

REPORT ON EXAMINATION

OF THE

FINANCIAL SECURITY ASSURANCE INC.

AS OF

DECEMBER 31, 2007

DATE OF REPORT

MARCH 13, 2009

EXAMINER

MARIBEL C. NUÑEZ, CPCU

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

March 13, 2009

Honorable Eric R. Dinallo  
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 22761 dated April 11, 2008 attached hereto, I have made an examination into the condition and affairs of the Financial Security Assurance Inc. as of December 31, 2007, and submit the following report thereon.

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

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 31 West 52<sup>nd</sup> Street, New York, New York 10019.

## 1. SCOPE OF EXAMINATION

The Department has performed an examination of Financial Security Assurance Inc. The previous examination was conducted as of December 31, 2002. This examination covered the five-year period from January 1, 2003 through December 31, 2007. Transactions occurring subsequent to this period were reviewed where deemed appropriate by the examiner.

This examination was conducted in accordance with the National Association of Insurance Commissioners (“NAIC”) Financial Condition Examiners Handbook which requires that we plan and perform the examination to evaluate the financial condition and identify prospective risks of the Company by obtaining information about the Company including corporate governance, identifying and assessing inherent risks within the Company and evaluating system controls and procedures used to mitigate those risks. This examination also included the assessing of the principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation, management’s compliance with Statutory Accounting Principles and annual statement instructions when applicable to domestic state regulations.

All accounts and activities of the Company were considered in accordance with the risk-focused examination process. This examination also included a review and evaluation of the Company’s own control environment assessment and evaluation based upon the Company’s Sarbanes-Oxley documentation and testing. The examiners also relied upon audit work performed by the Company’s independent public accountants (“CPA”) when appropriate.

This examination report includes a summary of significant findings for the following items as called for in the Financial Condition Examiners Handbook of the NAIC:

- Significant subsequent events
- Company history
- Corporate records
- Management and control
- Territory and plan of operation
- Growth of Company
- Loss experience
- Reinsurance
- Accounts and records
- Financial statements
- Summary of recommendations

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

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

## **2. DESCRIPTION OF COMPANY**

The Company was incorporated under the laws of New York on March 16, 1984 and commenced operations on September 23, 1985. The Company was initially organized as a property/casualty insurance company; however, on August 2, 1989, the Company restated its charter and amended its license to become a financial guaranty insurance corporation pursuant to the provisions of Article 69 of the New York Insurance Law. The Company 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. (“Dexia”), 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. FSAH is primarily engaged in the business of providing financial guaranty insurance on asset-backed and municipal securities.

Capital paid in is \$15,000,000 consisting of 344 shares of \$43,604.65 par value per share common stock. Gross paid in and contributed surplus is \$355,818,475. Gross paid in and contributed surplus decreased by \$135,929,666 during the examination period, as follows:

<u>Year</u>	<u>Description</u>	<u>Amount</u>	
2002	Beginning gross paid in and contributed surplus		\$491,748,138
2003	Capital Contribution	\$ 10,520,988	
2003	Capital Distribution	(3,605,280)	
2004	Capital Contribution	20,419,592	
2004	Capital Distribution	(1,260,584)	
2005	Capital Contribution	3,900,916	
2005	Capital Distribution	(1,343,424)	
2006	Capital Contribution	2,639,822	
2006	Capital Distribution	(100,964,123)	
2007	Capital Contribution	115,591,693	
2007	Capital Distribution	<u>(181,829,266)</u>	
	Total Surplus Contributions (Distributions)		<u>(135,929,666)</u>
2007	Ending gross paid in and contributed surplus		<u>\$355,818,475</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 or more than twenty-one members. The board meets four times during each calendar year. At December 31, 2007, the board of directors was comprised of the following thirteen members:

<u>Name and Residence</u>	<u>Principal Business Affiliation</u>
Robert Phillips Cochran New York, NY	Chairman and Chief Executive Officer, Financial Security Assurance Inc.
Séan Wallace McCarthy New York, NY	President and Chief Operating Officer, Financial Security Assurance Inc.
Russell Brown Brewer II Darien, CT	Managing Director/Chief Management Officer, Financial Security Assurance Inc.
Francis Joseph Coughlin Jr. Manhasset, NY	Managing Director/Chief Underwriting Officer (Municipal Finance), Financial Security Assurance Inc.
Richard George Holzinger Norwalk, CT	Managing Director/Corporate Finance, Financial Security Assurance Inc.
Edsel Clinton Langley Jr. Short Hills, NJ	Managing Director of Corporate Development, Financial Security Assurance Inc.
Thomas Joseph McCormick North Haven, CT	Managing Director/Chief Underwriting Officer (International Public Finance), Financial Security Assurance Inc.
Scott Cranston Richbourg New Canaan, CT	Managing Director/Municipal Finance, Financial Security Assurance Inc.
Joseph Walter Simon Scarsdale, NY	Managing Director/Chief Financial Officer, Financial Security Assurance Inc.
Bruce Elliot Stern Bronxville, NY	Managing Director/General Counsel/Secretary, Financial Security Assurance Inc.
Philippe Zoetelief Tromp London, England	Managing Director/European Region, Financial Security Assurance Inc.
Glenn Tso New York, NY	Managing Director/Asset Management, Financial Security Assurance Inc.

Name and ResidencePrincipal Business Affiliation

Malcolm Douglas Watson Jr.  
New York, NY

Managing Director/Domestic Structured Finance,  
Financial Security Assurance 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, 2007, the principal officers of the Company were as follows:

<u>Name</u>	<u>Title</u>
Robert Phillips Cochran	Chairman and Chief Executive Officer
Séan Wallace McCarthy	President and Chief Operating Officer
Bruce Elliot Stern	Secretary and General Counsel
Laura Ann Bieling	Controller

B. Territory and Plan of Operation

As of December 31, 2007, the Company was licensed to write business in all fifty states, the District of Columbia, Puerto Rico, Guam, and the U.S Virgin Islands.

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,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 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:

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>
2003	\$174,602,088	\$789,246,783	22.12%
2004	\$180,049,298	\$755,879,678	23.82%
2005	\$179,727,857	\$752,415,863	23.89%
2006	\$167,056,557	\$620,316,500	26.93%
2007	\$239,647,311	\$691,063,529	34.68%

The Company provides financial guaranty insurance for a broad range of financing, including municipal bonds and loans, asset-backed securities collateralized by consumer or corporate receivables, collateralized debt obligations, international public-sector project financings, credit default swaps, and other structured financial obligations that remain in force for many years.

Financial guaranty insurance written by the Company typically guarantees scheduled payments on financial obligations. Upon a payment default on an insured obligation, the Company is generally required to pay the principal, interest or other amounts due in accordance with the obligation's original payment schedule or may, at its option, pay such amounts on an accelerated basis.

C. Reinsurance

Assumed reinsurance accounted for 14.83% of the Company's gross premium written at December 31, 2007. The Company's assumed reinsurance business has increased since the last examination.

The majority of the Company's assumed business derives from a quota share and stop loss reinsurance agreement effective April 27, 1994 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 discussed further herein.

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 2007, the Company assumed approximately 96.25% of FSAUK's liabilities after third party reinsurance. Under the stop loss portion of the agreement, the Company is responsible for 100% of losses and loss adjustment expenses incurred above net earned premiums plus amounts deducted from FSAUK's contingency reserves during the calendar year. The Company received premiums under the stop loss agreement of 12.5% of FSAUK's annual net earned premiums each year and has incurred no losses during the examination period.

Effective November 3, 1998, the Company also provides stop loss reinsurance coverage to its affiliate, Financial Security Assurance International Ltd. ("FSAINT") with similar terms to the stop loss agreement with FSAUK. The Company received premiums under the stop loss agreement of 12.5% of FSAINT's annual net earned premiums each year and has incurred no losses during the examination period. The purpose of the stop loss agreements is to allow the companies to maintain triple-A ratings from the various rating agencies.

The Company utilizes reinsurance accounting as defined in Statement of Statutory Accounting Principle ("SSAP") No. 62 for all of its assumed reinsurance business.

#### Quota Share Reinsurance Pooling Agreement ("Pooling Agreement")

Effective July 1, 1986, the Company is a party to a quota share reinsurance pooling agreement between itself and two of its subsidiaries, FSA Insurance Company ("FSAIC"), and FSAINT. The agreement was restated effective October 1, 1996. Pursuant to the agreement, the companies share in the net retained risk insured by each of the companies, after cessions to other reinsurers, on a pro-rata basis in proportion to each company's relative surplus as regards policyholders and contingency reserve, as reported in the most recently filed statutory statements at the time the business is written. At December 31, 2007, the Company's, FSAIC's, and FSAINT's pooling percentages were approximately 64.59%, 31.40%, and 4.01%, respectively. This agreement was non-disapproved by the Department on October 17, 1996.

CededFacultative Reinsurance Agreement

Effective August 16, 2005, the Company entered into a facultative reinsurance agreement with its affiliate FSAINT. Under this agreement, the Company cedes 100% of losses coming within the 1<sup>st</sup> loss layer reinsurance of a particular policy. In addition, FSAINT assumes on a quota share basis its allocable share (10%) of the Company's exposure under the policy in excess of the 1<sup>st</sup> loss layer. The quota share reinsurance shall be in addition to FSAINT's quota share reinsurance of the policy under the pooling agreement. This agreement was non-disapproved by the Department on December 7, 2005.

The Company has structured its ceded reinsurance program to limit its maximum exposure on any one risk as follows:

<u>Type of Treaty</u>	<u>Coverage</u>
Municipal Quota Share	6.10% quota share of each covered policy up to a maximum cession per single risk of \$16.26 million. The Company could increase this percentage at its option to a quota share cession of 46% per covered policy up to a limit per single risk of \$122.66 million. Maximum single risk of \$267 million.
24.59% Authorized	
75.41% Unauthorized	
Non-Municipal Quota Share	6.35% quota share of each covered policy up to a maximum cession per single risk of \$12.7 million. The Company could increase this percentage at its option to a quota share cession of 13.7% per covered policy up to a limit per single risk of \$27.4 million. Maximum single risk amount of \$200 million.
23.62% Authorized	
76.38% Unauthorized	
1 <sup>st</sup> , 2 <sup>nd</sup> , 3 <sup>rd</sup> , and 4 <sup>th</sup> loss reinsurance treaty for Project finance transactions.	Provides reinsurance of four loss layers for policies issued during 2007 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 in certain qualifying jurisdiction including the United States, member countries of the European Union, Australia, Brazil, Chile, Japan, Mexico, New Zealand, Singapore, South Korea, Taiwan and Thailand. The treaty provides for varying amounts of reinsurance depending on whether the gross principal amount of a covered transaction is less than \$300 million, equal to or greater than \$300
11% Authorized	
89% Unauthorized	

<u>Type of Treaty</u>	<u>Coverage</u>
Surplus Share Treaty – AMBAC 100% Authorized	<p>million, but less than \$500 million, or equal to or greater than \$500 million. The loss layer percentage depends on the treaty rating category. The percentage ranges from 3% for AA to 5% for BBB. At a minimum the treaty provided for approximately 25% reinsurance of the loss layer and approximately 14% reinsurance of the excess layer and at a maximum it provided for approximately 80% reinsurance of the loss layer and approximately 45.6% reinsurance of the excess layer.</p> <p>Provides quota share reinsurance for (a) project finance transactions where the gross outstanding principal insured by FSA per single risk equals or exceeds \$400 million and (b) US health care transactions where the gross outstanding principal insured by FSA per single risk exceeds \$50 million or \$75 million depending on the hospital rating and type. AMBAC's cession limit was the lesser of (1) a specific numeric limit and (2) 20% of FSA's net retention of the insured single risk.</p>
Surplus Share Treaty – FGIC 100% Authorized	<p>Provides quota share reinsurance for (a) project finance transactions where the gross outstanding principal insured by FSA per single risk equals or exceeds \$500 million and (b) US health care transactions where the gross outstanding principal insured by FSA per single risk exceeds \$50 million. FGIC's cession limit was the lesser of (1) a specific numeric limit, and (2) 20% of FSA's net retention of the insured single risk.</p>

The Company also has in place a master facultative reinsurance agreement with: ACA Financial Guaranty Corp; Assured Guaranty Re; Blue Point Re, Limited; CIFG Assurance North America; FGIC; R.V.I. Guaranty Co; and XLFA (now known as Syncora Guarantee Inc.) whereby the Company cedes to the reinsurer the share of a risk(s) insured by the Company as specified and agreed to by the parties in a reinsurance memorandum.

Additionally, the Company has in effect in 2007 seven automatic facultative agreements with various authorized and unauthorized reinsurers. Under these agreements, the Company is required to make individual facultative cessions in an aggregate amount ranging from 0.6% to 5% of the gross principal insured under FSA policies which qualify for cessions to the reinsurers under the

Company's quota-share treaties, with an option to cede up to approximately 30% of FSA's gross principal insured to all such reinsurers.

Under one of the automatic facultative agreement, the Company is required to cede from 3.5% to 7% of the gross principal insured by the Company during the calendar year. The 3.5% does not include the amounts ceded to this reinsurer under the Company's quota-share treaties.

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

It is the Company's policy to obtain the appropriate collateral for its cessions to unauthorized reinsurers. Letters of credit and trust accounts obtained by the Company to take credit for cessions to unauthorized reinsurers were reviewed for compliance with Department Regulations 133 and 114, respectively. No exceptions were noted.

Reinsurance agreements with affiliates were reviewed for compliance with Article 15 of the New York Insurance Law. It was noted that all affiliated reinsurance agreements were filed with the Department pursuant to the provisions of Section 1505(d)(2) of the New York Insurance Law.

All ceded reinsurance agreements in effect as of the examination date were reviewed and found to contain the required clauses, including an insolvency clause meeting the requirements of Section 1308 of the New York Insurance Law.

Examination review of the Schedule F data reported by the Company in its filed annual statement was found to accurately reflect its reinsurance transactions. Additionally, management has represented that all material ceded reinsurance agreements transfer both underwriting and timing risk as set forth in SSAP No. 62. Representations were supported by appropriate risk transfer analyses and an attestation from the Company's chief executive officer pursuant to the NAIC Annual Statement Instructions. Additionally, examination review indicated that the Company was not a party to any finite reinsurance agreements. All ceded reinsurance agreements were accounted for utilizing reinsurance accounting as set forth in SSAP No. 62.

During the period covered by this examination, the Company commuted various reinsurance agreements where it was a ceding/assuming reinsurer. These commutations were neutral to the Company's surplus position.

D. Holding Company System

The Company is 100% owned by 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 FSAIC and FSAIC's subsidiaries: FSAINT, Financial Security Assurance (U.K.) Ltd., ("FSAUK"), and FSA Mexico Holdings Inc. and FSA Sequros Mexico S. A. de C. V. ("FSA Mexico")

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.

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.

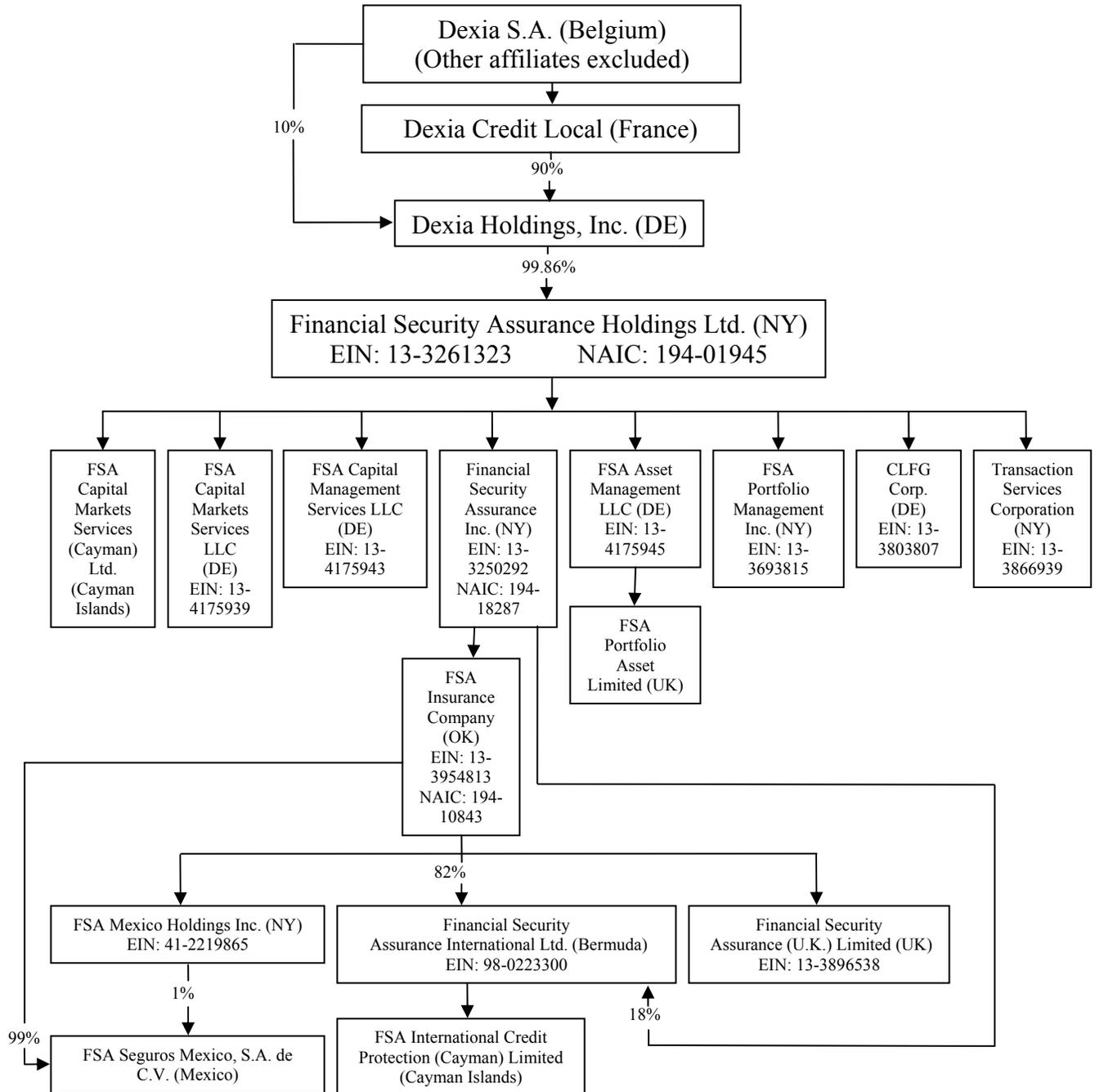
FSA Mexico Holdings is a New York domiciled holding company, which is wholly-owned by FSAIC. FSA Mexico Holdings' sole business is the ownership of shares of FSA Mexico. FSA Mexico Holdings owns 1% of FSA Mexico and the remaining 99% of FSA Mexico is owned by FSAIC. FSA Mexico is authorized in Mexico to write financial guaranty insurance.

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.

In December 2007, the Company received authorization from the Department to repay its entire surplus note obligation of \$108.9 million to its parent company. At the same time, the parent re-contributed the proceeds from the repayment to the Company as a capital contribution. In addition, the parent forgave all interest expense for 2007 and reimbursed the Company \$3.6 million already paid by the Company.

The following is an abridged chart of the holding company system at December 31, 2007:

**FINANCIAL SECURITY ASSURANCE HOLDINGS LTD.  
HOLDING COMPANY CHART AS OF DECEMBER 31, 2007  
Part I: FSA Group**



Notes: If no percentage is shown, ownership interest is 100% , except for FSA Capital Markets Services (Cayman) Ltd., in which Financial Security Assurance Holdings Ltd. has no ownership interest, and FSA International Credit Protection (Cayman) Limited, in which Financial Security Assurance International Ltd. has no ownership interest. Percentages shown represent voting control. All companies listed are corporations.

At December 31, 2007, in addition to the reinsurance agreements mentioned in Item 2C, the Company was party to the following agreements with other members of its holding company system:

#### Trust Agreement

Effective December 31, 1999, the Company entered into a trust agreement with its affiliate FSAINT and Bankers Trust Company, Bahamas branch, as the trustee. The agreement was entered into in conjunction with the quota share reinsurance pooling agreement mentioned in Item 2C. This agreement was non-disapproved by the Department on December 29, 1999.

#### 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 FSAH and several of its subsidiaries. On January 1, 2006, this agreement was amended and restated to delete White Mountain Holdings, Inc. and other subsidiaries from the agreement. The agreement complies with the requirements of the Department Circular Letter No. 33 (1979). This agreement was non-disapproved by the Department on November 21, 2006.

#### 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 10,00,000 pounds sterling as determined under the law 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. This agreement was non-disapproved by the Department on March 17, 1993.

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 FSAIC. Under this agreement the Company agreed to maintain FSAIC's minimum required amount of surplus to policyholders of \$66,400,000, subject to certain limits. This agreement was non-disapproved by the Department on April 11, 1997.

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. This agreement was non-disapproved on October 30, 1998.

On September 12, 2007, the Company entered into a net worth maintenance agreement with its subsidiary, FSA Mexico. Under this agreement, the Company agrees to maintain assets covering the minimum guarantee capital, as referred to in Article Fourteen of the First Chapter of Title III of the Operational Rules for Financial Guaranty Insurance of the Ministry of Finance and Public Debt of Mexico equal to the greater of the following amount (i) the minimum paid in capital required by Article Six of the Third Chapter of Title 1 of the Operational Rules as currently in effect or with such changes thereto as FSA shall approve and (ii) the minimum guarantee capital required by Article Fourteen of the First Chapter of Title III of the Operational Rules as currently in effect or with such changes thereto as FSA shall approve. This agreement was non-disapproved by the Department on November 1, 2006.

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

The Company has in effect as of December 31, 2007, various agreements among its parent, affiliates and subsidiaries for cooperative and joint use of personnel, property and services. Under these agreements FSA provides equipment, and services, as available, with respect to administrative, audit, underwriting, accounting, treasury, legal, marketing, claims, electronic data processing, compliance and surveillance, reinsurance, workouts, credit exposure management, and risk management as will enable them to conduct an insurance business and other corporate functions. FSA charges costs (direct and indirect) and expenses for providing such services. These agreements were non-disapproved by the Department on various dates.

#### Other Agreements

Effective July 1, 2000, the Company entered into a guaranty underwriting representative agreement with its affiliate, FSA Services (Australia) PTY Limited ("FSA Australia"), whereby FSA Australia provides services to the Company for the issuance of guaranties with respect to financial transactions involving Australian assets or obligors. This agreement was non-disapproved by the Department on June 5, 2001.

Effective 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 S.A. 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 S.A. and FSA with respect to the particular transaction. On January 6, 2005, the Company withdrew its submission of the Master Letter Of Credit Issuance and Reimbursement Agreement with Dexia Bank S.A. noting that no letter of credit was ever issued.

Effective October 1, 2002, the Company and 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 loss models, (b) transaction structure advice, and (c) education and training with respect to the foregoing. This agreement was non-disapproved by the Department on June 19, 2003.

Effective October 1, 2002, the Company entered into a service agreement with FSA Services (Japan) Inc. Under this agreement, the Company obtains support services in Japan to conduct its business related to Japan. This agreement was non-disapproved by the Department on May 15, 2002.

Effective May 3, 2004, the Company entered into a tax representative agreement with its affiliate FSAUK. Under this agreement the Company appointed FSAUK as its tax representative and authorizes it to act as fiscal representative in respect of reinsurance by the Company of all U.K. financial guarantees or similar instruments in connection with which tax is due. This agreement was non-disapproved by the Department on May 20, 2004.

Effective October 31, 2005, the Company entered into a share exchange agreement with FSAINT whereby the Company exchanged the 1,200 preferred shares held in XL Insurance (Bermuda) Ltd., for 64 common shares in FSAINT for a consideration of \$39,133,401. This agreement required no approval or non-disapproval by the Department.

Effective January 1, 2006, FSA entered into a service agreement with FSA Services (Americas) Inc. Under this agreement, FSA obtains support services in countries in the Americas, including Mexico, to conduct its business. This agreement was non-disapproved by the Department on December 29, 2005.

E. Significant Operating Ratios

The following ratios have been computed as of December 31, 2007, based upon the results of this examination:

Net premiums written to surplus as regards policyholders	24%
Liabilities to liquid assets (cash and invested assets less investments in affiliates)	86%
Premiums in course of collection to surplus as regards policyholders	5%

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	\$69,564,557	5.65%
Other underwriting expenses incurred	577,562,645	46.92
Net underwriting gain	<u>583,792,547</u>	<u>47.43</u>
Premiums earned	<u>\$1,230,919,749</u>	<u>100.00%</u>

F. Accounts and Records

Subrogation Recoverable

During 2007, the Company reported \$26,298,934 as subrogation recoverable. This subrogation recoverable represents amounts expected to be recovered from future cash flows of some of the deals on which the Company had paid claims but case reserves were not established since the model used to calculate these reserves showed a net salvage on a discounted basis. SSAP 55(7)(d)(12) indicates:

“If a reporting entity chooses to anticipate salvage and subrogation recoverables (including amounts recoverable from second injury funds, other governmental agencies, or quasi-governmental agencies, where applicable), the recoverable shall

be estimated in a manner consistent with paragraphs 8 through 10 of this statement and shall be deducted from the liability for unpaid claims or losses.”

In addition, Section 6903(b) of the New York State Insurance Law states in part:

“ . . . The case basis method or such other method shall be used to establish and maintain loss reserves, net of collateral, for claims reported and unpaid. . . ”

Therefore, it is recommended that the Company does not set subrogation recoverable as an asset but rather as a debit against the reported case reserves.

### **3. FINANCIAL STATEMENTS**

#### A Balance Sheet

The following shows the assets, liabilities and surplus as regards policyholders as of December 31, 2007 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	\$2,974,406,136	\$ 0	\$2,974,406,136
Common stocks	896,495,763	0	896,495,763
Cash, cash equivalents and short-term investments	66,763,759	0	66,763,759
Other invested assets	128,221,889	0	128,221,889
Receivable for securities	1,773,508	0	1,773,508
Investment income due and accrued	39,915,271	0	39,915,271
Uncollected premiums and agents' balances in the course of collection	88,742,256	537,024	88,205,232
Amounts recoverable from reinsurers	25,595,664	0	25,595,664
Net deferred tax asset	142,966,738	117,464,479	25,502,259
Electronic data processing equipment and software	678,916	0	678,916
Furniture and equipment, including health care delivery assets	26,237,251	26,237,251	0
Receivables from parent, subsidiaries and affiliates	16,132,693	887,435	15,245,258
Miscellaneous receivables	3,478,932	3,317,816	161,116
Subrogation recoverable	26,298,934		26,298,934
Prepaid expenses	8,158,785	8,158,785	0
Other assets	<u>648,818</u>	<u>648,818</u>	<u>0</u>
Total assets	<u>\$4,446,515,313</u>	<u>\$183,550,542</u>	<u>\$4,262,964,771</u>

Liabilities, Surplus and Other Funds

Losses		\$ 64,531,726
Other expenses (excluding taxes, licenses and fees)		155,664,819
Taxes, licenses and fees (excluding federal and foreign income taxes)		8,149,400
Current federal and foreign income taxes		22,472,758
Unearned premiums		1,486,993,219
Ceded reinsurance premiums payable (net of ceding commissions)		83,705,883
Payable to parent, subsidiaries and affiliates		22,908,334
Contingency reserve		775,838,685
Miscellaneous Liability		<u>40,059,301</u>
Total liabilities		\$2,660,324,125

Surplus and Other Funds

Common capital stock	\$ 15,000,000	
Gross paid in and contributed surplus	355,818,475	
Unassigned funds (surplus)	<u>1,258,121,105</u>	
Surplus as regards policyholders		<u>1,628,939,580</u>
Total liabilities, surplus and other funds		<u>\$4,289,263,705</u>

NOTE: The Internal Revenue Service has completed its audits of the Company's consolidated Federal Income Tax returns for tax years 2005 and 2006. No changes were made as result of the audit. 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 increased \$489,112,474 during the five-year examination period January 1, 2003 through December 31, 2007, detailed as follows:

Underwriting Income

Premiums earned		\$1,230,919,749
Deductions:		
Losses incurred	\$ 65,453,221	
Loss adjustment expenses incurred	4,111,336	
Other underwriting expenses incurred	577,562,645	
Aggregate write-ins for underwriting deductions	<u>0</u>	
Total underwriting deductions		<u>647,127,202</u>
Net underwriting gain or (loss)		\$583,792,547

Investment Income

Net investment income earned	\$785,257,373	
Net realized capital gain	<u>43,676,560</u>	
Net investment gain or (loss)		\$828,933,933

Other Income

Aggregate write-ins for miscellaneous income	<u>\$ 25,426,573</u>	
Total other income		<u>\$25,426,573</u>
Net income after dividends to policyholders but before federal and foreign income taxes		\$1,438,153,053
Federal and foreign income taxes incurred		<u>322,440,867</u>
Net income		<u>\$1,115,712,186</u>

### C. Capital and Surplus Account

Surplus as regards policyholders per report on examination as of December 31, 2002			\$1,139,827,106
	<u>Gains in</u>	<u>Losses in</u>	
	<u>Surplus</u>	<u>Surplus</u>	
Net income	\$1,115,712,186		
Net unrealized capital gains or (losses)	231,665,288		
Change in net unrealized foreign exchange capital gain (loss)		\$20,968,778	
Change in net deferred income tax	118,202,853		
Change in non-admitted assets		127,758,189	
Change in surplus notes		214,865,585	
Capital changes transferred from surplus (stock dividend)	1,473,828		
Capital changes transferred to surplus		1,473,828	
Surplus adjustments paid in		134,455,835	
Surplus adjustments transferred to capital (stock dividend)		1,473,828	
Dividends to stockholders		257,000,000	
Aggregate write-ins for gains and losses in surplus	<u>0</u>	<u>219,945,638</u>	
Total gains and losses	<u>\$1,467,054,155</u>	<u>\$977,941,681</u>	
Net increase (decrease) in surplus			<u>489,112,474</u>
Surplus as regards policyholders per report on examination as of December 31, 2007			<u>\$1,628,939,580</u>

#### 4. LOSSES

As of December 31, 2007, the Company reported losses of \$64,531,726. However, during 2008, the Company significantly increased its case reserves due to the unprecedented levels of delinquencies and new defaults in the U.S. residential mortgage markets. At December 31, 2008, the Company reported \$1,104,939,586 in loss reserves, a substantial increase over the amount reported at December 31, 2007.

A review of the Company's case reserve modeling and assumptions was performed by the Department's Capital Markets Bureau. The review did not indicate any basis for rejecting or amending the Company's 2007 reserves, despite the dramatic increase in the Company's reserves from 2007 to 2008. Such increases were not deemed to be attributable to flaws in the Company's methodologies or models, but rather to unforeseeable factors, namely the accelerated deterioration in the housing and mortgage markets and the impact this had on financial markets, institutions, and the global economy.

The Company's primary area of focus was its residential mortgage portfolio surrounding home equity lines of credit ("HELOC"), option adjusted rate mortgages ("Option ARM"), Alt-A first-lien mortgages, and alt-A closed-end second-lien mortgages ("Alt-A closed-end"). These four sectors have deteriorated significantly during 2008 and it is expected to continue.

During 2008, the Company increased its net reserves for its U.S. residential mortgage portfolio as follows: HELOC \$388 million; ARM \$170.6 million; Alt-A (CES) \$153 million; Financial Products portfolio \$137.7 million; Alt-A First lien \$62.8 million, One Pooled Corp \$61.7 million; one additional Public Finance transaction \$35.9 million; NIM \$31.3 million; and One Subprime asset back transaction \$11.9 million.

Case reserves for financial guaranty insurance companies differ from those of traditional property and casualty insurance companies. The primary difference is that traditional property and casualty case reserves include only claims that have been incurred and reported to the insurance company. Unlike traditional property and casualty claims, financial guaranty losses arises from the extension of credit protection and occur as the result of the credit deterioration of the issuer or underlying assets of the insured obligations over the lives of those insured obligations. A case reserve is determined using cash flow or similar models that represent the Company's estimate of the net present value of the anticipated shortfall between (a) schedule payments on the insured obligation plus anticipated loss adjustment expenses and (b) anticipated cash flow from and proceeds to be received on sales of any collateral supporting the obligation and other anticipated recoveries. The Company uses assumptions, which represent current and forward looking perspectives of the underlying risks and market conditions. However, the Company is only able to forecast assumptions using data available at the time of the analysis.

Commencing in the fourth quarter of 2007, major financial institutions, including financial guaranty insurers, have seen deterioration in the performance of insured obligations in various asset classes, with the predominance of the deterioration seen in the residential mortgage-backed securities ("RMBS") and in collateralized debt obligations that are collateralized by residential mortgage and asset-backed loans and securitizations.

## 5. SUBSEQUENT EVENTS

### (1) Capital Contribution

On February 15, 2008, the Company received a capital contribution of \$500 million from its parent company, FSAH. At the same time, FSA made a capital contribution of \$250 million to its subsidiary, FSAIC.

On July 31, 2008 the Company made a capital contribution of \$12.3 million to FSAINT.

### (2) Sale of minority interest in XL Financial Assurance Ltd.

On August 4, 2008, the Company sold its minority interest in XL Financial Assurance Ltd. for a consideration of \$1,208,677.

### (3) Surplus Notes

On September 8, 2008, the Company issued a non-interest bearing surplus note obligation of \$300 million to its parent company. This transaction was approved by the Department.

### (4) Rating Downgrade

On November 21, 2008, Moody's Investors Service downgraded to Aa3 from Aaa the insurance financial strength rating of the Company and supported insurance companies. In the same rating action, Moody's downgraded the debt ratings of Financial Security Assurance Holdings, Ltd. (senior unsecured debt to A3 from Aa2) and related financing trusts.

On October 8, 2008, S&P placed the Company on review for downgrade and on November 6, 2008, S&P reported that the Company surpassed its triple-A minimum requirement with a margin of safety of 1.3 – 1.4 times.

On October 9, 2008, Fitch also placed the Company's triple-A ratings on negative credit watch.

(5) Exit of Business Segment

During the third quarter of 2008, as result of the increased credit deterioration in the residential mortgage-backed portfolio and general economic condition, FSA and Dexia S.A. (Belgium) (the Company's ultimate parent) undertook a strategic business review, which resulted in the Company exiting the asset-backed sector to focus exclusively on U.S. and international public finance transactions and Dexia assuming the liquidity and credit risk associated with the financial products portfolio.

(6) Sale of the Company

On November 14, 2008, Dexia Holdings, Inc. announced its intention to sell FSAH, (excluding the financial product sector) to Assured Guaranty Ltd ("Assured"), a Bermuda holding company, for a consideration of US \$361 million in cash and US \$44.6 million of newly issued Assured shares based on Assured's closing price on November 13, 2008 of US \$8.10 per share. As of the date of this report, the sale had not been completed.

## 6. COMPLIANCE WITH PRIOR REPORT ON EXAMINATION

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

<u>ITEM</u>	<u>PAGE NO.</u>
A. <u>Holding Company System</u>	
<u>Other Agreements</u>	
i. 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.	18
The Company has complied with this recommendation.	
ii. 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.	19
The Company has complied with this recommendation.	
iii. 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 New York Regulation 30.	20
The Company has complied with this recommendation.	
iv. It is 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.	20
The Company has complied with this recommendation.	
v. It is recommended that the Company seek reimbursement for overhead services provided to other members of its holding company system in accordance with Section 1505(a) of the New York Insurance Law.	20
The Company has complied with this recommendation.	

<u>ITEM</u>	<u>PAGE NO.</u>	
vi.	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.	21
	The Company has complied with this recommendation.	
B. <u>Accounts and records</u>		
	<u>Unearned Premium</u>	
	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
	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.	
	The Company has complied with this recommendation.	
	<u>Surplus Notes</u>	
i.	It is recommended that the Company comply with SSAP 41 and classify as a liability all surplus notes approved for repayment by the Department.	24
	The Company has complied with this recommendation.	
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
	The Company has complied with this recommendation.	
	<u>Bank Reconciliation</u>	
	It is recommended that the Company institute procedures to ensure that bank reconciliations are properly completed.	25
	The Company has complied with this recommendation.	

ITEMPAGE NO.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

The Company has complied with this recommendation.

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

The Company has complied with this recommendation.

## 7. SUMMARY OF COMMENTS AND RECOMMENDATIONS

ITEMPAGE NO.A. Accounts and records

It is recommended that the Company does not set subrogation recoverable as an asset but rather as a debit against the reported case reserves.

17

Respectfully submitted,

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Maribel C. Nuñez, CPCU  
Senior Insurance Examiner

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

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

\_\_\_\_\_  
Maribel C. Nuñez

Subscribed and sworn to before me

this \_\_\_\_\_ day of \_\_\_\_\_, 2009.

Appointment No. 22761

STATE OF NEW YORK  
INSURANCE DEPARTMENT

I, Eric R. Dinallo, Superintendent of Insurance of the State of New York,  
pursuant to the provisions of the Insurance Law, do hereby appoint:

**Maribel Nunez**

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

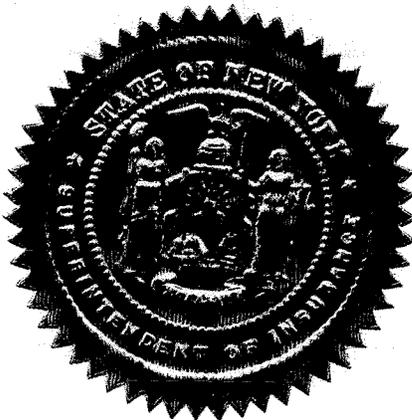
**FINANCIAL SECURITY ASSURANCE INC.**

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

**Incorporated**

*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 11th day of April, 2008*

A handwritten signature in black ink that reads "Eric R. Dinallo".

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ERIC R. DINALLO  
*Superintendent of Insurance*