

REPORT ON ASSOCIATION EXAMINATION

OF

FINANCIAL SECURITY ASSURANCE INC.

AS OF

DECEMBER 31, 2002

EXAMINER

MARC ALLEN  
JAMES O'SULLIVAN, CFE

STATE  
PARTICIPATING

NEW YORK  
MISSISSIPPI

ZONE

NORTHEASTERN  
SOUTHEASTERN

Honorable James H. Brown  
Secretary, Southeastern Zone  
Insurance Commissioner  
State of Louisiana 70801

Honorable Gregory V. Serio  
Superintendent of Insurance  
State of New York  
Albany, New York 12257

Honorable George Dale  
Commissioner of Insurance  
State of Mississippi  
Jackson, Mississippi 39201

Honorable Diane Kohen  
Secretary – Treasurer, Northeastern Zone  
Insurance Commissioner  
Pennsylvania Insurance Department  
1326 Strawberry Square, 13<sup>th</sup> Floor  
Harrisburg, Pennsylvania 17120

June 7, 2004

Sirs/Madam:

In accordance with your several instructions, an Association Examination has been made, as of December 31, 2002 into the financial condition and affairs of the Financial Security Assurance Inc. and the following report is thereon respectfully submitted.

Where the designations “Financial Security” or “Company” appear herein without qualification, they should be understood to mean Financial Security Assurance Inc.

Respectfully submitted,

REPORT ON EXAMINATION  
OF  
FINANCIAL SECURITY ASSURANCE INC.  
AS OF  
DECEMBER 31, 2002

EXAMINER

MARC ALLEN

DATE OF REPORT

JUNE 7, 2004

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

June 7, 2004

Honorable Gregory V. Serio  
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 22089 dated August 26, 2003, attached hereto, I have made an examination into the financial condition and affairs of the Financial Security Assurance Inc. as of December 31, 2002, and submit the following report thereon.

The examination was conducted at the Company's home office located at 350 Park Avenue, New York, New York 10022.

Wherever the designations "Financial Security" or "Company" appear herein without qualification, they should be understood to indicate Financial Security Assurance Inc.

Whenever, the designation "Department" appears herein without qualification, it should be understood to indicate the New York Insurance Department.

## **1. SCOPE OF EXAMINATION**

The previous examination of the Company was conducted as of December 31, 1999. This examination covered the three-year period from January 1, 2000 through December 31, 2002. Transactions occurring subsequent to this period were reviewed where deemed appropriate by the examiner. The examination was comprised of a complete verification of assets and liabilities as of December 31, 2002, a review of income and disbursements deemed necessary to accomplish such verification and utilized, to the extent considered appropriate, work performed by the Company's independent certified 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:

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

A review was also made to ascertain what action was taken by the Company with regard to the 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**

Financial Security Assurance Inc. (“FSA”) is a wholly-owned subsidiary of Financial Security Assurance Holdings LTD (FSAH). FSAH is ultimately owned by Dexia S.A., a limited liability company organized under the laws of the Kingdom of Belgium. In July, 2000 Dexia Holdings, Inc. (“Sexia”), an indirect wholly-owned subsidiary of Dexia S.A. acquired all of the issued and outstanding shares of stock of FSAH. Prior to its acquisition by Dexia, FSAH was a publicly held company with its shares listed on the New York Stock Exchange. FSA is primarily engaged in the business of providing financial guaranty insurance on asset backed and municipal securities. The Company was incorporated under the laws of New York on March 16, 1984 and commenced operations on September 23, 1985.

At December 31, 2002, the capital structure of the Company was \$15,000,000 which is comprised of 400 issued and outstanding shares with a par value of \$37,500 per share.

Gross paid in and contributed surplus decreased by \$35,066,742 during the examination period as follows:

<u>Year</u>	<u>Description</u>	<u>Amount</u>
2000	Beginning gross paid in and contributed surplus	\$ 526,814,880
2000	Surplus paid out	(55,000,000)
2001	Surplus paid in	5,079,676
2002	Surplus paid in	<u>14,853,584</u>
2002	Ending gross paid in and contributed surplus	<u>\$ 491,748,138</u>

### A Management

Pursuant to the Company’s charter and by-laws, corporate powers shall be exercised by a board of directors consisting of not less than thirteen nor more than twenty-one members. As of December 31, 2002, the board of directors was comprised of the following thirteen members:

<u>Name and Residence</u>	<u>Principal Business Affiliation</u>
Robert P. Cochran New York, NY	Chairman, Chief Executive Officer, Financial Security Assurance Inc.
Sean W. McCarthy New York, NY	President, Chief Operating Officer, Financial Security Assurance Inc.
Roger K. Taylor New Canaan, CT	Vice Chairman, Financial Security Assurance Inc.
Russell B. Brewer II Darien, CT	Managing Director & Chief Risk Management Officer, Financial Security Assurance Inc.
Daniel C. Farrell Chatham, NJ	Managing Director Asset Finance, Financial Security Assurance Inc.
Joseph W. Simon Scarsdale, NY	Managing Director, Chief Financial Officer, Financial Security Assurance Inc.
Bruce E. Stern Bronxville, NY	Managing Director, General Counsel, Secretary, Financial Security Assurance Inc.
Suzanne Marie Finnegan Mt. Kisco, NY	Managing Director, Chief Municipal Underwriting Officer, Financial Security Assurance Inc.
Richard G. Holzinger Singapore	Managing Director Asia Region, Financial Security Assurance Inc.
Thomas J. McCormick North Haven, CT	Managing Director, Chief International Underwriting Officer, Financial Security Assurance Inc.
Scott C. Richbourg New Canaan, CT	Managing Director Municipal Finance, Financial Security Assurance Inc.
Philippe Zoetelief Tromp London, UK	Managing Director Europe Region, Financial Security Assurance Inc.
Glenn Tso Westport, CT	Managing Director Asset Management, Financial Security Assurance Inc.



The board met four times during each calendar year under examination. The minutes of all meetings of the board of directors held during the examination period were reviewed. The meetings were generally well attended and each of the directors had a satisfactory attendance record.

The principal officers of the Company as of December 31, 2002 were as follows:

Name	Title
Robert P. Cochran	Chairman/Chief Executive Officer
Sean W. McCarthy	President/Chief Operating Officer
Russell B. Brewer II	Managing Director & Chief Risk Management Officer
Bruce E. Stern	Managing Director/General Counsel/Secretary
Daniel C. Farrell	Managing Director Asset Finance
Joseph W. Simon	Managing Director/Chief Financial Officer
Edsel C. Langley Jr.	Managing Director/Treasurer
Jeffrey S. Joseph	Managing Director/Controller

**B Territory and Plan of Operation**

The Company is licensed to conduct business in all fifty states, the District of Columbia, Puerto Rico, Guam, and the U.S. Virgin Islands.

The following schedule shows direct premiums written in New York State compared to direct business written in the United States for the five years covered by this examination:

**DIRECT PREMIUM WRITTEN**

<u>Calendar Year</u>	<u>New York State</u>	<u>Total United States</u>	<u>Percentage of Premiums Written in New York State To the Total United States</u>
2000	\$ 50,859,423	\$ 325,610,613	16%
2001	\$ 76,941,115	\$ 465,376,908	17%
2002	\$171,043,578	\$ 726,208,996	24%

As of December 31, 2002, 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>Kind of Insurance</u>
16 (C,D,E,F)	Fidelity and surety
17 (A)	Credit
25	Financial guaranty

Operations are currently limited to the writing of financial guaranty insurance on asset backed and municipal securities offered in domestic and foreign markets.

Based upon the lines of business for which the Company is licensed, and pursuant to the requirements of Articles 41 and 69 of the New York Insurance Law, Financial Security is required to maintain a minimum surplus to policyholders of \$66,400,000.

C. Reinsurance

The Schedule F data as contained in the Company's annual statements filed for the years within the examination period accurately reflected its reinsurance transactions.

The examiner reviewed all assumed and ceded reinsurance contracts in effect as of the examination date. These contracts all contained the required standard clauses including insolvency clauses meeting the requirements of Section 1308 of the New York Insurance Law.

During 2002, Financial Security assumed written premiums from affiliates and non-affiliates in the amounts of \$39,149,000 and \$2,384,000, respectively.

### Affiliates

#### Quota Share Reinsurance Pooling Agreement (“Pooling Agreement”)

The Company and certain of its subsidiaries are parties to a quota share reinsurance pooling agreement dated July 1, 1986. The pooling agreement was restated on October 1, 1996, and amended on September 23, 1997, November 1, 1998, and November 1, 2001. The parties to the pooling agreement as of November 1, 1998 to present are the Company, FSA Insurance Company (“FSAIC”) and Financial Security Assurance International Ltd. (“FSAINT”).

Pursuant to the pooling agreement, after reinsurance cessions to other reinsurers, the Company, FSAIC and FSAINT share in the net retained risk insured by each of these companies. The business is shared on a pro-rata basis in proportion to each companies’ surplus to policyholders and contingency reserve as reported in the most recent filed statutory statements. At December 31, 2002, the Company’s, FSAIC’s and FSAINT’s shares were approximately 66.91%, 25.05%, and 8.04% respectively.

#### Stop Loss Reinsurance Agreement

Effective November 3, 1998, the Company entered into a stop loss reinsurance agreement with its affiliate, Financial Security Assurance International Ltd. (“FSAINT”). Under this agreement, if FSAINT’s cumulative net losses incurred exceed \$25,000,000, the Company is

responsible for 100% of the amount by which the sum of (1) FSAINT's annual net losses incurred plus (2) FSAINT's annual incurred expenses exceeds the sum of (a) 100% of FSAINT's annual net earned premium plus (b) the amounts deducted from FSAINT's contingency reserves during the calendar year to fund FSAINT's annual net losses incurred. The Company's maximum annual limit of liability is the sum of (i) the principal insured by FSAINT under the two largest transactions insured by FSAINT, plus (ii) 20% of the total principal insured, in both cases (i) and (ii) outstanding as of December 31 of the prior year and net of all reinsurance other than this stop loss reinsurance agreement.

The agreement covers business written on or after November 3, 1998. Pursuant to the agreement FSAINT pays the Company a premium of 12.5% of FSAINT's annual net earned premiums during the calendar year. The Company incurred no losses under this agreement during the examination period.

The pooling and the stop loss reinsurance agreements were submitted to the Department pursuant to Section 1505(d)(2) of the New York Insurance Law.

#### Quota Share and Stop Loss Reinsurance Agreement

Effective April 27, 1994, the Company entered into a quota share and stop loss reinsurance agreement with its affiliate, Financial Security Assurance (U.K.) Ltd. ("FSAUK"). This agreement covers business written on or after April 27, 1994. The business assumed from FSAUK is shared with other affiliates pursuant to the pooling agreement mentioned above.

Under the quota share portion of the agreement, the Company assumes a proportionate share of the liabilities under each policy, contract or binder of insurance or reinsurance written by FSAUK. The proportionate share of liabilities to be assumed by the Company under this agreement is determined on April 1 of each year. The percentage of business shared is in proportion to their relative surplus to

policyholders and contingency reserve. During 2002, the Company assumed approximately 98.89% of FSAUK's liabilities after third party reinsurance.

Under the stop loss portion of the agreement, the Company is responsible for 100% of the amount by which the sum of (1) FSAUK's annual net losses incurred plus (2) FSAUK's annual incurred expenses exceeds the sum of (a) 100% of FSAUK's annual net earned premium plus (b) the amounts deducted from FSAUK's contingency reserve during the calendar year to fund FSAUK's annual net losses incurred. The Company's maximum annual limit of liability is the sum of (i) the principal insured by FSAUK under the two largest transactions by FSAUK, plus (ii) 20% of the total principal insured, in both cases (i) and (ii) outstanding as of December 31 of the prior year and net of all reinsurance other than this stop loss reinsurance.

For the stop loss reinsurance provided by the agreement, FSAUK pays a premium of 12.5% of its annual net earned premium during the calendar year. The Company incurred no losses under this agreement during the examination period. The agreement was submitted to the Department pursuant to Section 1505(d)(2) of the New York Insurance Law.

## 2. Ceded

At December 31, 2002, the Company was a party to the following reinsurance agreements:

<u>Type of Treaty</u>	<u>Coverage</u>
Municipal Quota Share 50% Authorized 50% Unauthorized	6% quota share of each covered policy up to a maximum cession per single risk of \$16 million. The Company could increase this percentage at its option to a quota share cession of 35% per covered policy up to a limit per single risk of \$93.33 million. Maximum single risk amount of \$267 million.

<u>Type of Treaty</u>	<u>Coverage</u>
<p>Non-Municipal Quota Share 53.80% Authorized 46.20% Unauthorized</p>	<p>6.5% quota share of each covered policy up to a maximum cession per single risk of \$13 million. The Company could increase this percentage at its option to a quota share cession of 13% per covered policy up to a limit per single risk of \$26 million. Maximum single risk amount of \$200 million.</p>
<p>1<sup>st</sup>, 2<sup>nd</sup>, 3<sup>rd</sup>, and 4<sup>th</sup> loss treaty for U.S auto loan-backed, corporate bond backed, corporate -loan backed, and U.S. mortgage backed transactions</p> <p>The percentage of authorized reinsurers for the Auto (1<sup>st</sup> three layers), CBO/CLO, and Mortgage backed sections of the treaty is respectively 61%, 53%, and 64%.</p>	<p>Treaty provides for three loss layers except for auto-backed policies where it provides for four. For auto-loan backed policies the treaty provides for a 55% quota share on the first two layers, 56% on the third and 51% on the fourth layer. For corporate-bond and loan backed transactions the treaty provides for a 55% quota share on the first layer and a 56% quota-share on layers 2 and 3. For mortgage backed transactions the treaty provides for a 60% quota share for layers 1 and 2, and a 61% quota share for layer 3. The Company retains at least 20% of the first loss layers and 15% of each of the other loss layers. Each loss layer shall equal the loss layer percentage for such policy multiplied by the initial principal insured under such policy.</p>
<p>1<sup>st</sup>, 2<sup>nd</sup>, 3<sup>rd</sup>, and 4<sup>th</sup> loss reinsurance treaty for international project finance transactions.</p> <p>71.61% Authorized 28.39% Unauthorized</p>	<p>Provides reinsurance of four loss layers for policies issued during 2002 insuring the timely payment of principal and interest on securities and obligations where the insured obligations provide financing or refinancing for a governmental or public-purpose infrastructure project located outside of the United States. The treaty provides for a maximum 77.5% quota share for each of the four loss layers and up to 22.5% of an excess layer. Each loss layer shall equal the loss layer percentage for such policy multiplied by the initial principal insured under such policy. The loss layer percentage depends on the treaty rating category.</p>
<p>Emerging Market CBO/CLO aggregate excess of loss and quota share treaty.</p> <p>57.50% Authorized</p>	<p>This treaty covers emerging market CBO/CLO transactions insured by FSA. It includes both a quota share and excess of loss component. Under the quota share component FSA cedes 50% of all emerging market CBO/CLO transactions. The</p>

## 42.50% Unauthorized

aggregate excess of loss cover applies to the Company's outstanding retention after application of the quota share reinsurance. The aggregate excess of loss cover is divided into three layers with the first layer of 50 million retained by the Company. The 2<sup>nd</sup> layer is 222,222,222 dollars with 10% retained by FSA and 200 million dollars ceded. The third layer is retained by FSA.

Additionally, the Company has in effect six automatic facultative agreements with various authorized and unauthorized reinsurers. Under three of these agreements the Company is required to make individual facultative cessions in an aggregate amount ranging from 1.6% to 4.0% of the gross principal insured under FSA policies which qualify for cessions to the reinsurers under the Company's quota-share treaties.

Under two of the automatic facultative agreements, the Company is required to make individual facultative cessions in an aggregate amount ranging from 0 to 2 percent, of the gross principal insured by FSA under all policies issued in 2002, with an option to cede up to 7.1% to the two reinsurers.

Under the sixth automatic facultative agreement, the Company is required to cede 5% of the gross principal insured by the Company during the calendar year. The 5% includes the amounts ceded to the reinsurer under the Company's quota share treaties.

The Company also employed facultative reinsurance on various transactions during the examination period.

The Company is 100% owned by Financial Security Assurance Holdings Ltd. (“FSAH”), a holding company domiciled in New York. On July 5, 2000, Dexia S.A., a limited liability company organized under the laws of the Kingdom of Belgium, acquired through indirect subsidiaries 100% of the issued and outstanding shares of stock of FSAH, thus becoming the Company’s ultimate parent.

The Company is a member of the Financial Security Assurance Group, which consists of the Company and its subsidiary FSA Insurance Company (“FSAIC”) and FSAIC’s subsidiaries: Financial Security Assurance International Ltd. (“FSAINT”), and Financial Security Assurance (U.K.) Ltd., (“FSAUK”).

FSAINT is a Bermuda domiciled insurance company that primarily provides financial guaranty insurance for transactions outside of Europe and the United States. It also provides reinsurance to the Company. FSAINT is 80% owned by FSAIC and 20% owned by XL Capital Ltd.

FSAUK is a United Kingdom domiciled insurance company that primarily provides financial guaranty insurance for transactions in the United Kingdom and other parts of Europe.

FSA also owns a minority interest in XL Financial Assurance Ltd., a Bermuda-based captive reinsurance company majority owned by XL Capital. The Company controls less than 10% of the voting shares of XL Financial Assurance Ltd.

During the period under examination FSAH took net capital distributions from the Company in the amount of \$35,066,742.



In addition, the Company entered into two surplus note agreements with FSAH pursuant to Section 1307 of the New York Insurance Law in the amounts \$50,000,000 and \$96,850,000 respectively. The Company also repaid an existing surplus note in the amount of \$50,000,000 and repaid \$4,000,000 on a surplus note with an original amount of \$70,000,000 leaving a balance of \$66,000,000. Both repayments were approved in advance by the Superintendent of Insurance pursuant to Section 1307 of the New York Insurance Law. In summary, the Company had a total of \$212,850,000 in surplus note agreements in place at December 31, 2002.

As a member of a holding company system, the Company files registration statements pursuant to Article 15 of the New York Insurance Law and Department Regulation 52.

The following is an organizational chart of the holding company system as of December 31, 2002 showing the relationship of the Company with its parent and subsidiaries:



As of December 31, 2002, in addition to the reinsurance agreements mentioned in Item 2C, the Company has the following agreements with members of its holding company system:

Trust Agreement

Effective December 31, 1999, Financial Security entered into a trust agreement with its affiliate FSAINT and Bankers Trust Company, The Bahamas branch, as the Trustee. The agreement was entered into in conjunction with the quota share reinsurance pooling agreement mentioned in Item 2C. The agreement, along with the quota share reinsurance pooling agreement, was non-disapproved by the Department.

Tax Allocation Agreement

On July 5, 2000, the Company entered into a tax allocation agreement with the other members of the Financial Security Assurance Group, Dexia Holdings, Inc., White Mountain Holdings, Inc. as well as Financial Security Assurance Holdings Ltd and several of its subsidiaries. The agreement complies with the requirements of the Department's Circular Letter 33 (1979).

Net Worth Maintenance Agreements:

On April 27, 1994, the Company entered into a net worth maintenance agreement with its subsidiary FSAUK. Under this agreement the Company agrees to maintain FSAUK's amount of assets in excess of liabilities at 10,000,000 pounds sterling as determined under the laws of the United Kingdom or such greater amount required by the Insurance and Friendly Societies Division of the Financial Services Authority, subject to certain limits.

On September 23, 1997 the Company amended a net worth agreement originally dated April 27, 1994. The amendment replaced Financial Security Assurance of Maryland Inc. as a party to the

On September 23, 1997 the Company amended a net worth agreement originally dated April 27, 1994. The amendment replaced Financial Security Assurance of Maryland Inc. as a party to the

agreement with FSA Insurance Company (“FSAIC”). Under this Agreement the Company agreed to maintain FSAIC’s surplus to policyholders of \$66,400,000, subject to certain limits.

On November 3, 1998, the Company entered into a net worth maintenance agreement with its subsidiary FSAINT. Under this agreement the Company agrees to maintain FSAINT’s minimum shareholders’ equity required under the laws of Bermuda, subject to certain limits.

During the period under examination, January 1, 1995 through December 31, 1999, the Company made no contributions to its subsidiaries under the aforementioned net worth maintenance agreements.

#### Agreements for Cooperative and Joint Use of Personnel, Property and Services

The Company has in effect as of December 31, 2002, various agreements among its parent, affiliates and subsidiaries for cooperative and joint use of personnel, property and services. The parties to the agreement provide each other with personnel, property, equipment and services, as available, with respect to administrative, underwriting, accounting, legal, marketing, program development, claims, electronic data processing, compliance and surveillance, and reinsurance as will enable them to conduct an insurance business and other corporate functions. The Company that provides the services charges costs (direct and indirect) and expenses for providing such services.

### Other Agreements

On January 1, 1996, the Company entered into a service agreement with its affiliate company, Transactions Service Corporation (“TSC”). Under this agreement, TSC performs certain loss avoidance and asset management services for transactions subject to financial guaranty insurance policies and other insurance policies or guaranties issued or reinsured from time to time by the Company. The Company reimburses actual expenses incurred by TSC for its services.

On October 1, 2002, the Company along with other members of the holding company system entered into a consulting agreement with FSAINT whereby FSAINT agrees to provide the following consulting services: (a) credit analysis, including preparing and running default models, (b) transaction structure advice and (c) education and training with respect to the foregoing.

On October 1, 2002, the Company entered into a service agreement with FSA Services (Japan) Inc. whereby FSA Services agrees to provide the Company certain support services in Japan to conduct its business related to Japan.

Effective December 26, 2002, the Company entered into a service agreement with FSA Holdings and Dexia Credit Local whereby Dexia Credit Local will assist the Company in the origination and structuring of FSA insured transactions. Dexia Credit Local is a foreign banking organization licensed by the New York Banking Department to operate as an agency.

On June 1, 2000, the Company and its subsidiaries entered into a master letter of credit issuance and reimbursement agreement with Dexia Bank, S.A. Pursuant to the agreement Dexia Bank agrees to issue letters of credit for the benefit of the Company covering all or a portion of the risk of loss on

particular FSA insured transactions, as negotiated on an arms-length basis between Dexia Bank and FSA with respect to the particular transaction. There were no such letters of credit issued during the examination period.

The Department non-disapproved all of the aforementioned agreements pursuant to Section 1505 of the New York Insurance Law.

The examiner reviewed the Company's filed agreements for cooperative and joint use of personnel, property, and services and the accounting for them. This review indicated that the parties to the agreements failed to prepare quarterly billing statements reflecting amounts due under the agreement as called for in the filed agreements. The agreements generally call for the preparation of these statements within forty-five days after the end of each calendar quarter. The Company simply recorded journal entries to reflect the various transactions as they occurred.

It is recommended that the Company prepare quarterly billing statements reflecting amounts due under the various treaties for cooperative and joint use of personnel, property, and services in accordance with the terms of such filed agreements or amend such filed agreements to reflect the actual way the various transactions are reported and accounted for.

It was additionally noted, during the review, that the Company failed to allocate expenses to FSA Insurance Company in accordance with the filed agreement. The Company took the position that it was reimbursed for services provided through the ceding commission paid by FSA Insurance Company provided for in the reinsurance agreement entered into between the two companies (see pooling agreement in section c).

It is recommended that the Company seek reimbursement from FSA Insurance Company in accordance with its filed cooperative and joint use agreement or amend and file such agreement to reflect the Company's actual practice.

Samples of the intercompany transactions were reviewed as part of the examination. Generally speaking the Company was able to provide appropriate documentation backing up such transactions. In most cases the transactions simply reflected FSA paying a bill on behalf of the other company.

In the case of FSAUK the intercompany transactions involved the allocations of payroll for personnel performing work for both Companies as well as other joint expenses. Similar transactions were also recorded in connection with the Company's service agreement with Transactions Service Corporation. In both Cases the Company failed to provide documentation supporting its basis of cost allocation between the two companies. The failure to provide such supporting documentation is a violation of Section 1505(b) of the New York Insurance Law and Section 109.2(b) of Department Regulation 30. Section 1505(b) states:

"The books, accounts, and records of each party to all such transactions shall be so maintained as to clearly and accurately disclose the nature and details of the transactions including such accounting information as is necessary to support the reasonableness of the charges or fees to the respective parties".

Section 109.2(b) of Department Regulation 30 states in part:

"...(1) When a direct allocation is not made, salaries, with certain exceptions hereinafter noted, shall be allocated on which-ever of the following bases, or combinations thereof, are appropriate: number of items or units, time studies, overhead on other allocations, premiums, dollar volume of losses, other special studies

(2) The effects of the application to each operating expense classification of all bases of allocation shall be shown on records kept in clear and legible form. Such records shall be readily available for examination".

It is recommended that the Company allocate joint expenses, such as salaries, with other companies in its holding company system in accordance with Section 109.2(b)(1) of Department Regulation 30.

It is further recommended that the Company maintain the records documenting the allocation of shared and joint expenses in a clear, legible and readily available format in accordance with Section 1505(b) of the New York Insurance Law and Section 109.2(b)(2) of Department Regulation 30.

It was noted that the Company fails to seek reimbursement from other companies in the holding company system for overhead services provided including but not limited to services provided by the Company's legal and accounting departments. The Company's failure to charge for the overhead services it provides, is a violation of Section 1505(a) of the New York Insurance Law which states:

“Transactions within a holding company system to which a controlled insurer is a party shall be subject to the following: (1) the terms shall be fair and equitable; (2) charges or fees for services performed shall be reasonable; and (3) expenses incurred and payments received shall be allocated to the insurer on an equitable basis in conformity with customary insurance accounting practices consistently applied”.

It is recommended that the Company seek reimbursement for overhead services provides to other members of its holding company system in accordance with Section 1505(a) of the New York Insurance Law.

It was additionally noted that during the examination period the Company received regular services from Dexia Credit Local without informing the Department. These services involved Dexia Credit Local assisting the Company in the origination and structuring of FSA insured transactions. The failure to notify the Department is a violation of Section 1505(d)(3), which states:



“The following transactions between a domestic controlled insurer and any person in its 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: (3) rendering of services on a regular or systematic basis;”.

It is recommended that the Company notify the Department prior to receiving or providing services on a regular basis with another member of its holding company system in accordance with Section 1505(d)(3) of the New York Insurance Law.

It should be noted that the Company corrected this issue at the end of 2002 by formalizing the service agreement with Dexia Credit Local and submitting such agreement to the Department.

F. 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.

G. Significant Operating Ratios

The following ratios have been computed as of December 31, 2002, based upon the results of this examination:

Net premiums written in 2002 to surplus as regards policyholders	.31 to 1
Liabilities to liquid assets (cash and invested assets less investments in affiliates)	72.90%
Premiums in course of collection to surplus as regards policyholders	3.72%

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 three-year period covered by this examination:

	<u>Amounts</u>	<u>Ratios</u>
Losses and loss adjustment expenses incurred	\$ 32,196,452	7.04%
Other underwriting expenses	265,376,285	58.05
Net underwriting gain	<u>159,622,730</u>	<u>34.91</u>
Premiums earned	<u>\$457,195,467</u>	<u>100.00%</u>

## H. Accounts and Records

### Unearned Premium

A review of the Company's unearned premium liability calculation revealed that the Company calculates the unearned premium on single premium asset backed policies based on the expiration of the principal or par amount of the insured debt. This method of calculation is not in compliance with Section 6903(c) of the New York Insurance Law which requires premiums to be earned in proportion to the expiration of total debt service (principal plus interest) on the insured debt. Section 6903(c) states:

“An unearned premium reserve shall be established and maintained net of reinsurance with respect to all financial guaranty premiums. Where financial guaranty insurance premiums are paid on an installment basis, an unearned premium reserve shall be established and maintained, net of reinsurance, computed on a daily or monthly pro rata basis. All other financial guaranty insurance premiums written shall be earned in proportion with the expiration of exposure, or by such other method as may be permitted by the superintendent”.

The Company has been calculating the unearned premium on single premium asset backed policies using this method since its inception. The Company calculated that its unearned premium at December 31, 2002 would be \$17,554,332 higher if it had calculated its unearned premium liability had been calculated in accordance with Section 6903(c) of the New York Insurance Law.

It is recommended that the Company record in its current financial statements a cumulative adjustment going through surplus that reflects the change in accounting principles in reference to the calculation of the unearned premium liability.

It is further recommended that in the future that the Company calculate its unearned premium liability in accordance with Section 6903(c) of the New York Insurance Law.

### Surplus Notes

It was noted that at December 31, 2002, the Company had received the Department's approval to repay \$40,000,000 of the \$212,500,000 in outstanding surplus notes. Statutory accounting requires the reclassification of surplus notes approved for repayment from company surplus to a liability account. Specifically paragraph 8 of statement of Statutory Accounting Principles ("SSAP") 41 states:

"As of the date of approval of principal repayment by the commissioner of the state of domicile, the issuer shall reclassify such approved payments from surplus to liabilities".

It is recommended that the Company comply with SSAP 41 and classify all surplus notes approved for repayment by the Department as a liability.

The Company had a total of \$212,850,000 in surplus note agreements in place at December 31, 2002. The Company, however, reported \$214,865,585 in surplus notes on the 2002 annual statement. This is because the Company accrued \$2,015,585 in interest expense on these notes and added this amount to the face of the notes. The repayment of \$2,015,585 in interest expense was not approved by the Department. The recording of interest expense and adding it to the principal amount of the note is not in compliance with paragraph 7 of SSAP 41 which states:

"Interest shall not be recorded as a liability nor an expense until approval for payment of such interest has been granted by the commissioner of the state of domicile. All interest, including interest in arrears, shall be expensed in the statement of operations when approved for payment. Unapproved interest shall not be reported through operations, shall not be represented as an addition to the principal or notional amount of the instrument..."

It is recommended that the Company comply with SSAP 41 and only record interest expense that has been approved by the Department for repayment.

The examiner did not change the financial statements included in this report in reference to the issues addressed in above due to the immateriality of the amounts involved.

### Bank Reconciliation

The Company did not complete adequate bank reconciliations for its various bank accounts. The reconciliations contained a large volume of unexplained and dated reconciling items as well as large numbers of dated outstanding checks.

It is recommended that the Company institute procedures to ensure that bank reconciliation are properly completed.

#### I. Custodian Agreement

Management answered affirmatively to the following General Interrogatory:

“Excluding items in Schedule E, real estate, mortgage loans and investments held physically in the reporting entity’s offices, vaults or safety deposit boxes, were all stocks, bonds and other securities, owned throughout the current year held pursuant to a custodial agreement with a qualified bank or trust company in accordance with Part 1-General, Section IV.H-Custodial or Safekeeping Agreements of the NAIC Financial Condition Examiners Handbook”.

However, examination review indicated that the Company’s custodial agreement did not contain all of the protective covenants set forth in Section IV.H of the NAIC Financial Condition Examiners Handbook.

It is recommended that the Company amend its custodial agreement to incorporate all of the provisions set forth in the NAIC Examiners Handbook.

Internal Controls

It was noted during the examination that the Company has no formal control mechanisms in place to monitor the effects of foreign currency fluctuations on its exposure on insured debt service which is not denominated in United States dollars. These fluctuations could potentially lead to an exposure on a single risk exceeding the guide lines set forth in Section 6904(d) of the New York Insurance Law.

It is recommended that FSA put in place control procedures providing for regular monitoring of the Company's exposure on single risks not denominated in United States dollars.

### 3. FINANCIAL STATEMENTS

#### A. Balance Sheet

The following shows the assets, liabilities and surplus as regards policyholders as determined by this examination as of December 31, 2002. The statement is the same as the balance sheet filed by the Company.

	<u>Assets</u>	<u>Assets Not Admitted</u>	<u>Admitted Assets</u>
Bonds	\$1,931,601,613		\$1,931,601,613
Common stocks	398,087,842	\$4,374,563	393,713,279
Cash and short term investments	345,217,139		345,217,139
Other invested assets	73,354,175		73,354,175
Foreign currency options	889,278		889,278
Premiums and agents' balances in course of collection	42,380,798		42,380,798
Reinsurance Recoverables	828,203		828,203
Federal and foreign income tax recoverable	17,491,133	7,648,800	9,842,333
Electronic data processing equipment and software	3,096,163		3,096,163
Interest due and accrued	28,486,815		28,486,815
Receivable from parent, subsidiaries and affiliates	14,030,246		
Other assets non-admitted	8,414,533	8,414,533	
Aggregate write-ins for other than invested assets	<u>19,298,308</u>	<u>9,055,522</u>	<u>10,242,786</u>
Total Assets	<u>\$2,883,176,246</u>	<u>\$29,493,418</u>	<u>\$2,853,682,828</u>

Liabilities, Surplus and Other FundsLiabilities

Losses loss adjustment expenses	\$ 36,293,456
Other Expenses	121,137,787
Taxes, licenses and fees	4,026,141
Unearned premium	710,990,809
Ceded reinsurance premiums payable	147,816,034
Funds held by Company under	
Reinsurance treaties	192,131,179
Payable for securities	2,361,087
Contingency reserve	481,563,060
Miscellaneous liability	17,630,945
Other accounts payable	<u>(94,776)</u>
Total Liabilities	\$1,713,855,722

Surplus and Other Funds

Common capital stock	\$ 15,000,000
Surplus notes	214,865,585
Gross paid in and contributed surplus	491,748,138
Unassigned funds	<u>418,213,383</u>
Surplus as regards policyholders	<u>1,139,827,106</u>
Total liabilities and surplus	<u>\$2,853,682,828</u>

NOTE 1: The Internal Revenue Service has completed its audits of the consolidated income tax returns filed on behalf of the Company through tax year 1996. All material adjustments, if any, made subsequent to the examination and arising from said audits, are reflected in the financial statements included in this report. Audits covering subsequent tax years have yet to commence. The examiner is unaware of any potential exposure of the Company to any further tax assessment and no liability has been established herein relative to such contingency.

NOTE 2: No liability appears in this balance sheet for a loan for \$212,000,000. This loan was granted pursuant to Section 1307 of the New York Insurance Law. Payment of principal and interest shall only be made out of free and divisible surplus, subject to the prior approval of the Superintendent.



B. Underwriting and Investment Exhibit

Surplus as regards policyholders increased \$320,231,240 during the three-year examination period, January 1, 2000, through December 31, 2002 detailed as follows:

Statement of Income

Statement of Income

Underwriting Income

Premiums earned		\$457,195,467
Deductions:		
Losses and loss adjustment expenses incurred	\$32,196,452	
Other underwriting expenses incurred	240,239,454	
Aggregate write-ins	<u>25,136,83</u>	
Total underwriting deductions		<u>297,572,737</u>
Net underwriting gain		\$159,622,730

Investment Income

New investment income earned	\$290,995,485	
Net realized capital gains	4,804,284	
Net investment gain		295,799,769

Other Income

Miscellaneous income	<u>3,237,988</u>	
Total other income		<u>3,237,988</u>
Net Income before Federal income taxes		\$458,660,487
Federal income taxes incurred		<u>120,509,164</u>
Net income		<u>\$338,151,323</u>

Capital and Surplus Account

Surplus as regards policyholders, December 31, 1999			
Per report on examination:			\$819,595,866
	<u>Gains in</u>	<u>Losses in</u>	
	<u>Surplus</u>	<u>Surplus</u>	
Net income	\$338,151,323	\$	
Net unrealized capital gain	27,825,345		
Change in not admitted assets	36,358,988		
Change in surplus notes	94,865,585		
Paid in capital changes		44,049,890	
Paid in surplus adjustment		35,066,740	
Change in contingency reserve		127,634,141	
Tax and loss bonds	15,633,034		
Deferred asset change	<u>14,147,736</u>	_____	
Total gains and losses	<u>\$526,982,011</u>	<u>\$206,750,771</u>	
Net increase (decrease) in surplus as regards policyholders			<u>320,231,240</u>
Surplus as regards policyholders, December 31, 2002			
Per report on examination			<u>\$1,139,827,106</u>

#### **4. LOSSES AND LOSS ADJUSTMENT EXPENSES**

The examination liability of \$36,293,456, is the same amount reported by the Company in its 2002 filed annual statement. 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 equal to the average 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 time value of money included as a reduction in the Company's loss reserves was \$6,762,881. The Company discounted its loss reserves at rates that range from 4.77% to 6.1%.

In addition to case reserves, Financial Security is required to establish and maintain contingency reserves for the protection of policyholders 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, 2002, FSA reported contingency reserves of \$481,563,060.

#### **5. MARKET CONDUCT ACTIVITIES**

In the course of this examination, a review was made of the manner in which Financial Security conducts its business and fulfills its contractual obligations to policyholders and claimants.

The review was directed at practices of the Company in the following major areas:

- A. Sales and advertising materials
- B. Underwriting

No problem areas were encountered.

## 6. COMPLIANCE WITH PRIOR REPORT ON EXAMINATION

The prior report on examination contained the following recommendations (page numbers refer to the prior report):

<u>ITEM</u>	<u>PAGE NO.</u>
<p>A. <u>Reinsurance</u></p> <p>Regarding the quota share and stop loss reinsurance agreement with its affiliate Financial Security Assurance (U.K.) Ltd., it is recommended that the Company comply with the notification requirements set forth in Section 1505(d)(2) of the New York Insurance Law.</p> <p>The Company complied with this recommendation.</p>	<p>5-11</p>
<p>B. <u>Abandoned Property Law</u></p> <p>It is recommended that the Company comply with Section 1316 of the New York Abandoned Property Law and file the requisite abandoned property reports with the Office of the New York State Comptroller on a yearly basis.</p> <p>The Company complied with this recommendation.</p>	<p>15</p>
<p>C. <u>Fidelity Bonds</u></p> <p>It is recommended that the Company maintain the minimum amount of fidelity bond insurance suggested by the NAIC on a yearly basis.</p> <p>The Company complied with this recommendation.</p>	<p>16</p>
<p>D. <u>Accounts and Records</u></p> <p>It is recommended that the Company comply with the reporting provisions of Section 1307 of the New York Insurance Law and not report the interest on Section 1307 loans as part of its legal liabilities.</p> <p>A similar comment is included in this report.</p>	<p>16</p>



ITEMPAGE NOB. Accounts and recordsUnearned Premium

It is recommended that the Company record in its current financial statements a cumulative adjustment going through surplus that reflects the calculations that should have been made in accordance with Section 6903(c) of the New York Insurance Law in reference to the unearned premium liability on single premium asset-backed policies. 23

It is recommended that in the future that the Company calculate its unearned premium liability in accordance with Section 6903(c) of the New York Insurance Law. 23

Surplus Notes

(i) It is recommended that the Company comply with SSAP 41 and classify all surplus notes approved for repayment by the Department as a liability. 24

(ii) It is recommended that the Company comply with SSAP 41 and only record interest expense that has been approved by the Department for repayment. 24

Bank Reconciliation

It is recommended that the Company institute procedures to ensure that bank reconciliations are properly completed. 25

Custodian Agreement

It is recommended that the Company amend its custodial agreement to incorporate all of the provisions set forth in the NAIC Financial Condition Examiner's Handbook. 25

Internal controls

It is recommended that FSA put in place control procedures providing for regular monitoring of the Company's exposure on single risks not denominated in United States dollars. 25-26

Respectfully submitted,

\_\_\_\_\_/S/\_\_\_\_\_  
Marc Allen  
Associate Insurance Examiner

STATE OF NEW YORK )  
                                  ) SS.  
                                  )  
COUNTY OF NEW YORK)

MARC ALLEN, being duly sworn, deposes and says that the foregoing report submitted by him is true to the best of his knowledge and belief.

\_\_\_\_\_/S/\_\_\_\_\_  
Marc Allen

Subscribed and sworn to before me  
this \_\_\_\_\_ day of \_\_\_\_\_ 2004.

State of New York  
County of Westchester

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 Security Assurance Inc.
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 Security Assurance Inc. 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 James F. O'Sullivan on this 14th day of April, 2005.

JS  
Notary Public

My commission expires 7/10/06 [date].

**ALYSSA TURKOVITZ**  
Notary Public, State of New York  
No. 01TU6044514  
Qualified in Westchester County  
Commission Expires 7/10/06



Appointment No 22089

STATE OF NEW YORK  
INSURANCE DEPARTMENT

I, GREGORY V. SERIO, Superintendent of Insurance of the State of New York,  
pursuant to the provisions of the Insurance Law, do hereby appoint:

**Marc Allen**

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

**FINANCIAL SECURITY ASSURANCE INC.**

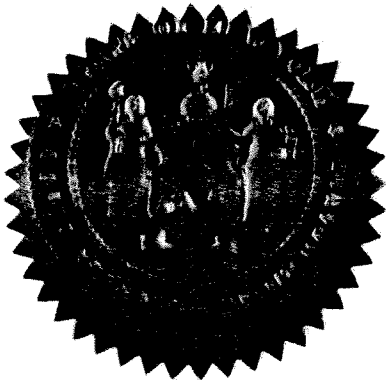
*and to make a report to me in writing of the condition of the said*

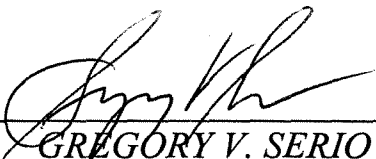
**Corporation**

*with such other information as he 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 26th day of August, 2003*



  
\_\_\_\_\_  
GREGORY V. SERIO  
Superintendent of Insurance