MEETING DATE: 8/18/2008
ITEM NO: 15
DESK ITEM

COUNCIL AGENDA REPORT

DATE: August 18, 2008

TO: MAYOR AND TOWN COUNCIL

FROM: GREG LARSON, TOWN MANAGER

SUBJECT: ACCEPT STATUS REPORT AND CONSIDER DISPOSITION OF FANNIE MAE AND FREDDIE MAC FEDERAL HOME LOAN COUPON NOTES INVESTMENT STRATEGIES

DISCUSSION:

Council Member Glickman requested that the attached material be distributed to Council for this item.

PREPARED BY: **GREG LARSON**
Town Manager

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Reviewed by: _____Assistant Town Manager _____Town Attorney
_____ Clerk Administrator _____Finance _____Community Development

Bloomberg.com

Harman, LECG, MBIA, R.H. Donnelley, SanDisk: U.S. Equity Movers

By Lynn Thomasson

Aug. 18 (Bloomberg) -- The following companies are having unusual price changes in U.S. markets. Stock symbols are in parentheses after company names, and prices are as of 11:40 a.m. in New York.

Mortgage lenders **Fannie Mae** (FNM US) and **Freddie Mac** (FRE US) fell the most in the Standard & Poor's 500 Index. Barron's said it is ``increasingly likely'' the U.S. Treasury Department will recapitalize the home-loan providers, which would leave the shares worthless. Fannie Mae lost 14 percent to $6.77. Freddie Mac declined 14 percent to $5.04.

The stocks led **financials** in the S&P 500 to a 1.5 percent drop, the biggest among 10 industries.

SanDisk Corp. (SNDK US) slumped 7.7 percent, the most in a month, to $16.28. The shares of the biggest maker of memory cards for digital cameras should be sold following the stock's 15 percent gain this month, Citigroup Inc. analysts said.

First Marblehead Corp. (FMD US) increased the most since December, adding 44 percent to $4.32. The arranger of securities backed by student loans replaced its chief executive officer and said it obtained financing from Goldman Sachs Group Inc.'s private-equity arm.

Harman International Industries Inc. (HAR US) dropped 6.8 percent to $34.48, bringing its four-day loss to 21 percent. On Aug. 15, the audio-equipment maker reported quarterly earnings that decreased more than some analysts estimated.

Hershey Co. (HSY US) dropped the most since September 2002, tumbling 9.8 percent to $37.53. The largest U.S. chocolate maker said price increases will curb sales and profit growth in 2009. Citigroup Inc. cut its rating on the shares to ``hold'' from ``buy.''

Huntington Bancshares Inc. (HBAN US) dropped 7.2 percent, the most since July 28, to $7.40. The Ohio-based bank, which has a lending agreement with subprime mortgage company Franklin Credit Management Corp. (FCMC US), said Franklin will probably report a second-quarter loss as high as $285 million. FTN Midwest Securities cut Huntington to ``sell'' from ``neutral.''

LECG Corp. (XPRT US) tumbled 11 percent, the most since July 30, to $8.20. The provider of expert testimony and advice to companies was cut to ``neutral'' from ``buy'' by UBS AG.

MBIA Inc. (MBI US) advanced for a fourth day, rising 5.3 percent to $11.81. **Ambac Financial Group** (ABK US) increased 7 percent to $6.08. Standard & Poor's affirmed its rating of 619 classes of U.S. asset-backed securities backed by the two largest bond insurers. S&P last week maintained the companies' credit ratings and said they are taking steps to shore up their businesses.

R.H. Donnelley Corp. (RHD US) rose 23 percent, the most since July 23, to $2.31. The yellow-pages publisher, buckling under $9.7 billion in net debt and falling advertising revenue, may rally from its 94 percent decline this year if the directories remain popular, Barron's said, citing no one.

ShengdaTech Inc. (SDTH US) gained the most since Aug. 5, rising 5.8 percent to $10.07. The China-based maker of chemicals reported second-quarter adjusted profit of 18 cents a share, more than the 14-cent average estimate of analysts surveyed by Bloomberg.

UnionBanCal Corp. (UB US) rose 12 percent to $73.21, the highest since at least 1985. Mitsubishi UFJ

Bloomberg.com

MBIA, Ambac Jump After S&P Ends Credit Rating Review (Update5)

By Jody Shenn

Aug. 15 (Bloomberg) -- MBIA Inc. and Ambac Financial Group Inc., the bond insurers that lost at least 79 percent of their market value in the past year, rose in New York trading after Standard & Poor's affirmed the companies' credit ratings and said they are taking steps to shore up their businesses.

Ambac rose $1.12, or 25 percent, to $5.68, the highest since April, in New York Stock Exchange composite trading. MBIA climbed 90 cents, or 8.7 percent, to $11.22, the highest since May. MBIA Insurance Corp. and Ambac Assurance Corp. remain AA rated, New York-based S&P said in statements yesterday.

``This is just another indication that the words `insolvency' and Ambac and MBIA should not be used in the same sentence," said Tom Brown, the chief executive officer of New York-based Second Curve Capital LLC, which holds shares of MBIA and Ambac.

S&P, which stripped away the companies' AAA bond insurer ratings in June, ended a review for further downgrades and said the companies are doing well enough to maintain their current AA status. The affirmation may help to strengthen a recovery in financial company shares that began July 15, Brown said.

``You need actions like this to help reduce the fear and pessimism," Brown said in a telephone interview today.

Financial stocks in the S&P 500 rose about 1 percent today and are up about 23 percent since July 15.

Creditworthiness

Armonk, New York-based MBIA and New York-based Ambac as of June 30 guaranteed about $1.1 trillion in bonds and securities issued by cities, states, corporations and other businesses. The value of those guarantees and the ability to sell new policies declined after the bond insurance units lost their AAA ratings.

Perceptions that the creditworthiness of bond insurers is declining contributed to the more than $502 billion in asset writedowns and credit losses at the world's top banks and brokers since the start of last year.

Bond insurers owned by MBIA, Ambac, Syncora Holdings Ltd., FGIC Corp., and CIFG Holdings lost their top ratings as losses grew from collateralized debt obligations and other mortgage- linked securities.

MBIA Insurance's capital levels remain ``well above the level required for a AA rating," S&P said. Ambac Assurance's efforts to cancel protection on mortgage-linked debt also ``are starting to bear fruit," the ratings company said.

``I still think the rating agencies are acting like lunatics" for not assigning higher ratings, Brown said.

CDOs

Ambac said Aug. 1 it tore up a $1.4 billion CDO contract with Citigroup Inc. for $850 million. CDOs repackage assets such as mortgage bonds, loans and derivatives into new securities with varying risks.

``Ambac's remediation and commutation efforts will continue to address S&P's concerns related to"

mortgage exposures, Chief Executive Officer Michael Callen said in a statement yesterday.

MBIA shares remain 79 percent lower than a year ago, while Ambac has fallen 90 percent. The S&P 500 financial stocks index is down 34 percent over the period.

S&P's outlook for the insurers' ratings is negative. A negative outlook indicates a downgrade is more likely than an upgrade over the longer term. MBIA's outlook reflects the potential for home-loan losses to rise beyond S&P's expectations. Ambac's outlook reflects the prospects for ``reduced business'' because of damage to its reputation from its losses, S&P said.

New York-based Moody's Investors Service rates MBIA's main insurance unit the equivalent of three levels lower than S&P, at A2, and Ambac's unit one level lower, at Aa3.

Earnings

MBIA's second-quarter net income jumped eightfold to a record $1.7 billion, or $7.14 a share, because of a $3.3 billion gain on the declining value of its liabilities. New accounting rules allowed the company to log gains on the declines in its perceived creditworthiness. Ambac had earnings of $823.1 million, or $2.80 a share, amid a similar $5.2 billion gain.

Ambac and MBIA have been losing business to Hamilton, Bermuda-based Assured Guaranty Ltd. and New York-based Financial Security Assurance Holdings Ltd. Ambac and MBIA had a combined market share of 3.2 percent in the first half of the year, down from 42.2 percent in the same period of 2007.

As of June 30, MBIA had guarantees on $644 billion of debt, according to company presentations. Ambac had $487 billion and FSA $443 billion.

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Bloomberg.com

Bill Ackman Was Right: MBIA, Ambac on `Ratings Cliff' (Update1)

By Christine Richard

June 18 (Bloomberg) -- Bill Ackman was right: the world's largest bond insurers aren't worthy of a AAA credit rating and may be headed for the bottom of the scale.

Ackman, the 42-year-old hedge fund manager who says he stands to make hundreds of millions of dollars betting against MBIA Inc. and Ambac Financial Group Inc. if they go bankrupt, will tell investors at a conference in New York today that losses posted by bond insurers may threaten to breach the capital limits allowed by regulators, making them insolvent.

That once-unthinkable scenario would trigger clauses in $400 billion of derivative contracts written to insure collateralized debt obligations and other securities, allowing policyholders to demand immediate payment for market losses, which have reached $20 billion, according to company filings. Downgrades of the insurers would cause a drop in rankings for the $2 trillion of debt that the companies guarantee, wiping out the value of the CDO insurance held by Wall Street firms, analysts at Oppenheimer & Co. said.

``Given the volume of credit-default swap contracts the industry has written, there is a real element of a ratings cliff across the bond insurance sector,'' said Fitch managing director Thomas Abruzzo, the first analyst to strip MBIA and Ambac of their top ratings.

Ambac said today it asked Fitch to remove ratings on all of the company's subsidiaries. MBIA asked Fitch to stop assigning a financial strength rating in March.

17 Levels

CIFG North America may fall first. The company's credit rating has been cut by 17 levels to CCC from AAA by Fitch since March because of concern it won't be able to make payments on $57 billion of the contracts.

Ackman said CIFG ``provides a road map for what happens to a bond insurer when its capital is depleted.'' Ackman, whose $6 billion Pershing Square Capital Management hedge fund in New York returned 22 percent last year, began betting against bond insurers in 2002. In his report ``Is MBIA Triple-A?,'' Ackman was the first to say the insurer's use of derivatives to guarantee debt threatened to drain capital.

MBIA, of Armonk, New York, Ambac, Security Capital's XL Capital Assurance and FGIC Corp. also have guarantees with similar clauses to CIFG that may allow policyholders to demand billions of dollars if the companies became insolvent, according to company filings.

CIFG, XL Capital Assurance, and FGIC's insurance unit may all fall short of regulatory capital requirements by June 30, according to Robert Haines, an analyst with CreditSights Inc. in New York.

`Highly Theoretical'

Downgrades may cause Citigroup Inc., Merrill Lynch & Co. and UBS AG to write down the value of insured-debt holdings by at least $10 billion, according to Meredith Whitney, an analyst at Oppenheimer in New York. Banks and insurance companies would also be required by regulators to hold more capital to protect against losses on lower-rated debt, according to analysts at Charlotte, North

Carolina-based Wachovia Corp.

CIFG is working on a plan to bolster capital, spokesman Michael Ballinger said. Because MBIA has a surplus of $3.9 billion, insolvency is ``both highly theoretical and extremely unlikely,'' Kevin Brown, a spokesman for MBIA said in an e-mailed statement. Vandana Sharma, a spokeswoman for Ambac, with a $3.6 billion surplus, declined to comment, as did Security Capital spokesman Michael Gormley and New York-based FGIC's chief risk officer, John Dubel.

Insurers, including MBIA and Ambac, expanded beyond municipal debt into insuring CDOs, which package pools of securities and slice them into pieces of varying risk. The move was criticized by Ackman, who said it may ultimately bankrupt the companies.

Pershing Square

In January, Ackman, who started a hedge fund after working at his family's commercial mortgage brokerage, estimated MBIA and New York-based Ambac faced losses on home-loan securities of almost $12 billion each, a claim the companies disputed as recently as February.

Ackman said he took an interest in MBIA after asking a credit-market trader which companies didn't deserve AAA ratings. That led to his report and his decision to take a short position in MBIA and Ambac stock, selling borrowed stock, expecting to repurchase it later at a lower price. Ackman also bought credit- default swaps on MBIA and Ambac debt. The swaps would rise in value if doubts about the companies grew.

Pershing Square profited as MBIA tumbled 91 percent in the past 12 months and Ambac plunged 98 percent in New York Stock Exchange composite trading. Security Capital is down 99 percent.

Investor Bets

Instead of writing standard insurance policies for the CDOs, the companies provided guarantees in the form of credit-default swap contracts, financial instruments that allow one party to assume the risk of a security defaulting in exchange for a fee from another.

The contracts were designed to mirror insurance policies, said Bob Mackin, the Albany, New York-based executive director of the Association of Financial Guaranty Insurers.

Unlike insurance, the swaps include so-called termination clauses that can be triggered if a company becomes insolvent, Mackin said. The feature requires insurers to compensate CDO holders for any drop in value, or mark-to-market loss, on the securities.

Moody's wrote in 2006 that the companies were ``well insulated from liquidity risk,'' because credit-default swaps ``protect the guarantor from ever having to pay claims on an accelerated basis.'' Moody's spokesman Abbas Qasim declined to make analysts available for this story.

`Serious Consequences'

The credit ratings of some CDOs have tumbled so far that the insurers have recorded combined unrealized losses of at least $20 billion.

Some companies' termination payments would eat up all their claims-paying resources, according to filings and rating company reports.

``It doesn't make sense for companies and regulators to have gone knowingly into this, given the very serious consequences,'' said Lawrence Hamilton, an insurance attorney with Mayer Brown LLP in Chicago. ``At the time, the possibility of a bond insurer becoming insolvent seemed so remote.''

If a company's surplus to policyholders -- or assets over liabilities -- falls below zero, it's considered insolvent under New York State Insurance Department rules and would be taken over by Superintendent Eric Dinallo, unless it comes up with a plan to correct the impairment, Deputy Superintendent Michael Moriarty said in an e-mailed statement.

Moriarty wouldn't comment on the likelihood of the department taking over the companies under that

scenario.

`Extremely Alarming'

In a June 8 report, CreditSights' Haines wrote that ``statutory surplus levels at some of the monoline financial guarantors are extremely alarming."

Companies may avoid making the termination payments by raising capital or reducing loss reserves. CIFG and FGIC are seeking ways to raise capital, they said. MBIA and Ambac have said they don't anticipate losses will be large enough to erode their surpluses.

Even in an insolvency, regulators may step in to halt the payments or banks may decide not to demand compensation, Abruzzo said. **ACA Financial Guaranty Corp.** has reached five agreements with banks since December, allowing it to avoid posting collateral on CDOs it guaranteed using swaps. ACA has been cut to CCC by S&P.

Fitch is assuming in its ratings that regulators will allow the payments, Abruzzo said.

CIFG, FGIC

CIFG, based in Hamilton, Bermuda, had a surplus of $80 million at the end of the first quarter, down from $103 million, according to filings. It set aside more than $100 million for losses in the first three months of the year.

Security Capital's XL Capital Assurance booked about $200 million of losses in the first quarter, shrinking its surplus to $167 million, according to company **filings**. SCA, based in Hamilton, Bermuda, wouldn't be able to cover termination payments on swaps if they were triggered, according to regulatory filings. XL is rated BB by Fitch, A3 by Moody's and BBB- at S&P.

FGIC had a cushion of $366 million at the end of March, compared with loss reserves of about $1.8 billion taken in the past year, according to company **filings**. FGIC is rated BBB by Fitch, Baa3 at Moody's and BB by S&P.

MBIA and Ambac may need to raise capital to avoid becoming insolvent if loss reserves continue at the recent pace, Haines said. The companies were both cut to AA from AAA by Fitch and S&P. Moody's said on June 4 that it probably will also reduce its ratings.

S&P spokeswoman **Mimi Barker** declined to make analysts available for this story.

`Nightmare Scenario'

In the past two quarters, MBIA's insurance unit set aside reserves of $2 billion to cover losses on $51 billion of guarantees on home-equity securities and CDOs backed by subprime mortgages.

Ambac booked about $2 billion of loss reserves, leaving it with a statutory surplus of $3.6 billion. It guaranteed around $47 billion of CDOs and home-equity debt.

While both companies are above the regulatory capital requirements, S&P said in a February report that in a ``stress case scenario," MBIA may be forced to pay a total $7.9 billion in claims on a present-value basis and Ambac may be forced to pay $6.2 billion.

``That's what puts these companies into the nightmare scenario," CreditSights' Haines said.

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Last Updated: June 18, 2008 14:32 EDT

Bloomberg.com

Moody's Cuts MBIA, Ambac, Taking Last Aaa Ratings (Update2)

By Christine Richard and Bryan Keogh

June 19 (Bloomberg) -- Moody's Investors Service stripped MBIA Inc. and Ambac Financial Corp. of their Aaa, following Fitch Ratings and Standard & Poor's, ending the bond insurers' run of at least two decades at the top of the ratings scale.

MBIA's MBIA Insurance Corp. unit was reduced five levels to A2 from Aaa, New York-based Moody's said today in a statement. Ambac Assurance Corp. was lowered three steps to Aa3, Moody's said in a separate release. The outlook on both is negative.

The downgrades end more than seven months of speculation about whether the bond insurers would keep their top ratings at all three firms. Five of seven companies lost their top ratings as projections for losses on securities backed by home loans surged and confidence in the companies collapsed, causing municipalities to shun their insurance. The downgrades span more than $2 trillion of debt sold by issuers ranging from school districts and sewer authorities to Wall Street firms.

MBIA's downgrade reflects its ``limited financial flexibility and impaired franchise,'' Moody's analyst Jack Dorer said today in a statement. Ambac has ``significantly constrained new business prospects'' and likely will incur more losses, Dorer said.

Armonk, New York-based MBIA and Ambac of New York both said they were ``disappointed'' by Moody's decision.

``Our financial condition is very strong,'' MBIA Chief Executive Officer Jay Brown said in a statement today. ``We remain committed to maintaining capital strength for our policyholders and financial flexibility.''

Ambac said it can ``manage through the current credit crisis.''

CDOs

The bond insurers lost their top ratings after straying from the business of backing municipal bonds, which rarely default, to guaranteeing more untested securities such as collateralized debt obligations, which package pools of securities, including those backed by subprime mortgages, and slice them into pieces of varying risk.

Further downgrades may cause Citigroup Inc., Merrill Lynch & Co. and UBS AG to write down the value of insured-debt holdings by at least $10 billion, according to Meredith Whitney, an analyst at Oppenheimer & Co. in New York. Banks and insurance companies would also be required by regulators to hold more capital to protect against losses on lower-rated debt, according to analysts at Charlotte, North Carolina-based Wachovia Corp.

MBIA and Ambac were once the top two insurers of municipal debt, a mantle that has been taken by competitors Financial Security Assurance Holdings Ltd. and Assured Guaranty Ltd. Financial Security insured 64 percent of all municipal bonds sold in the U.S. during the first quarter, according to Thomson Reuters.

Losses

Combined with a slump in the value of derivatives contracts used to guarantee CDOs, the lack of new

revenue weighed on the company's credit ratings. Ambac reported a $1.66 billion net loss in the first quarter after $3.1 billion in charges for subprime- mortgage securities that it insured. MBIA had a loss of $2.4 billion as the value of derivatives it sells to guarantee debt tumbled $3.58 billion.

Moody's said it was reconsidering downgrades on June 4, citing a drop in demand for the companies' insurance and their limited ability to raise capital. In response, MBIA and Ambac said they disagreed with the assessment and had no plans to raise more money.

A day later, S&P removed the AAA insurance rating from both companies.

Moody's and S&P first put the ratings of Ambac and MBIA under review in January, citing the deepening housing slump and rising losses on securities backed by home loans.

`Strongly Capitalized'

MBIA and Ambac then sold a combined $4.1 billion in shares, bonds and convertible debt in the first quarter to save their ratings. Moody's affirmed the Aaa ratings on the insurance units of MBIA in February and Ambac in March.

The capital wasn't enough to keep top rankings from Fitch, which cut Ambac to AA in January, and MBIA to AA in April. As the slump worsened, Moody's and S&P took a second look at their assessments.

In the past two quarters, MBIA's insurance unit set aside reserves of $2 billion to cover losses on $51 billion of guarantees on home-equity securities and CDOs backed by subprime mortgages.

MBIA is $2.6 billion short of its target capital level for an Aaa company, Moody's said. The rating company also said MBIA's decision to retain $1.1 billion at its holding company was ``indicative of a more aggressive capital management strategy'' and contributed to the extent of the downgrade.

Ambac is $225 million below the Aaa target level, Moody's said.

At the current rating, Ambac has a ``substantive capital cushion,'' Moody's said. MBIA is also ``strongly capitalized'' for an Aa rating, Moody's said.

To contact the reporter on this story: Christine Richard in New York at crichard5@bloomberg.net

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BloggingStocks

Worst 10-year performers: MBIA takes a triple-A nosedive on risky mortgage debt

Posted Aug 1st 2008 5:00PM by **Elizabeth Harrow**
Filed under: **Major movement, Bad news, S and P 500, Housing, MBIA Inc (MBI)**

*In this series, we take a look at the 25 stocks on the S&P 500 Index (SPX) that have turned in the worst performance during the past decade -- what went wrong, and what happens next. (**See all 25**).*

While financial-services firms have been dragged down as a group for more than a year, few have flamed out with the spectacular ferocity of municipal bond insurer **MBIA Inc.** (NYSE: **MBI**). In fact, among equities listed on the S&P 500 during the past decade, only one stock has suffered a more severe plunge in share price.

What went wrong? At no. 2 on our list of SPX slackers, MBI lost 91% of its value during the decade that ended June 30, 2008. The stock peaked at $76.02 in January 2007, which marked the last in a series of higher highs for the formerly uptrending security.

MBIA's troubles first started in January 2007, though its issues at the time would pale in comparison with later challenges. Then, the company agreed to pay $75 million to settle civil securities-fraud charges by federal and New York State authorities. MBIA was accused of making secret side deals with reinsurance companies to avoid stating a $170-million loss in 1998. As part of the settlement, MBIA said it would restate earnings from 1998 through 2004 and improve its business and accounting procedures.

Pressure ramped up on MBIA when the credit crunch rattled world equity markets in the second half of 2007. The company insured collateralized debt obligations, or CDOs, saddled with subprime debt. As a bond insurer, MBIA was almost completely reliant on its triple-A debt ratings; after all, if you can't get a guarantee from an insurer, what's the point?

The triple-A ratings were never questioned in the company's early days, when it insured municipal bonds almost exclusively -- defaults were rare on these vehicles, to say the least. However, the CDO situation involved an entirely different risk level. By mid-2007, major investment banks had already written off billions of dollars in CDO losses, and investors began to wonder why MBIA should be any different.

Last December, Moody's said it was placing MBIA's triple-A ratings under review for possible downgrade. The ratings firm said that MBIA was "at greater risk of exhibiting a capital shortfall than previously communicated," thanks in no small part to the $11.09 billion in subprime mortgage debt to which it was exposed.

Now fully under fire, MBIA announced news of a $1-billion investment from private-equity firm Warburg Pincus. Last January, in a scramble to save its triple-A status, the company slashed its dividend and said it would sell $1 billion in debt to raise capital. The amount the bond insurer planned to raise seemed woefully inadequate in comparison with its losses; in its quarterly earnings release that month, MBIA reported a $3.5-billion write-down on its credit derivatives portfolio.

The pressure was also rising on ratings agencies. Many on Wall Street accused the firms of turning a blind eye to the heightened risk inherent with certain types of CDOs, thereby leaving institutions and investors vulnerable to massive losses. Moody's and Standard & Poor's capitulated, to an extent; both firms vowed to review MBIA's ratings. However, both eventually affirmed their existing opinions. Meanwhile, Fitch Ratings was not convinced, and stated that MBIA needed more capital to support its asset-backed securities. MBIA's response couldn't have done much to boost investor sentiment -- the battered bond insurer asked Fitch to stop issuing credit ratings altogether on its insurance units.

What next? After admitting that its ratings may have been handed out in a rather Pollyanna-ish fashion, Moody's attempted to save face by dropping MBIA's rating from triple-A to A2 in June. As a result, MBIA found itself selling municipal bonds to raise cash; the downgrade triggered a collateral call of $4.5 billion and termination payments of $2.9 billion on guaranteed investment contracts. A fund-raising bake sale seems like a none-too-distant possibility in the future.

Most recently, MBIA said it had approximately $1.15 billion in exposure to three securitizations of loans backed by IndyMac Bancorp, which recently failed. In its upcoming earnings report -- for which no date has yet been confirmed -- analysts expect an operating loss of 94 cents per share.

Elizabeth Harrow is an analyst and financial writer in the research department at ***Schaeffer's Investment Research****. She is featured in the weekly video series* ***Option Basics*** *on SchaeffersResearch.com.*

Tags: bond insurer, MBI, MBIA Inc., Mbialnc., Moodys ratings, mortgage debt

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES ACT OF 1933
Release No. 8776 / January 29, 2007

SECURITIES EXCHANGE ACT OF 1934
Release No. 55184 / January 29, 2007

ACCOUNTING AND AUDITING ENFORCEMENT
Release No. 2548 / January 29, 2007

ADMINISTRATIVE PROCEEDING
File No. 3-12551

In the Matter of MBIA Inc., Respondent.	ORDER INSTITUTING CEASE-AND-DESIST PROCEEDINGS, MAKING FINDINGS, AND IMPOSING A CEASE-AND-DESIST ORDER PURSUANT TO SECTION 8A OF THE SECURITIES ACT OF 1933 AND SECTION 21C OF THE SECURITIES EXCHANGE ACT OF 1934

I.

The Securities and Exchange Commission ("Commission") deems it appropriate that cease-and-desist proceedings be, and hereby are, instituted pursuant to Section 8A of the Securities Act of 1933 ("Securities Act") and Section 21C of the Securities Exchange Act of 1934 ("Exchange Act"), against MBIA Inc. ("MBIA").

II.

In anticipation of the institution of these proceedings, MBIA has submitted an Offer of Settlement ("Offer") which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over it and the subject matter of these proceedings, which are admitted, MBIA consents to the entry of this Order Instituting Cease-and-Desist Proceedings, Making Findings, and Imposing a Cease-and-Desist Order Pursuant to Section 8A of the Securities Act of 1933 and Section 21C of the Securities Exchange Act of 1934 ("Order"), as set forth below.

III.

On the basis of this Order and MBIA's Offer, the Commission finds[1] that:

SUMMARY

1. This proceeding arises out of a fraudulent transaction that MBIA executed to mask the true financial impact of a massive loss it suffered on its guarantee of municipal bonds. In 1998, MBIA learned that it would have to make good on its guarantee of $256 million of bonds issued by a set of hospitals owned by the Allegheny Health, Education and Research Foundation ("AHERF"), which had defaulted. The default would have resulted in the first quarterly loss in MBIA's corporate history. To counter the potential negative market reaction, senior MBIA executives devised a scheme to obtain retroactive reinsurance that would cover the entire net present value of the anticipated loss, or about $170 million, for a nominal premium. The effect of the transaction was to offset the entire $170 million loss MBIA recorded on its income statement in the third quarter of 1998 with a roughly equivalent reinsurance recoverable, thus masking the AHERF loss and converting a quarterly loss into a gain. The transaction was a sham.

2. MBIA entered into three purported reinsurance contracts under which the reinsurers agreed to provide retroactive coverage of up to $170 million for the AHERF loss (the "excess of loss" or "reinsurance" contracts). The excess of loss contracts were written as if it was unclear whether the reinsurers would have to provide the full amount of the agreed upon coverage, and MBIA's files were likewise papered to make this appear to be the case. This purported uncertainty about the extent of the reinsurers' payout to MBIA was critical to the desired accounting. To the extent that the reinsurers' payments under the excess of loss contracts were not expected to vary significantly, such payments could not be treated as reinsurance for accounting purposes, and MBIA would not be able to mask the effect of the AHERF loss on its income statement by offsetting the reinsurance recoveries against the loss. In fact, MBIA expected that the reinsurers would be called upon to pay out under the excess of loss contracts.

3. Because the reinsurers expected to pay out under the reinsurance contracts, they protected themselves against loss on the transaction by entering into separate agreements by which MBIA agreed to cede to them future business (the "quota share contracts"). The quota share contracts, which covered a significant percentage of MBIA's portfolio, ceded to the reinsurers hundreds of millions of dollars in premiums on future business. Although the ceding contracts did not on their face constitute compensation to the reinsurers (because the reinsurers were undertaking some limited risk associated with the ceded premiums), in substance, they were compensation, because the contracts ceded so little risk associated with the amount of premium received. Indeed, in the case of one reinsurer, which had agreed to pay $70 million of MBIA's AHERF loss, MBIA ceded $101 million in net premiums (representing $13 billion of underlying insurance risk), but then secretly agreed to re-assume all but $13 million of the risk in an oral side agreement, leaving

[1] The findings herein are made pursuant to MBIA's Offer of Settlement and are not binding on any other person or entity in this or any other proceeding.

the reinsurer with all the ceded premium and virtually no risk. With respect to the other two reinsurers, which each paid $50 million of the AHERF loss, MBIA ceded a tremendous volume of business based upon a formula that virtually assured that the reinsurers would be repaid in full for their payments under the excess of loss contracts, even taking into account the risk they would be undertaking on the ceded business.

4. In September 2004, the reinsurer with the oral side agreement sued MBIA to enforce the side agreement. The lawsuit led to an investigation by the Audit Committee of MBIA's Board of Directors, which concluded, in March 2005, that "it appears likely that such an [oral side] agreement" existed, and resulted in MBIA's restatement of its consolidated financial statements for the years 1998 through 2003. However, MBIA restated only the $70 million of reinsurance associated with the side agreement. It did not restate the remaining $100 million, which was improperly accounted for and which had been the subject of numerous misleading press releases and periodic filings.

5. As a result of the foregoing conduct, MBIA, directly and indirectly, has violated Sections 17(a) of the Securities Act of 1933 ("Securities Act"), and Sections 10(b), 13(a), 13(b)(2)(A) and 13(b)(2)(B) of the Securities Exchange Act of 1934 ("Exchange Act"), and Rules 10b-5, 12b-20, 13a-1, 13a-11, 13a-13, and 13b2-1 thereunder.

RESPONDENT

6. **MBIA Inc.** is a Connecticut corporation headquartered in Armonk, New York. Through its principal operating subsidiary, MBIA Insurance Corporation ("MBIA Corp."), the company is a leading financial guarantor and provider of specialized financial services. MBIA Corp. has a financial strength rating of Triple-A from Moody's Investors Service, Standard & Poor's Ratings Services, Fitch Ratings, and Rating and Investment Information, Inc. MBIA's common stock trades on the New York Stock Exchange and it files periodic reports with the Commission pursuant to Section 13 of the Exchange Act.

OTHER RELEVANT ENTITIES

7. **AHERF** is a nonprofit operator of hospitals in Pennsylvania. In 1996, MBIA guaranteed $256 million of bonds issued by a set of AHERF-owned hospitals known as the Delaware Valley Obligated Group ("AHERF bonds").

8. **Axa Re Finance** ("Axa") is an indirect subsidiary of Axa SA, an insurance group and asset management company headquartered in Paris, France. Axa SA's American Depository Receipts trade on the New York Stock Exchange under the symbol AXA. One of Axa SA's primary subsidiaries is Axa Re, which focuses on the property and catastrophe reinsurance business. Axa is a wholly-owned subsidiary of Axa Re that was formed in 1997 to expand Axa Re's presence in the financial guarantee markets.

9. **Muenchener Rueckversicherungs-Gesellschaft AG** ("Munich") is a German corporation whose core businesses are reinsurance, primary insurance and asset management.

10. **Zurich Reinsurance (North America), Inc.** ("Zurich"), was, at the relevant time, a subsidiary of Zurich Financial Services Group, a Switzerland-based insurance and financial services company. Zurich is now known as Converium Reinsurance (North America) Inc., and is part of Converium Holding AG, an independent international multi-line reinsurer with headquarters in Switzerland.

MBIA Engaged in a Fraudulent Scheme to Mask the Effect of the AHERF Loss On Its Earnings

11. The AHERF loss was a significant event for MBIA. Not only was it the first sizeable loss in its history, but the loss exceeded MBIA's unallocated loss reserves by about $100 million and was the subject of intense market concern. MBIA designed the AHERF reinsurance transaction specifically to address the anticipated market reaction by masking the effect of the loss on earnings. Ultimately, MBIA achieved the desired income statement effect by entering into an excess of loss contract and one or more quota share contracts with each of three reinsurers, the key monetary terms of which are summarized below.

Counterparty	Excess of Loss Coverage	Quota Share Contract Gross Premiums
Munich	$50 million	$98 million ($28 million to be paid in fourth quarter 1998)
Axa	$50 million	$97 million ($60 million to be paid by March 31,1999)
Zurich	$70 million	$145 million ($101.5 million net)
Total:	**$170 million coverage**	**$340 million gross ceded premium**

12. The quota share contracts were carefully devised to fully compensate the reinsurers for the amounts they expected to pay under the excess of loss contracts. In addition, they were structured and documented so as to pass scrutiny by MBIA's auditor. Specifically, certain aspects of the quota share contracts were changed or omitted and made the subject of separate, and in some instances secret, side deals.

MBIA's Business: Writing to a "Zero-Loss" Standard

13. MBIA, primarily through its subsidiary MBIA Corp., is and was at all relevant times, engaged in providing financial guarantee insurance for municipal and other government bonds and for structured finance obligations. Financial guarantee insurance provides an unconditional and irrevocable guarantee of payment, when due, of the principal and interest or other amounts owing on insured obligations. The value of MBIA's guarantee is dependent on its credit rating, which historically has been Triple-A. That Triple-A rating in turn is dependent on MBIA's financial condition and its ability to control its losses.

14. Because MBIA underwrites to a "zero loss" standard, the chance of a loss on account of a default on the issues it guarantees is, by design, typically small. According to MBIA, "[e]very transaction [the company] look[s] at is structured to a no-loss standard to avoid losses even under the worst probable case scenario." Therefore, although a loss, even a significant one, was possible, the company operated using a business model that assumed there would be no such losses, and at the relevant time, its history demonstrated that such losses were rare.

The AHERF Loss and Its Effect on MBIA's Stock Price

15. In 1996, the AHERF bonds were issued, with MBIA's guarantee. The AHERF bonds were not general obligation bonds backed by tax revenues. By the spring of 1998, it was apparent that AHERF was in financial distress and that MBIA would have to make good on its guarantee. As a result, the investment community was concerned about the possible negative impact on MBIA resulting from its AHERF exposure. This concern was exerting downward pressure on MBIA's stock price, which fell from a high of $77.94 in April 1998 to a low of $67.62 on June 15, 1998.

16. On July 21, 1998, AHERF filed for bankruptcy protection, and MBIA issued a press release stating that the AHERF bankruptcy would have no impact on its earnings because "the company's unallocated loss reserve [of approximately $75 million] will be sufficient to meet anticipated losses." The market remained concerned, and MBIA's stock price continued to fall. On September 2, 1998, AHERF announced that its 1997 financial statements would be restated and should not be relied upon. By September 10, 1998, the price of MBIA's stock had fallen to $46.30.

17. It was in this context that senior MBIA executives negotiated and executed the excess of loss and quota share contracts, for the purpose of masking the effects of the AHERF loss on MBIA's earnings and thus allaying the market's concern. The contracts were negotiated, structured, and documented by MBIA's then-chief executive officer and chairman of the board ("CEO") and its then-chief financial officer and later special assistant to the chairman ("CFO").

18. MBIA first announced a reinsurance solution during an investor call on September 11, 1998, and the news had an immediate positive impact on MBIA's stock price. By the close of business on September 11, the price had climbed to $52.09 from $46.30 the day before. Ultimately, in a September 29, 1998 press release, MBIA announced that it had obtained $170

million in reinsurance for its anticipated AHERF loss and that as part of the reinsurance agreements it had "entered into strategic business relationships with highly rated reinsurers to provide them with future business." MBIA did not identify the reinsurers or provide details of the "strategic business relationships." After the issuance of this press release, and through the filing of MBIA's third quarter earnings release and Form 10-Q in mid-November, MBIA's stock price recovered so that by year end it was trading in the mid-$60s.

19. The July press release and the September conference call and press release were deliberately or recklessly misleading. When the July release was issued, MBIA's own internal analysis was that the AHERF loss would likely exceed its unallocated loss reserves. When MBIA announced in the September conference call and the September press release that the loss would be covered by reinsurance, it knew that the excess of loss contracts were not agreements subject to reinsurance accounting but were in substance loans, and that the "strategic business relationships" were mechanisms designed to fully compensate the reinsurers for the amounts they had paid under the excess of loss contracts.

The Terms of the AHERF "Reinsurance" Arrangement and the Applicable Accounting Principles

20. The essence of the reinsurance arrangement was that Munich, Axa and Zurich each agreed to "reinsure" a portion of the AHERF loss retroactively, i.e., to pay MBIA for a loss that it had already incurred, in return for premiums on future MBIA business. The reinsurance arrangements took the form of excess of loss contracts, which were organized into three layers, with Munich bearing responsibility for the first $50 million of the AHERF loss, Axa responsible for a second $50 million layer, and Zurich responsible for a third $70 million layer. (In an excess of loss reinsurance contract, a reinsurer pays its insured when the insured's loss is in "excess" of a set amount.) In return, MBIA agreed to pay the three insurers a nominal premium for the excess of loss contracts, and agreed to provide the reinsurers with, or "cede," future business, with total gross premiums of $340 million, under quota share contracts. (In a typical quota share contract, the reinsurer takes on a percentage of risk for a percentage of the premium, minus the expenses of the company providing, or "ceding," the risk and associated premiums.)

21. To achieve the desired accounting treatment, which would permit MBIA to offset the $170 million AHERF loss with the $170 million reinsurance gain in the third quarter, MBIA knew that the excess of loss contracts had to transfer insurance risk on the date they were agreed upon. The applicable GAAP is Statement of Financial Accounting Standards Number 113, Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts ("FAS 113"). Paragraph 9 of FAS 113 sets out the requirements for transferring insurance risk:

a. The reinsurer assumes significant insurance risk under the reinsured portions of the underlying insurance contracts[; and]

b. It is reasonably possible that the reinsurer may realize a significant loss from the transaction.

> A reinsurer shall not be considered to have assumed significant insurance risk under the reinsured contracts if the probability of a significant variation in either the amount or timing of payments is remote.

22. In addition, even if there had been sufficient variability as to the timing and amount of payments under the excess of loss contracts, to qualify for reinsurance accounting MBIA knew that it also had to be "reasonably possible that the reinsurer[s] [might] realize a significant loss on the transaction." To make that determination, the reinsurer's exposure and compensation on all the applicable agreements had to be considered. FAS 113, according to FASB Staff Implementation Guide on FAS 113, requires that:

> [F]eatures of the contract or other contracts or agreements that directly or indirectly compensate the reinsurer or related reinsurers for losses be considered in evaluating whether a particular contract transfers risk. Therefore, if agreements with the reinsurer or related reinsurers, in the aggregate, do not transfer risk, the individual contracts that make up those agreements also would not be considered to transfer risk, regardless of how they are structured. (See EITF Topic No. D-34, question 13)

If, as was the case, it was not reasonably possible that the reinsurers would realize a significant loss on the arrangement, the payments under the excess of loss contracts could not be treated as reinsurance but rather would have to be accounted for as deposits.

23. In fact, the AHERF reinsurance arrangement failed the FAS 113 test because MBIA knew that its estimate of the loss was at least the amount of the reinsurance coverage, and each reinsurer expected to pay the full amount of its commitment. That fact alone meant that the arrangement could not be treated as reinsurance, even when combined with the quota share contracts. And because the quota share contracts were designed to compensate the reinsurers for their payments under the excess of loss contracts, it was not reasonably possible that the reinsurers would realize a significant loss on the excess of loss contracts.

MBIA's Misleading Announcements About the Impact of AHERF

24. On July 20, 1998, just one day before AHERF filed for bankruptcy protection, MBIA's surveillance department, which was responsible for preparing loss estimates for senior management, prepared a memorandum advising MBIA's president on reserving alternatives and press strategy regarding AHERF. The memo stated:

> We think $95-100MM – half way between the (highly unlikely) best case [of $57 million] and the much more likely worst stress case [of $136 million] is an appropriate starting point. We would expect that it is more likely than not we would have to ratchet the loss estimate up over the estimated two years it will take for the bankruptcy case to play out. On the other hand, the presence of four current bidders may give us a better outcome than currently expected. Accordingly, choosing a half-way number seems like a reasonable course at this point.

25. The president and the CEO rejected the surveillance department's recommendation for a $95-$100 million reserve. They did so because the figure exceeded MBIA's unallocated loss reserves, a fact that they did not want to disclose to the market. If MBIA announced its actual estimate of the loss, it would have had to disclose in its Form 10-Q for the second quarter, which was being prepared at the time, that the company expected its loss on AHERF to exceed its unallocated loss reserve.

26. On July 21, MBIA issued a press release, approved by the president and the CEO, which stated that MBIA expected that its unallocated loss reserve (then approximately $75 million) would "be sufficient to meet anticipated losses from the bankruptcy filing," without any explanation of that conclusion. As a result, according to the release, "the company [did] not expect losses from this insured credit to affect its earnings."

27. The July 21 press release was false because it implied that MBIA's exposure on AHERF was less than $75 million, when in fact the company's own surveillance department was anticipating a loss perhaps as much as $136 million, and was recommending a reserve amount of $95-100 million, far in excess of $75 million.

28. On August 4, 1998, MBIA issued its second quarter earnings release. In the release, the CEO was quoted as saying that the company's unallocated loss reserves "will be adequate to handle the AHERF loss." This statement was restated essentially verbatim in MBIA's Form 10-Q for the quarter ended June 30, 1998, filed on August 14, 1998, in a note on subsequent events meriting mention. This statement was also incorporated in a prospectus MBIA filed on September 28, 1998 in connection with a $150 million debenture offering, and in a later filing. The CEO had no reasonable basis to make such a statement because MBIA had no estimate of loss other than the surveillance department's suggested reserve of $95-100 million.

29. On September 1, the day before MBIA entered into the excess of loss contracts with Munich and Axa, MBIA senior executives received a briefing on the status of AHERF from the surveillance department. At that briefing, they were told that "[a]t expected Ch. 11 auction sales ranges of $500-650 [million], MBIA will suffer a [net present value] loss of $100-150 [million] on [its AHERF bond] exposure of $256 million net." Thus, by the eve of September 2, 1998, the earliest date by which MBIA claims to have reached agreements in principle to the purported reinsurance agreements with Munich and Axa, MBIA's loss estimates had climbed to approximately $100-150 million.

30. On September 11, 1998, MBIA held a conference call for the stated purpose of addressing "the sharp and precipitous decline in MBIA's stock price over the last two weeks." That call, which had over 250 participants from major investment banks and institutional investors, specifically addressed, among other things, the AHERF situation. On the call, the president and the CEO made several statements about reinsurance the company was in the process of arranging to cover its AHERF exposure, including the following:

- "we have been making arrangements, not yet finalized, in the reinsurance marketplace which at very little cost has the effect of more than doubling the general loss reserve."

- although the AHERF situation was "fluid," MBIA "continue[s] to believe that after the arrangements we are making as to reinsurance . . . , the unallocated reserve that we have at present will cover any losses that will be incurred by MBIA as a result of [AHERF.]"

- MBIA "did not believe there would be any earnings impact from [AHERF.]"

31. The statements in paragraph 30 were false because MBIA knew that the excess of loss contracts were not agreements subject to reinsurance accounting but were in substance loans.

32. The statements by MBIA's senior executives had the desired effect on the market. MBIA's stock price rose 12.4% over the previous day's close of $46.30 to $52.03, and remained in the $50s through the end of September.

The Negotiations with the Reinsurers

33. The quota share contracts ultimately reached with the reinsurers took advantage of the unusually low-risk, high-return nature of the financial guarantee business. MBIA's business model, based on a "zero loss" underwriting standard, was exceedingly profitable. Historically, most of MBIA's insureds, such as municipalities, other government entities and private issuers of structured finance obligations, were able to make all principal and interest payments from reliable sources of revenue, such as general tax revenues and private consumer receipts. Moreover, unlike traditional insurance, the entire amount of the premium on most municipal and other government entity guarantee insurance is paid up front, when the policy is written. Thus, in ceding business to the reinsurers, MBIA was in reality ceding an expected profit stream on a low-risk business.

34. Moreover, to make certain that the reinsurers would be reimbursed through the quota share contracts, MBIA agreed to modify its usual ceding commission, which is the amount the ceding insurer (MBIA) typically charges a reinsurer for ceding business. The "ceding commission" is typically a fixed percentage of the gross premium ceded. MBIA's standard ceding commission was 32.5%; that is, MBIA usually retained 32.5% of the gross premiums it ceded to its reinsurers. But in the quota share contracts with Munich and Axa, MBIA used a sliding scale commission. For both Munich and Axa, MBIA agreed to lower its standard ceding commission from 32.5% to 17.5%, depending on the amount of losses the companies incurred on the risks they assumed. The sliding scale commission was a mechanism to help protect the profit that the reinsurers expected from the quota share contracts.

35. MBIA's auditor reviewed the Munich and Axa quota share contracts to determine whether it was "reasonably possible that the reinsurer [might] realize a significant loss from the transaction," when the excess of loss contract was combined with the quota share contract. The auditor advised MBIA senior executives that its quota share contracts with Munich and Axa as initially proposed did not pass the FAS 113 test. As a result, the agreements were changed and certain aspects were made the subject of separate agreements.

The Negotiations with Munich

36. The negotiations with Munich began in late July, 1998. From the beginning, Munich assumed that it would be paying the full $50 million on the excess of loss contract. As a result, the negotiations focused on the quota share contracts and making certain that Munich would be fully reimbursed. Under the initial quota share proposal, MBIA was to cede $98 million in premiums to Munich with a sliding scale commission. MBIA also agreed that the premiums would be ceded on a facultative basis – that is that Munich could choose from among the business MBIA sought to cede to it, unlike a typical quota share contract in which the contract identifies the types of risk the reinsurer has agreed to accept and the insurer has agreed to cede, but does not allow the reinsurer to reject any risk of the type agreed upon. By having the right to select only the risks it wanted, Munich minimized its risk even further.

37. MBIA's auditor rejected the initial proposal because "the way it is currently structured there is no reasonable chance that [Munich] would lose money." The auditor indicated that in order to pass the risk transfer requirements, the premium ceded under the quota share contract with a sliding scale could not be more than $70 million.

38. Because they knew that $70 million would not be sufficient compensation for Munich, the MBIA senior executives proposed that MBIA and Munich enter into two agreements, the first for $70 million, which the auditor had indicated would pass the FAS 113 test, and a second that ceded $28 million in additional premiums. This second quota share agreement did not have a sliding scale, but provided that all premiums would be paid before the end of 1998. With that feature, the two contracts effectively achieved the objective of providing adequate compensation to Munich. And under the analysis MBIA's auditor employed, there was virtually no chance that Munich would lose money on the deal.

The Negotiations with Axa

39. MBIA also began to negotiate the quota share contract with Axa in July. By the end of August, Axa expected that it would have to pay at least $30 million of its excess of loss contract. Axa also knew, however, that there was a substantial chance that it may need to pay the full $50 million due under the excess of loss contract.

40. To ensure that Axa would be fully compensated in either event, MBIA and Axa agreed that MBIA would cede $60 million in premiums with a sliding scale commission under the excess of loss contract. Of this $60 million, $23 million was to be ceded by March 30, 1999. In addition, senior MBIA and Axa executives proposed what they referred to as a "gentlemen's agreement," which initially had a "springing quota share" feature, as well as a sliding scale commission. Under the "gentlemen's agreement," MBIA agreed to cede an additional $37 million in premiums if Axa had to pay more than $30 million on the excess of loss contract.

41. The MBIA and Axa senior executives had planned not to memorialize this "gentlemen's agreement." However, MBIA's auditor learned about the "gentlemen's agreement," and initially said that the arrangement could be part of the written contract. But after reviewing a

draft of the quota share agreement with the "springing" provision included, it said that such a provision could not be part of the written contract.

42. Axa and MBIA therefore entered into a quota share contract for $60 million. On that basis, MBIA's auditor approved reinsurance accounting for the reinsurance arrangement with Axa.

43. MBIA and Axa also entered into the "gentlemen's agreement" that the auditor had rejected. This oral side agreement provided Axa with an additional $37 million in premiums, also with a sliding scale commission. By the time the agreement was memoralized in December 1998, the "springing" feature was dropped, because it was known that Axa would have to pay the full $50 million under the excess of loss contract. It was also agreed that the entire $37 million was to be ceded by the end of the month. Consequently, of the $97 million in total premiums ceded to Axa, $60 million was to be ceded by March 30, 1999.

The Announcement of the Reinsurance Solution and Its Impact on Earnings

44. On September 29, 1998, the bankruptcy court conducted an auction of AHERF's assets. The auction resulted in gross proceeds of $345 million. From this amount, MBIA later claimed that it was able to estimate a $170 million net loss on AHERF. Also on September 29, MBIA issued a press release entitled "MBIA Announces Exposure to Bankrupt Pennsylvania Hospital Group to be Covered by Reinsurance Agreements; Expects no Impact on Earnings." In the press release, MBIA announced that it had "obtained $170 million of reinsurance that it expects will cover anticipated losses arising from [AHERF]."

45. The September 29 release was false. On September 2, the earliest date by which MBIA claims to have reached agreements in principle with Munich and Axa for excess of loss coverage on the first $100 million of its AHERF exposure, MBIA and the reinsurers knew that the best estimate of MBIA's loss was at least $95 to $100 million. Because there was no uncertainty as to the amount the reinsurers would pay, the excess of loss contracts did not transfer any risk under FAS 113. Moreover, the reinsurers expected to be fully compensated for their payouts, which also precluded reinsurance accounting under FAS 113.

The Trouble with Zurich and the Secret Side Agreement

46. After MBIA issued the September 29 press release, the purported deal between MBIA and Zurich collapsed as a result of issues raised by MBIA's auditor. This ultimately led to significant changes in the written contracts, and to the secret side agreement between Axa and MBIA relating to Zurich.

47. The negotiations with Zurich began in August. By September 28, Zurich and MBIA had exchanged a draft that provided both excess of loss coverage on AHERF and a quota share feature. The most prominent feature of the initial draft was that the agreement limited Zurich's exposure by capping its losses on the quota share contract.

48. By mid-to-late October, MBIA's auditor advised that for the company to obtain the desired accounting treatment, the caps on Zurich's losses on the quota share had to be removed. However, MBIA senior executives knew that Zurich would not accept more risk.

49. Thus, by that time, there was no Zurich deal. However, in its September 29 press release, MBIA had already told the market that it had three reinsurers lined up to reimburse it for losses relating to AHERF. Accordingly, the CFO, with the CEO's knowledge and approval, set about salvaging the Zurich layer of the excess of loss by arranging for another reinsurer to assume the bulk of Zurich's risk on the quota share.

50. As it happened, the unraveling of the Zurich deal coincided with a planned gathering for MBIA and Axa senior executives at a resort in Portugal, which occurred from October 26 through 28. The CEO and CFO attended for MBIA, and Axa's CEO and Chief Operating Officer attended along with its chairman, who was also the chairman and CEO of Axa's parent company.

51. In Portugal, the CFO approached Axa about assuming Zurich's risk under the quota share contract for a nominal premium. Axa said it would only do so if another reinsurer could be found to relieve it of that risk as it built on Axa's books, because even if the chance of paying out on those risks was low, Axa would be required to post reserves against the potential risk. During or shortly after the Portugal trip, the CFO and CEO assured Axa that MBIA would relieve Axa of the risk it had agreed to take on from Zurich. This side agreement was not reduced to writing and was not disclosed to MBIA's auditor.

52. In addition to the side agreement, Axa's agreement to take on Zurich's risk under the quota share contract resulted in three additional agreements because Zurich's payment under the excess of loss contract was to be funded by Interpolis Reinsurance Services, Ltd., a Dutch reinsurer. In exchange, Zurich gave to Interpolis the bulk of premiums it received from MBIA under the quota share contract, and Interpolis agreed to take on Zurich's risk from $13 million to $163 million. Axa took on this entire risk from Interpolis, through two separate agreements, one covering the risk from $13 million to $88 million, and the second covering the risk from $88 million to $163 million. In addition, Axa entered into a contract with Zurich under which it assumed Zurich's risk above $163 million. In return, Axa received $1 million in premium for each agreement, for a total of $3 million. In other words, Zurich and Interpolis retained $99 million in net premiums and retained only $13 million of the risk associated with those premiums, in exchange for the $70 million they provided MBIA to cover for the AHERF loss. Axa, on the other hand, assumed all the risk above $13 million for only $3 million in premium.

53. In short, the Zurich reinsurance arrangement involved limited transfer of risk to Zurich. Under the secret side agreement with MBIA, the risk under the quota share contract was transferred back to MBIA, except for $13 million that was more than covered in full by the premiums that Zurich and Interpolis retained. In addition, by the time the deal was reached, there was no uncertainty or variability as to Zurich's payment under the excess of loss contract, because it was known by then that Zurich would have to pay the full amount of its commitment.

MBIA Created a Paper Trail to Justify Reinsurance Accounting

54. In order to obtain the auditor's approval for the desired accounting treatment, MBIA senior executives created a paper trail to justify the reinsurance accounting. This paper trail included several affirmative misrepresentations about the agreements, including but not limited to the following:

(a) First, MBIA represented that its estimate of its AHERF loss on the date on which it reached the reinsurance arrangements with Munich, Axa, and Zurich was less than the amount of excess of loss coverage agreed upon. Specifically, MBIA represented its estimate of loss at the time the reinsurance agreements were reached was $0-$117 million. This representation was false. By September 2, 1998, the earliest date by which MBIA claims the Munich and Axa agreements were purportedly in place, MBIA's surveillance department had estimated a loss of at least $95-100 million, and possibly as high as $150 million. The representation was also false with regard to Zurich because the deal that was in place in September was not the deal MBIA and Zurich ultimately entered into in October. By the time that deal was entered into, the AHERF loss was known to be at least $170 million.

(b) Second, the CEO and the CFO provided a letter for the auditor's files representing that MBIA had "an agreement in principal [sic]" with Zurich, and that "[t]he principal terms were agreed to on September 22nd with the understanding that certain refinements needed to be made to comply with standard reinsurance and accounting practices." The CEO and CFO each knew when they signed the representation letter that the agreement ultimately reached with Zurich was fundamentally different than the one that was contemplated in September, and they knew that the auditor was unaware of the side agreement in which MBIA effectively agreed to take back all but $13 million of the risk it had ceded to Zurich under the quota share agreement.

MBIA's Misleading Financial Statements

55. MBIA recorded the $170 million Munich, Axa, and Zurich agreed to pay under the excess of loss contracts as a receivable in the third quarter of 1998, and its consolidated financial statements for the third quarter of 1998 and for the 1998 fiscal year included the entire amount as income.

56. In its November 3, 1998 earnings release, the company stated: "MBIA expects that any anticipated losses arising from [its AHERF exposure] will be fully covered by reinsurance. As a result, the company's third quarter earnings have not been affected by the bankruptcy." The release was filed on Form 8-K on November 4.

57. In its Form 10-Q for the quarter ended September 30, 1998, which was filed on November 16, 1998, MBIA stated that it had recorded "$198 million of reinsurance recoverables" for the AHERF loss, which included the $170 million receivable from Munich, Axa, and Zurich.

58. The recoverable under the purported reinsurance contracts, net of the nominal premium on those contracts, thus offset virtually the entire reported AHERF loss, which was recorded as an expense for the quarter. As a result, MBIA reported net income of approximately $100 million for the third quarter and $432 million for the year ended December 31, 1998, and diluted earnings per share of $1.08 and $4.32 for the respective periods.

59. MBIA's financial statements and the above-quoted representations in its releases and filings were false and misleading because it was improper to recognize the $170 million as income and because MBIA did not disclose material facts that would have given the true picture of the transaction.

60. MBIA made these representations despite the fact that the CEO and CFO knew, or recklessly disregarded, that reinsurance accounting for the AHERF reinsurance arrangement was improper because there was no risk transfer under the excess of loss agreements and the reinsurers expected to be fully compensated for their payments under the excess of loss contracts by the quota share arrangements.

61. The AHERF reinsurance arrangement had a material and substantial impact on MBIA's reported earnings. Had the transaction been accounted for properly, as a financing, the $170 million receivable under the excess of loss contracts would not have been reported as income in 1998. The income statement effect was substantial: it would have resulted in at least $100 million less pre-tax income for the full year 1998 and, in the third quarter, would have resulted in MBIA's first quarterly loss. As a result of its fraudulent accounting for the recovery under the excess of loss contracts, MBIA was able to report that it "continu[ed] [its] unbroken streak of double-digit increases since [it] became a public company in 1987," as the company touted in its Annual Report for 1998.

MBIA Continued to Misrepresent Its Results for 1998

62. MBIA's misleading financial results for the 1998 third-quarter and fiscal year were republished in subsequent filings made in 1999, 2000, and 2001 and continued to create the false impression that the company had an uninterrupted succession of profitable quarters. Those filings continued to conceal the true facts about the purported reinsurance recovery on AHERF, including the side agreement between MBIA and Axa.

63. It was not until March 2005, after Axa filed suit in France, that MBIA publicly acknowledged the side agreement and the effect of it on its reported results for 1998. In March 2005, MBIA restated its consolidated financial statements for the calendar years 1998 through 2003 in light of the conclusion reached in the course of the internal investigation that the existence of a side agreement "appear[s] likely." The effect on the company's consolidated income statement for the third quarter of 1998 and fiscal year 1998 was to reverse the $70 million gain attributable to the reinsurance receivable under the excess of loss contract with Zurich, which

originally had offset part of the $170 million AHERF loss. MBIA also reversed the expense for the $102 million in net premiums it had ceded to Zurich, which it then recognized as income over a six-year period beginning in 1999. In addition, the company eliminated the $70 million receivable from Zurich originally reflected on its September 30, 1998 balance sheet.

64. The company did not restate its accounting for the other $100 million of reinsurance, which was improper.

VIOLATIONS

65. As a result of the conduct described above, MBIA violated Section 17(a) of the Securities Act, which prohibits fraudulent conduct in the offer or sale of securities. MBIA made material misstatements and omitted material facts concerning the AHERF transaction in connection with its September 1998 debenture offering.

66. As a result of the conduct described above, MBIA violated Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, which prohibit fraudulent conduct in connection with the purchase or sale of securities. MBIA improperly recognized the $170 million it received under the excess of loss contracts as income and did not disclose material facts concerning the AHERF transaction in its periodic filings that would have given the true picture of the transaction.

67. As a result of the conduct described above, MBIA violated Section 13(a) of the Exchange Act and Rules 13a-1, 13a-11, 13a-13 and 12b-20 thereunder, which require issuers to file true, accurate, and complete periodic reports with the Commission. Because of its misstatements and omissions of material facts concerning the AHERF transaction, MBIA filed false periodic reports and earnings releases with the Commission.

68. As a result of the conduct described above, MBIA violated Section 13(b)(2)(A) of the Exchange Act, which requires reporting companies to make and keep books, records, and accounts which, in reasonable detail, accurately and fairly reflect their transactions and dispositions of their assets. Because MBIA improperly recorded the excess of loss and quota share contracts, its books, records and accounts did not, in reasonable detail, accurately and fairly reflect its transactions and dispositions of assets.

69. As a result of the conduct described above, MBIA violated Section 13(b)(2)(B) of the Exchange Act and Rule 13b2-1 thereunder, which require all reporting companies to devise and maintain a system of internal accounting controls sufficient to provide reasonable assurances that transactions are recorded as necessary to permit preparation of financial statements in conformity with generally accepted accounting principles and prohibit them from, directly or indirectly, falsifying or causing to be falsified, any book, record, or account. MBIA's internal controls were not sufficient to prevent numerous false accounting entries related to the AHERF reinsurance agreements to be recorded that were not in conformity with generally accepted accounting principles.

UNDERTAKINGS

MBIA undertakes to:

70. Cooperate fully with the Commission in any and all respects relating to or arising from the matters described in the Offer. In connection with such cooperation, MBIA undertakes to:

(a) produce, without service of a notice or subpoena, any and all documents and other information requested by the Commission's staff ("Staff");

(b) be interviewed by the Staff at such times as the Staff reasonably may direct;

(c) upon the request of the Staff, waive any applicable privilege with respect to MBIA's internal investigation concerning the matters addressed in this Order;

(d) appear and testify truthfully and completely without service of a notice or subpoena as may be requested by the Staff;

71. Independent Consultant. In accordance with the procedure specified in subparagraph 71(k) below, retain, pay for, and enter into an agreement with an independent consultant, not unacceptable to the Staff ("Independent Consultant"), to conduct a comprehensive review of the areas specified in subparagraphs (a) and (b) below, and to make recommendations to MBIA's Board of Directors, after consultation with the Staff, regarding best practices in these areas. The agreement with the Independent Consultant shall contain the following provisions:

(a) The Independent Consultant shall review:

(i) MBIA's accounting for, and disclosures concerning, its investment in Capital Asset Holdings GP, Inc., and

(ii) MBIA's accounting for, and disclosures concerning, its exposure on notes issued by the US Airways 1998-1 Repackaging Trust.

(b) The Independent Consultant shall also review the design of the review conducted on behalf of the Audit Committee of MBIA's Board of Directors by Promontory Financial Group LLC, of MBIA's compliance organization and monitoring systems, internal audit functions, governance process and other controls including risk management, and records management policies and procedures ("Audit Committee Review"), and the implementation of any recommendations by Promontory.

(c) The Independent Consultant shall issue a report to the Staff and MBIA's Board of Directors within six months of appointment, setting forth:

(i) with respect to the items identified at subparagraph 71(a) above, his or her findings on whether MBIA acted in a manner consistent with generally

accepted accounting principles ("GAAP") and the federal securities laws. With respect to any matter as to which he or she concludes that MBIA acted in a manner inconsistent with GAAP or the federal securities laws, he or she shall propose a plan of review designed to evaluate similar transactions or occurrences, if any, and provide reasonable assurance that all similar conduct inconsistent with GAAP or the federal securities laws has been identified and corrected; and

(ii) with respect to the matters identified at subparagraph 71(b) above, his or her findings concerning whether the Audit Committee's Review was reasonably designed and implemented and, if not, any recommendations for further review to determine what policies and procedures should be implemented to achieve best practices.

The Report shall also include a description of the review performed, the conclusions reached, the Independent Consultant's recommendations for any changes in or improvements to MBIA's policies and procedures necessary to conform to best practices and a procedure for implementing the recommended changes in or improvements to MBIA's policies and procedures.

Terms of Independent Consultant's Retention

(d) In addition to the report identified above, the Independent Consultant shall provide the Staff and the Board of Directors with such documents or other information concerning the areas identified in subparagraphs 71(a) and (b), above, as any of them may request during the pendency or at the conclusion of the review.

(e) The Independent Consultant shall have reasonable access to all of MBIA's books and records, and the ability to meet privately with MBIA personnel. MBIA may not assert the attorney-client privilege, the protection of the work-product doctrine, or any privilege as a ground for not providing the Independent Consultant with contemporaneous documents or other information related to the matters that are the subject of the review. MBIA shall cooperate with the Independent Consultant, by, among other things, making available to the Independent Consultant the results of the investigation of Capital Asset conducted in 1999 by outside counsel at the direction of the Audit Committee of MBIA's Board of Directors. The Independent Consultant may consider and use the results of such prior investigation to the extent he or she deems appropriate in the course of conducting his or her own review. MBIA shall instruct and otherwise encourage its officers, directors, and employees to cooperate fully with the review conducted by the Independent Consultant, and inform its officers, directors, and employees that failure to cooperate with the review will be grounds for dismissal, other disciplinary actions, or other appropriate actions.

(f) The Independent Consultant shall have the right, as reasonable and necessary in his or her judgment, to retain, at MBIA's expense, attorneys, accountants, and other persons or firms, other than officers, directors, or employees of MBIA, to assist in the discharge of his or her obligations under these Undertakings. MBIA shall pay all reasonable fees and expenses of any persons or firms retained by the Independent Consultant.

(g) The Independent Consultant shall make and keep notes of interviews conducted, and keep a copy of documents gathered, in connection with the performance of his or her responsibilities, and require all persons and firms retained to assist the Independent Consultant to do so as well.

(h) As to the Commission and its Staff, the Independent Consultant's relationship with MBIA shall not be treated as one between an attorney and client. The Independent Consultant will not assert the attorney-client privilege, the protection of the work-product doctrine, or any privilege as a ground for not providing any information obtained in the review sought by the Staff.

(i) If the Independent Consultant determines that he or she has a conflict with respect to one or more of the areas described in paragraph 71 or otherwise, the responsibilities with respect to that subject shall be delegated to a person selected pursuant to the procedures set forth in subparagraph 71(k) below.

(j) For the period of engagement and for a period of two years from completion of the engagement, the Independent Consultant shall not enter into any employment, consultant, attorney-client, auditing or other professional relationship with MBIA, or any of its present or former affiliates, directors, officers, employees, or agents acting in their capacity as such; and shall require that any firm with which the Independent Consultant is affiliated or of which the Independent Consultant is a member, and any person engaged to assist the Independent Consultant in performance of the Independent Consultant's duties under this Order not, without prior written consent of the Staff, enter into any employment, consultant, attorney-client, auditing or other professional relationship with MBIA, or any of its present or former affiliates, directors, officers, employees, or agents acting in their capacity as such for the period of the engagement and for a period of two years after the engagement. For the purposes of this section, representation of a person or firm insured by MBIA shall not be deemed a professional relationship with MBIA.

MBIA Obligations Relating to the Independent Consultant

(k) Within twenty days of the date of entry of this Order, MBIA will submit to the Staff a proposal setting forth the identity, qualifications, and proposed terms of retention of the Independent Consultant. The Independent Consultant's compensation and expenses shall be borne exclusively by MBIA, and shall not be deducted from any amount due under the provisions of this Order. After consultation and coordination with the New York Attorney's Office and the New York Insurance Department, the Staff, within thirty days of such notice, will either (a) approve MBIA's choice of Independent Consultant and proposed terms of retention or (b) require MBIA to propose an alternative Independent Consultant and/or revised proposed terms of retention within fifteen days. This process will continue, as necessary, until MBIA has selected an Independent Consultant on retention terms that are not unacceptable to the Staff (and the New York Attorney's Office and the New York Insurance Department.)

(l) MBIA shall adopt all recommendations contained in the report of the Independent Consultant referred to in subparagraph 71(c), above; provided, however, that within fifteen days of receipt of the report, MBIA shall in writing advise the Independent Consultant and the Staff of any recommendations that it considers to be unnecessary or inappropriate. With respect to any recommendation that MBIA considers unnecessary or inappropriate, MBIA need not adopt that recommendation at that time but shall propose in writing an alternative policy, procedure or system designed to achieve the same objective or purpose.

(m) As to any recommendation with which MBIA and the Independent Consultant do not agree, such parties shall attempt in good faith to reach an agreement within thirty days of the issuance of the Independent Consultant's report referred to in subparagraph 71(c), above. In the event MBIA and the Independent Consultant are unable to agree on an alternative proposal, MBIA will abide by the determinations of the Independent Consultant.

(n) MBIA, including the board of directors and committees of the board of directors of MBIA, shall not assert the attorney-client privilege, the protection of the work-product doctrine, or any privilege as a ground for not providing any documents, information, or testimony requested by the Staff related to the review conducted by the Independent Consultant.

(o) MBIA shall retain the Independent Consultant for a period of nine months from the date of appointment. The Staff or MBIA may in either's discretion extend the Independent Consultant's term of appointment.

(p) Within ninety days of the receipt of the report referred to in subparagraph (c), MBIA shall certify to the Staff that all procedures recommended in the Independent Consultant's report, and any additional or alternative procedures agreed upon as a result of the procedure set out in subparagraphs 71(l) and (m), have been implemented, or will be implemented on a schedule agreed to by the Independent Consultant, and set out in the certification.

(q) With respect to any procedures to be implemented on a schedule agreed to by the Independent Consultant but not yet implemented by the date of the certification required pursuant to subparagraph 71(p), MBIA shall certify to the Staff within ten days after the end of the schedule agreed to by the Independent Consultant that all such procedures have been implemented.

Accountants' Report

(r) MBIA shall engage certified public accountants, which may be MBIA's usual public accounting firm, to: (a) review whether MBIA acted in a manner consistent with GAAP and the federal securities laws in its accounting for, and disclosures concerning: (i) advisory fees, and (ii) the assets within Triple A One Funding, LLC, Polaris Funding Company LLC, and Meridian Funding Company, LLC; and (b) provide a written report of its review and conclusions to the Staff within sixty days of the entry of this Order ("Accountants' Report").

Miscellaneous Provisions

(s) MBIA shall, at the Staff's discretion, (a) expand the scope of the Independent Consultant's engagement to include (i) the review of similar transactions or occurrences referred to at subparagraph 71(c)(i) above, or (ii) following the Staff's review of the Accountants' Report, MBIA's accounting for, and disclosures concerning: advisory fees, or the assets within Triple A One Funding, LLC, Polaris Funding Company LLC, and Meridian Funding Company, LLC.; and (b) extend any of the deadlines set out in this paragraph 71.

72. Pay the expenses and fees, if any, for the distribution of any Fair Fund established pursuant to Section 308(a) of the Sarbanes-Oxley Act of 2002 established in the related civil action captioned Securities and Exchange Commission v. MBIA Inc., 07 Civ. 658 (JGK) (S.D.N.Y., filed Jan. 29, 2007).

73. Restate its financial statements in a manner not inconsistent with the findings in this Order.

74. In determining whether to accept the Offer, the Commission has considered the above undertakings.

The New York Times
nytimes.com

January 30, 2007

MBIA to Pay $75 Million in Settlement

By THE ASSOCIATED PRESS

WASHINGTON, Jan. 29 (AP) — MBIA, the large insurer of municipal bonds, has agreed to pay $75 million to settle civil securities-fraud charges by federal and New York State authorities over what they said was a sham $170 million transaction in 1998, the company and regulators announced Monday.

The settlements were the latest action to come out of wide-ranging inquiries in the United States and abroad into so-called finite risk reinsurance — which regulators say is sometimes used improperly to help companies artificially inflate earnings without a real transfer of risk.

MBIA signed one accord with the Securities and Exchange Commission and another with the office of New York Attorney General Andrew M. Cuomo and the New York State Insurance Department. The company agreed to pay a total of $65 million in civil fines, restate its earnings from 1998 through 2004, and make improvements in its accounting and business procedures.

The regulators accused MBIA of using secret side agreements with two reinsurance companies to eliminate the risk to the companies in the transaction. They said MBIA used the deal to avoid having to book a $170 million loss in 1998, the first major loss in its history.

The $50 million civil fine against MBIA with the S.E.C. will go to a special fund for defrauded American investors set up after the corporate scandals of 2002. In the agreement with Mr. Cuomo's office and the insurance regulators, MBIA is paying a $15 million fine and $10 million in restitution to MBIA shareholders.

MBIA, which is based in Armonk, N.Y., also agreed to hire an independent consultant, who began work last summer, to review its accounting and financial reporting. The company neither admitted nor denied the regulators' accusations under the settlements.

The $170 million loss stemmed from a July 1998 default on municipal bonds that MBIA had guaranteed for a Pennsylvania hospital chain, the Allegheny Health, Education and Research Foundation. To conceal the anticipated third-quarter loss, MBIA's senior management devised the scheme to obtain reinsurance to cover the value of it and thereby convert a loss into a reported gain, the regulators said.

MONDAY, JUNE 25, 2007

FEATURES MAIN

A Mortgage Meltdown for MBIA

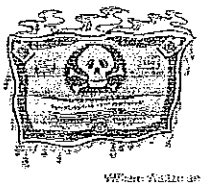
By JONATHAN R. LAING | MORE ARTICLES BY AUTHOR

The giant municipal-bond and corporate-debt insurer could get slammed by further subprime-mortgage fallout. Is its triple-A rating at risk?

DESPITE ITS REPUTATION FOR somewhat slipshod underwriting, giant municipal-bond and corporate-debt insurer MBIA seemed to have allayed investors' concerns of late by working its way out of some tough situations.

For instance, an impending debt-restructuring will defer or perhaps eliminate the insurer's obligation to make future principal and interest payments on some $1.5 billion of debt securities it had insured for the troubled Eurotunnel project. Likewise, MBIA has dramatically whittled down its once-$4 billion exposure of securities backed by manufactured housing, $2 billion of rental-car securitizations, and various equipment trust certificates of the formerly bankrupt carriers Northwest and US Airways. The fact is, few financial insurers are better at restructuring problem deals or stringing out repayments of deals gone bad.

Yet trouble may be brewing in MBIA's $1 trillion guaranty portfolio -- and from a piece of it that has been virtually ignored. The potential losses from these obligations could be of a dimension and immediacy that dwarf MBIA's record $170 million in payments to cover bond-guaranty losses incurred when in 1998 a Pennsylvania hospital group named Allegheny Health, Education and Research Foundation, or Aherf, declared bankruptcy. Namely, MBIA could suffer massive losses from the blowback of the subprime mortgage crisis, through the billions of dollars of subprime-mortgage securitizations that MBIA has insured.



MBIA insures dangerous collateralized debt obligations backed by subprime loans.

The issue was first raised by hedge-fund manager Bill Ackman of Pershing Square Capital Management at an investment conference. In a presentation provocatively-entitled "Who's Holding the Bag?," Ackman contended that MBIA has guarantees on some $5 billion worth of potentially dicey securitizations of subprime-mortgage and other types of asset-backed debt that could ultimately damage the company's balance sheet. Based in Armonk, N.Y., MBIA guarantees the timely payment of interest and principal on municipal bonds and other forms of debt.

The peril is particularly acute because the company will have a narrow cushion of perhaps $500 million or so by yearend over the minimum capital level required to maintain a triple-A rating. Currently, MBIA has $6.8 billion in statutory or insurance-company-level capital, plus unallocated reserves of $200 million, to protect its total guaranteed portfolio of $635 billion in par value against loss. And if woes of the subprime-mortgage market continue to wax as some expect, MBIA could sustain claims losses of more than half a billion bucks.

The company is quick to play down such doubts, and it brushes Ackman aside. It points out to *Barron's* that Ackman's past intimations of MBIA's impending doom -- such as on the Chunnel project -- have come to naught. Ackman has sold large amounts of MBIA stock short, betting on declines, since late 2002, when he issued a lengthy negative report on MBIA -- and has lost money on the trades. Ever since, both sides have engaged in a jihad that has included attempts by each party to push the Securities and Exchange Commission and New York Attorney General into bringing charges against the other side.

The battle royal is far from over, although Ackman appears to be winning the latest round. Since his report in May, MBIA's stock (ticker: MBI) has fallen from over 70 to under 65, despite a strong stock market. Yet renowned value players like Marty Whitman's Third Avenue Fund and Dodge & Cox remain in the stock, no doubt attracted by its modest price-to-earnings ratio of 10.4 times analysts' consensus forecast for 2007 earnings.

As of March 31, 2007, MBIA had insured $5.4 billion in subprime mortgage-backed securities, or MBS, which receive cash flow from underlying pools of mortgages. Here, MBIA probably faces negligible risk, since it generally insures higher-rated classes, or tranches, of MBS, including the triple-A bonds that have first dibs on the flow of mortgage interest and principal payments cascading down the payment waterfall.

But MBIA could be in significant peril as a result of its guarantee of a class of subprime-mortgage derivatives called collateralized debt obligations, or CDOs. These instruments represent a degree of separation from underlying mortgage-backed securities, since CDOs are constructed from individual classes hived off from different MBS or, in the case of "CDOs-Squared," classes of other CDOs.

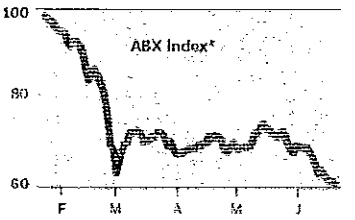
THE RISK OF CDOS IS AMPLIFIED BY THE FACT that they tend to be built from lower-rated tranches of different mortgage-backed securities, classes far below the top of the payment cascade. Thus, any depletion in the value of mortgage pools backing the MBS can so restrict the flow of cash down to the tranches near the bottom of the waterfall that the CDO investors, in effect, die of thirst.

On its Website, MBIA said that as of year end, some $2.4 billion of the total $7.7 billion in mortgage CDOs it has insured were backed by subprime mortgages. The $2.4 billion of CDOs, in turn, is a mix of "mezzanine" and "high-grade" CDOs, according to the company. Mezzanine portfolios are comprised of MBS tranches rated no higher than triple-B, while about two-thirds of high-grade CDOs are made up of single-A tranches.

The risks in such CDOs are indeed daunting, should the subprime-mortgage market continue to deteriorate. The triple-B tranches of MBS are protected by a mere 7% or so of the underlying mortgage pools of total collateral. So, if the cumulative collateral losses mount to 7%, the holders of the triple-B tranches would torched. Once losses hit 10%, the single-A tranches also get snuffed.

MBIA	
Recent Price	$64.53
52-Week High-Low	$76.02 - $56.00
Market Cap (bil)	$8.2
Earnings Per Share	
2006	$5.81
2007E	$6.19
P/E '07E	10.4
Dividend Yield	2.2%

E-Estimate Source: Thomson Financial Baseline



*Measures BBB-minus-rated subprime mortgage bonds.
Sources: Markit; CDS IndexCo

Although MBIA's stock looks cheap by some measures, it could take some hits from the company's securitizations of subprime loans. A key index of such securities has fallen some 40% since January.

While in a 10% loss scenario, more than 85% of an MBS capital structure would survive intact, subprime CDOs built from lower-rated MBS tranches would face catastrophic losses. Many mezzanine CDOs would be completely pancaked. Meantime, high-grade CDOs could lose as much as 65% of their value as the A-rated tranches took gas. MBIA typically insures only the triple-A portion of the latter, but this affords it only 20% collateral protection before the losses attach to it. Yet it would be potentially on the hook for covering 45 percentage points of the 65% in overall losses or over half of the 80% in par value it had insured.

SUCH A MELTDOWN IN SUBPRIME, ONCE DEEMED remote, is indeed possible these days. Since January, the ABX index that measures the performance of triple-B subprime MBS tranches has lost nearly 40% of its value. Credit downgrades of MBS are spiraling, with Moody's alone chopping the ratings of 131 bonds earlier this month.

In a report, Moody's dolefully revealed that an unprecedented 3% of the subprime mortgages securitized in last year's third quarter are now in foreclosure. Likewise, the rating concern projected that because of unfavorable trends in home prices, mortgage rates and lending standards, cumulative losses on loans backing 2006 subprime securitizations will "generally range between 6% and 8%." Some private estimates see losses of 10% or more in the 2006 loan vintage.

Part of the problem is mortgages taken out by fraudsters who lied on their applications as to their income and net worth, and by property-flippers who mail in their home keys after seeing home prices fall in such premium markets as California, Florida, Arizona and Las Vegas.

A far more ominous drama figures to play out over the next two years, when more than $600 billion in subprime mortgages will "reset" from low, fixed teaser rates to higher-floating rates. Monthly payments will soar 50% or more for already-financially strapped homeowners caught in a proverbial roach motel.

Tightened lending requirements and falling home values will likely choke off any opportunity to refinance at attractive teaser-rate levels. Nor will these homeowners be able to find refuge in a fixed-rate, 30-year loan, with no equity value in their homes and long-term rates moving up.

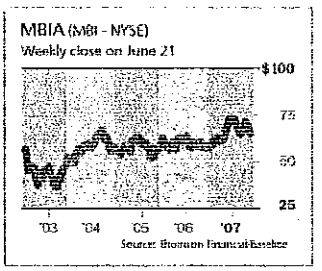
In such an environment, foreclosure rates figure to soar and lender-recovery rates to plummet. And efforts by lenders to restructure loans via interest-rate reductions, payment deferrals and the like in order to avoid foreclosure will be all the more difficult because of the complexity of sub-prime loans,

now mostly lodged in securitizations.

Contacted by *Barron's*, MBIA officials denied that either its $5 billion in mezzanine CDOs or its $2.4 billion in subprime-mortgage CDO exposure constitutes a major risk to the company. Firstly, its mezzanine CDOs consist of other types of collateral in addition to subprime mortgages, including prime mortgages, corporate debt, credit-card receivables and auto-loan paper. Many of the CDOs are likewise overcollateralized, although the company refused to quantify at what level. Likewise, the levels or tranches of CDOs insured by MBIA often sit higher up in the structure than even the triple-A level, with additional collateral protection.

The latter consideration, however, may prove nugatory -- a luxury suite on the Titanic, if you will -- should MBIA's subprime mezzanine CDOs run into trouble. Senior position matters little if all the collateral gets wiped out. The company conceded that some $800 million of its $2.4 billion subprime CDO collateral is of the mezzanine variety, with "some small buckets"of double-B tranches mixed in with the triple-B holdings. Collateral impairment could thus move more rapidly up the CDO structure than even the bears imagine.

A dose of skepticism certainly is in order for dealing with MBIA, since the company has sometimes seemed less than candid in its recent history. One only has to look back to the aforementioned $256 million bond default in 1998 by the hospital chain Aherf, when MBIA cooked up an apparently phony reinsurance scheme to avoid taking a $170 million charge to earnings that year.



The full $170 million amount was made good by three European reinsurers. At the same time, MBIA entered into a reinsurance agreement on future business with the same reinsurers, guaranteeing them nearly $300 million in future premiums over a period of years. Subsequently, MBIA insisted that the $170 million in loss payments and the $297 million in future premiums wasn't a disguised loan agreement but two separate, bona fide reinsurance deals. The appeal of that interpretation was clear: If the opposite were true, then MBIA wouldn't have qualified for insurance-accounting treatment. Instead, it would've been required to take a $170 million charge, dinging 1998 earnings by 25% -- a serious blow to its dependable growth-stock image and its then much-ballyhooed claim of being a zero-loss underwriter. By virtue of a decorously long payback period, MBIA could both spread and bury the loss over seven years or more.

Finally, in early '05, the MBIA story began to unravel as a result of an aggressive joint investigation of the Aherf deal by the New York Attorney General's office, SEC and the U.S. Justice Department. Smoking guns abounded. Among other things, investigators turned up secret side agreements between MBIA and the reinsurers, leaving little doubt as to the true loan nature of the transaction.

MBIA AGREED TO PAY FINES AND RESTITUTION of $75 million without "admitting or denying any wrongdoing." It also was required to hire and pay for an independent consultant to review the company's auditing, compliance and accounting procedures and investigate some other possibly suspect MBIA deals. In a posting on its Website, MBIA says that it doesn't "anticipate any further enforcement action with respect to any of the matters being reviewed by the Independent Consultant or with respect to any of the other matters that were under investigation."

That may be too optimistic. The consultant, John Siffert, is a tough former federal prosecutor in Manhattan who's now a civil and criminal litigator. And unless he has gone native during his MBIA probe, he should have plenty of grist for his mill in MBIA's handling of an investment it made in the late '90s in a municipal property-tax lien company called Capital Asset Research.

The Capital Asset contretemps began innocently enough, with MBIA's parent concern purchasing a 46% stake in the lien concern for just $15 million. But by 1998, just two years later, the company had gone haywire and MBIA was in deeply over its head. Just how badly came out at a Capital Asset directors' meeting when Gary Dunton, then MBIA chief investment officer and now chairman, president and CEO, was caught on videotape complaining to a fellow director that MBIA's exposure to Capital Asset's woes had ballooned to something like $500 million.

Two weeks earlier, the same Dunton had assured analysts on a conference call that MBIA had only about $140 million at risk in Capital Asset and three other municipal finance operations it had lumped into the same unit.

MBIA, which has not commented on the Capital Asset saga, ultimately suffered around a $300-million loss, but was able to delay recognition of $200 million of that over the next eight years or so by prevailing on its insurance unit to guarantee two securitizations of more than $300 million of Capital

Asset's horribly-performing tax lien portfolio. The quality of one of the securitizations was so bad that MBIA whimsically dubbed it "Caulis Negris," an incorrect Latin translation of "black hole."

Such non-triple-A behavior for a time emboldened Pershing Square's Ackman and fellow shorts to think the unthinkable -- that perhaps the rating agencies like Moody's and S&P might decide to take away MBIA's vaunted credit rating. Such a move would be the proverbial knockout punch effectively putting the company out of business.

But that is highly unlikely. MBIA is one of the rating agencies' biggest revenue sources. They are also loath to call into question their triple-A ratings on the $635 billion par value of MBIA-guaranteed debt that's currently outstanding. A sudden markdown of that much debt could have calamitous legal and political repercussions for the rating-agency oligopoly.

Bottom Line

If the subprime-mortgage market worsens, MBIA could sustain claims losses exceeding a half-billion bucks. It might have to issue more stock, diluting shareholders.

So these days, Ackman and the other shorts have more modest ambitions. By constantly sounding the undercapitalization tocsin, they hope to starve the holding company by cutting off the flow of munificent upstream payments from the insurance unit that the parent has used to bolster the stock through fat dividend payments and large stock buybacks. Or even better, the shorts are hoping that a spiral in future claims losses might force the holding company to raise more equity and dilute shareholders.

If the subprime-mortgage market continues to unravel, the shorts might finally get a measure of solace.

CNNMoney.com

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DECEMBER 20 2007: 3:36 PM EST

Bond giant's $8.1 billion surprise

That huge sigh of relief you heard from investors in MBIA after the bond insurer avoided a damaging downgrade? It didn't last long.

By Katie Benner, writer-reporter

(Fortune) -- Just hours after dodging a potentially devastating downgrade from ratings agency S&P, bond insurance giant MBIA disclosed late Wednesday a massive $8.1 billion exposure to the same risky investments that have been wreaking havoc on Wall Street in recent months.

It's unlikely now that MBIA can escape a ratings downgrade. The news could also jeopardize an offer by buyout firm Warburg Pincus to invest $1 billion in the beleaguered company.

MBIA's surprise announcement could rattle Wall Street at a critical time. If MBIA is downgraded or fails to secure financing from Warburg Pincus, then the bonds it guarantees will be downgraded, likely resulting in more losses for investment banks and prolonged turmoil in the credit markets.

Analysts said they were dismayed by MBIA's disclosure. "We are shocked that management withheld this information for as long as it did," wrote Morgan Stanley's Ken Zerbe and Yoana Koleva in a research note issued after Wednesday's writedown was announced. "This new disclosure completely changes our view of MBIA being a 'more conservative underwriter' relative to [competitor] Ambac."

MBIA (MBI) shares were down more than 25 percent in mid-afternoon trading Thursday.

MBIA, the country's largest bond insurer, revealed late Wednesday that the $8.1 billion is backed by collateral debt obligations (CDOs) and residential mortgage-backed securities, whose value has fallen steeply since credit markets seized up this summer. Of the total exposure, $5.1 billion was written in 2006 and 2007, when Wall Street firms were inking some of the riskiest loans.

The latest developments would spell even more trouble for MBIA and Ambac Financial Group (ABK). These so-called monolines have insured about $652 billion and $546 billion in debt, respectively, that could be downgraded and fall in value if those insurers are downgraded. Before MBIA's $8.1 billion

disclosure, S&P estimated that MBIA faces $3.1 billion in losses on securities backed by subprime mortgages.

MBIA said it was establishing loss reserves of between $500 million and $800 million as protection against losses from its insured bonds. But that amount is woefully small compared to the value insured investments now at risk of crumbling. Too little capital combined with high-risk exposure is a problem that dogs nearly all of the monoline insurers, most of which are facing downgrades by S&P and Moody's.

MBIA would not be the first bond insurer to be downgraded. That honor goes to ACA (ACAH), which on Wednesday had its investment-grade A credit rating slashed to the junk rating CCC by S&P. Economists and Wall Street analysts worry that bond insurer implosions will ripple through the financial system as waves of bonds are downgraded and investment banks are forced to take more writedowns as a result. (See "Bond insurer defaults threaten big banks")

In part to stave off a meltdown, buyout firm Warburg Pincus offered Dec. 10 to buy $1 billion in MBIA shares and nominate two new members to the MBIA board. MBIA accepted the offer, but it still requires shareholder and regulatory approval. And given what appear to be serious problems at the insurance company, at least one high-profile investor doubts that the transaction will proceed.

Bill Ackman, who runs activist hedge fund Pershing Square, recently sent a letter to federal and New York state regulators challenging the Warburg deal. Ackman, who's been betting for years that MBIA shares will fall, wrote Dec. 14 that MBIA's press releases regarding the Warburg plan "are misleading" because they treat it like a done deal. Far from complete, Ackman said, key conditions are likely to derail it.

Ackman didn't elaborate because key terms of the agreement were not disclosed. But he went on to claim that MBIA misled investors about its capital and risk profile, and may already be in violation of agreements it made to Warburg.

MBIA and Warburg Pincus did not return calls seeking comment.

"Far from a vote of confidence in MBIA, the transaction appears to be a conditional contract....It does not appear to be a bona fide commitment to invest come hell or high water," wrote Ackman.

If Ackman's right, MBIA's problems could soon be Wall Street's too. ■

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RESEARCH UPDATE

MBIA Insurance Corp. 'AA' Rtgs Affirmed With Negative Outlook; Off CreditWatch Neg

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RatingsDirect Publication Date
August 14, 2008

Rationale

On Aug. 14, 2008, Standard & Poor's Ratings Services affirmed its 'AA' financial strength rating on MBIA Insurance Corp. and removed it from CreditWatch Negative. The outlook is negative due to MBIA's significant exposure to domestic nonprime mortgages and related exposures to collateralized debt obligations (CDO) of asset-backed securities (ABS).

In addition, the negative outlook reflects our belief that the MBIA franchise has been damaged and that the company will face diminished new business flow. Removal of the negative outlook will be dependent on clarification of ultimate potential losses as well as future business prospects, the outcome of strategic business decisions, and potential regulatory developments.

The 'AA' financial strength rating on the company is supported, in our opinion, by currently sound claims paying ability and liquidity levels. MBIA's margin of safety, as measured by Standard & Poor's capital adequacy test, is in the 1.0x–1.1x range, well above the level required for a 'AA' rating.

In our view, MBIA's success in accessing $2.6 billion of additional claims-paying resources is a strong statement of management's ability to address the concerns relating to the capital adequacy of the company. MBIA did not, however, receive value in the capital adequacy model for the $1.1 billion of capital retained at the holding company as this money may be used to fund its proposed new insurance subsidiary or support other initiatives. It is worth

noting that, although this money sits at the holding company, management has stated that it will maintain a high capital level to support current policyholders. Notwithstanding this commitment and funds at the holding company, in our view, the company's ability to access the capital markets at this time is limited as a result of market concerns about the company's exposure to a continued deterioration in key areas of the U.S. residential mortgage sector and related CDO of ABS structures. This limitation may place increasing pressure on capital adequacy if additional capital is needed.

Standard & Poor's understands that management has initiated a plan that would restructure its business in such a way that, according to MBIA, the public finance business would be insured by a separate now-dormant insurance subsidiary and stabilize MBIA's 'AA' rating.

With regard to the current financial guarantee operations, management has indicated that over the next 12 to 18 months, new business underwritten will be negligible as management works toward this goal. Our view of the restructuring will depend in large part on whether we believe management can put together a sustainable business model and demonstrate the ability to generate a profitable stream of revenue that is of sufficient volume and quality to support the capital employed in the business.

Outlook

The negative outlook reflects Standard & Poor's concerns relating to MBIA's exposure to domestic nonprime mortgages and related CDO of ABS exposures, as well as our belief that the MBIA franchise has been damaged and that the company will face diminished new business flow. A revision of the negative outlook will depend on, among other factors, clarification of ultimate potential losses as well as future business prospects, the outcome of strategic business decisions, and potential regulatory developments.

Ratings List

Ratings Affirmed; CreditWatch/Outlook Action

	To	From
MBIA Insurance Corp.		
MBIA Insurance Corp. of Illinois		
MBIA Assurance S.A.		
Capital Markets Assurance Corp.		
Issuer Credit Rating		
Local Currency	AA/Negative/—	AA/Watch Neg/—
MBIA Insurance Corp.		
MBIA U.K. Insurance Ltd.		
MBIA Insurance Corp. of Illinois		
MBIA Assurance S.A.		
Capital Markets Assurance Corp.		
Financial Strength Rating		
Local Currency	AA/Negative/—	AA/Watch Neg/—
MBIA Insurance Corp.		
MBIA U.K. Insurance Ltd.		

MBIA Assurance S.A.		
Financial Enhancement Rating		
Local Currency	AA/—	AA/Watch Neg/—
MBIA Inc.		
Issuer Credit Rating		
Local Currency	A-/Negative/—	A-/Watch Neg/—
MBIA Insurance Corp.		
Senior Unsecured (1 issue)	A	A/Watch Neg
MBIA Global Funding LLC		
Senior Secured (4 issues)	AA	AA/Watch Neg
Senior Unsecured (77 issues)	AA	AA/Watch Neg
MBIA Inc.		
Senior Unsecured (7 issues)	A-	A-/Watch Neg
North Castle Custodial Trust I		
Preferred Stock (1 issue)	A-	A-/Watch Neg
North Castle Custodial Trust II		
Preferred Stock (1 issue)	A-	A-/Watch Neg
North Castle Custodial Trust III		
Preferred Stock (1 issue)	A-	A-/Watch Neg
North Castle Custodial Trust IV		
Preferred Stock (1 issue)	A-	A-/Watch Neg
North Castle Custodial Trust V		
Preferred Stock (1 issue)	A-	A-/Watch Neg
North Castle Custodial Trust VI		
Preferred Stock (1 issue)	A-	A-/Watch Neg
North Castle Custodial Trust VII		
Preferred Stock (1 issue)	A-	A-/Watch Neg
North Castle Custodial Trust VIII		
Preferred Stock (1 issue)	A-	A-/Watch Neg

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