Is MBIA Triple A?
A Detailed Analysis of SPVs, CDOs, and Accounting and Reserving Policies at MBIA, Inc.
(NYSE: MBI)
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Disclaimer
Funds managed by Gotham and its affiliates own investments that are bearish on MBIA. These investments include credit-default swaps, equity put options, and short sales of common stock.
This report is based upon Gotham’s own reading of MBIA’s SEC filings and other public documents. Gotham’s views are also informed by its knowledge of, experience in, and opinions about MBIA’s business and financial institutions generally. In addition, a Gotham representative met with MBIA’s management at its headquarters in Armonk, NY on August 14, 2002 and has had other conversations and correspondence with MBIA’s management.
In this report, Gotham has endeavored to distinguish clearly between facts and opinions. The facts are based upon MBIA’s SEC filings and numerous other public sources that we believe to be reliable and relevant to our findings. (To provide the reader with an indication of the scope of our research, we plan to publish a bibliography of sources we consulted in analyzing the company and preparing this report.) On some issues – for example, uncovering the assets in MBIA’s off-balance-sheet special purpose vehicles, which MBIA does not itself disclose – it has been difficult to amass the necessary facts. We have done our best to be thorough and accurate at all times. If, however, we have made any errors, or if any readers have additional facts that we have not considered, we welcome hearing from you.
As to the opinions expressed here, others may disagree with some or all of them. Gotham urges anyone interested in MBIA to read its SEC filings and to consult whatever other sources they deem appropriate in order to form their own opinions on the topics covered in this report.
We wish to be clear that our purpose here is to focus on MBIA in an effort to find and disseminate public information that we believe has not been made readily available to the investing public, but is germane to an evaluation of MBIA. While our opinions on MBIA are critical, we do not intend to criticize any individual or to suggest wrongdoing by anyone.
We welcome a response from the company and the analysts who cover the stock on the issues raised in this report. We are willing to make ourselves available to discuss our
points of view with the company and/or its analysts in a public forum. This report is not intended as investment advice to anyone.

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I. OVERVIEW OF OPINIONS AND CONCLUSIONS

• **Summary.** MBIA is an insurer whose primary business is to provide guarantees on financial obligations in exchange for upfront or installment premiums. Management describes the company as a “long-term buyer and holder of risk,” which underwrites to a “no-loss” standard. MBIA operates its insurance business through its AAA rated insurance subsidiary, MBIA Insurance Corp. The insurance company’s AAA rating is critical to the success of the entire enterprise.

Were the insurance company downgraded by even one notch (from AAA to AA+), even the company acknowledges its business could be materially impaired. In light of MBIA’s enormous leverage, the company’s credit quality, underwriting, transparency, accounting, and track record must be beyond reproach. In addition, and as importantly, the company must have minimal liquidity risk. Based on our research, we conclude that MBIA fails to meet these standards.

It appears to us that an actual or perceived downgrade of MBIA would have fairly draconian consequences to the company and create substantial drains on the company’s liquidity. The self-reinforcing and circular nature of the company’s exposures make it a poor candidate for a AAA rating.

• **High Leverage.** Compared with other AAA rated companies, MBIA is unusual for its high degree of leverage. At September 30, 2002, MBIA’s $5.5 billion of shareholders’ equity supported $764 billion of outstanding guarantee liabilities (net par and interest), a ratio of liabilities to equity of 139 to 1. Even when compared with the company’s $483 billion of net par insured, MBIA is leveraged
nearly 88 to 1. MBIA has been able to achieve a AAA rating despite its enormous leverage because of the perceived high quality of its guarantee portfolio, its long track record of minimal reported losses, its modest on-balance sheet leverage, and the fact that the rating agencies believe that MBIA is not exposed to accelerating guarantees and has no short-term debt.

- **MBIA’s AAA Rating Can Withstand Only $900 million to $1.7 billion of Losses.** According to MBIA’s CFO, the company would be at risk of a downgrade in the event it were to incur losses of $900 million to $1.7 billion, a mere 20 to 35 basis points loss on its $483 billion net par guarantee portfolio.

- **Municipal Finance Versus Structured Finance.** In MBIA’s traditional business of guaranteeing municipal debt, the company had an informational advantage compared to Wall Street that enabled it to profit from the sale of insurance to municipalities which could not easily access capital without its guarantee. MBIA’s recent growth has been driven by the corporate and structured finance markets in which there are alternatives to financial guarantees. We do not believe that MBIA has a competitive advantage in these markets.

- **Reserving.** MBIA’s reserves are consistent with its perceived high quality guarantee portfolio, i.e., its reserves are extraordinarily low compared to those of other financial institutions. Excluding reserves for known losses, the company has approximately 4 basis points of reserves against potential losses in its guarantee portfolio.

- **Transparency.** MBIA prides itself on the quality and transparency of its public disclosure. This high degree of transparency is critical for rating agencies, regulators, and shareholders because of the company’s high leverage and low reserves.

- **Special Purpose Vehicles (SPVs).** MBIA has approximately $8.6 billion of assets and liabilities in five off-balance sheet Special Purpose Vehicles (SPVs), supported by a total of $125,000 (one hundred twenty-five thousand dollars) of third-party equity. These SPVs were disclosed for the first time in MBIA’s 2001 Annual Report, although they have been part of MBIA since early 1998. While the company states that all SPV assets at the time of purchase were investment grade, MBIA itself may determine whether an asset qualifies as investment grade. In addition, there is apparently no requirement that the ratings of assets in the SPV be updated. MBIA claims that it cannot reveal the contents of the SPVs because of confidentiality agreements it has signed.

- **We Reveal $4 Billion of the SPVs Assets.** In this report, we provide information on all of the assets that we have been able to identify in the SPVs. These identified assets total more than $4 billion or nearly half of the SPV assets. Many of the SPV assets are warehouse lines of credit to poorly capitalized and/or financially distressed sellerservicers of auto loans, defaulted credit card receivables, home equity mortgages, and healthcare receivables. We believe that if investors were to become aware of the quality of the assets in the SPVs, they might not be willing to purchase commercial paper or medium-term notes backed by these assets.

- **$3 Billion of the SPV Debt is Commercial Paper.** Slightly more than $3 billion of the $8.6 billion of SPV debt at September 30, 2002 was in the form of commercial paper (CP). MBIA should, in our view, be considered the de facto issuer of the outstanding commercial paper because MBIA guarantees the CP and the liquidity facilities that back-up the CP. The rating agencies, however, do not consider the CP to be debt of MBIA or,
alternatively, are unaware that MBIA, through an SPV, has this short-term debt outstanding.

• **Triple-A One Funding Corp.’s CP Creates Substantial Liquidity Risk for MBIA.** We believe that Triple-A One Funding Corp.’s (one of the SPVs) $3 billion of commercial paper creates significant liquidity risk for MBIA because, in the event of a decline in MBIA’s actual or perceived credit rating, these CP buyers may withdraw their support, requiring the SPV to draw upon its outstanding bank liquidity lines. MBIA provides no disclosure about this SPV’s liquidity facilities; however, CP conduit liquidity facilities typically contain two “outs” which allow banks not to fund. These outs include bankruptcy of the issuer and/or insufficient asset values to cover the outstanding commercial paper.

• **A Reduction in MBIA’s Rating Will Likely Cause the SPVs’ Assets to Be Less Than Their Liabilities.** Since the assets of MBIA’s SPVs are AAA rated only because of MBIA’s guarantee, a decline in MBIA’s actual or perceived credit rating may substantially reduce the value and marketability of the SPV assets. In light of the nominal equity in this SPV, we believe it is highly probable that the market value of Triple A One’s assets will not exceed its outstanding commercial paper in the event of an actual or perceived downgrade of MBIA, increasing the risk of a liquidity facility covenant violation.

• **Accounting Treatment of SPVs.** We do not believe that MBIA’s SPVs qualify for off-balance sheet treatment under current or proposed accounting rules. MBIA’s five off-balance sheet SPVs, with $8.6 billion of debt guaranteed by MBIA have a total of $125,000 of third-party equity which equates to 0.0014% of total SPV assets or $14 for each $1,000,000 of debt, well below the minimum 3% threshold required under GAAP for non-consolidation of SPVs. We believe MBIA’s SPVs fail the requirements for non-consolidation for the following reasons: (1) no third party has made a substantive equity investment; (2) the SPVs are effectively controlled by MBIA; (3) as guarantor of the SPVs assets and liabilities, MBIA is at risk of loss; and (4) MBIA apparently receives nearly all of the SPV profits in the form of advisory and administrative fees.

• **MBIA Will Likely Be Forced to Consolidate the SPVs at Its Insurance Subsidiary.** We understand that MBIA is now telling investors and analysts that it intends to consolidate the SPV debt at the holding company, MBIA Inc., rather than at the AAA insurance subsidiary, MBIA Insurance Corp., which is the guarantor of the SPV obligations. We believe MBIA will have substantial difficulty consolidating the SPVs at the holding company under the newly proposed SPV consolidation rules because the rules require the SPVs to be consolidated with their “primary beneficiary” if the SPVs do not effectively disperse risks among the parties involved.

• **MBIA Says That Rating Agencies Will Ignore the SPVs If Consolidated.** MBIA explains that the rating agencies have indicated that they will ignore the consolidation of the SPV indebtedness when these entities are brought on balance sheet because the debt will be offset by an approximately equal amount of AAA rated assets. The SPVs have 99.9996% leverage held against their assets – $8.6 billion of assets supporting $8.6 billion of liabilities. As such, we believe that only if the SPVs’ assets were liquid and AAA on a stand-alone basis should the rating agencies consider offsetting the impact of this additional debt on MBIA’s balance sheet in determining the company’s leverage and
rating. In light of the apparently low and deteriorating quality of the assets in the SPVs, we believe that

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their consolidation will require MBIA to write down these carrying values significantly.

- **SPV Assets and Liabilities Have Grown Significantly.** Since December 31, 2001, the SPVs liabilities have increased from $7.8 billion to approximately $8.6 billion at September 30, 2002. The company is currently on a road show to sell $500 million of additional debt for Meridian Funding, MBIA’s largest SPV. We find the substantial size and growth of MBIA’s “black box” SPVs troubling, particularly in light of the company’s statements about its transparency.

- **CDOs and Credit-Default Swaps.** CDOs and credit-default swaps (CDS) comprised 13.6% of MBIA’s total par insured at Q3 2002. At August 31, MBIA had gross CDO exposure of $75.6 billion with net par of $65.9 billion. While the company’s recent CDO guarantees have focused on AAA tranches, the company’s earlier guarantees include BBB tranches of CDOs.

- **MBIA Has a Multi-Billion Dollar Loss In Its CDO Portfolio According to Dealers.** We asked a number of Wall Street dealers to estimate the mark-to-market values of MBIA’s CDOs. Based on mid-market prices for the CDO exposures disclosed by MBIA as of August 31, 2002, we estimate that MBIA has a $5.3 billion to $7.7 billion mark-to-market loss in its portfolio. We find it surprising that the company’s reports only $35.5 million of unrealized derivative losses at September 30, 2002. The company appears to be marking its portfolio to its internal models rather than dealer quotes. When we compare any of these numbers against MBIA’s $5.5 billion of equity capital or against its $900 million to $1.7 billion cushion against a rating downgrade, one begins to suspect that the risk of substantial loss and downgrade is much greater than is suggested by its AAA rating.

- **MBIA’s Synthetic CDO Portfolio Exposes the Company to the Risks of Writing Single-Name Credit Default Swaps.** According to dealers, approximately 80% of the notional amount of synthetic CDOs are represented by the same 200 to 250 credits. MBIA had $44 billion of synthetic CDOs at August 31, 2002. If the overcollateralization in these CDOs burns off through a sufficient number of defaults, each subsequent default will lead to the same loss for each credit as if MBIA had entered into 200 to 250 separate single-name transactions with $140 to $180 million of exposure to each credit. The unprecedented level of investment-grade defaults in the last three years substantially exceeds levels predicted by MBIA’s models when it originally entered into most of these transactions.

- **MBIA Structures Its CDS Transactions to Avoid New York State Insurance Department Regulations Against Using Insurance Company Capital to Guarantee Derivatives.** MBIA guarantees credit-default swaps indirectly through LaCrosse Financial Products, LLC, an “orphaned subsidiary” or “SPV transformer,” which enters into credit-default swaps directly and whose obligations are in turn guaranteed by MBIA Insurance Corp. LaCrosse is a minimally capitalized SPV, the equity of which is owned by a nominee. MBIA Insurance Corp’s statutory filings with the NY State Insurance Department state that the company “has not entered into any transactions classified as derivative instruments.” Because LaCrosse
does not have sufficient wherewithal to meet its CDS obligations without full credit support from MBIA, we believe this structure obscures the company’s true credit derivative exposure.

- **MBIA’s Models Have Failed to Predict the High Level of Credit Defaults.** We believe that the apparent failure of MBIA’s models to predict CDO and CDS defaults is due to several factors which include: (1) the adverse selection of credits in CDO transactions, (2) the fact that rating agency data do not include restructuring as a credit event, (3) inadequate consideration of correlation risk, and (4) problems with modeling low-probability events.

- **MBIA Has Sold Credit Protection On Itself.** We have learned that MBIA has sold default protection on itself through the purchase of credit-linked notes for its insurance investment portfolio or alternatively through the sale of fully collateralized credit-default swaps. We believe these transactions are not a good use of MBIA’s insurance capital. By purchasing MBIA CLNs, the company is leveraging itself up in an undisclosed fashion while reducing trading spreads of the company’s CDS. Ironically, because MBIA is AAA rated, the purchase of credit-linked notes improves the portfolio’s average credit rating, while simultaneously weakening the company’s liquidity to the extent of the new investment.

- **MBIA Has Not Disclosed the Large Number of Restructurings It Has Performed.** MBIA has done approximately 130 to 195 restructuring of transactions over the last 13 years according to the CEO. In its public statements, management often refers to how much money has been “saved” by its “surveillance” activities, estimated by management to be $700 million to $1 billion. We believe these savings are more likely to represent deferred losses. When MBIA restructures a problem deal, it often refinances a near-defaulting obligation with a larger guaranteed loan. Contrary to other financial institutions, MBIA provides no disclosure in its public filings as to what percentage or dollar amount of its guaranteed portfolio has been restructured.

- **The Number of MBIA’s Problem Guarantees Is Increasing at a High Rate.** The company does not disclose the dollar amount of its guaranteed assets in default; instead MBIA periodically discloses only the number of problem issues. The number of problem issues increased by 92% over the last three years, from 25 to 48 (as of 12/31/01) and has continued to grow at a 27% annual rate to 54 issues for the six months ended June 30, 2002.

- **MBIA Has Changed Its Reserving Methodology Twice Within the Last Three Years.** From its inception until 1999, MBIA had reserved two basis points of the par value of its outstanding guarantees for unidentified potential losses in its portfolio. In 1999, after the bankruptcy of AHERF (Allegheny Health Education and Research Foundation) and losses of nearly $320 million, MBIA retroactively increased its reserves from two basis points to four basis points of its guarantee portfolio and made a one-time addition of $153 million to “bolster reserves.” Beginning in January 2002, MBIA has again changed its reserving methodology, this time to 12% of earned premium, which effectively guarantees the company an 88% gross margin on its new guarantees.

- **MBIA Has Substantial Exposure to High Risk Asset Classes.** MBIA has substantial exposure to high risk asset classes which are currently experiencing financial stress.
including: healthcare, sub-prime home-equity and manufactured home loans, secured and unsecured debt of investor-owned utilities, vocational student loans, airline equipment trust certificates, airport and other travel-based exposures, sub-prime credit cards, and CDOs.

- **Reinsurance.** MBIA reinsured $106 billion of its $589 billion of gross par at September 30, 2002. The credit quality of MBIA’s reinsurers is critical to the company’s long-term capital requirements. This is due to the fact that the rating agencies “haircut” reinsurance provided by non-AAA reinsurers. However, 65% of MBIA’s reinsurance comes from reinsurers whose business is directly correlated with the company’s. MBIA’s reinsurance program is another form of off-balance sheet leverage that can functionally accelerate. In the event of a downgrade of a reinsurer, MBIA is considered by the rating agencies to have received the ceded risks back on its books. In effect, MBIA is confronted with a capital call when its reinsurers are downgraded. A number of MBIA’s principal reinsurers have been downgraded recently, and others are at risk of being downgraded.

- **Accounting Issues.** In recent years, MBIA has structured a substantial portion of its guarantee fees as advisory and other fees that the company books immediately as income at the closing of a transaction. We believe that a combination of accelerated revenue recognition of guarantee and advisory fees, the company’s immaterial levels of reserves, and its deferral of a substantial portion of the company’s operating expenses cause MBIA’s GAAP earnings to overstate significantly the company’s true economic earnings.

- **Substantial Growth in Below-Investment-Grade (BIG) Assets.** MBIA had $6.8 billion of net par of BIG assets at September 30, 2002 versus $4.8 billion at June 30, 2002. The $2 billion growth represents a 42% increase for the quarter. BIG assets are now 25% more than MBIA’s total equity of $5.5 billion. The absolute size of these numbers and their enormous growth in the last quarter should raise red flags for investors and rating agencies and are inconsistent with a no-loss underwriting strategy.

**Investment Portfolio.** While MBIA’s portfolio averages AA, the large amount of wrapped AAA credits in the portfolio (approximately 50% of the portfolio), about 50% of which is guaranteed by MBIA itself, serves to artificially boost the portfolio’s stated credit quality. The large amount of wrapped paper allows MBIA to generate wider spreads for its AA average-rated portfolio in two ways: first, wrapped AAA paper generally trades at wider spreads than “natural” AAA credits; and second, the company is able to add larger amounts of higher yielding A and BBB credits while still maintaining a AA average. In addition, the investment portfolio’s credit quality will be reduced by the addition of the SPV assets to MBIA’s balance sheet because of their lower quality and reduced liquidity.

**II. BACKGROUND**

MBIA Inc. is a holding company whose primary subsidiary, MBIA Insurance Corp., provides guarantees on financial obligations in exchange for upfront or installment premiums. MBIA and its competitors are often referred to as monoline insurers or, simply, “monolines.” Management describes the company as a “long-term buyer and holder of risk” and, in the company’s case, long-term can be as long as 40 years. In our
interview with Mr. Joseph W. “Jay” Brown, the Chairman and CEO, he described the company as a bank, but one in which the funding is provided by the capital markets rather than depositors.1

MBIA explains in its Annual Report and other public presentations that it underwrites to a “no-loss” standard. It must do so because, according to the CFO Neil G. Budnick,

We cannot charge enough to make up for losses. 2

According to Mr. Budnick, MBIA would be at risk of a downgrade in the event it were to incur losses approximating $900 million to $1.7 billion.3 The rating agencies also state that if the company’s guarantee portfolio is downgraded, MBIA could be downgraded even if it has not yet experienced large losses.5

MBIA’s insurance company’s AAA rating is critical to the success of the entire enterprise. Were the insurance company to be downgraded by even one notch (from AAA to AA+6), even the company acknowledges its business could be materially impaired.7

Monolines are unusual when compared with other AAA rated enterprises for their high degree of leverage. At September 30, 2002, MBIA’s $5.5 billion of shareholders’ equity supported $764 billion of outstanding guarantee liabilities (net par and interest), a ratio of liabilities to equity of 139 to 1. Even when compared with the company’s $483 billion of net par insured, MBIA is leveraged nearly 88 to 1.

1 We met with a number of members of management at the company’s headquarters in Armonk, New York on August 14, 2002. These individuals included: Mr. Jay Brown, Chairman and CEO; Mr. Neil G. Budnick, CFO; Mr. Doug Hamilton, Controller; Ms. Ruth M. Whaley, Chief Risk Officer; Mr. Kevin T. Brown, Equity Investor Relations Director; Mr. Mark Gold, Senior CDO Underwriter; Mr. David Dubin, co-head European Structured Finance (telephonically); Mr. Chris Jumper, Underwriter.


3 Speech at the Wall Street Analyst Forum, 45th Institutional Investor Conference, Mr. Neil Budnick, September 10, 2002 at which he cites S&P’s determination of MBIA’s threshold over a AAA rating.

4 We refer to the assets that underlie MBIA’s guarantees as the company’s guarantee portfolio.


6 We use the Standard & Poor’s nomenclature for ratings unless we are referring specifically to a published Moody’s rating of an issuer.

7 MBIA 2001 10-K: “The Triple-A ratings are important to the operation of the Company’s business and any reduction in these ratings could have a material adverse effect on MBIA Corp.’s ability to compete and could have a material adverse effect on the business, operations and financial results of the Company.”

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Monolines have been able to achieve AAA ratings despite their enormous leverage because of their perceived high quality guarantee portfolios, their long track records of minimal reported losses, their limited on-balance sheet leverage, and the fact that monolines do not generally guarantee obligations that accelerate. According to Mr. Budnick:
We don’t want to have a run on the bank so we pay [our guarantee obligations] according to the original schedule. The purpose of this non-acceleration limitation, which is stated in the governing New York State Insurance Law, is to protect the monolines from periods in which there are large numbers of corporate and municipal defaults. Since monolines are only required to make timely payments of interest and principal, their liquidity requirements are much more limited than they would be if they had to pay the principal amount of an obligation upon its default. Making interest payments rather than principal payments obviously requires much less capital, particularly for obligations that can extend for decades.

In MBIA’s traditional business of guaranteeing municipal debt, the company had an informational advantage compared to Wall Street that enabled it to profit from the sale of insurance to municipalities which could not easily access capital without its guarantee. In contrast, MBIA’s recent growth has been driven by the structured finance markets for which there are alternatives to monoline guarantees. Issuers can achieve AAA ratings in structured finance transactions through overcollateralization, subordination, financial triggers, and other methods. MBIA competes with these alternatives by insuring an underlying instrument with a rating below AAA for a fee that is less than the capital markets would charge for the same risk.

We do not believe that MBIA has an informational or other advantage in assessing structured finance risk versus other informed investors in these markets. These markets are highly liquid and have high quality information available to all participants. Without an informational advantage for MBIA and other monoline insurers, we believe there is likely to be no arbitrage available to generate profits without significant risk. Rather, we believe, the monoline insurers are assuming risk in return for inadequate compensation.

The financial guarantee business is predominantly a U.S. phenomenon. We believe that this is largely due to the fact that the underwriting of credit and financial guarantees has been prohibited by Lloyd’s of London since 1924, following a scandal in which Stanley Harrison, the underwriter of a five-name syndicate lost a then-substantial sum, £367,787, by guaranteeing the value of used cars in dealers’ lots. In a recent Lloyd’s review article the author explained Lloyd’s of London’s concerns about financial guarantee insurance:

It is more vulnerable to moral hazard. Some forms of financial guarantee create an asset which can be used to support further transactions. Most are in some respects a commercial alternative to other financial instruments which make use of different capital and pricing methods. Buyers can therefore weigh up insurance against other forms of finance (whereas in conventional insurance they usually just weigh up insurance against no insurance) and underwriters may find themselves being bet against by assureds.

It is more exposed to correlation. The result of a macro-economic catastrophe may be that such business – for example a mixed book of residual value, credit, contract frustration and mortgage indemnity business in a number of countries – responds adversely and simultaneously to one crisis. [Emphasis in original.]
There is much to be learned from Lloyd’s of London’s early experience in financial guarantee insurance, for we believe it is applicable to MBIA today.

In this report, we will examine MBIA in great detail. In particular, we will shed light on the contents of the company’s special purpose vehicles (SPVs), the company’s mark-to-market losses on collateralized debt obligations (CDOs) and credit derivatives, its accounting for restructured transactions, the adequacy of its reserves, correlation risk in the company’s investment portfolio and with its reinsurance providers, and other issues.

9 “Financial Guarantee Insurance at Lloyd’s,” Lloyd’s, Simon Johnson (undated).

III. SUMMARY OF MBIA FACTS

A. Expansion of the Charter

Since its inception in 1974, MBIA, originally Municipal Bond Insurance Association, has been a municipal bond insurer, insuring general obligation and project-specific financings for municipalities. The muni guarantee business had minimal losses and was profitable for many years because municipalities rarely default and almost never repudiate their debts. Since MBIA’s traditional business required the company to step in only rarely to pay interest payments, and typically only for brief periods of time, the company’s business was inherently low risk and had limited liquidity requirements. According to Mr. Brown, at a board meeting in Bermuda in 1991, the board and management concluded that it would have to expand the company’s charter – which had previously restricted MBIA’s business to muni guarantees – in order to meet the company’s earnings and growth targets in light of increasing competition and the limited size of the municipal market.10 In 1992, the company diversified its business to begin guaranteeing other financial obligations.

B. Changing Business Mix of Public Finance Portfolio

MBIA’s public finance guarantee exposure has taken on additional risk as the low-risk profits of general obligation bonds and bonds backed by other taxpayer-supported municipal projects have been reduced due to competition. Non-taxpayer supported, project-based, public finance transactions like hospitals, stadiums, and toll roads suffer from similar risks to those incurred in private enterprise. Unlike traditional municipal guarantees that rely on a city’s or state’s taxing authority, tax-exempt project finance relies solely on a project’s cash flows and its long-term operating performance to meet its obligations.

C. Growth in Corporate and Structured Finance

In the 1990s, MBIA expanded its risk tolerance and guarantee portfolio to include domestic and global structured finance guarantees on asset classes including sub-prime home equity mortgages, manufactured housing finance, aircraft leases and equipment trusts, bonds backed by hotel taxes, passenger facility charges, commercial mortgage-backed securities (CMBS), sub-prime credit card receivables, sub-prime loans on new and used autos, rental car fleets, health care equipment financing, student loans, investor-owned utilities, credit-default swaps, collateralized debt obligations backed by high-yield and investment grade bonds (CDOs), synthetic CDOs (portfolios of credit-default swaps that are then securitized and guaranteed by MBIA), construction loans, emerging market CDOs, leveraged buyouts, and general corporate and other project finance.

10 Interview with Mr. Jay Brown, Armonk, NY, August 14, 2002.
The company’s newer business lines offer risk profiles which are dramatically different from its taxpayer-supported muni business. Corporations and consumers, the underlying borrowers of structured finance portfolios, are more likely than cities to default on their obligations and do, in fact, repudiate their debts in the bankruptcy process. Corporations also, of course, have no ability to access taxpayer funds to repay their liabilities. Recent large corporate and project finance transactions highlighted in MBIA’s 2001 Annual Report include a guarantee of $700 million of Eurotunnel junior debt, a $761 million construction financing for a privately owned complex of buildings to be occupied by the U.S. Patent and Trademark Office (20-year lease, 30-year bond, with MBIA taking the renewal risk with 57% of the bond principal outstanding in year 2011), and a $1.2 billion securitization of regional jet and turboprop aircraft for BAE Systems. We believe these and other recent transactions are inconsistent with the company’s “no-loss” underwriting standard because they depend upon market-based assumptions and projections which may not be met, in which event losses can be material.

D. Purchase of CapMAC
In February 1998, MBIA accelerated its exposure to the structured finance business by purchasing CapMAC, a financial guarantee company focused on the structured finance markets that was at risk of being downgraded as a result of its exposure to the late 1990’s Asian financial crisis.

E. Reserves
MBIA’s reserves are consistent with its perceived high quality guarantee portfolio, i.e., its reserves are extraordinarily low compared to those of other financial institutions. MBIA and the other monolines’ reserves are the lowest of any non-government-sponsored financial institution of which we are aware.

At September 30, 2002, MBIA had $568 million of net loss and LAE (7.4 b.p.) against $764 billion of guarantees, comprised of $483 billion principal of guarantees and $280 billion of interest payment guarantees. Of the $568 million of Loss and LAE, $241 million is allocated to known losses, and the balance of $327 million (4.3 b.p.) is available for the $763 billion portfolio of guarantees without identified problems.

F. No Acceleration of Obligations
In the event of a default on a financial guarantee obligation, MBIA is generally required only to pay interest and amortization payments on the defaulted obligation as they come due. We understand that New York State Insurance Law does not permit the company to guarantee obligations that accelerate in the event of a default. Article 69 of New York’s "Financial Guaranty Insurance," which is defined generally in section 6901(a), as insurance where a loss is payable upon failure of any obligor on or issuer of any debt instrument or other monetary obligation (including equity securities guaranteed under a surety bond, insurance policy or indemnity contract) to pay when due to be paid by the obligor or scheduled at the time insured to be received by the holder of the obligation, principal, interest, premium, dividend or purchase price of or on, or other amounts due or payable with respect to, such instrument or obligation, when such failure is the result of a financial default or insolvency or, provided that such payment source is investment
grade, any other failure to make payment, regardless of whether such obligation is incurred directly or as guarantor by or on behalf of another obligor that has also defaulted. [Emphasis added]

This prohibition against guaranteeing accelerating obligations benefits MBIA from a liquidity standpoint because its guarantee obligations are expected to remain deferred even in periods of high defaults. We quote Moody’s below:

MBIA’s guarantee is provided through an insurance policy that typically covers full and timely payment of scheduled principal and interest on debt securities. The nature of this guarantee is an important facet of the guarantor’s business profile, because the company is ordinarily not subject to the acceleration of principal repayments on its insured transactions. This protection is necessary for a financial guarantor since the leverage present in its capital structure limits its ability to cover large obligations on a short-term basis.12

G. Transparency of Financial Disclosure

MBIA prides itself on the quality and transparency of its public disclosure. This high degree of transparency is critical for rating agencies, regulators, and shareholders because of the company’s high degree of leverage. All of MBIA’s constituencies need to be able to monitor the company’s underwriting, underlying asset quality, and overall performance to establish whether the company’s apparently strong historic track record and underwriting standards are being maintained.

At MBIA’s recent NY Society of Analysts presentation, Mr. Budnick stated:

MBIA is extremely regulated and transparent. We have a level of transparency that no one can even come close to. 13

Standard & Poor’s has reached a similar conclusion, recently rating MBIA one of the most highly transparent companies in the U.S.14


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IV. SPECIAL PURPOSE VEHICLES

MBIA has approximately $8.6 billion of assets and liabilities in five off-balance sheet Special Purpose Vehicles (SPVs). These SPVs were disclosed for the first time in MBIA’s 2001 Annual Report although they were acquired along with CapMAC in February 1998. The company, to date, refuses to disclose any detailed information about the contents of the SPVs. Instead, management says the rating agencies have signed off on every SPV asset.15 There appears to be no disclosure of the SPVs in MBIA’s statutory filings with the New York State Insurance Department. As of December 31, 2001, the SPVs, their assets and liabilities were as follows16:

<table>
<thead>
<tr>
<th>Special Purpose Vehicle</th>
<th>December 31, 2001</th>
</tr>
</thead>
<tbody>
<tr>
<td>Meridian Funding</td>
<td>Assets</td>
</tr>
<tr>
<td></td>
<td>$4,254</td>
</tr>
<tr>
<td>Company, LLC</td>
<td></td>
</tr>
<tr>
<td>--------------------------------------</td>
<td>--------------</td>
</tr>
<tr>
<td>Triple-A One Funding Corp.</td>
<td>2,762</td>
</tr>
<tr>
<td>Hemispheres Funding Corp.</td>
<td>391</td>
</tr>
<tr>
<td>Polaris Funding Company, LLC</td>
<td>313</td>
</tr>
<tr>
<td>885 Warehouse, LLC</td>
<td>59</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$7,779</strong></td>
</tr>
</tbody>
</table>

By September 30, 2002, the SPVs’ total debt had risen to $8.6 billion. The company is currently on a road show to sell an additional $500 million of Meridian Funding medium-term notes.

MBIA has stated that all SPV assets were investment grade at the time of purchase. However, according to an analyst report’s summary of the offering prospectus for medium-term notes issued by Meridian Funding, if an asset is not rated by a rating agency, MBIA itself may determine whether an asset qualifies as investment grade:

- Each investment made by the issuer must have an announced or implied investment grade rating at the time of purchase. Implied ratings must include a certification by the guarantor (MBIA) that the investment is of equal quality to other rated investment grade issues.  

Obviously, such a standard gives MBIA a high degree of discretion as to what assets are included in the SPVs. In addition, there does not appear to be any obligation for Meridian to update the rating of any underlying assets. Based on the investments that we have identified (discussed below), we believe that many of these SPV assets would not currently receive investment-grade ratings.


16 Assets and liabilities reflect impact of SFAS 133 mark-to-market adjustment for interest-rate derivatives. Some of MBIA’s SPV assets have been reinsured. The table included in the text shows gross exposures.


For example, in one $355 million warehouse facility provided by Triple-A One Funding to Onyx Acceptance Corp., we have discovered that MBIA consented to the removal of an earlier requirement that the transaction must be rated investment grade by S&P or Moody’s. (We will discuss Onyx in further detail below.) On November 30, 2001, MBIA agreed to the elimination of certain conditions precedent for the effectiveness of this warehouse facility, including Section 4.1(l) which had required:

- Surety Provider Credit Risk. S&P and Moody’s shall each have informed the Surety Provider [MBIA] that the transactions contemplated by the Triple-A One Credit Agreement and the other Operative Documents (without regard to the Surety Bonds) is an investment-grade risk.

If, indeed, MBIA may subsequently remove the investment-grade rating requirement of even one of the SPV assets, we believe this calls into question the requirement that the
SPV assets receive an investment-grade rating from a rating agency.

A. MBIA’s Non-Disclosure of SPV Assets

MBIA has stated that it cannot disclose the contents of its SPVs because of confidentiality agreements that it has executed with the issuers in the SPVs. We are told by investment banks that have placed medium-term notes (MTNs) and commercial paper (CP) for the SPVs that they are unaware of the contents of the SPVs. When we asked Mr. Budnick for additional disclosure on the SPVs, he stated that:

---

We have signed strict confidentiality agreements on these assets and therefore we can make no such disclosure. They [the SPVs] have to be a black box. That’s the law.18

---

While Mr. Budnick cites confidentiality agreements for not disclosing the contents of the SPVs, nearly all confidentiality agreements we have seen permit an exception if the information is otherwise made public. Because we have been able to identify many of the SPVs’ assets from public sources, we do not believe that confidentiality agreements should apply to these assets. Moreover, MBIA’s non-disclosure policy is in opposition to its supposed high degree of transparency.

B. Identification of the SPV Assets

Solely by analyzing publicly available information, we have been able to identify a substantial number of the assets in the SPVs and believe they are of questionable quality and inconsistent with the company’s “no-loss” underwriting policy.

Below we have provided information on all of the assets that we have been able to identify in the SPVs. The list of assets has not been filtered in any way. We obtained information about the assets through key-word searches of the SEC EDGAR and Lexis-Nexis databases.

18 Interview with Mr. Neil G. Budnick, Armonk, NY, August 14, 2002.

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While we do not know all of the assets in each of the five SPVs, we have obtained information on $4 billion of assets, representing approximately 60% of the assets of Triple-A One Funding Corp. and approximately 46% of the assets of Meridian Funding Company, LLC. Together, Triple-A One and Meridian comprise more than 90% of the total SPV assets at September 30, 2002.

In providing information below about the SPVs’ underlying assets and counterparties, we do not purport to provide an exhaustive review of all materials facts. Rather, we are highlighting sources of risk. We do this in order to assess the SPVs’ assets and counterparties against MBIA’s stated “no-loss” underwriting standard. If, as we believe, the SPVs’ assets and counterparties present material risks of loss, then they call into question MBIA’s “no-loss” underwriting standard. At a minimum, they demand significant explanations as to how and why they are in MBIA’s portfolio of risks.

1. Assets in Triple-A One Funding, LLC19

<table>
<thead>
<tr>
<th>Borrower</th>
<th>Business</th>
<th>Type of Facility</th>
<th>Amount of Facility</th>
</tr>
</thead>
<tbody>
<tr>
<td>American Business Financial Services, Inc. (NASDAQ: ABFI)</td>
<td>Home Equity Loans and Subordinated Investment Notes to Credit Impaired</td>
<td>Warehouse Facility</td>
<td>$100 million</td>
</tr>
<tr>
<td>Borrowers</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>-----------------------------------------------</td>
<td>--------------------------------</td>
<td>--------------------------------</td>
<td>--------------------------------</td>
</tr>
<tr>
<td>Capital Automotive REIT (NASDAQ: CARS)</td>
<td>Owner of Real Estate Leased to Car Dealerships</td>
<td>Mortgage Loan</td>
<td>$173 million</td>
</tr>
<tr>
<td>Commodity Capital Group (Private)</td>
<td>Securitizer of commodities</td>
<td>Commercial Paper Securitization Facility</td>
<td>$200-$300 million</td>
</tr>
<tr>
<td>Continental Auto Receivables (Private)</td>
<td>Auto Loan Originator</td>
<td>Warehouse Facility</td>
<td>$175 million</td>
</tr>
<tr>
<td>Credit Card Receivables Of Cayman Island Issuer</td>
<td>Credit Card Receivables</td>
<td>Receivables Purchase</td>
<td>$300 million</td>
</tr>
<tr>
<td>ePlus, Inc. (NASDAQ: PLUS)</td>
<td>IT Equipment Lease Financing</td>
<td>Lease Receivables Purchase Facility</td>
<td>$50 million</td>
</tr>
<tr>
<td>Exterra Credit Recovery, Inc. (Private)</td>
<td>Purchaser and Servicer of Non-Performing Credit Card Debt</td>
<td>Warehouse Facility</td>
<td>$50-$100 million</td>
</tr>
<tr>
<td>HPSC, Inc. (AMEX: HDR)</td>
<td>Practice &amp; Equipment Financing for Doctors, Dentists, and Veterinarians</td>
<td>Warehouse Facility</td>
<td>$450 million</td>
</tr>
<tr>
<td>Onyx Acceptance Corp. (NASDAQ: ONYX)</td>
<td>Purchaser and Securitizer of Used Car Loans to Sub-Prime Borrowers</td>
<td>Warehouse Facility</td>
<td>$355 million</td>
</tr>
<tr>
<td>Outsourcing Solutions, Inc. (Private)</td>
<td>Purchaser and Servicer of Defaulted Credit Card and Other Receivables</td>
<td>Warehouse Facility</td>
<td>$100 million</td>
</tr>
</tbody>
</table>

19 The list of assets reflects information we have obtained from public sources. To the extent that this information has been updated since the latest public data we have found, the amounts of these facilities may have changed.

*American Business Financial Services, Inc. (Nasdaq: ABFI).* A $100 million mortgage loan warehouse facility. ABFI provides home equity loans and subordinated investment notes to “credit-impaired” consumer and corporate borrowers and sells and services small-ticket leases for the acquisition of business equipment. ABFI has an equity market capitalization of $29 million. In 2001, ABFI was investigated by the Pennsylvania Attorney General for predatory lending practices and was forced to disgorge certain fees and pay the Attorney General’s costs. At September 30, 2002, ABFI had $670 million in subordinated debt outstanding with $385 million maturing within 12 months. ABFI’s 10-Q from September 30, 2002 includes the following disclosure:
Because we have historically experienced negative cash flows from operations, our business requires continual access to short and long-term sources of debt to generate the cash required to fund our operations. Our cash requirements include funding loan originations and capital expenditures, repaying existing subordinated debt, paying interest expense and operating expenses, and in connection with our securitizations, funding overcollateralization requirements and servicer obligations.

Including income from gain-on-sale, ABFI’s ratio of earnings to fixed charges has declined over the past five years from 2.23 times to 1.19 times.

• **Capital Automotive REIT (NASDAQ: CARS).** A $173 million non-recourse loan secured by auto dealerships.

• **Commodity Capital Group, Inc.** An approximate $200 to $300 million commercial paper securitization facility to this securitizer of agricultural and other commodities. In the press release which announced the financing, MBIA was disclosed as a 27% owner of the equity of Commodity Capital.

• **Continental Auto Receivables.** A $175 million commercial paper warehouse facility to Continental Auto Receivables Inc., a private, five-year-old auto loan originator.

• **Credit Card Receivables.** $300 million of securities backed by credit card receivables from an undisclosed Cayman Islands-based issuer.

• **ePlus, Inc. (NASDAQ: PLUS).** A $50 million commercial-paper-backed lease receivables purchase facility for ePlus, Inc., formerly MLC Holdings, a provider of equipment lease financing for computers, routers, and other IT related infrastructure. At the time the company obtained the financing commitment on December 31, 1998, the company’s CEO stated:

  This CP-backed facility gives the Company access to a different funding mechanism than its usual sources, without the significant upfront costs and lower advance rates found in more traditional conduit programs. The Company provides no credit enhancement, which combined with the 100% advance rate on the present value of the lease receivables, provides a low overall cost of funds. This program will allow the company to fund a larger volume of business on a more efficient basis.

• **Exterra Credit Recovery, Inc. (Private).** A $50 million to $100 million five-year credit-enhanced warehouse facility for Exterra Credit Recovery, Inc., a venture-funded private purchaser and servicer of non-performing credit card debt. At June 30, 2002, Allied Capital Corp. (NYSE: ALD), a publicly traded investment company valued its investment in Exterra common stock at zero and its preferred stock investment at 20% of cost.

• **HPSC, Inc. (AMEX: HDR).** A $450 million warehouse facility for HPSC, Inc., a provider of practice and equipment financing to doctors, dentists, and veterinarians. HPSC has a book value of $37 million and a market capitalization of $33 million. Recently, HPSC
announced that an officer of the company committed fraud in stealing $5 million from the company. As a result of the theft, the company has been required to restate its financial statements. In August 2002, in addition to bringing its financial covenants into line with new covenants required by its new revolving lender, HPSC received formal waivers of its covenant violations for periods from January 1996 to June 30, 2002. In September 2002, the Triple-A One facility was increased from $385 million to its present $450 million. This facility has a 90% advance rate against eligible receivables. At September 30, 2002, HPSC had $722 million of on- and off-balance sheet debts including $388 million drawn on the Triple-A One warehouse facility.

- Onyx Acceptance Corp. (NASDAQ: ONYX). A $355 million warehouse facility to Onyx Acceptance Corp., a purchaser and securitizer of used car loans to sub-prime borrowers. The warehouse facility, which had $214 million drawn at September 30, 2002, provides for a 98% advance rate against eligible receivables. In November 2001, the facility was amended to eliminate the requirement that the warehouse facility assets receive an investment-grade rating from S&P and Moody’s. Onyx’s 10-Q from September 30, 2002 includes the following disclosure: The Company’s primary source of funds from continuing operations is securitization proceeds. The Company uses the cash generated from securitizations to pay down outstanding commercial paper obligations. These facilities are then used to fund the purchase of Contracts or to finance normal operating expenses. The Company has historically operated on a negative cash flow basis from operating activities.

An Onyx competitor, Union Acceptance Corp., filed for bankruptcy protection on October 31, 2002 citing MBIA’s unwillingness to guarantee future securitizations as a proximate cause of the filing. Given Onyx’s reliance on its MBIA-guaranteed warehouse facility and MBIA-insured securitizations, we believe that a withdrawal of MBIA’s continued support or a downgrade of MBIA would substantially threaten Onyx’s viability. Onyx has an equity market capitalization of $19 million, making its ability to access significant equity capital unlikely.

- Outsourcing Solutions, Inc. (Private, SEC filer). A $100 million non-recourse five-year warehouse facility for Outsourcing Solutions Inc., the largest private purchaser of defaulted credit card and other receivables. On November 4, 2002, S&P downgraded OSI to ‘D’ from ‘C,’ stating that: “the ratings actions follow OSI’s failure to make its November 1, 2002 interest payment on $100 million 11% senior subordinated notes.” At June 30, 2002, OSI had $531 million of on-balance sheet debt in addition to this off-balance sheet SPV facility and negative book equity of $160 million. In OSI’s 2001 10-K, the company indicated that it would need to restate its financials for the year ended December 31, 2000 and for
the nine-month period ended September 30, 2001 due to “inaccurate financial reporting of certain transactions.” The company also announced in the 2001 10-K that it was in breach of the Triple-A One warehouse facility but had obtained a waiver.

2. Assets in Meridian Funding Company, LLC

<table>
<thead>
<tr>
<th>Borrower</th>
<th>Business</th>
<th>Type of Facility</th>
<th>Amount of Facility</th>
</tr>
</thead>
<tbody>
<tr>
<td>AmeriCredit Corp. (NYSE: ACF)</td>
<td>Sub-prime Auto Lender and Securitizer</td>
<td>Warehouse Facilities</td>
<td>$1.75 billion</td>
</tr>
<tr>
<td>Meridian Funding Company, LLC JPN</td>
<td>Undisclosed</td>
<td>Undisclosed</td>
<td>$695 million</td>
</tr>
</tbody>
</table>

**AmeriCredit Corp. (NYSE: ACF)**. A total of $1.75 billion of warehouse facilities provided to AmeriCredit, a sub-prime auto lender. Meridian provided $500 million of financing in December 2000, an additional $750 million financing in June 2001, and a further $500 million of financing in February 2002. All of the agreements provide for a 95% advance rate, subject to adjustment. In October 2002, after AmeriCredit had to negotiate amendments to its insurance agreements for securitizations insured by FSA, MBIA provided the insurance for $1.7 billion of securitizations issued by AmeriCredit, the first time MBIA has done so for AmeriCredit.

We believe that AmeriCredit has substantial solvency risk that was recently only partially addressed through a recent rescue equity issue in which shareholders were diluted by 50%.

**Meridian Funding Company, LLC JPN**. A $695 million net structured finance exposure to an undisclosed credit in Japan. This credit is listed as “Meridian Funding Company, LLC JPN” on the company’s list of top 50 structured finance credits. The October 27, 1997 issue of the Asset Sales Report makes reference to Meridian Funding’s purchase of:

- the portion of a CLO and secured promissory notes acquired by a Japanese finance company. The program was also amended to increase the facility limit to $280 million for advertising receivables, and to increase the facility limit for relocation loans made to employees of large corporations.

The credit’s substantial size, the continuing deterioration of the Japanese economy, and the lack of disclosure about the underlying issuer provide reason for concern about this credit.

C. Asset Quality and Credit Risk

Many of the SPV assets that we have been able to identify are warehouse lines of credit to poorly capitalized seller-servicers of auto loans, defaulted credit card receivables, home equity mortgages, and healthcare receivables. Recently, we have seen the bankruptcy (Union Acceptance) and financial distress (AmeriCredit and others) of a number of such enterprises. We believe that warehouse facilities are comparable in risk to short-term secured bridge loans because they rely on new financings in order to be repaid. Unlike securitizations that are financed by liabilities that typically match the term
of the underlying assets, warehouse facilities are typically shorter-term facilities that bridge the issuer in accumulating a sufficient amount of assets for eventual securitization. The warehouse lender’s exit is usually dependent upon the issuer’s ability to access the securitization markets. Because MBIA often guarantees the securitization that is used to repay a warehouse facility it has guaranteed or otherwise provided, there is a high degree of correlation between the likelihood of repayment of an MBIA warehouse facility and MBIA’s own credit quality. Were MBIA’s credit quality to decline, its guarantee might be insufficient to support the financing of securitizations, and the repayment of its warehouse facilities would therefore be at greater risk.

While securitizations and the SPVs’ warehouse facilities are generally considered separate from a servicer’s estate in bankruptcy, the financial wherewithal of the servicer is still an important consideration in determining the credit quality of a warehouse facility or securitization backed by the servicer’s loans or receivables. Moody’s describes the risks inherent in securitizations of financially distressed seller-servicers below:

- Corporate financial weakness of the seller may negatively affect the quality of the receivables’ performance. The actual or perceived imminent bankruptcy of an originator may lead to lower willingness by obligors to pay, evidenced by higher delinquencies, increased offsets or other dilution and slower turnover. The seller may be unable to provide sufficient collateral when needed. The seller may grant more liberal credit underwriting policies in order to boost sales. Servicing of collections may deteriorate and

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  there may be increased risk of fraud and the risk of cash being trapped in the bankrupt originator’s estate. Higher delinquencies, losses and dilutions may be expected as the originator’s financial performance deteriorates.21

While securitizations of low-credit quality issuers are risky for the above reasons, we believe that warehouse facilities to these issuers contain even greater risks. This added risk is due to the fact that warehouse facilities contain the most recent loan and receivable purchases of a servicer, i.e., assets that are more likely to be of poorer quality because of reduced underwriting standards, as Moody’s described above. In addition, levels of overcollateralization are often substantially smaller for warehouse facilities than term securitizations.

We believe that MBIA’s recent experience with Union Acceptance Corp. (UAC) is an indication of what can happen when MBIA withdraws its credit support from an issuer. A press release issued by Fitch in explaining its downgrade of UAC stated:

  Fitch Ratings has lowered the senior unsecured ratings of Union Acceptance Corp. to 'D' from 'B', following the company's announcement that it has sought Chapter 11 bankruptcy protection. Approximately $43 million of senior unsecured debt is affected by this action. The company has indicated that its current surety provider [MBIA] has not indicated a willingness to support future term securitizations as an important consideration in seeking bankruptcy protection.22

MBIA issued a press release one day after UAC’s bankruptcy filing, stating:

  MBIA Inc. (NYSE: MBI) announced that it does not expect to incur any losses as a result of yesterday’s Chapter 11 bankruptcy protection filing by
MBIA has guaranteed **18** securitizations of non-prime auto receivables originated by UAC and currently has $1.6 billion in net par exposure ($2.4 billion gross par) under its guarantees. UAC is the servicer of the MBIA insured transactions. [Emphasis added.]

UAC’s complaint against MBIA in the bankruptcy explains that MBIA has guaranteed only **17** UAC securitizations. According to the Complaint, MBIA’s 18th exposure to UAC is not, in fact, a securitization as stated in the press release, but rather a full faith and credit guarantee of a $350 million warehouse facility provided by Bank of America, a loan that suffers from similar risks to MBIA’s SPV warehouse facilities.

Without MBIA’s guarantee on future securitizations, UAC was forced to file for bankruptcy, leaving MBIA exposed on this $350 million warehouse facility as well as the outstanding securitizations. Alternatively, if MBIA had continued to provide wraps for future UAC securitizations, it would find itself with even greater exposure to this poorly performing servicer. As MBIA’s experience with UAC suggests, doing business with financially weak servicers is a risky proposition.

**D. Liquidity Risk of SPVs**

In a typical wrapped transaction, an investor views the underlying assets of the securitization as the primary source of repayment and MBIA’s guarantee as a secondary source of payment. The prospectus for a wrapped securitization provides substantial detail on the quality and performance of the assets to be securitized. In addition, investors are provided with rating agency review and regular updates on asset quality and performance. Investors assess the quality of the assets in a transaction and are comforted by the two layers of protection afforded by such a structure – first, a Moody’s, S&P, and/or Fitch-rated investment-grade portfolio of assets on which investors are provided substantial information, and second, MBIA’s AAA rated guarantee.

MBIA’s SPV commercial paper purchasers, MTN buyers, and banks receive no information on the underlying assets and, therefore, require MBIA’s guarantee of all the assets in the SPV and a direct repayment guarantee. Unlike its traditional guarantee business where MBIA is a secondary source of repayment, for the SPVs, MBIA is, in effect, the primary source of repayment.

Meridian Funding Company, LLC’s private placement memorandum states that MTN investors should rely on MBIA rather than on the underlying assets as a source of repayment:

> Any investment decision to purchase the notes should be based solely on the claims paying ability of the Guarantor (MBIA).

Because these investors do not know the contents of the SPV and because MBIA can determine their credit quality, the company has an unusual degree of flexibility with the
contents of the SPVs.
Slightly more than $3 billion of the $8.6 billion of SPV debt at September 30, 2002 was in the form of commercial paper (CP). 26 MBIA should, in our view, be considered the de facto issuer of the outstanding commercial paper because MBIA guarantees the liabilities of the SPVs and the SPVs would not stand alone without MBIA’s guarantees. The rating agencies, however, do not consider the commercial paper to be debt of MBIA or, alternatively, are unaware that MBIA, through its SPVs, has this short-term debt outstanding:

24 While we were able to obtain a copy of a private placement memorandum from one of the underwriters of a medium-term note (MTN) issuance by Meridian Funding Company, LLC, MBIA’s largest SPV, which comprises $5.3 billion of the approximate $8.6 billion of assets in SPVs at September 30, 2002, we have chosen not to cite information from that document because it purports to impose a confidentiality obligation on any recipient of the memorandum.


26 Confirmed by email from Mr. Kevin Brown, MBIA Equity Investor Relations, November 5, 2002.

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The guarantor’s exposure to liquidity risk is relatively modest, given the low historical frequency and severity of insured defaults, coupled with the nature of its insurance contract, which protects against the acceleration of principal payments. Furthermore, MBIA does not issue short-term debt, lessening the need for significant amounts of back up liquidity. 27

[Emphasis added.]

We believe this SPV’s CP creates significant liquidity risk for MBIA because, in the event of a decline in MBIA’s actual or perceived credit rating, these CP buyers may withdraw their support of Triple-A One Funding, requiring the SPV to draw upon its outstanding bank liquidity lines.

MBIA provides no disclosure about Triple-A One’s liquidity facilities; however, CP conduit liquidity facilities typically contain two “outs” which would allow banks not to fund. These outs include bankruptcy of the issuer and/or insufficient asset values to cover the outstanding commercial paper. 28

Since the assets of Triple-A One Funding are AAA rated only because of MBIA’s guarantee, a decline in MBIA’s actual or perceived credit rating will substantially reduce the value and marketability of the SPV assets. In light of the nominal equity in this SPV ($25,000) as we will discuss further below, we believe it is highly probable that the market value of the SPV’s assets will not exceed its outstanding commercial paper in the event of an actual or perceived downgrade of MBIA, increasing the risk of a liquidity facility covenant violation. In the event Triple-A One Funding sought to draw down on its bank facilities to repay expiring commercial paper, the liquidity banks may require an audit of the market value of the SPV assets before funding.

Even if the bank lines were drawn, conduit liquidity facilities usually extend for no more than 364 days. As a result of the short-term nature of this financing, MBIA would still face a significant short-term liquidity threat.

This same analysis is likely to hold true to a less significant degree for the SPVs that are
funded by MTNs, for these MTN holders often have put rights in the event of default by the financial guarantor on any of its guarantee obligations.

As a result of the relatively short-term nature of a substantial portion of MBIA’s SPV obligations and the potential threat of acceleration of the MTNs, we believe that the SPVs


28 “The covenants on liquidity facilities typically give the banks few ‘outs’. Usually the bank is not required to lend if the issuing vehicle is insolvent but this is unlikely given the limited nature of its activities. Often the bank is also not required to lend if the value of the assets in the portfolio falls below that of the outstanding commercial paper. But this is usually unlikely given the short maturity of commercial paper and the typical requirement that the value of assets should exceed that of commercial paper by a margin at the time of issue. In effect, the banks would be likely to take on the credit risk on the asset portfolio before its value could fall sufficiently to expose investors to loss. Banks are, however, protected by any credit enhancement once they have financed the assets.”


pose a significant short-term liquidity risk for MBIA. MBIA’s guarantee of the SPV’s large liabilities create a much greater threat to the company’s viability when compared to an off-balance sheet obligation backed by underlying assets of known and independently verified quality and supported by substantive third-party equity.

E. Accounting Requirements for SPVs

We do not believe that MBIA’s SPVs qualify for off-balance sheet treatment under current or proposed accounting rules. MBIA’s five off-balance sheet SPVs, with $8.6 billion of debt guaranteed by MBIA, are each capitalized with approximately $25,000 of equity:

The current conduit ownership structure is as follows: Meridian and Polaris are each owned 99% by Global Securitization Services (www.gssnyc.com) and 1% by MBIA. Triple-A One Funding is 100% owned by GSS. Hemispheres is 100% owned by Lord Securities (www.lordspv.com). The third-party ownership is for non-consolidation purposes. The amount of equity in the conduits is nominal (<$25,000). [Emphasis added.]

The $125,000 total of third-party equity equates to 0.0014% of total SPV assets or $14 for each $1,000,000 of debt, well below the minimum 3% threshold required under GAAP for non-consolidation of SPVs. In addition, this equity capital is provided by investors who receive administrative and other fees from the SPVs.

MBIA’s 2001 Annual Report provides a summary of the GAAP requirements for an SPV to be considered off-balance sheet:

Under current accounting guidelines, MBIA does not include the accounts of the SPVs in the consolidations of the MBIA group. When a SPV does not meet the formal definition of a qualifying special purpose vehicle under SFAS 140, the decision as to whether or not to consolidate depends on the applicable accounting principles for non-qualifying SPVs. Consideration is given to, for example, [Test One:] whether a third party has made a substantive equity investment in the SPV; [Test Two:] which
party has voting rights, if any; [Test Three:] who makes decisions about assets in the SPV; and [Test Four:] who is at risk of loss. The SPVs would be consolidated if MBIA were to retain or acquire control over the risk and the rewards of the assets in the SPVs. [2001 Annual Report, p. 47.]

When examined under the standards for non-consolidation provided by MBIA, we believe that MBIA has failed three of the four tests in actual fact, and the fourth, voting control, in substance because effective control over the SPV is apparently immediately transferred to MBIA upon the SPVs formation:

• Test One: No third party has made a substantive equity investment – $125,000 of equity supporting $8.6 billion of debt is clearly not substantive, and the equity has been invested by parties that receive fees for providing accounting and other

services to the SPVs. FASB and SEC guidelines currently require a minimum of 3% equity provided by a third-party investor who is not otherwise affiliated with the issuer of the SPV. The proposed new FASB regulations for SPVs require a minimum of 10% third-party equity.

• Tests Two and Three: While the non-MBIA board members of the SPVs may legally have voting control over the SPVs, the SPVs have engaged MBIA to administer, invest and deal in the SPVs’ assets. In fact, all documents signed by the SPVs that we have been able to find are signed by MBIA as attorney in fact.

• Test Four: As guarantor of the SPVs assets and liabilities, MBIA is at risk of loss. It appears, as well, that MBIA already receives whatever profits the SPVs earn. Those profits should be substantial because of the large interest-rate spread between the cost of the SPVs’ funds as a AAA credit versus the higher rates charged to the SPVs’ far lower quality borrowers. According to the 2001 Annual Report, however, the profits of the SPVs are nominal:

> [G]iven the inconsequential level of residual profits of these entities, the consolidated net income of the Company would not materially change.
> [2001 Annual Report, p. 30]

In light of this statement, we infer that, through administrative, advisory and other fees charged to the SPVs, MBIA is already receiving whatever profits might otherwise be available from them.

As a result of failing these tests, we believe MBIA must consolidate the SPVs and should have been consolidating them since they were acquired along with CapMAC in February 1998.

**F. Where Will MBIA Consolidate the SPVs?**

We understand that MBIA is now telling investors and analysts that it intends to consolidate the SPV debt at the holding company, MBIA Inc., rather than at the AAA insurance subsidiary, MBIA Insurance Corp., which is the guarantor of the SPV obligations. If MBIA were successful in convincing its auditors of its proposed new treatment, MBIA Insurance Corp. would continue to appear to be debt-free. While there is little if any difference in economic substance between these two alternatives, we believe the company will have substantial difficulty consolidating the SPVs at the holding company under the newly proposed SPV consolidation rules. The new rules require SPVs to be consolidated with their “primary beneficiary” if they do not
effectively disperse risks among the parties involved. The primary beneficiary of an SPV is deemed to be the parent of the SPV.\textsuperscript{31}

\textsuperscript{30} SEC guidance EITF 90-15 provided that 3\% should be considered the minimum amount of equity for purposes of non-consolidation.


In summary, the new FASB rules provide that an SPV should be consolidated with its primary beneficiary if the primary beneficiary provides to the SPV any one or more of the following which are known as variable interests (an interest through which an enterprise provides financial support to an SPV):

- Subordinated loans
- Leases
- Management or other service contracts
- Referral agreements
- Options to acquire assets
- Purchase contracts
- Credit enhancements
- Guarantees
- Derivative instruments

In addition, an SPV previously qualifying for non-consolidation shall also be consolidated with the primary beneficiary if the primary beneficiary meets two of the following three criteria:

- It has authority to purchase and sell assets for the SPV and has sufficient discretion in exercising that authority to significantly affect the revenues, expenses, gains, and losses of the SPV.
- It provides a guarantee, a back-up lending arrangement, or other form of liquidity, credit, or asset support that is subordinate to the interests of other parties.
- It receives a fee that is not market based.\textsuperscript{32}

It is clear to us that MBIA Insurance Corp. is the primary beneficiary of each of the SPVs because it is the guarantor of assets, liabilities, and liquidity facilities, serves as the administrative servicer and manager, and receives substantially all of the economic profits from the SPVs.

Under the new rules, if MBIA’s SPVs were to be consolidated at the holding company, MBIA Inc., and not at MBIA Insurance Corp., then the holding company would have to invest a minimum of 10\% or $860 million dollars of equity in the SPVs, which is far greater than MBIA Inc.’s available resources. Even if MBIA Inc. were able to raise the $860 million of required equity, we believe non-consolidation treatment would fail because of the holding company’s affiliation and reliance on funding from its insurance subsidiary.\textsuperscript{33}


\textsuperscript{33} In addition, we would expect the purchasers of the $300 million of MBIA Inc.’s unsecured notes that were issued this August in a Goldman Sachs’ led transaction to have been informed in the event the company intended to consolidate an additional $8.6 billion plus of debt onto the holding company’s
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There is no mention of the SPVs or the potential for additional consolidated debt in the transaction offering memorandum. Similarly, we would be surprised that the holding company could still achieve a AA rating with nearly $10 billion of debt in light of its reliance on its insurance subsidiary’s dividends as its primary source of liquidity.

G. Consolidation Will Have No Effect, According to MBIA

Until the publication of MBIA’s 2001 Annual Report, an investor examining its SEC or statutory filings would have concluded that MBIA’s insurance subsidiary was debt-free. We now understand that the company has guaranteed $8.6 billion of indebtedness of which a substantial portion is commercial paper and is supported by assets of questionable quality.

MBIA has publicly stated that it intends to bring the SPVs on balance sheet as soon as the new FASB requirements for SPVs are promulgated. The company further explains that the rating agencies have indicated that they will ignore the consolidation of the SPV indebtedness when these entities are brought on balance sheet because the debt will be offset by an approximately equal amount of AAA rated assets.

We believe that this analysis is flawed because the only reason the assets in the SPVs are rated AAA is because they are guaranteed by MBIA. We would also argue that MBIA’s guarantee of these assets should be ignored for the purpose of valuing these assets when they are consolidated on the company’s balance sheet. MBIA cannot benefit from its own guarantee of securities because the guarantee is, in effect, an inter-company transaction. While the value and liquidity requirements of these $8.6 billion of debts is a certainty, the value and liquidity of the assets which support them are not. The SPVs have 99.9996% leverage held against their assets – $8.6 billion of assets supporting $8.6 billion of liabilities. As such, we believe that only if the SPVs’ assets were liquid and AAA on a stand-alone basis should the rating agencies consider offsetting the impact of this additional debt on MBIA’s balance sheet in determining the company’s leverage and rating.

In light of the apparently low and deteriorating quality of the assets in the SPVs, we believe that their consolidation will require MBIA to write down these carrying values significantly. Even if MBIA were not required to mark these assets to market upon consolidation, we believe that investors should only consider their fair value and liquidity without the benefit of MBIA’s guarantee in determining the company’s credit quality, liquidity risk, and asset values.

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H. What Purpose Do the SPVs Serve?

We believe that if investors were to become aware of the quality of the assets in the SPVs, they might not be willing to purchase commercial paper or medium-term notes backed by these assets. Investors in securitizations backed by MBIA rely on the quality and structuring of the underlying assets in addition to the company’s guarantee. As a result, investor review provides effective limits on what MBIA can guarantee. Because the contents of the SPVs are unknown, however, MBIA has the flexibility to include whatever assets it wishes as long as one rating agency or MBIA itself deems the asset investment grade at the time of its initial inclusion in the SPV.

As a result, MBIA can act like a bank by indirectly (via the SPV) making a loan to
borrowers without third-party investors’ review of the quality of the loan and the borrower. MBIA can, therefore, provide liquidity to servicers and other borrowers which do not have access to the equity markets because they are either private, have microcapitizations, have untested securitization programs or who could not otherwise obtain equity or debt capital from other financial institutions. This flexibility is valuable to MBIA because it can also support issuers for which the company has substantial additional exposure that would be put at risk in the event of the issuers’ failure to access other capital.

MBIA’s SPVs have grown significantly. Even since December 31, 2001, the SPVs liabilities have increased substantially, i.e., from $7.8 billion to approximately $8.6 billion at September 30, 2002. The company is currently on a road show to sell an additional $500 million of Meridian Funding MTNs. In light of MBIA’s policy and statements regarding transparency, we find the growth in “black box” SPVs troubling.

V. CDOS AND CREDIT-DEFAULT SWAPS (CDS)
Guarantees of cash CDOs and synthetic CDOs (securitizations of pooled single-name CDS) have become large sources of growth in par insured for MBIA in recent years. In the third-quarter operating supplement, MBIA disclosed its CDO balances at August 31, 2002, which comprised 13.6% of its total par insured at Q3 2002. 34 At August 31, MBIA had gross CDO exposure of $75.6 billion with net par of $65.9 billion. The company provides no details on the $9.7 billion of par insured that has been reinsured. While the company’s recent writings of CDO guarantees have focused on AAA tranches, its earlier history in the business began with guarantees of BBB tranches of CDOs.

A. MBIA’s Multi-Billion Mark-to-Market Loss on CDOs
MBIA recently disclosed the date of execution and original ratings of the underlying credits it has guaranteed through credit derivative transactions. We asked three of the most active dealers in the credit derivatives market to provide mid-market quotes to price transactions of comparable vintage and rating to MBIA’s CDO portfolio. One of the dealers elected not to provide quotes. The two other dealers provided market quotes, but required that we keep their identities anonymous.

Because CDOs are pools of diversified corporate credits and because MBIA participated in numerous CDO transactions each year, the company’s credit exposure is likely to be sufficiently diversified so that their values can be approximated by this admittedly simplistic approach.

Based on these dealers’ quotes, we estimate MBIA’s mark-to-market losses to be approximately $5.3 billion to $7.7 billion, i.e., from nearly 100% to over 140% of MBIA’s total equity capital.

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<th>Year</th>
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The rating agencies, while generally slow to downgrade CDOs, fell materially behind over the summer on downgrading these credits. While all other information in the company’s third quarter earnings release and operating supplement was provided as of September 30, 2002, the company chose to provide disclosure about its CDO and CDS portfolio as of August 31, 2002.

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The above table is from the August 31st Operating Supplement and includes our addition of columns labeled “MTM Value” and “MTM Loss” or mark-to-market value and loss for each dealer. MTM Loss is obtained by multiplying the MTM value, which is a percentage of face amount, by the amount outstanding in a particular year and subtracting that amount from the amount outstanding.35 Admittedly, our estimate is imprecise. In light of the fact that MBIA is required to mark these exposures to market under SFAS 133, however, we find it surprising that the company’s total unrealized mark-to-market losses on its entire derivative portfolio (including interest rate swaps etc.) are reported at September 30, 2002 as being only $35.5 million.

The company appears to be marking its portfolio to its internal models rather than dealer quotes. On the third-quarter conference call, a Morgan Stanley analyst questioned management about how it marked to market its CDOs:

Charles Schorin, Morgan Stanley:
I have a couple of questions about your super-senior exposure business of CDO’s. First of all, what’s the extent and frequency of your mark to market because right now, looking at the CDO market or the CDS market, the market seems to be implying bigger credit risks than perhaps the rating of the underlying would suggest.

Gary Dunton, MBIA President and COO
What is the frequency that we mark them?

Charles Schorin:
Yes, and to what extent are you marking based upon rating changes of the underlying references or are you doing it based upon where the CDS – the credit defaults – are actually trading?
Gary Dunton
We do it quarterly. It’s based on a model we have. It looks at spreads. It looks at ratings. It looks at interest rates.

Charles Schorin:
You are incorporating market activity.

Gary Dunton:
Yes.

The reader will note that the 1996 deals were valued at a higher mark-to-market value than the 1997 and 1998 transactions by Dealer A. According to Dealer A, this is due to the fact that the 1996 CDOs missed the telecommunication financing boom which began later in 1997 and 1998.

While Mr. Dunton states, when prompted, that he is “incorporating market activity” in the company’s pricing models, this is not the same as marking to market. In any event, we are at a loss to explain the enormous gap between dealer mid-market pricing, that shows the company with a $5.3 to $7.7 billion pre-tax loss, and the $35.5 million loss reported by the company.

We quote below from a Morgan Stanley research report written by Ms. Alice Schroeder, in which she comments on insurance company managements’ preference for ignoring mark-to-market adjustments in earnings:

We understand that managements often sincerely believe that mark-to-market impairments are not permanent, and should not flow through earnings. However, we view that as simply an argument for earnings smoothing. We also do not view the market value change of a CDO as equivalent to a change in value of an investment portfolio. Insurers are the risk-bearing counterparty in CDO transactions; this is part of their core underwriting operations. The mark-to-market can be viewed as a consensus market measure of the required loss reserve on an insurance policy.

Companies (not just insurers) usually would prefer to recognize some losses only after they are proved beyond a reasonable doubt. That is a natural human tendency called “persistence” and is what keeps football teams trying when they are 10 points down with one minute to play in the fourth quarter. It’s a good quality in individuals, but can lead to bad accounting without some checks and balances in the system.

We understand that MBIA has been telling investors and analysts recently that it is not required to mark to market its cash CDO portfolio because it believes these guarantees are more akin to insurance contracts than derivative obligations. We quote Ms. Schroeder’s thoughts on this issue:

[A]nother area of investor focus has been the underlying accounting for these transactions. In general, credit default swaps and the guarantees on collateralized debt obligations are considered derivative instruments for accounting purposes. As such, they must be marked to market, with the resulting gain or loss flowing through net income.

There is no dispute, however, that the company must mark to market its synthetic CDO portfolio which comprises $44 billion of its $65 billion of exposure and which we
estimate to account for $2 to $3 billion of the $5.3 to $7.7 billion MTM loss based upon the dealer quotes.38

Whether or not the company marks its CDO exposure to market, MBIA is apparently underwater by billions of dollars on these investments. While the MTM values do not necessarily mean that MBIA will ultimately realize billions of dollars in losses, these values are the market’s best current estimate of expected losses on these transactions.36 “Insurance & Risk Briefing,” Alice Schroeder, Morgan Stanley, August 8, 2002, p. 6. 37 “Insurance & Risk Briefing,” Alice Schroeder, Morgan Stanley, August 8, 2002, p. 5.

38 The synthetic CDO market did not represent a meaningful part of MBIA’s CDO portfolio until 2001. Since then, it has accounted for nearly all of the company’s CDO business. The greater seniority of these synthetic transactions, coupled with the fact that they are two years old or less, accounts for their higher values.

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B. Liquidity Risks of Credit-Default Swaps

MBIA’s guarantees of credit-default swaps create substantial potential liquidity risks for the company. When the reference obligation of a CDS defaults, the guarantor must either repurchase for par the reference obligation that is put to it, or for cash-settled swaps, pay the difference between par value and recovery value. The amount of this payment can be as much as 90% or more of the par value of the insurance and has averaged 79% in recent periods based on average recovery values of 21%.39 MBIA has $44 billion of net exposure to CDS primarily through guarantees of synthetic CDOs.

MBIA states that it no longer guarantees single-name CDS,40 however, because of the company’s large exposure to synthetic CDOs which are comprised of pooled CDS, the company has, in effect, re-entered the single-name CDS business, but on a much larger scale. While each synthetic CDO transaction contains a diversified pool of 100 or so equally weighted credits, there are a limited number of issuers which trade actively in the CDS market and which are included in synthetic transactions. According to active synthetic CDO issuers, there are approximately 200 to 250 credits that represent 80% or more of the CDS that underlie these transactions. While each transaction is diversified usually with 100 names, the limited universe of actively included names makes the company’s effective overall exposure meaningfully less diversified on a consolidated basis. Assuming MBIA’s $44 billion of net exposure as of August 31, 2002 of which 80%, or $35.2 billion, is represented by these 200 to 250 names, one can determine that MBIA has approximately $140 to $180 million of exposure to each credit. This exposure is spread across numerous CDO transactions, but should be considered on a consolidated basis when analyzing MBIA’s credit exposure. If the overcollateralization of MBIA’s synthetic CDOs is burned off through a sufficient number of defaults, each subsequent default will lead to the same loss for each credit as if MBIA had entered into 200 to 250 separate single-name transactions with $140 to $180 million of exposure to each credit.

C. Regulatory Issues

When we asked the company how they were able to guarantee credit-default swaps in light of the New York State Insurance Department’s prohibition against financial guarantors guaranteeing obligations that can accelerate, Mr. Mark Gold, the company’s senior CDO underwriter, explained that the company guarantees credit-default swaps indirectly through an "orphaned subsidiary" which enters into the business directly and
whose obligations are in turn guaranteed by MBIA.


40 The company apparently has only $300 million of single-name CDS outstanding.

41 We met with representatives of the New York State Insurance Department (personnel from its Property & Casualty department who are involved in the oversight of MBIA as well as personnel from the Capital Markets department) and shared with them the facts and opinions discussed in this report.

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This “orphaned subsidiary” is called LaCrosse Financial Products, LLC. The disclosure concerning LaCrosse in the 2001 Annual Report is illuminating:

   LaCrosse Financial Products, LLC (LaCrosse), formerly King Street Financial Products, LLC, was created in December 1999 to offer clients structured derivative products, such as credit default, interest rate and currency swaps. While MBIA does not have a direct ownership interest in LaCrosse, it is consolidated in the financial statements of the Company on the basis that substantially all rewards and risks are borne by MBIA. (AR 2001, p. 43). [Emphasis added.]

According to CDS dealers, MBIA refers to LaCrosse as an “SPV transformer.” In essence, LaCrosse “transforms” obligations that MBIA cannot guarantee directly into ones it believes it can guarantee indirectly. LaCrosse is a minimally capitalized SPV, the equity of which is owned by a nominee. It relies on MBIA Insurance Corp.’s guarantee of its indebtedness to support its obligations.42

MBIA Insurance Corp’s statutory filings with the NY State Insurance Department state that the company has no derivative exposure:

   MBIA has not entered into any transactions classified as derivative instruments.43

Because LaCrosse does not have sufficient wherewithal to meet its CDS obligations without full credit support from MBIA, we believe this statement obscures the company’s true credit derivative exposure.

D. Where Did MBIA Go Wrong in its CDO and CDS Businesses?

According to the company, MBIA determined its pricing and capital requirements for CDO and CDS guarantees based on an internal model it developed which is similar to the Moody’s model. The model takes into consideration the credit rating of issuers, and from that, determines the probability of default and the recovery rates in default. The model is based on a 30-year study of corporate defaults in determining default probabilities and recovery rates.

In our interview with Mr. Gold, he acknowledged that he was concerned about MBIA’s CDO and CDS performance so far:

   We are mindful of the poor performance of the segment which makes us wonder what is going on. Loss rates are well above our mean expectations, well in excess of historical levels, and not in keeping with actuarial assumptions. At the same time, we are putting on a large amount of exposure.

We suspect that MBIA has not properly considered the risks inherent in its reliance on internal financial models even if these models are apparently corroborated by the rating
agencies. While the company would not tell us how much capital it holds against its super-senior CDS exposure, Mr. Gold explained that the rating agencies assign as little as 10 basis points of capital against these risks.

MBIA’s pricing of its synthetic CDO guarantees has historically been extraordinarily low at 4 to 7 bps of the guarantee amount per annum. FSA’s and Ambac’s recent withdrawal from the CDS market, however, and the poor performance of these transactions led to a near doubling of pricing in the market to between 9 and 12 bps per annum for so-called “super-senior” CDS, and in recent months to levels of 20 bps or more.

While the pricing of super-senior CDS has doubled and perhaps tripled in recent months, we believe that it remains extremely low for the risks taken by MBIA and other writers of this insurance. The fact that FSA and Ambac withdrew from this market suggests that they have come to similar conclusions about the inadequacy of reward compared with the risk of this product.

We believe that the risk-reward ratio of super-senior CDS for the seller of insurance is extremely unattractive. MBIA, however, views super-senior CDS as perhaps its most profitable product. Based on MBIA’s internal capital models, the company estimates that it earns between 40% and 100% Risk Adjusted Return on Capital (RAROC) for these guarantees. Perhaps this explains the company’s enormous growth of this guarantee product. MBIA has written approximately $30 billion of synthetic CDO guarantees in the first nine months of 2002.

We believe that MBIA calculates such a high RAROC for its synthetic CDOs because it charges itself only approximately 10-12 bps of capital for these transactions and establishes reserves for losses equal to 12% of premium or only 1.2 to 1.4 bps on these transactions. We believe MBIA’s capital requirements and reserving assumptions for this business are understated.

MBIA’s super-senior transactions apparently have attachment points of 88% to 92% of the face value of investment-grade CDOs, implying 8% to 12% overcollateralization for these transactions. While these levels may be sufficient to insure near-zero defaults under MBIA’s models to a 99.99% confidence level, we believe they are likely to be inadequate for real world conditions.

We believe that the apparent failure of MBIA’s models to predict CDO and CDS defaults is due to several factors which include: (1) the adverse selection of credits in these transactions, (2) the fact that rating agency data do not include restructuring as a credit event, (3) inadequate consideration of correlation risk, and (4) problems with modeling low-probability events.

“Ambac Steps Back From Credit Protection, Derivative Week Says,” Bloomberg News, September 30, 2002. We have learned from numerous dealers that FSA has also withdrawn from the market.

Interview with Mr. Mark Gold, Senior CDO Underwriter, and Ms. Ruth M. Whaley, Chief Risk Officer, Armonk, NY, August 14, 2002.

Interview with Mr. Mark Gold, Armonk, NY, August 14, 2002.
1. Adverse Selection
The structurers of CDOs and CDS do not include a random selection of credits in their securitizations. Rather, they include credits on which they would like to hedge their risk, ones for which they believe the credit rating overstates the actual credit quality of the issue, and ones for which there is significant Wall Street demand for credit insurance. Many of the participants in the credit-default swap market are banks that have access to superior information and buy protection on credits that they believe are deteriorating. As a result, CDOs represent an adversely selected group of credits for MBIA, and, therefore, historical performance of the investment-grade credits will likely understate the eventual losses borne by CDO investors and guarantors like MBIA.

In recent years, so-called arbitrage CDOs have been drivers for the creation of CDOs and CDS. Moody’s explains:

The two primary sources of current demand for CDOs are regulatory and economic arbitrage. Regulatory arbitrage relates to the opportunity to reduce regulatory costs (i.e., capital charges) while economic arbitrage relates to market mispricing of credit risks. Economic arbitrage should remain strong over the medium term, but regulatory arbitrage beyond the next couple of years is more questionable as new bank regulations could impact regulatory arbitrage opportunities currently enjoyed by banks. That being said, economic arbitrage and the use of CDOs for balance sheet management or genuine credit risk transfer still represent long-term opportunities for the financial guarantors.

Moody’s explains that economic arbitrage is due to the mispricing of credit risk. While we agree with Moody’s characterization of economic arbitrage as the mispricing of credit risk, we believe the mispricing is not done by the public market for credit, as Moody’s implies, but rather by the monoline insurers and the rating agencies. The problem with the rating agency models, as one former S&P employee now employed in the credit-derivative department of a major bank told us, is that the rating agencies can only accept that “an A is an A is an A,” or in other words that any A rated credit is no different than any other A rated credit.

The credit-default swap market, however, prices credit minute-by-minute and with greater resolution than the rating agencies. As a result, there are many credits which trade at substantially wider credit-default spreads than other similarly rated credits. For example, Campbell Soup, an A- credit, recently traded at a bid/ask spread of 40/50 bps on the same day that Aon Corp., also an A- credit, traded at 340/380 bps. Despite the fact that these credits are rated the same, the market apparently believes that there is nearly an order of magnitude higher probability of default for Aon than for Campbell Soup. The rating agencies, however, do not acknowledge this difference, for if Aon’s probability of default were higher, it should carry a lower credit rating.

CDO transaction, dealers assembling a CDO transaction have an incentive to include CDS of issuers whose credit spreads are wider than comparably rated credits. By including the widest spread credits of a particular rating, the dealer can maximize its profit from the transaction. 48 If the pricing of credit risk as determined by the trading of CDS is a better indicator of default risk than the underlying company’s rating, then the arbitrage profits being earned by dealers on CDOs are due to the arbitrage between a credit rating and the market’s assessment of credit risk. The CDS market has been determined to be a good leading indicator of the probability of default. 49 This is somewhat due to the fact that rating agencies are slower to change their ratings.

In sum, investors in the CDS, equity and debt markets are risk capitalists who seek to profit when market mispricing creates opportunity. We believe, therefore, that the implied ratings of credits as determined by the capital markets are the best indicator of credit quality. As a result, by relying on CDO models that primarily use rating agency inputs for their estimations of default, we believe MBIA is more likely to have underpriced and underestimated the risk of loss in these transactions.

2. Rating Agency Default Data Do Not Include Restructuring As a Default

Synthetic CDOs and credit derivatives rely on the definitions of credit events as promulgated by the International Swaps and Derivatives Association (ISDA) in its 1999 ISDA Credit Derivatives Definitions. Market convention for corporate obligations defines a credit event as failure to pay, bankruptcy, acceleration, repudiation or moratorium, and restructuring.

One problem with the longitudinal default studies compiled by the rating agencies for corporate defaults on which MBIA bases its models is that the definition of default in the default studies does not include restructuring. Moody’s describes this risk:

> These non-“default” defaults [e.g., restructurings] will introduce risk to the financial guarantors which is very different from that experienced by them in the operation of their financial guaranty business. Under a financial guaranty the guarantor is obligated to make a payment only when insufficient funds from the issuer are available to pay.

48 Some observers have suggested that synthetic CDO issuers have an incentive which offsets the adverse selection concern, i.e., they have an incentive to select underlying CDS with a low risk of default because of their ownership of the first-loss, 1-2% equity tranche of a CDO. We understand from dealers, however, that they write down their equity interest to zero at the time of the closing of the transaction, and can still make a large profit assuming their retained equity is ultimately found to be worthless because of the substantial arbitrage.


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regularly scheduled debt service. In those cases the Moody’s rating on the underlying asset will accurately predict whether and when a payment can be expected to be made. As the asset’s rating goes lower on the rating scale, the chance of the guarantor having to make a payment because of
the asset’s default increases. There is no such prediction available for those credit events [e.g., restructuring] which do not constitute defaults within the meaning employed by Moody’s. Therefore, since CDS consider restructuring as a default, the fact that the rating agencies’ longitudinal studies do not include restructuring as a default means that these studies will underestimate the risk of loss in CDO transactions.

3. Correlation Risk

As stock markets decline, investors’ appetite for risk similarly declines. During periods of equity devaluation, companies’ ability to access debt and equity capital is also diminished. These two factors together explain why the overall market for corporate credits can collectively worsen in the event of a loss of investor confidence, a global recession/depression, a substantial rise in energy prices, continued global terrorism, or even an accounting crisis or other negative multi-industry event. We believe that MBIA has not properly considered the correlation risks among different industries and with respect to credit conditions generally. Correlation risk is a large risk for the writer of super-senior exposures. The environment in which the super-senior insurer is likely to pay claims is likely to be one in which all credit events become correlated, i.e., a substantial decline in overall corporate credit quality and/or a substantial stock market decline.

Morgan Stanley’s Alice Schroeder has also commented recently on the risks that are associated with writing credit insurance. Below, we provide an excerpt from a research report in which she compares credit insurance to writing catastrophe insurance on correlated risks:

Another concern with this business is that writing large amounts of credit insurance is essentially akin to taking catastrophe risk – something the primary [property and casualty] insurers are very careful to inform investors that they offload to reinsurers. Yet, it appears they are willing to take it on the credit side, without any reinsurance protection.

We note that large hurricanes, earthquakes and cataclysmic credit events have a key similarity – they are all low probability events that investors tend not to focus on much. A key difference, though, is that hurricanes and earthquakes generally are limited to a certain geographic area and therefore geographic diversification of risk can avert loss aggregation. In other words, these events tend to be independent of each other – an earthquake in California doesn’t necessarily cause an earthquake in New York.

Credit problems, however, don’t necessarily discriminate among industries or underlying credit quality and can have a chain reaction. Global credit markets are fundamentally

50 “Credit Default Swaps versus Financial Guaranties – Are the Risks the Same?” Moody’s Investor Service, June 2001, p. 5.
point and both were included in many collateralized debt obligations…. However, each new large credit that crumbles puts additional pressure on those parties holding these “diversified” bonds. In other words, in a widespread credit event, diversification doesn’t matter as much.  

Ms. Schroeder also questions the risk-reward of super-senior CDOs, comparing their risk of loss to earthquake risk:

- Our major question is whether what amounts to “earthquake risk” in the credit markets is really worth taking.
- As such we wonder if the relatively small profits to be made are worth the “tail risk” – that is, the large exposure to credit losses if the “unthinkable” happened. We could argue that, playing mostly in the super-triple A layers, the value of diversification is not as great as it appears.
- Unanticipated correlations might tend to arise that might not be worth the franchise bet being made. We view this business as similar to writing property catastrophe reinsurance on credit exposures, in other words, but at a lower rate on line.  

Commonsense also suggests to us that MBIA’s pricing of the risk of super-senior guarantees is inadequate. While the company’s exposure is realistically a substantial portion of the notional amount of the guarantee, MBIA has only typically been paid 4 to 12 bps per annum for these guarantees. If the company’s estimates of losses are slightly wrong, its losses will be enormous. The potential revenue, however, is limited to the annual guarantee fee of 4 to 12 bps per annum, and for more recent transactions as much as 20 bps. We believe the expression “Picking up pennies in front of a steamroller” is perhaps the most appropriate characterization of MBIA’s super-senior guarantee business.

4. The Problem with Modeling Low Probability Events

MBIA builds its models to a 99.99% confidence level and implies that such a confidence level is extraordinarily high. We quote from the 2001 Annual Report:

- In 1998, we started to look at our credits on a more broad ranging portfolio basis. We assigned default probabilities, severity tests and default volatilities to each credit. We looked at the correlations among all of the sectors, and we ran all this data on a simulation model to see what our distribution of losses would be all the way up to a 99.99% confidence level, [2001 Annual Report, p.14 (Emphasis added)]

MBIA supports this view by explaining that coincidentally Moody’s was going through a similar analysis at the same time and then further explains the importance of its financial modeling to its business:


As it turns out, Moody’s was going through a very similar exercise for the industry and established a portfolio simulation model as a critical element of its ratings approach to financial guarantors. Moody’s uses two different confidence levels, 99.9% and 99.99% as part of its capital adequacy ratios. The likelihood of default for 99.9% is one in one thousand while 99.99% is one in ten thousand.
Fundamentally, MBIA uses its own portfolio model to assist in the management of our business. It helps us gain perspective on total capital needs and capital we use on a deal by deal basis. It helps us price each transaction, and it assists us in our reinsurance strategy. We believe we have the most sophisticated day-to-day risk management capabilities in the industry. [2001 Annual Report, pp. 14-15]

While the Moody’s model may be appropriate for evaluating mean outcomes, Moody’s itself questions the validity of relying on its models for pricing low probability events. In a study produced by Moody’s on the use of models in rating securitizations, it expressed concern about the ability of models to quantify outlier events:

[W]hereas statistical models are quite good at estimating the mean, or the “expected” case of loss, it is much more difficult to quantify the tail of the probability distribution – that is, to assign probabilities to the extreme cases of loss scenarios that are several standard deviations away from the mean. It appears that the probability of these extreme cases is much more sensitive to economic changes, the originator’s credit “culture,” the servicing quality and other factors that are difficult – or virtually impossible – to quantify. The distribution tail will also be much more sensitive to data problems and the other quantitative hurdles that are discussed in this report.53

In particular, Moody’s expressed concern about the use of its models in determining expected losses in higher-rated classes of a securitization. Moody’s concern is particularly applicable to estimating the default probability of super-senior tranches of synthetic CDOs that are deemed to be even better than AAA credits by MBIA and other market participants:

Naturally, the tail of the loss distribution is nearly all that matters when it comes to assigning credit enhancement levels to the highly rated classes, because a high rating means that the security can sustain a greater level of stress without suffering losses, and is accordingly associated with the extreme cases. Therefore, it may well be the case that a model is sufficiently accurate with respect to the credit enhancement of the speculative grade classes, which are closer to the mean; but is erroneous with respect to the enhancement of the investment-grade classes due to inaccuracies in the pool data, unreported credit changes, origination strategy changes, and other non-quantified factors.54 [Emphasis added.]

In addition, Moody’s explains the risks of relying on four standard deviations in a prescient report issued only 60 days prior to September 11, 2001 in which Moody’s acknowledges the limitations of its historically based rating models:


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Credit analysts use past data – the only available information for these models. This directly exposes the model’s inherent limitation; past data is insufficient because they compose a sequence rather than a set of
independent observations as demanded by the laws of probability. It is only natural to expect a familiar sequence of historic events to repeat or maintain itself in the future. However, unimaginable “wild” events are bound to happen at some point - the only question is when. There are a number of historic examples of such unexpected events. One of these was the moment in the late 1950s, when bonds first started yielding more than stocks, thereby blowing apart a relationship established during more than 80 years of history. Another, more chilling example is the US. Stock market crash in 1987 (see sidebar). A more relevant example in the context of securitization is the unprecedented wave of mortgage prepayments in the U. S. at the end of 1997 and the beginning of 1998, which was fueled by both a low interest rate environment and fierce competition among mortgage lenders.

Sidebar: Reminder: The New York Stock Market Crash of 1987
....The magnitude of the crash took nearly all investors by surprise...
Some market observers calculated that the 19 October crash was a 27 standard deviation event, which should occur with the probability of 10 to the 160th power – a virtual impossibility.

Each of the last three years has reflected record levels of corporate defaults “unmatched in number and dollar volume since the Great Depression...” Through the third quarter of 2002, $135.9 billion of debt from 195 corporate issuers defaulted compared with $117.4 billion from 220 issuers in full year 2001. By year-end 2002, total defaulted corporate debt is projected to reach $160 billion across 242 issuers.


By the end of January 1998, the Mortgage Banking Association Refinancing Index reached an unprecedented level of 3115.8.


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Source: Standard & Poor’s, August 2002

<table>
<thead>
<tr>
<th>Global Defaults</th>
<th>02040608010012014016018019811984198719901993199619992002P</th>
</tr>
</thead>
<tbody>
<tr>
<td>Billions</td>
<td>$050100150200250300Default CountTotal Debt DefaultingTotal Defaults</td>
</tr>
</tbody>
</table>

In addition, we have recently witnessed an unprecedented number of events that are not contemplated by a model that limits its predictive capability to include only those events that can be explained with 99.99% probability. These events include the collapse of the technology and telecommunication bubbles, the September 11th terrorist attacks and their repercussions, a rogue Big Five auditor and pervasive aggressive accounting among even what were previously perceived as the highest quality companies, record low interest rates and record high mortgage prepayment levels.

It is too early to tell what the ultimate effects of recent events might be on the monoline insurers because it takes time for the impact of these greater-than-four-standard-deviation
events to generate guarantee payments due to overcollateralization, debt service reserves and other mechanisms that postpone loss recognition.

Any one of these events is sufficient to call into question a model that posits a world where only four standard deviations explain everything. The models also do not appear to assess adequately correlation risks among corporate credits that can be caused by reduced investor appetite for risks. A recent IMF working paper on investor contagion assesses the recent stock market bubble:

Throughout most of 1999 investors appeared to have a high appetite for risk and were willing to buy equity stakes in small technology companies which had no track record, current revenues or any near-term expectations of breaking even. These companies were able to raise new capital readily and invest, which further raised hopes of future revenues and attracted yet more investors. When investors’ appetite began to wane in late 1999 and turned sharply lower in the first quarter of 2000, the very same companies could not raise any new capital; and as they did not have sufficient revenues even to cover their operating costs, creditors began to pull the plug, leading to a collapse in equity prices and widespread bankruptcies.\(^59\)

The recent stock market bubble and its collapse are a good reminder that the “unthinkable” and the “unpredictable” occur more often than expected.

**E. MBIA’s Sale of Credit-Default Swaps on Itself**

Gotham has been able to purchase substantial amounts of credit-default swaps on MBIA. While we were initially surprised by the large available supply of CDS for an investment that offers the writer of the insurance a very modest premium and, we believe, enormous downside, we believe that MBIA may have been on the other side of a number of our trades. We believe that MBIA has either sold protection to dealers through the purchase of credit-linked notes for its insurance investment portfolio, or alternatively through the sale of fully collateralized credit-default swaps. A recent Barclays Capital research report confirms MBIA’s sale of default protection:

Notably, MBIA has recently sold credit default protection on itself. We believe this is an indication that the company views current spread levels as overdone.\(^60\)

MBIA’s addition of supply of CDS in its own name has created the opportunity for dealers to sell protection on MBIA to Gotham and others at more favorable prices. As to the motivation of an issuer like MBIA selling credit-default protection itself, we quote MBIA’s CEO Jay Brown at a BankAmerica conference in California on September 25, 2002. In response to a question concerning credit-default swaps on MBIA, Mr. Brown said:

> It is one of those markets when you go in and say I will buy some of that – sell the protection against your own name or against one of your competitors names. It shrinks in quickly if you try and create any volume. So we are never quite sure in that market. It’s not a lot of serious contracts being traded. [Emphasis added.]

This summer, when spreads had widened to more than 200 bps per annum, a large seller stepped in to the market and caused spreads to decline to approximately 100 bps. Spreads
have subsequently returned to higher levels.


The CDS market is considered to be more liquid than the cash market for corporate bonds.61 As with any market, however, if a large seller steps in and sells indiscriminately, the market will move in substantially.

We are not aware of any contemporaneous disclosure over the summer that MBIA was a seller of CDS on itself, nor are we aware of any subsequent disclosure by MBIA that it has been a seller of CDS on itself. The only public disclosure, of which we are aware, that MBIA was a seller of CDS on itself is the Barclays Capital report of December 2, 2002.

Combining the fact that MBIA has not publicly disclosed its participation in CDS on itself and Mr. Brown’s explanation that doing so makes the market “shrink[] in quickly,” it appears that MBIA has quietly sought to narrow its spreads in the marketplace by selling protection on itself.

We believe MBIA’s sale of credit-default protection on itself is not a good use of its insurance capital. In effect, by purchasing MBIA CLNs, the company is leveraging itself up in an undisclosed fashion. Because MBIA is AAA rated, if the company has purchased credit-linked notes for its investment portfolio, it would improve the portfolio’s weighted-average rating, while simultaneously weakening the company’s liquidity to the extent of the new investment.


VI. ACCOUNTING FOR LOSSES

A. MBIA’s Reported Track Record Does Not Include “Restructurings”

MBIA emphasizes in its public filings and presentations that it has incurred only 3 bps losses in its 28 years of existence over a total guarantee portfolio of $1.47 trillion. One problem with the company’s statement, however, is that its new business, which is growing at a rapid rate, has a materially different risk profile than its historical municipal bond insurance business.

Another problem with MBIA’s low reported loss statistics is that the company has not disclosed publicly approximately 130 to 195 “restructurings” of troubled transactions over the last 13 years. We determined this number from Mr. Brown’s estimate at our meeting with him that the company had “restructured 10 to 15 credits per year” since he joined the board of directors in 1990. In its public statements, management often refers to how much money has been “saved” by its “surveillance” activities, but we believe that it is more likely these savings simply represent deferred losses. Below, we quote Mr. Brown on the company’s surveillance activities:

   We do get some transactions wrong. We actively monitor and aggressively alter outcomes by working with issuers long before there is ever a loss in our portfolio. In our history as a company we have
probably saved the company anywhere from $700 to $1 billion in ultimate losses by changing or restructuring transactions.\textsuperscript{62}

In our meeting with Mr. Brown, he explained that in a restructuring, the company modifies the terms of existing indebtedness, often refinances obligations on new terms, with new amortization schedules, etc. so that a transaction can be brought back into compliance. Other financial institutions call these transactions workouts and are required to disclose their details and set aside appropriate reserves in regulatory and SEC filings. This is due to the fact that restructured loans with modified terms generally have higher future default risk than loans that do not require restructuring. MBIA provides no disclosure in its public filings as to what percentage or dollar amount of its guaranteed portfolio has been restructured.

According to Mr. Budnick, when MBIA restructures a problem deal, it typically refinances a near-defaulting obligation with a larger guarantee amount. When we asked Mr. Budnick what the company means by “surveillance” he responded as follows:

Restructuring deals. Throwing in dollars to make it work.\textsuperscript{63}

When MBIA refunds an existing deal, according to its accounting policies, it books immediately any unearned premium from that transaction.\textsuperscript{64} Since restructurings could

\textsuperscript{62} Speech by Mr. Jay Brown at the BankAmerica Securities conference, September 25, 2002.

\textsuperscript{63} Interview with Mr. Neil Budnick, Armonk, NY, August 14, 2002.

\textsuperscript{64} “When an insured issue is retired early, is called by the issuer, or is in substance paid in advance through a refunding accomplished by placing U.S. Government securities in escrow, the remaining deferred

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be characterized as refundings, we believe this policy may also apply to restructurings, although there may be instances in which MBIA credits a portion of the refunded premium to the new guarantee. In addition, we believe the company often takes waiver, advisory and other fees that are booked immediately into income in connection with these restructurings. According to Mr. Brown, the company takes no case reserves, nor books any losses for restructured or refinanced guarantees nor includes restructured deals in its reported cases of poorly performing transactions.\textsuperscript{65} It appears that MBIA’s accounting for restructurings may serve to accelerate earnings recognition when compared to its performing guarantee transactions.

\textsuperscript{65} 2001 Annual Report, p. 28.

While restructuring can be effective for an issuer that has a short-term fixable problem, restructuring credits with more fundamental or structural problems is likely to serve only to postpone loss recognition. Traditional corporate restructurings typically involve deleveraging a troubled company whereby existing debt is exchanged for new equity in the company, and previous equity investors are largely if not totally diluted. In other circumstances, new equity is invested which enables the restructured company to support new indebtedness.

In the restructuring examples cited by the company in our meetings with Mr. Brown and Mr. Budnick, no new equity was invested in transactions. Rather, MBIA through the guarantee of a larger bond issue provided incremental debt capital to the restructured credit. In that MBIA apparently does not take equity in transactions in exchange for debt,
it is not positioned to benefit materially if a troubled credit improves substantially; however, because it is guaranteeing a larger debt, it increases its exposure to the troubled credit.

In addition to the company’s restructurings, Mr. Budnick explained that MBIA uses “its influence” to force issuers to take back bad loans and receivables from poorly performing securitization transactions, i.e., MBIA threatens to not guarantee future securitizations if the issuer does not take back problem assets. While such a strategy can work in transactions with modest levels of losses and financially strong issuers, in circumstances with high levels of defaults, or in the event of a weak or bankrupt issuer, this approach will likely fail. While MBIA’s use of “influence” makes its reported performance appear superior, its actual historical loss performance is probably overstated as a result.

B. MBIA Discloses Only the Number of Its Problem Credits Not the Dollar Amount

The number of MBIA’s problem guarantees is increasing at a rapid rate. The company does not disclose the dollar amount of its guaranteed assets in default; instead MBIA periodically discloses only the number of problem issues. The number of problem issues increased by 92%, from 25 to 48 (as of 12/31/01) over the last three years and has continued to grow at a 27% annual rate to 54 issues for the six months ended June 30, 2002.

If a bank were to disclose only the number of its problem loans without disclosing their dollar amount and without providing further detail, investors would have reason to complain and, we believe, the SEC would not permit such a minimal degree of disclosure. MBIA, however, provides only the number of its problem credits with no further detail. The company’s lack of disclosure is particularly troubling in light of the enormous range in size of the guarantees it provides, i.e., from as small as several million dollars to as large as multi-billion dollar loans.

C. Reserves

From its inception until 1999, MBIA had reserved two basis points of the par value of its outstanding guarantees for unidentified potential losses in its portfolio. In 1999, after the bankruptcy of AHERF (Allegheny Health Education and Research Foundation) and losses of nearly $320 million, MBIA retroactively increased its reserves from two basis points to four basis points of its guarantee portfolio and made a one-time addition of $153 million to “bolster reserves.” Beginning in January 2002, MBIA has again changed its reserve methodology, this time to 12% of earned premium. The company explains:

Beginning in 2002, the Company has decided to change the methodology it uses to determine the amount of loss and loss adjustment expenses based upon a percentage of earned premiums instead of a percentage of net debt service written. There are two reasons for this change in methodology. First, the amount of net debt service written can significantly fluctuate from quarter to quarter while the related premium is earned more consistently over the life of the transaction. Second, during the quarter the premiums are written, the loss and loss adjustment charge is recognized in advance of the related earned premium because this revenue is essentially all deferred in the quarter that it is written. The intent of the change is to better match the recognition of incurred losses with the related revenue,
To summarize, the company states that its second adjustment in reserving in three years is due to its desire to smooth its recognition of expenses for GAAP. We interpret this change somewhat differently despite the company’s explanation that if it had used its new reserving methodology in the previous three years, its reserves would have been largely the same. MBIA’s business mix has changed substantially over the last several years. As a result of the growth in the company’s credit-default swap and CDO portfolios coupled with the new accounting change, it appears that future reserves will be lower as a result of the smaller premiums as a percentage of par insured for CDO transactions.

We question the logic of fixing loss and loss adjustment expenses as a percentage of earned premium, for this methodology guarantees the company a 12% loss ratio, or in other words, an 88% gross margin on its insurance business regardless of the competitiveness of the market. While there should be some correlation between risk of loss and premium earned, there have been many periods in history when insurance companies have underpriced risk. By guaranteeing the company a 12% loss ratio, MBIA’s new reserving methodology allows the company to report smooth earnings and large profits regardless of the competitiveness of the markets for its guarantee.

MBIA states that its reserving methodology is based on rating agency studies of default statistics over the last 30 years for rated corporate issuers. Unfortunately, however, there are no long-term data on structured finance or on CDO performance because of the products’ recent invention. As a result, we believe that MBIA has extrapolated from data that is not sufficient to determine appropriate levels of reserves. The historical data do not contemplate the adversely selected nature of CDO, credit-default swaps, and some of the more complex securitizations, and perhaps more importantly, recent events. Recent events, in particular, the recession, accounting problems and record numbers of investment-grade and high-yield defaults, make MBIA’s reserve assumptions even more unrealistic. While MBIA explains that diversification has reduced the company’s risk, it appears that nearly all of its asset classes have been impaired by events of recent years including the company’s municipal guarantees and other public finance credits. CDOs, credit-default swaps, and nearly all asset-backed securitizations are suffering losses well in excess of expectations. The large number of investment-grade and non-investment grade defaults have burned up a substantial portion of the overcollateralization in many CDOs.

D. Credit Concerns in MBIA’s Guarantee Portfolio

MBIA has in recent years begun to show problems in its guarantee portfolio. As mentioned previously, in 1999, one of the company’s larger hospital credits (Allegheny Health Education and Research Foundation) filed for bankruptcy leaving it with losses totaling approximately $320 million. MBIA was able to eliminate the earnings impact of this loss by obtaining $170 million of “reinsurance” which it used to offset the after-tax loss at a minimal undisclosed cost, in exchange for an agreement to cede future business to these reinsurers. We quote below from the company’s contemporaneous press release:

ARMONK, N.Y.--(BUSINESS WIRE)--Sept. 29, 1998--MBIA Inc. (NYSE: MBI) announced today that it has obtained $170 million of
reinsurance that it expects will cover anticipated losses arising from the bankruptcy of the Delaware Valley Obligated Group (DVOG) [a/k/a AHERF]. As a result, the company does not expect exposure to this insured credit to affect its earnings or reduce its unallocated loss reserve…

"As part of our risk management efforts, the company has entered into strategic business relationships with highly rated reinsurers to provide them with future business as part of the reinsurance agreement. The cost of these reinsurance arrangements over the next few years will have a minimal impact on earnings while strengthening our claims-paying resources and risk management capabilities," said Richard L. Weill, MBIA vice chairman.

Mr. Budnick described this transaction to us as the company “borrowing” money from the reinsurers and “paying it back” through a commitment to cede future businesses. As a result of the reinsurance, the company was able to avoid booking a loss on the AHERF transaction while simultaneously maintaining its unallocated loss reserve. Standard & Poor’s has recently described MBIA’s retroactive financial reinsurance of AHERF as “innovative.” 69 We do not know of other instances in which the company may have used financial reinsurance to mitigate other losses in its portfolio, but believe that this mechanism is not in fact reinsurance, but rather a loss-deferral, earnings-smoothing device.

MBIA’s healthcare assets (MBIA had $36.5 billion net par of hospital exposure at September 30, 2002) continue to be at substantial risk because of managed care and reduced Medicare reimbursements as well as the recent problems caused by National Century’s bankruptcy. According to Mr. Brown, other than AA rated hospitals, nearly every hospital deal that MBIA has done in recent years has been a restructuring of a previous deal.70

The company has substantial sub-prime home equity and mortgage exposure, which has also been under significant stress. At September 30, 2002, MBIA had total home equity net par of $21.1 billion. In addition, the company apparently has significant manufactured home exposure, although the company does not break this exposure out separately. MBIA has substantial secured and unsecured exposure to investor owned utilities. In 2001, Pacific Gas & Electric filed for Chapter 11 and Southern California Edison suffered a material downgrade. MBIA has approximately $1 billion of exposure to PG&E and Southern California Edison of which 41% is unsecured. $51 million of the company’s unsecured exposure to PG&E is in the form of a credit-default swap.71 At September 30, 2002, MBIA had $17.4 billion of additional net par exposure to investor-owned utilities.

On July 15th of this year, Royal Indemnity, a British Insurer, refused to honor its guarantee of $380 million of vocational student loans, citing fraud and negligent misrepresentations by the issuer, Student Finance Corp. MBIA guaranteed eight Royal Indemnity wrapped SFC securitizations. MBIA is suing Royal Indemnity for payment, but has stepped in to make good on the underlying bonds that have already generated...
$311 million of claims according to MBIA’s September 30, 2002 10-Q. In light of
69 “The 17.9% spike [in reinsurance] in 1998 was an aberration caused by MBIA
Insurance Corp.’s innovative use of reinsurance in connection with its exposure and
losses to the bankrupt Allegheny Health and Educational Research Foundation
(AHERF)” [Emphasis added.] “Extraordinary Events Test Bond Insurer’s Resilience,”
70 Interview with Mr. Jay Brown, Armonk, NY, August 14, 2002.

Royal Indemnity’s financial condition, there remains uncertainty about MBIA’s ability to
collect even if it is successful in the litigation.
As previously mentioned, on October 31, 2002, Union Acceptance Corp. filed for
bankruptcy protection. UAC securitizes sub-prime loans on used cars. MBIA is a
 guarantor of $2.4 billion of UAC’s securitizations and other debt including the guarantee
of a $350 million BankAmerica loan to the company. MBIA has substantial exposure to
other sub-prime auto lenders including AmeriCredit ($1.75 billion warehouse facility and
a recent $1.7 billion securitization), Onyx Acceptance Corp. ($355 million warehouse
facility and $1.9 billion net par of term securitizations), and Capital One. At September
30, 2002, MBIA’s total auto exposure was $13.6 billion of net par.
MBIA is a large guarantor of Enhanced Equipment Trust Certificates (EETCs) which are
financings secured by aircraft ($4 billion of gross exposure and $1.9 billion of net). The
company’s largest exposure is to U.S. Airways ($1.6 billion gross, $514 million net). The
bankruptcy of U.S. Airways and the growing probability of other airline bankruptcies
including United Airlines threatens the creditworthiness of these issues. While
bankruptcy of the issuer is certainly not a positive for EETC transactions, it is not the
most important factor in the credit quality of the issue. Underlying asset values of the
aircraft are also paramount. A continued decline in air travel due to growing terrorist
activities, the recession, and the potential upcoming war with Iraq will likely increase the
probability of loss to MBIA on these transactions.

<table>
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<th>EETC Exposure</th>
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<td>as of 8/12/2002</td>
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<tr>
<td>Airline</td>
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<td>US Airways</td>
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<td>7/18/09</td>
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<tr>
<td>$1,634,143</td>
<td>43,127</td>
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In addition to EETCs, MBIA has other travel-correlated exposures under significant stress including airport revenue bonds, passenger facility charges, car rental securitizations, and toll roads that lead to airports. Excluding toll roads, these exposures totaled $15 billion at December 31, 2001.

MBIA has substantial exposure to sub-prime credit lenders including Providian, Metris, and Spiegel. These transactions also do not appear to be performing according to original projections. We quote below from a recent Bank of America research report:

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We remain concerned about the subprime credit card segment. In our minds, this segment remains untested, and the experience at Providian highlights the risk there.  

With $2.8 billion of net par exposure, Providian Gateway Master Trust is MBIA’s largest structured finance risk. In an 8-K filed on November 18, 2002, Providian Financial Corp. reported that the Trust’s Annualized Net Credit Loss Rate was 17.5%, which represents gross charge offs less recoveries on previously charged off loans. The 8-K noted that the Net Credit Loss Rate would have been 19% if certain extraordinary adjustments were excluded from the calculation.

With $2.5 billion of net par exposure, Metris Master Trust is MBIA’s second largest structured finance risk. On October 28, 2002, Fitch downgraded all of the Metris Master Trust A/B/C notes other the trust series that are wrapped by MBIA. We quote from a Fitch press release below:

The rating actions primarily reflect persistent weakness and expected further deterioration of key master trust performance variables as well as the challenging financial and regulatory environment in which Metris continues to operate. Trust credit quality has worsened significantly beyond Fitch's original expectations and continues to deteriorate. In September, gross charge offs reached 16.83%, compared to an average of 12.8% in 2001 and 11.18% in 2000. In addition, late stage delinquencies, an indicator of future charge offs, continue to trend upward, reaching 11.1% in the latest period.

When modeling its new performance expectations, Fitch employed
several stress scenarios, giving increased consideration to the scenario that
incorporated a full purchase rate stress in conjunction with the stresses
applied to other key variables. The decision to emphasize the full purchase
rate stress scenario reflects Fitch’s concern that Metris would be unable
to fund new purchases on trust designated accounts in the event of
insolvency, bankruptcy, or receivership. [Emphasis added.]
Spiegel issued two series of asset backed securities from its retail credit card master trust
in 2000 and 2001. Both of these series were guaranteed by MBIA. MBIA had $840
million of net par exposure to Spiegel Credit Card Master Note Trust (MBIA’s 33rd
largest structured finance risk) at September 30, 2002.
On April 10, 2002, MBIA declared a “pay out event” for the two series due to higher than
anticipated fraud and credit losses, which averaged 17.3% over the trailing six months
and 19% in April. The day after MBIA declared the pay out event, Spiegel’s special
purpose bank sued MBIA in New York State Court and obtained a temporary restraining
order to prevent MBIA from enforcing the pay out event. Spiegel argued that no pay out
event actually had occurred.
MBIA ended up settling this dispute out of court, waiving the early amortization
covenant that is designed to protect MBIA against losses. The company has not been
willing to publicly disclose the details of its settlement with Spiegel.
VII. MBIA’S INVESTMENT PORTFOLIO
At September 30, 2002, MBIA’s insurance investment portfolio was comprised of $8.2
billion of fixed income assets at amortized cost. Fifty-six percent (56%) of these assets
are municipal bonds of which, according to MBIA, nearly 90% of the muni portfolio is
wrapped by monoline insurers including MBIA. According to Mr. Budnick, MBIA’s
guarantee supports as much as 50% of the wrapped portfolio,73 which implies that as
much as 25% of the company’s investment portfolio is rated AAA only because of
MBIA’s own guarantee. In addition, the company owns other assets in the taxable portion
of its investment portfolio that are guaranteed by MBIA and other monoline insurers
including $30 million of Meridian Funding Company, LLC MTNs and MBIA credit-
linked notes (CLNs) or fully collateralized credit-default swaps. We have not been able to
determine the precise amount of these other guaranteed assets.
While MBIA states that the investment portfolio’s rating averages AA, we believe that
this average rating is enhanced by the large percentage of securities which are rated AAA
because they are guaranteed by MBIA and other monoline insurers. The company’s
investment yield is also enhanced because wrapped AAA obligations tend to trade at
wider spreads than “natural” AAA rated securities.
As a result of the large amount of wrapped AAA obligations, the balance of MBIA’s
portfolio can be comprised of greater amounts of A and lower-rated corporate credits
while allowing the company to maintain an average AA rating. We do not believe that
MBIA should be relying on its own guarantee, nor that of its competitors in reporting the
credit quality of its investment portfolio.
MBIA’s concentration of credit risk in wrapped munis and taxable securities and, in
particular, its large ownership of MBIA-wrapped paper makes the company even more
vulnerable to a decline in its own credit quality and that of other monoline insurers. This is due to the fact that the event that will require MBIA to seek liquidity from its investment portfolio, i.e., a substantial number of defaults requiring guarantee payments, will occur at precisely the time that a substantial portion of MBIA’s wrapped portfolio will decline in value and become less marketable. This is also true for the company’s other monoline-wrapped obligations because of the likely high degree of correlation between the decline in the credit quality of one monoline and its competitors.

We have previously discussed some of the issues associated with consolidating the $8.6 billion of SPV debt on MBIA Insurance Corp.’s balance sheet. In the event of the consolidation, MBIA would also be required to include $8.6 billion at cost of investments whose collective ratings are substantially below AA, which would reduce the portfolio’s average investment rating and the average liquidity substantially. While we do not know the current average rating of the SPV assets, we are troubled by the quality of the assets that we have been able to identify.


VIII. REINSURANCE

MBIA reinsured $106 billion of its $589 billion of gross par at September 30, 2002. The business was divided as follows:

<table>
<thead>
<tr>
<th>Reinsurer</th>
<th>Billions</th>
<th>S&amp;P Rating</th>
<th>Moody’s Rating</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ace Guaranty</td>
<td>$20.0</td>
<td>AAA</td>
<td>Aa2</td>
</tr>
<tr>
<td>Radian Re</td>
<td>$18.9</td>
<td>AA</td>
<td>Aa2</td>
</tr>
<tr>
<td>Axa Re</td>
<td>$14.7</td>
<td>AAA</td>
<td>Aa1</td>
</tr>
<tr>
<td>Munich Re</td>
<td>$12.6</td>
<td>AAA</td>
<td>Aa1</td>
</tr>
<tr>
<td>Ambac</td>
<td>$10.5</td>
<td>AAA</td>
<td>Aaa</td>
</tr>
<tr>
<td>Zurich Re</td>
<td>$ 8.4</td>
<td>A+</td>
<td>A1</td>
</tr>
<tr>
<td>American Re</td>
<td>$ 8.4</td>
<td>AAA</td>
<td>Aa2</td>
</tr>
<tr>
<td>Other</td>
<td>$ 5.3</td>
<td>Undisclosed</td>
<td>Undisclosed</td>
</tr>
<tr>
<td>Ram Re</td>
<td>$ 4.2</td>
<td>AAA</td>
<td>Aa3</td>
</tr>
<tr>
<td>Mitsui Sumitomo Re</td>
<td>$ 2.1</td>
<td>AA</td>
<td>AA2</td>
</tr>
</tbody>
</table>

The credit quality of MBIA’s reinsurers is critical to the company’s long-term capital requirements. This is due to the fact that the rating agencies “haircut” reinsurance provided by non-AAA reinsurers. S&P discounts reinsurance from AA reinsurers by 30%, A reinsurers by 70%, and for reinsurers below A considers the entire risk to still remain on the books of the ceding primary insurer.

In a March 13, 2002 research report, S&P changed the outlooks on the then AAA ratings of the four monoline reinsurers, Radian, Ace, Axa, and Ram to negative from stable citing the:

deterioration in the reinsurers’ business positions vis-à-vis the primary insurers. This change has resulted in the reinsurers assuming business that
is less diversified, less profitable, and of a higher risk profile relative to that written by the primary insurers.  

On July 29, 2002, Fitch assigned a negative rating outlook on the monoline reinsurers which:

Reflects less favorable relationships and contractual terms with the companies’ major clients, as well as increased competition.

On September 17, 2002, S&P put Axa Re on creditwatch with negative implications implying that if the business was not sold (sale discussions were apparently in advanced stages), its credit would be downgraded.

On September 19, 2002, Moody’s downgraded Munich Re to Aa1 from AAA, and American Re to Aa2.


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On October 4, 2002, S&P downgraded MBIA’s second largest reinsurer, Radian Re, to AA which brings $5.7 billion of risk that was previously reinsured back onto MBIA’s books based on S&P’s 30% haircut methodology.

On October 8, 2002, S&P reaffirmed Ace Guaranty’s AAA rating but with a negative outlook.

Moody’s has also become “increasingly cautious” about the monoline reinsurers.

Moody’s stated on October 9, 2002 that its cautious outlook:

reflects increased uncertainty over the amount of benefits that primary insurers will recognize from ceding financial guaranty exposure to monoline reinsurers, as well as the changing strategic profile of certain reinsurers.

Fifty-five percent of MBIA’s reinsurance comes from monoline reinsurers. All of these reinsurers are under pressure for a ratings downgrade. As monoline reinsurers, effectively all of their business is directly correlated with the primary monoline insurers from whom they accept risk. According to S&P, this business is not only correlated but represents an adversely selected pool of risk from the monolines.

An additional 10% of MBIA’s reinsurance comes from Ambac whose book of business is extremely similar to MBIA’s. This is particularly true for the company’s international structured finance business, which was a joint venture with Ambac until March 2000. Ambac also purchases reinsurance from MBIA. In today’s accounting parlance, one might refer to the reciprocal quality of MBIA’s and Ambac’s reinsurance as “roundtrip reinsurance.”

As a result of the above exposures, 65% of MBIA’s reinsurance comes from reinsurers whose business is directly correlated with the company’s. The risks of such an approach become evident by example. Consider a property casualty company that writes P&C coverage for Florida property that purchases 65% of its reinsurance from reinsurers that only reinsure Florida coastal housing. The catastrophic event or series of events that make the insurer call upon its reinsurance is likely to be the event in which the reinsurers are least able to perform as a result of their concentrated exposure to the same risk.

The above correlations are compounded further by the fact that the monoline reinsurers stock their investment portfolios with obligations that are rated AAA only because they are wrapped by the primary monolines. For example, more than 60% of Ace Guaranty
Re’s portfolio is invested in wrapped municipal paper. 76 While Moody’s in a recent report discounted the impact of a one or even two notch downgrade of the reinsurers, i.e., from A1 to A2 (one notch) or to A3 (2 notches), it did, 75 “Moody’s Cautious on Bond Insurers; S&P Downgrades a Radian Unit,” The Bond Buyer, Vol. 27; No. 7; p. 6.

76 Interview with Mr. Budnick, Armonk, NY, August 14, 2002.

Gotham Partners Management Co., LLC Page 55 however, express concern about the risk if even one of the primary monoline reinsurers encounters credit quality deterioration:

While none of the primary guarantors, including MBIA, would suffer a credit event if one or more of their reinsurance providers were downgraded a notch or two, all of the financial guarantors may be vulnerable if one of their primary providers of reinsurance were to experience a significant credit quality deterioration or were to choose to exit this market. 77

MBIA’s reinsurance program is another form of off-balance sheet leverage that can functionally accelerate. In the event of a downgrade of a reinsurer, MBIA is considered by the rating agencies to have received the ceded risks back on its books. In effect, the company is confronted with a capital call when its reinsurers are downgraded. Since MBIA reinsures its higher-risk, lower-quality business, in the event of a reinsurer downgrade, MBIA’s potential exposure to its worst quality business will increase. Because of the high degree of correlation of the reinsurers with MBIA itself, the company is least likely to be prepared to insure the ceded risks at the time they are “put” to the company.


Gotham Partners Management Co., LLC Page 56 IX. OTHER ACCOUNTING ISSUES

We believe that conservative accounting is essential for investors to understand the true earnings power of MBIA. The company’s revenue and expense recognition policies, however, coupled with the company’s accounting for reserves suggest to us that MBIA’s accounting is not conservative.

A. Advisory Fees

In recent years, MBIA has structured a substantial portion of its guarantee fees as advisory and other fees that the company books immediately as income at the closing of a transaction. For example, according to Mr. Budnick, on the recent Eurotunnel deal the company booked upfront an $8 to $10 million advisory fee as part of its total fees on the transaction. 78

Over the past several years, advisory fees have grown to become a greater percentage of the company’s earnings and are up 39% from the comparable period from last year. Advisory fees for 2001 were also up 39% over 2000. The company also charges advisory fees to its SPVs, $8 to $9 million in 2001 according to Mr. Brown, in amounts that it appears to determine in its sole discretion. Mr. Brown described advisory fees as “found money.” 79

We also find troubling the apparent re-characterization of SPV interest income as advisory fees. In essence, via the SPVs, MBIA is paying advisory fees to itself in amounts it appears to determine in its sole discretion. Proper characterization of this
income is important because Wall Street has historically assigned higher multiples to fee income rather than interest income. We question the appropriateness of charging advisory fees that are recognized upfront rather than over the life of a transaction. Issuers who seek MBIA’s AAA guarantee likely consider advisory fees as simply another form of financing costs. Since advisory fees and guarantee fees are typically paid upfront in the public and project finance transactions in which they are earned, the borrower is indifferent to how the fees are labeled by MBIA because the borrower pays the fees upfront and only considers the all-in-cost rather than the categories of fees in a financing. Because of the accelerated recognition of advisory versus guarantee fees (advisory fees are typically recognized at the time of the closing of the transaction), we believe the company’s growth in advisory fees may be due to its simply shifting revenue from one category to another where it can be recognized immediately.

Interestingly, while Mr. Budnick was aware of the amount of the advisory fee earned on the Eurotunnel deal, Mr. David Dubin, co-head of MBIA’s European structured finance, did not know the amount of the advisory fee and could only tell us the all-in cost of the financing on a spread basis.

Interview with Mr. Jay Brown, Armonk, NY, August 14, 2002.

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B. Revenue Recognition

MBIA provided new disclosure in the 2001 Annual Report that explained the impact of the company’s revenue recognition methods. MBIA recognizes deferred premium on a principal balance of exposure basis, rather than equally over the life of an issue. Since the dollar value of each deal is greater in earlier years due to amortization, this accounting method greatly accelerates revenue recognition. The company explains the materiality of this revenue recognition policy for the first time in the 2001 Annual Report:

The effect of the Company’s policy is to recognize greater levels of upfront premium in the earlier years of each policy insured, thus matching revenue recognition with the underlying risk. Recognizing premium revenue on a straight-line basis over the life of each policy would materially affect the company’s financial results. [Emphasis added.]

While the company’s revenue recognition methodology may have logical appeal, because loss development often does not occur in the early years of a guarantee, frontloading revenue does not necessarily match revenue recognition with the company’s exposure to risk.

C. Deferred Acquisition Costs

We believe the company’s accounting for deferred acquisition costs is aggressive. The company capitalizes the variable costs associated with new business generation which are then amortized over the life of the transaction. Mr. Budnick explained to us that these costs include a portion of his and the controller’s salary, as well as all other deal participants and ancillary costs. According to Mr. Budnick, the deferred acquisition cost policy results in the deferral of 55% of the company’s operating costs over the life of its guarantee portfolio.80

While many insurance companies defer policy acquisition costs, we find MBIA’s approach aggressive because we believe MBIA’s business is more analogous to a finance company than a life or property casualty insurer. We do not believe that banks or finance
companies defer the salaries of underwriters and senior management over the life of a transaction. In addition, because of the long-term nature of MBIA’s guarantees, the company’s deferred acquisition cost policy significantly enhances the company’s reported net income when its results are compared with other financial institutions. In sum, we believe that the combination of accelerated revenue recognition of guarantee and advisory fees, the company’s immaterial levels of reserves, and its deferral of a substantial portion of the company’s operating expenses cause MBIA’s GAAP earnings to overstate significantly the company’s true economic earnings.

80 Interview with Mr. Budnick, Armonk, NY, August 14, 2002.

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X. CONCLUSION -- WHY WE BELIEVE THAT MBIA’S CREDIT RATING IS AT RISK.

We do not believe that MBIA deserves to be AAA rated. In particular, we believe that the dramatically increased liquidity, investment, underwriting, and correlation risks in MBIA’s business and investment portfolio in recent years do not justify this rating. While the company’s reporting of its overall credit quality appears to suggest that the guarantee portfolio has improved in quality, we believe the facts suggest otherwise.

A. Credit Quality of Existing Portfolio

MBIA points to the fact that in 1998 70% of the company’s guarantee portfolio was A or better versus 76% today.81 While MBIA is focused on what percentage of its business is of high quality, the relevant measure, we believe, is what percentage is of lower quality. With approximately $483 billion of net par insured at September 30, 2002, MBIA had $251 billion of net par rated A or below and $299 billion of net par rated A+ or below. A significant amount of the company’s growth in A or better ratings has come from its super-senior CDO business which is considered AAA by the rating agencies. We have previously explained why we believe the ratings for these transactions understate their risks. Yet it is the super-senior CDOs’ high ratings that allow MBIA to report improved average credit quality. In any event, we believe that investors and the rating agencies should focus on the absolute dollar amount of MBIA’s low quality business to assess trends in its risk profile.

If we look solely at assets rated BBB+ and below, MBIA had approximately $115 billion of net par exposure. From this we know that MBIA has large exposures to marginally investment-grade risks.

Furthermore, if we look at underlying assets rated Below Investment Grade (BIG) (i.e., assets rated BB+ to D), MBIA had $6.8 billion of net par at September 30, 2002 up from $4.8 Billion as of June 30, 2002.82 This $2 billion increase represents 42% growth in BIG assets in just one quarter. The $6.8 billion of BIG assets substantially exceeds MBIA’s equity of $5.5 billion. The absolute size of these numbers and their enormous growth in the last quarter should raise red flags for investors and rating agencies because BIG assets are inconsistent with no loss underwriting.

We also believe that MBIA’s $5.3 to $7.7 billion mark-to-market loss on its CDO portfolio, as estimated by CDO dealers, calls into question the company’s credit quality.

81 52% of MBIA’s book of business is actually A or below and 62% is A+ or below.


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When we compare any of these numbers against MBIA’s $5.5 billion of equity capital or
against its $900 million to $1.7 billion cushion against a rating downgrade, one begins to suspect that the risk of substantial loss and downgrade is much higher than the company suggests or than is implied by its AAA rating.

**B. MBIA’s Track Record**
MBIA marshals its reported 28-year track record of 3 bps of losses on $1.470 trillion of debt service from inception as an indication of its future probability of loss. We think the quality of MBIA’s track record is overstated for several reasons.
• First, MBIA’s business has changed materially since inception, as competition and the company’s desire to generate 15% compound earnings growth have forced it to guarantee riskier assets over time.
• Second, while the risk of MBIA’s current business is greater than its historic business, its historic business dilutes more recent loss experience by its inclusion in the denominator of the company’s total book of business.
• Third, because the company’s guarantees are long-term and defaults do not typically occur in the early years of a guarantee, the company’s high rate of growth masks reported losses through the inclusion of an ever-larger number of new guarantees in the denominator of the loss calculation.
• Fourth, the company’s data set of losses is obscured by its non-disclosure of restructurings that likely have had the effect of postponing loss recognition.
• Fifth, the company’s willingness to take on greater risks since its charter change in 1991 corresponds with the longest economic expansion in American history. While catastrophe insurers can look good when hurricanes are not in season, the true test to their underwriting occurs during hurricane season.

For the above reasons, we believe that MBIA’s reported loss statistics are not good predictors of future losses. Therefore, we believe they should not be relied upon by investors and rating agencies in estimating the company’s probability of loss in the future.

**C. Investment Portfolio**
We have previously described the company’s high degree of exposure to MBIA-guaranteed and other monoline-wrapped securities in its investment portfolio. While MBIA’s portfolio averages AA, the large amount of wrapped AAA credit in the portfolio serves to artificially boost the portfolio’s stated credit quality. This allows MBIA to generate wider spreads for its AA portfolio in two ways: first, wrapped AAA paper generally trades at wider spreads than “natural” AAA credits; and second, because of the high proportion of AAA credits, the company is able to add larger amounts of higher yielding A and BBB credits while still maintaining a AA average. Even more significantly, the addition of the SPV assets to MBIA’s balance sheet will further reduce the overall credit quality and liquidity of MBIA by the inclusion of lower quality, less liquid assets that will more than double the size of the investment portfolio.

**D. Liquidity Risks**
We believe the company faces substantial liquidity risk from its nominally capitalized SPVs which owe more than $8.6 billion of debt, of which $3 billion is commercial paper.
We also believe that investors and the rating agencies should be concerned about the liquidity risk of the company’s $44 billion synthetic credit-default swap guarantees that accelerate once overcollateralization levels have burned off.

As we have mentioned previously, in an August 2002 Moody’s report entitled “Ratings Triggers in the Financial Guarantee Industry,” the rating agency appears to be unaware that MBIA is exposed to accelerating risks and short-term debt:

[T]he guarantors’ exposure to liquidity risk is relatively modest, given the low historical frequency and severity or insured defaults, coupled with the nature of its insurance contract, which protects against the acceleration of principal payments. Furthermore, the guarantors do not issue short-term debt, lessening the need for significant amounts of back-up liquidity.

E. Correlation of Risks Could Lead to Downgrade Spiral

Most disconcerting of all, the combination of these risks could lead to a ratings downgrade, which, in turn, could lead to a self-reinforcing series of events. Moody’s alludes to this in describing perhaps the largest ratings trigger exposure at MBIA, i.e., the credit rating of the company itself:

The primary guarantors, of course, are also exposed to another form of rating trigger that is not embedded in any documentation, but is instead imposed by the market itself – If a financial guarantor were to lose its Aaa rating, it would likely be at a competitive disadvantage to other Aaa-rated guarantors operating in the same markets. While this factor would not directly impact the company’s current insured portfolio or claims-paying ability, it could affect the firm’s business prospects going forward. As a result, if a primary guarantor were to be downgraded, it may well be that the additional negative impact on the firm’s future franchise value from the downgrade itself could cause Moody’s to downgrade the company by an extra rating notch. Having said this, the importance of the rating to a guarantor’s business franchise provides a strong incentive for the company to maintain a strong credit posture, which is one of the reasons we have seen few downgrades in this sector. Therefore, although the Aaa ratings on financial

Gotham Partners Management Co., LLC Page 61 Gotham Partners Management Co., LLC Page 62 guarantors are likely to be quite stable as a group, the guarantors may be more vulnerable to a two-notch downgrade than some other companies. A two-notch downgrade could have catastrophic consequences for the company. It would likely create problems for the renewal of MBIA’s SPV commercial paper. It might also cause a reduction in the value of all of MBIA’s wrapped obligations including all of Triple-A One’s assets. The decline in values of these assets, in turn, could trigger covenant defaults in the SPV’s liquidity facilities, further exacerbating its immediate liquidity crisis. Additionally, Moody’s reports that MBIA’s ISDA documentation contains increasing collateral requirements in the event of a downgrade of the company. The company’s municipal GIC portfolio also has rating downgrade triggers. Perhaps most significantly, a downgrade could shut off a material percentage of the company’s cash flow, for MBIA may be unable to write new premium without a AAA rating. A Barclays Capital research report which is available on MBIA’s website explains:

Spiraling down…down…and down? In the event of a financial guarantor being
downgraded, will a vicious circle lead to rapid rating deterioration and potential bankruptcy? This is a much-debated question in that a financial guarantor who relies on its credit ratings for its business franchise could face a rapid decline in new business in the event of a downgrade, which could precipitate further downgrades. It appears to us that an actual or perceived downgrade of MBIA would have draconian consequences to the company and create substantial drains on the company’s liquidity. The self-reinforcing and circular nature of the company’s exposures makes it, we believe, a poor candidate for a AAA rating. In light of MBIA’s enormous leverage, the company’s credit quality, underwriting, transparency, accounting, and track record must be beyond reproach. The company can simply not afford any significant risk of loss in its nearly $500 billion of net par exposure, for a mere 20 to 35 basis points loss would equate to levels sufficient to cause a rating agency downgrade of the company. In addition, and as importantly, the company must have minimal liquidity risk. Based on our research, we conclude that MBIA fails to meet these standards. 

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