

[Note: the following provides a description of MBIA's strategy and approach to insuring CDOs. For information regarding MBIA's exposures to CDOs and subprime RMBS, please see the Company's Quarterly Operating Supplements (available at <http://investor.mbia.com/phoenix.zhtml?c=88095&p=irol-operating>) and the Investor Inquiries/FAQs section of the Company's website ([http://www.mbia.com/investor/investor\\_inquiries\\_faqs.html](http://www.mbia.com/investor/investor_inquiries_faqs.html)).]

## **MBIA's CDO Strategy**

### **What are CDOs?**

Collateralized Debt Obligations (CDOs) are among the tools that financial institutions are increasingly using to manage credit exposure and capital (regulatory or economic). CDOs involve the transfer of credit risk with respect to large, well-diversified pools of corporate, asset-backed securities and sovereign bonds and loans to special purpose vehicles, whose securities are broadly distributed. CDOs, like traditional securitizations, use the capital markets as a means of transferring credit and other risks to investors. Like securitizations of mortgages, auto loans, credit cards, trade receivables and other financial assets, the credit risk associated with a CDO is tranching into several "risk" layers, with investors buying into each of the different levels based on differing appetites for credit risk, liquidity risk and duration risk and, as a consequence, accept different corresponding levels of return. CDOs can include both cash assets (bonds or loans) and/or synthetic assets (credit default swaps) and can be either actively managed or static (the assets remain the same over time).

### **What is MBIA's underwriting approach to CDOs?**

MBIA's approach to underwriting CDOs comprises four primary components: First: MBIA evaluates the proposed collateral pool. For each transaction MBIA reviews the proposed portfolio by performing several analyses of the collateral pool to ascertain its overall credit quality and also to identify collateral with characteristics outside of norms for its asset class. All proposed corporate portfolios are run through market credit screening tools such as the KMV or Kamakura models to assess the overall credit quality of the pool and to determine if any collateral has a potentially higher default propensity than its current ratings might suggest. The KMV and Kamakura models are important tools used both in the initial review process, as well as on an ongoing basis over the deal's life for portfolio monitoring purposes. They estimate credit risk and correlation using equity market data. MBIA also uses one or more credit spread services to assess the overall spread characteristics of the pool to detect any proposed assets with spread wider than its peers by rating band. MBIA also compares the proposed collateral pool to MBIA's total CDO exposures to ascertain collateral overlap among transactions and the incremental exposure provided by any single piece of collateral given the subject transaction. Finally, MBIA's Corporate Analytics Group provides a fundamental assessment of certain names in the pool, e.g. names with higher KMV or Kamakura scores (a higher score suggests greater credit risk) or collateral obligors whose spreads are wide relative to peers. Based on its analysis, MBIA may require certain loans or bonds to be removed from the portfolio and/or that concentrations be reduced relative to industry or specific collateral.

For Multi-Sector CDOs of ABS (including RMBS collateral as well as other assets), MBIA utilizes the extensive structured finance expertise of its New Business, Underwriting and Insured Portfolio Management (surveillance) groups to undertake a rigorous analysis of each piece of the underlying collateral. The proposed portfolio is reviewed by experts in each asset class, with respect to quality of seller/servicer, composition of the underlying receivables backing each bond, historical performance of the asset class and underwriting trends in each asset class. All transactions have a matrix of concentration limits that restrict exposure to single issuers,

product types, geographic regions or other risk classifications in order to provide a diversified pool of exposure. MBIA is a significant participant in the global structured finance market, and access to expertise in various asset classes gives the Company an important advantage when underwriting CDOs of ABS.

Second: For managed CDOs, MBIA evaluates the quality of the collateral manager through extensive on-site due diligence. MBIA considers the quality of the collateral manager as essential to the successful performance of a managed CDO. MBIA has a dedicated Corporate Analytics Group that evaluates collateral managers, assigns internal ratings to the collateral managers based on its assessment of the managers' ability to select and manage the asset class and then monitors each manager's performance. This unit works closely with MBIA's surveillance group to constantly monitor and proactively manage transactions once they are closed. The MBIA insured CDO are structured to take into account the skills and capabilities of the approved CDO collateral manager.

Third: MBIA undertakes extensive cash flow and quantitative modeling for each CDO transaction using internal models and the Moody's and S&P models to confirm the rating analysis and proposed attachment points. MBIA's proprietary CDO model generates proposed collateral default and recovery rates which feed a full cash flow model. For funded transactions, MBIA runs all of its own stress case cash flow analyses utilizing a variety of timing scenarios for default rates and recovery timing, as well as various interest rate scenarios. All stress case scenarios must pass the no-loss standard (i.e., no losses are projected under reasonable worst case assumptions) in order to meet MBIA's credit approval requirements. MBIA typically requires Multi-Sector ABS and synthetic corporate transactions to have credit support levels well in excess of the Triple-A rating levels required by the rating agencies.

Fourth: MBIA, along with external legal counsel, evaluates the legal structure and documents to ensure they meet all of MBIA's standards. MBIA retains the right to remove and replace the collateral manager should certain events occur, including erosion in the value of securities providing over-collateralization for the most senior class of the transaction and certain events relating to the collateral manager's performance. Performance triggers in the CDO that protect the senior risk layer which MBIA is guaranteeing are critical to MBIA's transactions.

#### **What is the business strategy behind MBIA's CDOs?**

MBIA's overall business strategy is to participate in the most senior layer of the CDO capital structure while creating a balanced book of business across multiple underlying asset classes including Investment Grade Corporates, High Yield Loans, ABS/RMBS, CMBS and Emerging Markets.

Post 1999, MBIA has focused on insuring (i) funded CDOs having minimum Double-A shadow ratings by both Moody's and S&P (although almost all funded CDOs done by MBIA in the last 5 years have been at a minimum Triple-A level) and (ii) synthetic CDOs at the super Triple-A level by virtue of a rated Triple-A tranche subordinate to MBIA or by virtue of an attachment point that is a multiple of the Triple-A requirement imposed by the rating agencies.

MBIA is an active participant in the Multi-Sector ABS CDO market. MBIA, along with most market participants, segments this sector into two categories of deals: "High Grade" and "Mezzanine", reflecting the credit ratings on the underlying structured finance bonds supporting the CDO.

“High Grade” refers to transactions in which the underlying collateral credit ratings on a stand alone basis are Single-A or higher, and “Mezzanine” refers to transactions in which the underlying collateral credit ratings on a stand alone basis are below Single-A (generally Triple-B). Starting in 2004 MBIA elected to insure Mezzanine ABS CDOs only on a more selective basis due to concerns regarding structural provisions as well as concerns over the underlying collateral and weak pricing. MBIA has been a much more active player in the High Grade space where deals are characterized by much stronger collateral, better structural provisions, and more attractive risk adjusted pricing. MBIA typically guarantees Multi-Sector CDOs transacted at the “Super Triple-A” credit support level – which most often means 1.5x to 2.5x the credit support level of the rated triple-A tranches that are subordinate to the tranche that MBIA guarantees.

### **How are CDOs structured?**

A CDO consists of various layers of risk with the more junior layers having more leveraged or concentrated risks and the more senior layers having less risk. This “tranching” permits different investors with different risk appetites to participate in those risk layers with which they are more comfortable. Investors seeking yield (equity players mainly) may leverage their credit risk and returns by investing in the “first-loss” layers. Other investors seeking a somewhat lower risk/return profile may invest in the middle layers of risk (these layers are also sometimes referred to as “Mezzanine” or “Junior”), which are usually rated at the low investment grade or high speculative grade levels. The equity and Mezzanine/Junior layers are known as “risk layers.”

Risk-averse investors can participate in the lower risk/lower return segments of the capital structure, including the “super-senior” tranche or what is generally called the “capacity” layer. This layer is often referred to as “super” Triple-A because a layer below it is rated Triple-A by the rating agencies. This layer is most appealing to the monoline insurers because it is consistent with their overall business model displaying low levels of rating volatility and extremely low default propensity and, in the unlikely event of defaults, very low loss severity. In addition, because monoline insurers seek to mitigate the risk of correlated defaults, the most senior, highly rated capacity layers, with all their underlying protection, safeguard the monoline insurers from the risk of correlated defaults.

All subprime RMBS bonds, as well as CDOs containing this collateral, are not created equal. Losses will not be distributed evenly across all underlying collateral and CDOs. Losses will vary significantly based on how the mortgage originator underwrites the loans, how the servicer administers the loans, the characteristics of the loan portfolio as selected by the CDO manager, and the CDO transaction’s structure.

### **How are MBIA's Corporate Synthetic CDOs structured?**

MBIA has structured its synthetic corporate CDO transactions to be able to withstand a very large number of investment grade corporate defaults, typically about 10 times average historical default rates and more than 5 times historical peak maximum default rates before losing a single dollar. MBIA views the possibility of defaults approaching this level as an extremely unlikely and catastrophic event, approaching a global meltdown of corporate credit. The extreme level of protection also serves to protect against rating volatility in MBIA's back book of exposures. In this product area, protecting against adverse portfolio construction is a key factor in MBIA's credit underwriting process. (Please refer to “What is MBIA's underwriting approach to CDOs?” above.)

**What are the mark-to-market considerations for CDOs?**

As required by SFAS 133, MBIA marks to market all its credit derivatives through the income statement. The periodic mark-to-market introduces a degree of income statement volatility as credit spreads move, but it is not a good indicator of ultimate losses for MBIA. This is because MBIA does not trade the risk, but holds it to maturity. Because of the very low default probability, the cumulative marks to market on each individual synthetic CDO guarantee will, in all likelihood, ultimately go to zero provided there are no actual losses. MBIA will only have to pay a loss in the highly unlikely event that a CDO experiences an extraordinary number of defaults, which completely eliminates all subordinate tranches, including in most cases those rated Triple-A at inception.

**What is MBIA's outlook regarding the CDOs in its insured portfolio?**

MBIA does not expect its insured CDO portfolio to pose a risk to its ratings nor does it expect that it will represent a material risk to the Company's financial condition. MBIA believes that its disciplined underwriting approach, which requires high quality collateral managers and servicers and a review of the underlying collateral within each CDO, have resulted in subprime exposure consistent with our zero loss standard.

**Multi-Sector CDO Portfolio Overview:**

Multi-Sector CDOs are transactions that include a variety of structured finance asset classes in the collateral pools. The collateral in the Company's Multi-Sector CDOs includes asset-backed securities (e.g. securitizations of auto receivables, credit cards, etc.), commercial mortgage-backed securities, CDOs and various types of residential mortgage-backed securities including prime and subprime RMBS. This range of asset classes is found throughout the entire Multi-Sector CDO portfolio, which is comprised of transactions that rely on underlying collateral rated Single-A or above (High Grade CDOs) and in transactions that rely on collateral primarily rated Triple-B (Mezzanine CDOs). This highly diversified portfolio of asset classes results in a very low correlation of risk. Therefore, for instance, a troubled RMBS security (or pool of securities) in a CDO would not necessarily cause losses for MBIA, given the over-collateralization in the CDO, the cash allocation mechanics in the structures, and MBIA's senior position in the capital structure.

MBIA guarantees CDOs in the primary and secondary markets.

MBIA, along with most market participants, segments Multi-Sector CDOs into "High Grade" and "Mezzanine," categories, reflecting the credit ratings on the underlying asset-backed securities backing the CDO. High Grade collateral pools consist mostly of Double-A, and Triple-A-rated collateral tranches (with smaller buckets for Single-A collateral) of structured finance securities. Mezzanine collateral pools consist primarily of Triple-B-rated tranches of structured finance securities with small buckets (typically <10%) of Double-B-rated tranches. While the collateral in these Mezzanine transactions is generally rated Triple-B, MBIA attaches at a much higher ratings level in the CDO structure, predominantly Triple-A or "Super Triple-A."

The majority of MBIA's multi-sector CDOs with U.S. subprime RMBS have credit enhancement protecting MBIA's insured obligations that is equal to 1.5 – 2.0x (and occasionally as much as 3.0x) the Triple-A requirement established by the rating agencies. This level of credit support provides a significant level of cushion above the extremely unlikely losses that would need to occur to reach into the Triple-A level.

MBIA's underwriting process includes a review of each piece of collateral in the portfolio to ensure soundness of credit, appropriateness of rating and consistency with the manager's skills

and strategy. As described earlier, MBIA's CDO underwriting process for managed transactions includes a detailed review of the collateral manager's strategy, personnel, financial strength and operational capabilities through extensive on-site due diligence meetings. MBIA will not insure a transaction, regardless of attachment point, when the manager does not pass this review.