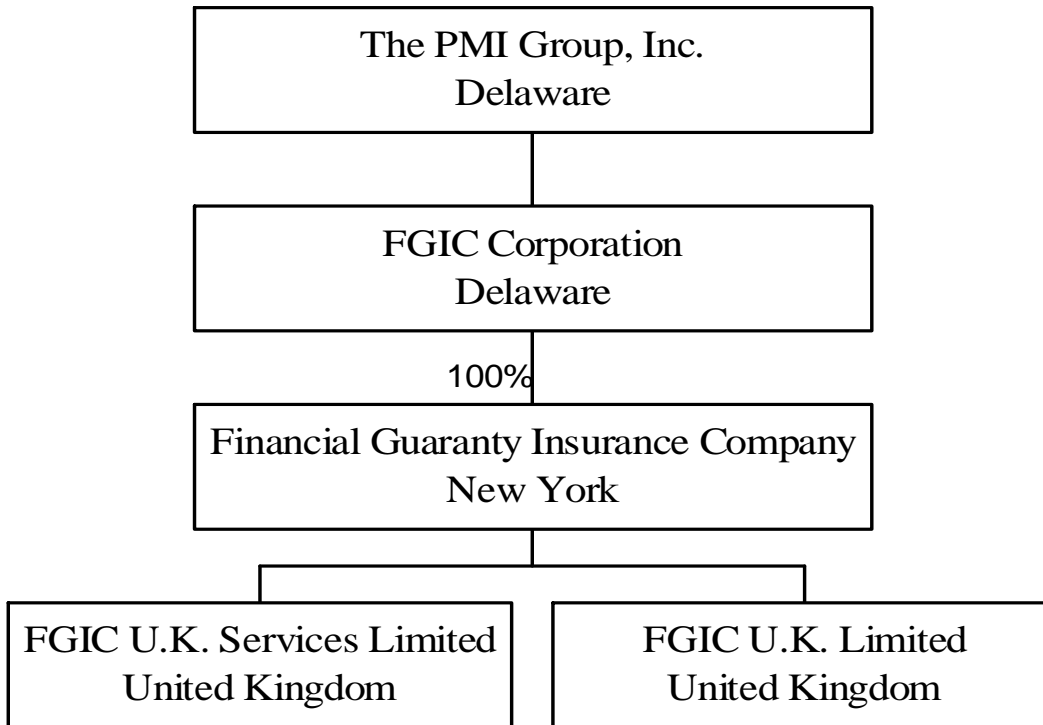
“any reinsurance treaty or contract within the holding company system may not be entered into unless the insurer has notified the superintendent in writing of its intention to enter into any such transaction at least thirty days prior thereto, or such shorter period as he may permit, and he has not disapproved it within such period”.

Since the contracts were not submitted at least 30 days prior to commencement, the Company was in violation of Section 1505(d)(2) of the New York Insurance Law. It is recommended that the Company submit to this Department any reinsurance treaty with an affiliate at least thirty days prior to commencement pursuant to the provisions of Section 1505(d)(2) of the New York Insurance Law.

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.

Pursuant to Article 15 of the New York Insurance Law, The PMI Group, Inc. is deemed to be the ultimate holding company of Financial Guaranty Insurance Company.

The following is an abbreviated chart of the holding company system at December 31, 2004:



At December 31, 2004, the Company was party to the following agreements with other members of its holding company system:

1. Federal Income Tax Allocation Agreement

The Company amended and restated its federal income tax allocation agreement with FGIC Corporation effective December 18, 2003. The agreement provides for the Company to file a consolidated income tax return with FGIC Corporation and all other subsidiaries of FGIC. The review of this agreement revealed that it is in compliance with the requirements of Department Circular Letter No. 33 (1979). This agreement was non-disapproved by this Department.

2. Space and Cost Sharing Agreement with FGIC Corporation

The Company makes available office space to FGIC Corporation. In addition, the Company and FGIC Corporation provides to each other actuarial, legal loss prevention, data processing, accounting, claims, appraisal, collection services, investment advice, technology, personnel, underwriting, risk management, surveillance, business continuity, disaster recovery and any other services related to the functions involved in the operation of the insurance business including and not limited to the business of an insurance holding company. This agreement became effective on January 1, 2004. The Department found this agreement non-objectionable.

3. Space and Cost Sharing Agreement with FGIC UK Ltd.

The Company provides actuarial, legal loss prevention, data processing, accounting, claims, appraisal, collection services, investment advice, technology, personnel, underwriting, risk management, surveillance, business continuity, disaster recovery and any other service related to the functions involved in the operation of the insurance business including and not limited to the business of an insurance holding company. This agreement became effective on November 16, 2004. The Department found this agreement non-objectionable.

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 under examination were not filed on a timely basis pursuant to the provisions of Section 1316 of the New York Abandoned Property Law. Abandoned property reports for the years ended 2003 and 2004 were filed after the due date of April 1st. Section 1316(2) of the Abandoned Property Law states in part:

"Such abandoned property shall be reported to the comptroller annually on or before the first day of April. Such report shall be in such form and manner as the comptroller may prescribe".

It is recommended that the Company file its abandoned property reports on a timely basis pursuant to the provisions of Section 1316 of the New York Abandoned Property Law.

The Company failed to provide copies of the abandoned property reports filed with the Office of the New York State Comptroller for the years 2000, 2001, and 2002 because the Company cannot locate the copies. Part 243.2 (a) of Department Regulation 152 states in part:

"...Every insurer shall maintain its claims, rating, underwriting marketing, complaint, financial, and producer licensing records, and such other records subject to examination by the superintendent, in accordance with the provisions of this Part".

As such, the Company is in violation of the records retention requirements of Regulation 152 (Part 243), Section 243.2(a) which requires the retention of this type of record for a period of six calendar years from its creation or until after the filing of the report on examination or the conclusion of the investigation in which the record was subject for review.

It is recommended that the Company comply with the record retention requirements of Department Regulation 152.

F. Significant Operating Ratios

The following ratios have been computed as of December 31, 2004, based upon the results of this examination:

| | |
|--|-----|
| Net premiums written to surplus as regards policyholders | 27% |
| Liabilities to liquid assets (cash and invested assets less investments in affiliates) | 63% |
| Premiums in course of collection to surplus as regards policyholders | 0% |

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 five-year period covered by this examination:

| | <u>Amounts</u> | <u>Ratios</u> |
|--|----------------------|----------------|
| Losses and loss adjustment expenses incurred | \$ 8,535,063 | 1.43% |
| Other underwriting expenses incurred | 206,696,876 | 34.57 |
| Net underwriting gain | <u>382,686,136</u> | <u>64.00</u> |
| Premiums earned | <u>\$597,918,075</u> | <u>100.00%</u> |

G. Accounts and Records

1) Custodian Agreement with State Street Bank

The review of the Company's custodian agreement with State Street Bank revealed that the agreement lacks one of the twelve NAIC custodian agreement provisions. The provision missing is as follows:

- a) That if the custodial agreement has been terminated or if 100% of the account assets in any one custody account have been withdrawn, the custodian shall provide written notification, within three business days of termination or withdrawal, to the insurer's domiciliary commissioner.

It was also noted that the Company's response to General Interrogatory No. 23 regarding custodian agreements was not accurately filled out.

It is recommended that the Company amend its custodian agreement to include all the protective covenants and provisions in order to comply with the requirements set forth in the NAIC Financial Condition Examiners Handbook and to Insurance Department guidelines.

It is also recommended that the Company respond accurately to General Interrogatory questions of the annual statement.

2) Certified Public Accountant ("CPA") Contract with Ernst & Young LLP

The Company retained Ernst & Young LLP as its independent certified public accountant for 2004. The review of the Company's contract with Ernst & Young for the 2004 audit revealed that the contract does not comply with the requirements specified in Section 89.2 of Department Regulation 118.

Section 89.2 states that:

"Every insurer subject to this Part shall retain an independent Certified Public Accountant (CPA) who agrees by written contract with such insurer to comply with the provisions of section 307(b) of the Insurance Law, this Part and the Code of Professional Conduct adopted by the American Institute of Certified Public Accountants (AICPA). Such contract must specify that:

(a) on or before May 31st, the CPA shall provide an audited financial statement of such insurer and of any subsidiary required by section 307(b)(1) of the Insurance Law together with an opinion on the financial statements of such insurer and any such subsidiary for the prior calendar year and an evaluation of the insurer's and any such subsidiary's accounting procedures and internal control systems as are necessary to the furnishing of the opinion;

(b) any determination by the CPA that the insurer has materially misstated its financial condition as reported to the superintendent or that the insurer does not meet minimum capital or surplus to policyholder requirements set forth in the Insurance Law shall be given by the CPA, in writing, to the superintendent within 15 calendar days following such determination; and

(c) the workpapers and any communications between the CPA and the insurer relating to the audit of the insurer shall be made available for review by the superintendent at the offices of the insurer, at the Insurance Department or at any other reasonable place designated by the superintendent. The CPA must retain for review such workpapers and communications in accordance with the provisions of Part 243 of this Title (Regulation 152). More specifically, such workpapers and communications must be retained by the CPA for the period specified in sections 243.2(b)(7) and (c) of this Title. For the purposes of this subdivision, the workpapers and communications shall be deemed to have been created on the date the filing required by section 89.2(a) of this Part was submitted to the superintendent”.

The review revealed that the contract does not contain the above provisions.

It is recommended that the Company ensure that the contract with its CPA firm complies with the requirements of Department Regulation 118.

3) Conflict of Interest – Surveillance & Underwriting

The review of the documents provided by the Company relative to the Surveillance Area and Underwriting personnel revealed that one employee who is listed as Managing Director in the Surveillance Area is also listed as Public Finance Risk Manager in the Underwriting Department in 2002.

Department guidelines require that financial guarantee insurers' surveillance function and the individuals performing this function are separate and apart from the individuals involved in underwriting decisions/operation. This is also a good business practice.

It is recommended that the Company comply with Department guidelines and segregate the duties of its employees.

H. Subsequent Events

The Company has exposures in areas affected by Hurricane Katrina. FGIC has indicated that it had insured almost \$4.13 billion (Net Par In-Force) as of September 30, 2005 of municipal debt in the region hit by Hurricane Katrina.

The Company's watch list as of September 30, 2005 included deals totaling \$977,345,378 Net Par In-Force related to Hurricane Katrina as follows:

Risk Category 1: There has been a significant event that is worthy of note and closer ongoing monitoring.

- 14 deals with \$399,262,653 Net Par In-Force.

Risk Category 2: Credit deterioration has occurred and there is a possibility of continued deterioration.

- 9 deals with \$503,082,725 Net Par In-Force.

Risk Category 3: Significant credit risk is present, but a limited margin of safety remains.

- No deals listed under this category.

Risk Category 4: Default has occurred or is highly likely. If default has not yet occurred, capacity for meeting financial commitments is highly questionable.

- One deal with \$75,000,000 Net Par In-Force.

3. FINANCIAL STATEMENTS

A. Balance Sheet

The following shows the assets, liabilities and surplus as regards policyholders as of December 31, 2004 as determined by this examination and as reported by the Company:

| <u>Assets</u> | <u>Assets</u> | <u>Assets Not Admitted</u> | <u>Net Admitted Assets</u> |
|---|------------------------|--------------------------------|--------------------------------|
| Bonds | \$2,805,929,623 | \$0 | \$2,805,929,623 |
| Preferred stocks | 19,242,285 | 0 | 19,242,285 |
| Common stocks | 38,165,768 | 0 | 38,165,768 |
| Cash, cash equivalents and short-term investments | 202,357,229 | 0 | 202,357,229 |
| Contract loans | 0 | 0 | 0 |
| Other invested assets | 10,809,930 | 0 | 10,809,930 |
| Investment income due and accrued | 36,131,921 | 0 | 36,131,921 |
| Amounts recoverable from reinsurers | (136,554) | 0 | (136,554) |
| Net deferred tax asset | 38,176,097 | 35,395,520 | 2,780,577 |
| Furniture and equipment, including health care delivery assets | 6,843,224 | 6,843,224 | |
| Receivables from parent, subsidiaries and affiliates | 485,801 | 0 | 485,801 |
| Aggregate write-ins for other than invested assets | <u>617,647</u> | <u>617,647</u> | <u>0</u> |
| Total assets | <u>\$3,158,622,971</u> | <u>\$42,856,391</u> | <u>\$3,115,766,580</u> |

Liabilities, Surplus and Other Funds

| | |
|---|--------------------|
| Losses | \$ 13,751,300 |
| Loss adjustment expenses | 1,027,351 |
| Other expenses (excluding taxes, licenses and fees) | 24,947,590 |
| Taxes, licenses and fees (excluding federal and foreign income taxes) | 3,332,268 |
| Current federal and foreign income taxes | 4,400,632 |
| Unearned premiums | 1,047,588,765 |
| Ceded reinsurance premiums payable (net of ceding commissions) | 3,826,186 |
| Payable for securities | 5,714,858 |
| Aggregate write-ins for liabilities | |
| Contingency reserves | <u>838,582,548</u> |
| Total liabilities | \$1,943,171,498 |

Surplus and Other Funds

| | |
|--|------------------------|
| Common capital stock | \$ 15,000,000 |
| Gross paid in and contributed surplus | 408,511,360 |
| Unassigned funds (surplus) | <u>749,083,721</u> |
| Surplus as regards policyholders | <u>1,172,595,081</u> |
| Total liabilities, surplus and other funds | <u>\$3,115,766,579</u> |

The Internal Revenue Service's ("IRS") audit of the Company's consolidated federal income tax returns with its former parent, General Electric Company, covering tax years 2000 through 2002 is currently in progress. The IRS has not yet performed the audit of the Company's tax returns covering tax years 2003 and 2004. The examiner is unaware of any potential exposure of the Company to any tax assessment and no liability has been established herein relative to such contingency.

B. Underwriting and Investment Exhibit

Surplus as regards policyholders decreased \$99,111,964 during the five-year examination period January 1, 2000 through December 31, 2004, detailed as follows:

Statement of Income

Underwriting Income

| | | |
|--------------------------------------|--------------------|--------------------|
| Premiums earned | | \$597,918,075 |
| Deductions: | | |
| Losses incurred | \$ 8,084,843 | |
| Loss adjustment expenses incurred | 450,220 | |
| Other underwriting expenses incurred | <u>206,696,876</u> | |
| Total underwriting deductions | | <u>215,231,939</u> |
| Net underwriting gain or (loss) | | \$382,686,136 |

Investment Income

| | | |
|--|--------------------|----------------------|
| Net investment income earned | \$607,839,189 | |
| Net realized capital gains | <u>200,346,864</u> | |
| Net investment gain or (loss) | | <u>808,186,053</u> |
| Net income before dividends to policyholders and before federal and foreign income taxes | | \$1,190,872,189 |
| Federal and foreign income taxes incurred | | <u>287,204,478</u> |
| Net income | | <u>\$903,667,711</u> |

Capital and Surplus Account

| | | | |
|--|----------------------|------------------------|------------------------|
| Surplus as regards policyholders per report on examination as of December 31, 1999 | | | \$1,271,707,045 |
| | <u>Gains in</u> | <u>Losses in</u> | |
| | <u>Surplus</u> | <u>Surplus</u> | |
| Net income | \$903,667,711 | | |
| Net unrealized capital (losses) | | \$ 4,890,330 | |
| Change in net unrealized foreign exchange capital gains | 7,928,947 | | |
| Change in net deferred income tax | 21,352,575 | | |
| Change in non-admitted assets | | 27,029,934 | |
| Change in provision for reinsurance | 25,000 | | |
| Change in surplus notes | 62,479 | | |
| Surplus (contributed to) withdrawn from protected cells | | | |
| Cumulative effect of changes in accounting principles | 1,803,187 | | |
| Surplus adjustments paid in | 25,000,000 | | |
| Dividends to stockholders | | 834,320,000 | |
| Aggregate write-ins for gains and losses in surplus | <u>0</u> | <u>192,711,599</u> | |
| Total gains and losses | <u>\$959,839,899</u> | <u>\$1,058,951,863</u> | |
| Net increase (decrease) in surplus | | | <u>(99,111,964)</u> |
| Surplus as regards policyholders per report on examination as of December 31, 2004 | | | <u>\$1,172,595,081</u> |

4. LOSSES AND LOSS ADJUSTMENT EXPENSES

The examination liability for the captioned items of \$14,778,651 is the same as reported by the Company as of December 31, 2004. The Company establishes a case basis reserve for the present value of an estimated loss when, in management's opinion, the likelihood of a future loss is probable and determinable at the balance sheet date. Pursuant to Section 6903(b) of the New York Insurance Law, financial guaranty companies are allowed to discount their loss reserves by a rate of return on the admitted assets of the insurer as of the day of the calculation of such reserves. As of the examination date, the discount to account for the time value of money included as a reduction in the Company's loss reserves was \$1,900,000. The Company discounted its loss reserves at a rate of 3.8%, which is the average pre-tax yield on admitted assets. This rate corresponds to the discount rate permitted by statute.

In addition to case reserves, the Company is required to establish and maintain contingency reserve for the protection of insureds and claimants against the effect of excessive losses occurring during adverse economic cycles. The amounts required for these reserves depend on the types of bonds being insured and are established according to Section 6903(a) of the New York Insurance Law. As of December 31, 2004, the Company reported contingency reserves of \$838,582,548.

5. MARKET CONDUCT ACTIVITIES

In the course of this examination, a review was made of the manner in which the Company conducts its business practices 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. Policy Forms

No problem areas were encountered.

6. COMPLIANCE WITH PRIOR REPORT ON EXAMINATION

The prior report on examination contained six recommendations as follows (page numbers refer to the prior report):

| <u>ITEM</u> | <u>PAGE NO.</u> |
|---|-----------------|
| A. <u>Management</u> | |
| It was recommended that the Company ensure that all directors, officers and key employees complete conflict of interest statements on yearly basis. | 6 |
| The Company has not complied with this recommendation. A similar comment is contained in this report. | |
| B. <u>Holding Company System</u> | |
| <u>Sub-lease Agreements</u> | |
| It was recommended that the Company comply with Section 1505(d)(3) of the New York Insurance Law in all future transactions with members of the holding company system. | 15 |
| It was recommended that the Company formalize its sub-lease agreements with GE Capital Preferred Asset Corporation (“GE Capital”) and pursuant to Section 1505(d)(3) of the New York Insurance Law submit them to the Department. | 16 |
| As of December 31, 2004, the Company does not have sub-lease agreements in its current space at 125 Park Avenue, New York, New York. | |
| <u>Cost Sharing Agreements and Space Sharing Agreements</u> | |
| It was recommended that the Company comply with the expense allocation and documentation requirements contained in its various cost sharing and space sharing agreements filed with the Department. | 18-19 |
| The Company has complied with this recommendation. | |

ITEMPAGE NO.Investment Management Agreement

It was recommended that the Company submit the investment management agreement entered into with its affiliate GECC, to this Department pursuant to Section 1505(d)(3) of the New York Insurance Law. 21

The Company's investment managers as of the examination date are unaffiliated with the Company.

C. Abandoned Property Law

It was recommended that the Company comply with Section 1316 of the New York Abandoned Property Law and file on a yearly basis, the required abandoned property reports with the Office of the New York State Comptroller. 22

The Company has not complied with this recommendation. A similar recommendation is contained in this report.

7. SUMMARY OF COMMENTS AND RECOMMENDATIONS

| <u>ITEM</u> | <u>PAGE NO.</u> |
|---|-------------------------------|
| <p>A. <u>Management</u></p> <p>It is recommended that the Company ensure that all directors, officers and key employees complete conflict of interest statements on a yearly basis.</p> | <p>6</p> |
| <p>B. <u>Reinsurance</u></p> <p>It is recommended that the Company ensure that reconciliation of balances between reinsurers and the Company's books are performed and reviewed on a timely basis and that the Company reflect the correct account balances in its filed annual statement.</p> | <p>8</p> |
| <p>C. <u>Holding Company System</u></p> <p>It is recommended that the Company submit to this Department any reinsurance treaty with an affiliate at least thirty days prior to commencement pursuant to the provisions of Section 1505(d)(2) of the New York Insurance Law.</p> | <p>9</p> |
| <p>D. <u>Abandoned Property Law</u></p> <p>i. It is recommended that the Company file its abandoned property reports on a timely basis pursuant to the provisions of Section 1316 of the New York Abandoned Property Law.</p> <p>ii. It is recommended that the Company comply with the record retention requirements of Department Regulation 152.</p> | <p>13</p> <p>14</p> |
| <p>E. <u>Accounts and Records</u></p> <p> <u>Custodian Agreement</u></p> <p>i. It is recommended that the Company amend its custodian agreement to include all the protective covenants and provisions in order to comply with the requirements set forth in the NAIC Financial Condition Examiners Handbook and to Department guidelines.</p> <p> It is also recommended that the Company respond accurately to General Interrogatory questions of the annual statement.</p> <p> <u>CPA Contract with Ernst & Young LLP</u></p> <p>ii. It is recommended that the Company ensure that the contract with its CPA firm complies with the requirements of Department Regulation 118.</p> | <p>15</p> <p>15</p> <p>16</p> |

ITEMPAGE NO.Conflict of Interest – Surveillance & Underwriting

- iii. It is recommended that the Company comply with Department guidelines and segregate the duties of employees. 17

Respectfully submitted,

Fe Rosales, CFE
Senior Insurance Examiner

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

FE ROSALES being duly sworn, deposes and says that the foregoing report, subscribed to by her, is true to the best of her knowledge and belief.

Fe Rosales

Subscribed and sworn to before me

this _____ day of _____, 2006.

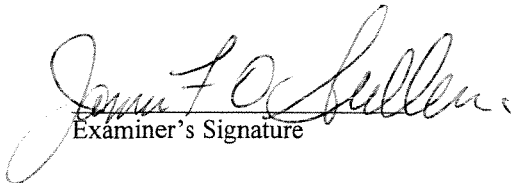
State of New York
County of New York

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


James F. O'Sullivan, BEING DULY SWORN, STATES AS FOLLOWS:

1. I have authority to represent the State of Mississippi in the examination of Financial Guaranty Insurance Company
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 Financial Guaranty Insurance Company was performed in a manner consistent with the standards and procedures required by the State of Mississippi.

The affiant says nothing further.


Examiner's Signature

Subscribed and sworn before me by James F. O'Sullivan on this 24th day of May 2006.


Notary Public

DEBORAH A. BRIFFA
Notary Public, State of New York
Qualified in Queens County
No. 01BR6135468
Commission Expires October 17, 2009

My commission expires _____ [date].

Appointment No 22373

*STATE OF NEW YORK
INSURANCE DEPARTMENT*

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

Fe Rosales

as proper person to examine into the affairs of the

FINANCIAL GUARANTY INSURANCE COMPANY

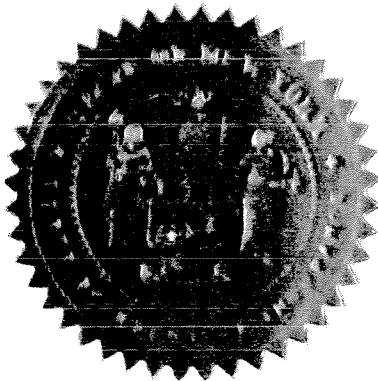
and to make a report to me in writing of the condition of the said

Company

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 13th day of May, 2005



A handwritten signature in dark ink, appearing to read "Howard Mills", written over a horizontal line.

HOWARD MILLS

Acting Superintendent of Insurance