



An Introduction to the Impact of “Mark to Market” Accounting on MBIA and Financial Guarantors

MBIA provides credit protection on municipal, essential asset and securitized financings, and the terms and conditions of the agreements under which we provide that protection to investors are laid out in contracts between MBIA and the insured party. Historically, all of our customers received protection written in the form of financial guarantee insurance policies, and today about 80% of our book is in that form. Financial guarantee insurance policies typically provide for principal and interest payments by us if there's a default in the underlying credit; but they also contain protections for us. In the event that an insured bond defaults, we typically have the option to either continue making the periodic principal and interest payments over the remaining life of the bond or we can accelerate the bond and pay off the obligation in its entirety - whichever has a superior outcome for us. This is a valuable option that can result in the ultimate payment of principal being far out in the future, giving the underlying credit or asset pool time to recover and reduce any loss to MBIA. Financial guarantee insurance policies are irrevocable and unconditional, and nearly impossible to transfer. In addition, our policies are *unsecured* - that is we do not have to post collateral against potential future payments.

Our original structured finance business provided insurance on bonds issued by securitization vehicles. In the late nineties, we began to write more business with financial institution customers that had loan assets on their balance sheets that were not destined for securitization vehicles. The accounting for these books of business involves so-called “fair value accounting,” in which the asset is recorded on the balance sheet at the price at which it can be sold, and changes to that fair value are recorded in income. We commonly refer to this as “mark to market accounting.” People often refer to the income statement change in fair value as “the mark.” Unfortunately, they also often refer to the balance sheet value as “the mark.” It's really “the cumulative mark,” or the summation of all marks taken to date.

Mark to market accounting is an accurate representation of the economics of a book of business that is actively traded – since the positions can be sold at any time, and may be collateralized based on changes in market value from time to time, the current realizable value is highly relevant. This accounting has been viewed as valuable by the financial institution regulators as it encourages firms to sell deteriorating assets, getting problems behind them quickly.¹

¹ There is, however, the risk that a market decline is reinforced and amplified by the marks to market, as deftly described in Holman Jenkins' editorial in the March 5, 2008 *Wall Street Journal* in a piece entitled “Mark to Meltdown?”

So our customers who are subject to mark to market accounting desired to hedge these assets; that is to transfer the risk of loss without selling the assets. One way to hedge is to buy protection from MBIA. A financial guarantee insurance policy is an effective hedge for the risk that the assets default, but it does nothing about the “mark to market.” The financial guarantee industry developed a way to deal with this – we would issue an insurance policy to a related company, which would enter into a contract with the financial institution. That contract, a credit default swap, would be subject to “derivatives accounting” - and since 2001, all derivatives have been accounted for on a mark to market basis (except for certain exceptions – which are extremely rare in our book and too complex to go into here) under an accounting rule called “FASB 133.” The swap contract has essentially all the same terms and conditions as the financial guarantee insurance policy – it’s a derivative *in form* but an insurance policy *in substance*. The financial institution customer gets the accounting they desire, and MBIA gets the economics and protections it desires.

Note that *the customer* gets the accounting they desire. MBIA doesn’t naturally desire mark to market accounting – our business is about taking credit risk until the maturity of the instruments we guarantee – so any notion of trading is irrelevant to us. We originally viewed the noise associated with mark to market accounting as a small price to pay for the very real economics of getting well paid to take what appeared to be very small amounts credit risk. Remember, the mark to market is tracking the fair value of the instrument we guarantee. But we *don’t guarantee the market value*. We guarantee against payment defaults. Therefore, mark to market accounting does not accurately reflect the economics of our business.

While changes in the risk of default due to poor credit performance are likely to be reflected in market values, there is rarely a one-to-one correspondence. Other factors, like general economic conditions, market illiquidity, technical trading and market sentiment can play dominant roles. For example, in 2002 we had a portfolio subject to mark to market accounting that largely contained guarantees of pools of corporate loans and bonds. During the mini-recession that year, corporate spreads widened substantially, and we had a \$77 million mark to market loss (which, at the time, seemed *huge* relative to our \$48 billion portfolio). Some activist short sellers were certain that this portended adverse future credit performance. Those predictions were wrong. That portfolio has largely amortized and matured since then, and our total losses were \$0. So the year end 2002 mark missed the, well, mark.

The point is that the market value can and sometimes does contain information about future credit performance, but it also carries information about *attitudes* toward credit performance, liquidity, availability of financing, etc. And it’s hard to separate one from the others. For a financial institution with a trading account, or a firm being liquidated, the relative impacts of these inputs really don’t matter. What the assets and liabilities will fetch in today’s market is key. However, banks’ investment accounts, insurance companies, pension plans, and bond insurance companies simply are not in either of those two camps. They typically do not intend to liquidate assets in the short term, but expect to hold them for a long time - until maturity in the case of a bond insurer. They aren’t in liquidation mode (with occasional exceptions). The daily, weekly, quarterly ups and downs of the market don’t matter much to them. What does matter is long term credit performance.

Imagine you're putting some money away for your kid's education in 18 years time (a lot of money!). You buy an insured zero coupon bond that provides certainty of funding in 18 years. During the 18 years, rates will go up and down and spreads may go up and down, dragging your bond's market value all over the place. But you don't care – you just want the proceeds at year 18. If however, the issuer of the bond gets downgraded because their credit is deteriorating, you'll care a lot about *that*, because if they default, you won't have the money when you need it.

This is how our business model works. We insure a bond for its full term, and if the issuer doesn't pay, we will. Our policy is a *contingent liability*, and it is irrevocable and unconditional – and we couldn't trade out of our positions if we wanted to. So if you think the markets' ups and downs are irrelevant to your college savings plan, they are even more irrelevant to our business model *except to the extent that they tell us something about future credit performance*. We do study the marks for that purpose, but they are not the sole, or even the best measure of credit performance.

As a credit risk management company, we have a disciplined, detailed and documented process for assessing future credit performance. We have a team of approximately 50 analysts and workout specialists who monitor the credit performance of every deal in our portfolio. For structured finance transactions, they receive monthly reports from the bond trustees on the key credit characteristics of each deal, including loan level delinquency and default data on the housing-related securitizations. Deals that under perform expectations are placed in a heightened surveillance status. Then these analysts run discounted cash flow analyses on all the structured transactions and fundamental credit analyses on the municipal, state and sovereign borrowers. If it appears that a given deal will generate insufficient cash to make its debt service payments, they estimate the amount and timing of potential MBIA payments. The present values of these payments are disclosed in our financial statements or the management discussion and analysis accompanying the financials – these are our credit losses. Credit losses are expressed as additions to loss reserves or impairments, depending on whether the contract is a financial guarantee insurance policy or a credit default swap. These transaction-level analyses result in an auditable estimate of future credit performance. It should be easy to see why a process like this is more reliable than a top-down one that relies on market spreads for the collateral in the deals and an assumption driven valuation model (which by the way is the only way to value these contracts – remember, they can't actually be sold or transferred).² Our reserves and impairments are our best guess about uncertain future events at a point in time. As the events get closer, our estimates are continually refined.

As if all that weren't enough, we also find that people are confused about the fact that our insured credit derivatives are called "credit default swaps," even though they have relatively little in common with the commonly held and traded instrument with the same name. Our swaps have most of the terms and conditions, and liquidity

² For those who are more technically oriented, there is a very detailed description of our process of determination of loss reserves and impairments in our form 10-K on pages 45 and 46 of the management discussion and analysis section. There is also a great deal of discussion of our methodology for marking our insured credit derivatives to market on pages 48 – 50 of the same section. This section is called "Critical Accounting Estimates," and they are in fact critical to understanding our reported results.

characteristics of insurance policies.³ We do not have to collateralize them, and they cannot be accelerated, unless we elect to do so as part of a remediation strategy.

Some of the big banks have been taking huge mark to market losses on portfolios of collateralized debt obligations (which is just a specialized form of securitization), or “CDOs.” Many of the deals that we have insured through credit default swaps are CDOs, and those swaps have also had large mark to market losses. A frequently asked question is “how come it seems that the banks are taking such big losses, as a percentage of their positions, and yours are relatively small?” For the record, the amount of mark to market loss in our portfolio in Q4 2007 was about 2% of the amount insured, while for Merrill Lynch and Citigroup the amounts were over 25%. So, why are they different?

- They are marking securities they own outright, while we are marking insurance policies on similar securities, which provide for subordination and prevent acceleration. An insurance policy on a security should therefore have a different mark than the security itself because of these features. Even when a bank is marking an identical security to one that we’ve wrapped, the liquidity advantage of the insurance policy should result in very different estimates of fair value.
- If they own the senior security we’ve guaranteed, the marks on the guarantee and their corresponding position largely offset each other, so the net mark that we see reflects only the change in value of the subordinate piece of the deal.
- Many of the securities they’re valuing were NOT guaranteed by MBIA, so it’s unclear what relevance that part of their marks has.
- Many of these institutions were *originators* of CDOs, and may be holding on balance sheet the portions of those deals that were hardest to sell, which also may be more volatile.

The banks have had very significant non-cash, mark to market losses in the past two quarters, on positions that most analysts expect will recover a good bit of the value lost quickly once liquidity returns to the securities market. Unfortunately, these mark to market losses affect the banks’ regulatory capital position, since their regulatory model is based on fair value accounting. As a result, we’ve seen them sell big equity positions to new investors, including sovereign wealth funds. They are raising *cash* to cover *paper* losses. Many analysts expect that as the values come back in line, the banks will find themselves with huge amounts of excess capital, that may be distributed to shareholders in the form of share repurchases. The practical effect of mark to market accounting then, may be to cause them to *sell equity when prices are low and buy it back when prices are high*.

Fortunately, the regulatory and rating agency evaluation of the bond insurers is NOT based on mark to market accounting. US statutory accounting, on which the capital

³ There are a couple of differences. For example, our insurance policies require that the insured own the bond we’re guaranteeing. The credit default swaps don’t, and that has facilitated their use in transactions where our customer isn’t *financing* anything, it is merely seeking an arbitrage between the price of default risk in the financial guarantee market versus other markets. We recently announced that we wouldn’t engage in credit default swap business any more, and that we wouldn’t provide our guarantee to arbitrage type transactions either.

evaluations are based, takes into account credit losses and impairments, but not fluctuations in fair value. It makes sense since the insurers have no option to realize, or risk of realizing, the current fair value. The mark to market serves only to confuse those who are not fully knowledgeable about the bond insurance business model. Unfortunately, this is all too large a population.

So comparing MBIA to the banks isn't all that fruitful. A more relevant comparison might be to a company with similar exposures to ours, like AMBAC. They also have a portfolio of unconditional irrevocable guarantees which are not subject to acceleration, uncollateralized instruments and don't trade. The marks relative to the exposure are also much smaller than those of Merrill and Citigroup in Q4 2007.

Since the prices of the instruments we guarantee can't be directly observed, our marks to market are calculated through a time-consuming analytical process. The process is described at length in the Critical Accounting Estimates section of the management discussion and analysis in our form 10-K; if you're inclined to detail. Basically, the marks are driven by spreads on indices or bonds that mimic the collateral in our insured deal. As market spreads get higher, our mark to market grows, and the relationship is non-linear (that is, the higher market spreads are, the more impact small changes in spreads have on our marks to market). At this point, the marks are very distant from our estimate of the future credit deterioration in the portfolio. As of year end 2007, we had a total cumulative mark of \$3.7 billion, while the total amount of impairment in the portfolio that's subject to mark to market accounting was \$200 million.

This huge difference is reflective of the market's bet that not only is the housing market in poor shape now, but that it will get *significantly* worse. To pick an obvious example of this – the year end 2007 rate of loss on 2006 subprime mortgage securitizations was 1.4%, according to S&P. The ABX index, a measure of price performance on 20 volatile securitizations, suggests that losses will be north of 40%. Remember, these are first mortgages on the homes of subprime borrowers. So the index is saying that 40% of all borrowers who got these loans in 2006 will be foreclosed out, and the lenders will lose ALL THEIR MONEY; or the lenders will lose a normal amount per home, say 40%, and EVERY LAST HOMEOWNER will be foreclosed (or obviously, something in between these extremes). Either way, that's a far far different housing market than that which S&P observes and most market participants saw at year end 2007. We each can have our own opinions about how this plays out; but as for MBIA, we think the losses will be much less than 50% - which means that much of this mark to market will reverse when the situation stabilizes.

Of course, in the absence of credit impairment, we expect our entire mark to market, \$3.7 billion, to reverse over time. Since we hold our position to maturity, there are only two possible outcomes. Returning to the "saving for college" example for a moment, either the issuer of the bond defaults or your kid goes to college. Either way, interim changes in market value over time don't matter at that point. The same is true of our portfolio. We expect some of the bonds to default, and the \$200 million impairment is our best estimate of the actual losses we will sustain. Other than that and any future impairments, we expect that our \$3.7 billion mark to market should reverse over time. If we're right that the current market is oversold, a good bit of it should be coming back quickly.

In conclusion, the marks to market in financial guarantee company financial statements have generated confusion - the numbers are very significant, but the accounting is totally inconsistent with the economics of the business. In the interest of enhancing the clarity of our reported results over time, we have decided not to write insurance coverage in this form in the future.