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SUPREME COURT OF THE STATE OF NEW YORK  
COUNTY OF NEW YORK

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| ABN AMRO BANK N.V., <i>et al.</i> ,             | : |
|   | : |
| Petitioners,                                    | : |
| v.  | : |
|   | : |
| ERIC DINALLO, in his capacity as Superintendent | : |
| of the New York State Insurance Department, the | : |
| NEW YORK STATE INSURANCE                        | : |
| DEPARTMENT, MBIA INC., MBIA INSURANCE           | : |
| CORPORATION, and MBIA INSURANCE CORP.           | : |
| OF ILLINOIS,                                    | : |
|   | : |
| Respondents.                                    | : |
| -----   | X |

Index No. 601846/09  
  
Hon. Barbara R. Kapnick  
  
**SUPPLEMENTAL AFFIDAVIT  
OF JACK R. BUCHMILLER**

STATE OF NEW YORK     )  
                                  ) ss:  
COUNTY OF NEW YORK )

JACK R. BUCHMILLER, being duly sworn, deposes and says:

1. I submit this affidavit in opposition to the Verified Petition and in support of the sur-reply of the State Respondents in this proceeding. This affidavit is based on my personal knowledge, as well as my review of certain documents filed or produced in this proceeding, and supplements my prior affidavit submitted in this matter, sworn to November 24, 2009.

**I. Background**

2. I am currently a Capital Markets Program Manager with the Capital Markets Bureau of the National Association of Insurance Commissioners ("NAIC"), where I focus on analyzing insurers' investment and derivative portfolios.<sup>1</sup> From 2000 to February 2011, I was a

<sup>1</sup> Founded in 1871, the NAIC is an organization comprised of the chief insurance regulatory officials in all 50 states, the District of Columbia and five U.S. territories, which works to establish standards and best practices for regulatory oversight activities among its member insurance departments. See Ex. 1, NAIC's history and background page (available at [http://www.naic.org/index\\_about.htm](http://www.naic.org/index_about.htm)). The NAIC's capital markets group is responsible for, among other things, developing consistent standards regarding structured finance modeling and insurance company

Supervising Risk Management Specialist in the Capital Markets Bureau of the New York State Insurance Department (the "Department"). I have over 30 years of experience in several financial industry sectors. After receiving my undergraduate degree in economics from Macalester College in 1975 and a M.B.A. from Washington University in 1977, I spent the next 22 years working at various commercial banks, where I developed expertise in commercial lending, derivatives and capital markets. I held NASD series 7 and 63 securities licenses for several years. My experience has included, among other things, creating, analyzing, and comparing financial models and projections on a regular basis.

3. The Department recruited me in 2000 to help launch its newly-created Capital Markets Bureau, a division charged with overseeing the capital markets and risk management activities of New York-domiciled insurers and public pension funds. The Capital Markets Bureau maintains a high level of expertise in analyzing the Department's regulated entities across all classes of assets and liabilities. The Capital Markets Bureau routinely examines these insurers by meeting with their employees and closely scrutinizing their overall financial condition. This process involves, among other things, analyzing an insurance company's investment and derivative portfolios; market, credit, liquidity and other economic exposures; and financial and investment management strategies, policies, procedures, and practices.

4. During my tenure at the Department, my Capital Markets Bureau colleagues and I looked at various aspects of the financial guaranty insurance industry to develop and maintain an understanding of the industry and how insurers like MBIA Insurance Corp. ("MBIA Corp.") monitor the performance of the structured finance securities they insure, and how they reserve for projected claims based on complex modeling forecasts. Additionally, we attended numerous

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examinations. See Ex. 2, my updated biography (available at [http://www.bloomberglink.com/gatherings\\_participants\\_bio.php?gathering=87&Id=1444](http://www.bloomberglink.com/gatherings_participants_bio.php?gathering=87&Id=1444)).

conferences and seminars, and engaged in discussions with experts in structured finance modeling techniques.

5. In my role at the Capital Markets Bureau, I was involved in the Department's development of an enhanced approach to insurance company oversight and regulation which has been formally adopted by the NAIC, known as the "risk focused" approach.<sup>2</sup> A "risk focused" examination of a company is concerned with that company's ability to "identify, measure, aggregate, and manage risk exposures within predetermined guidelines," and uses evaluation criteria that assess and quantify aggregate risk across the company's "key activities."<sup>3</sup> I have spoken several times on the use of "risk focused" examination principles in the current economic crisis, including at events alongside speakers from the U.S. Treasury's Office of Thrift Supervision, Royal Bank of Scotland, Deloitte and Zurich Financial Services.<sup>4</sup> As discussed below, these principles were a key component of the financial review I conducted in connection with MBIA Corp.'s application for approval and/or non-objection of the simultaneous transactions constituting what it referred to, and became known, as the "Transformation."

6. As a member of the Capital Markets Bureau, I personally participated in several financial examinations of financial guarantee insurers ("FGIs"), including examinations of MBIA Inc.'s subsidiary MBIA Corp. In the context of these MBIA Corp. examinations, I interacted with the company's Insured Portfolio Management group ("IPM"), and became familiar with the

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<sup>2</sup> See Ex. 3, "Enterprise Risk Management for Insurance Companies," my PowerPoint presentation to the Professional Risk Managers' International Association, dated February 10, 2011 (available at [http://www.prmia.org/Chapter\\_Pages/Data/Files/4511\\_4273\\_Presentation\\_20110210\\_JackRBuchmiller\\_presentation.ppt](http://www.prmia.org/Chapter_Pages/Data/Files/4511_4273_Presentation_20110210_JackRBuchmiller_presentation.ppt)). The Capital Markets Bureau of the Department began formally utilizing these "risk focused examination" principles in 2008. See Ex. 4, excerpt from "150th Annual Report of the Superintendent of Insurance to the New York State Legislature for the Year Ending December 31st, 2008" (available at <http://www.dfs.ny.gov/reportpub/insurance/annrpt08.pdf>), at 174.

<sup>3</sup> Ex. 4, at 175.

<sup>4</sup> See Ex. 3; Ex. 5, "Bloomberg Insurance Portfolio Strategies," March 2, 2011 (available at [http://www.bloomberglink.com/gatherings\\_participants.php?gathering=87](http://www.bloomberglink.com/gatherings_participants.php?gathering=87)); and Ex. 6, "Best Practices in Liquidity Risk Management," April 28, 2009 (available at [http://www.prmia.org/events/view\\_events.php?eventID=3341](http://www.prmia.org/events/view_events.php?eventID=3341)).

composition of MBIA Corp.'s insurance portfolio and IPM's role in modeling and managing the risks within that portfolio.

## **II. MBIA's Transformation Application and My Review Plan**

7. As the economic crisis unfolded in mid-2007, the Department increased its monitoring of FGIs and structured finance products. As part of this increased monitoring, I attended several meetings with various FGIs, including MBIA Corp., to discuss market conditions and particular issues facing the industry, and to learn how they monitored and modeled their structured finance exposures. Although I learned at these meetings that MBIA Corp.'s structured finance book had begun exhibiting signs of stress (as were those of other FGIs), I was not informed of any proposed restructuring by MBIA Corp. until after it submitted its formal Transformation application to the Department on December 5, 2008.

8. Soon after MBIA Corp. submitted its Transformation application, I was informed by the chief of the Capital Markets Bureau, Matti Peltonen, that I had been assigned to assist in the Department's review of the application. I was instructed that I should analyze MBIA Corp.'s financial statements and loss projections and notify senior Department officials of any findings that would call into question the post-Transformation solvency of MBIA Corp. Neither Mr. Peltonen nor Superintendent Dinallo, nor anyone else at the Department, issued me any instructions, orders or recommendations regarding either the timing or desired result of my review. Nonetheless, and as discussed in more detail below, I frequently communicated with senior Department officials to update them on the progress of my review, and understood that, due to the exigent circumstances of the financial crisis we were then facing, my review needed to be thorough but also expeditious.

9. Mr. Peltonen, as well as Superintendent Dinallo and other senior Department officials, made clear to me that Mr. Dinallo's chief concern was that, following the Transformation, MBIA Corp. would be solvent under the Insurance Law, *i.e.*, would have adequate claims-paying resources to pay all of its claims as they came due. Beyond this general charge, however, I was entrusted with the responsibility of determining the scope and methodology of my review.

10. Following my initial review of the materials MBIA submitted in connection with its Transformation application (which included statements of MBIA Corp.'s projected financial condition based on its own loss modeling) and my discussions with Department colleagues and MBIA executives, and given my prior knowledge and experience, I concluded that it would be neither necessary nor preferable for me to create my own loss models in order to evaluate MBIA Corp.'s post-Transformation financial condition.<sup>5</sup> I determined instead to undertake a review and analysis of MBIA Corp.'s loss modeling methodologies in order to validate their analytical soundness, and confirm that they were consistent with best practices.

11. Furthermore, I determined that my review should be "risk focused," *i.e.*, focused chiefly on the "key" sectors in which MBIA Corp. had already experienced losses and/or could likely or possibly be expected to experience losses. I also determined that the review should be focused on a subset of MBIA Corp.'s structured finance exposures within these key sectors, as I would be able to extrapolate the results of my review to the remainder of the policies in those sectors. In short, and as I stated in my 59-page memorandum summarizing my review (the "File Memorandum"), I reviewed MBIA Corp.'s loss modeling methodologies "to form opinions on their veracity (ability to replicate reality), internal and external consistency, whether the

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<sup>5</sup> Indeed, even in the context of a full-scope examination, it is not the role of the Department to recreate, replicate, or replace the regulated insurer's models with its own.

assumptions used were reasonable at the time made and as fact-based as possible, and whether the results were robustly stress-tested for worse-than expected future results or development."<sup>6</sup>

12. Petitioners contend that, before my review of the Transformation application, I "had no prior experience in loss reserve modeling." (*See* Petitioners' Reply and Memorandum of Law in Further Support of Their Verified Petition, dated March 11, 2011 ("Reply Mem."), at 45.) This is inaccurate. At the time of my review of the Transformation, I had substantial prior experience in creating and reviewing a variety of financial models and projections, including during my 22 years of experience in commercial banking, derivatives, and securities prior to joining the Department. Moreover, I had experience with loss reserve modeling at the Department as a result of my participation in several financial examinations of FGIs (including MBIA Corp.) and other projects for the Department before my review of the Transformation.

13. Petitioners also claim that, as part of my review, I should have "reconstructed" MBIA Corp.'s loss models instead of focusing, as I did, on confirming and validating the analytical soundness of its loss modeling methodologies. (Reply Mem. at 45.) Though I had the ability to reconstruct MBIA Corp.'s models, building models simply is not what the Department does; we do not write or rewrite the insurers' financial statements, we analyze them, and if necessary, restate them. Moreover, where the "accuracy" of certain information provided by the insurer is essentially unknowable in the present, as it was in this case regarding MBIA Corp.'s predictions of its future losses, the Department does not, and cannot, analyze the insurer's predictions for their eventual "accuracy," but instead analyzes the methodologies used to arrive at those predictions for their soundness, consistency, and alignment with best practices. My review of MBIA Corp.'s statements of financial condition followed this approach. As my File

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<sup>6</sup> *See* Ex. 7, "Examination of MBIA Insurance Corporation (of NY) and related 'Transformation' due diligence," dated February 16, 2009 (NYSID0002798-2852), at 2798-99.

Memorandum documented, I analyzed in detail MBIA Corp.'s construction and operation of its proprietary models in connection with my Transformation review. Further, even before MBIA Corp.'s application, I was already familiar with its third-party models and data sources, and the proprietary models of certain other FGIs and financial institutions.

14. To examine MBIA Corp.'s loss modeling methodologies for their analytical soundness, I reviewed all aspects of its models (including MBIA Corp.'s assumptions concerning, among other things, "roll" rates, burnout periods, default and severity vectors, and discount rates) and how MBIA Corp. developed its assumptions (both conceptually and mechanically). I held numerous lengthy and detailed meetings with MBIA Corp.'s IPM team to discuss their loss modeling. I also reviewed MBIA Corp.'s models on my own and analyzed IPM's assumptions for their reasonableness. I frequently requested further information from IPM relating to MBIA Corp.'s cash flow modeling,<sup>7</sup> stress testing,<sup>8</sup> and "roll-rates,"<sup>9</sup> which are used to project the percentage of loans that will incur losses. IPM promptly provided me with all of the information I requested, and their ability to provide this information promptly was itself something that I was evaluating as part of my review.

15. I believed, and continue to believe, that the Department had and deployed more than sufficient internal resources to perform a thorough review of the financial issues surrounding the Transformation application on its own. Nonetheless, in connection with my financial review, I spoke generally with various financial consultants, including BlackRock Solutions, about how they modeled structured finance transactions, in order to ensure that MBIA Corp.'s models were in conformity with FGI and other financial industry best practices. Based

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<sup>7</sup> See Ex. 8, MBIA\_NYS0004296.

<sup>8</sup> See Ex. 9, MBIA\_NYS0004370-71, at 4370.

<sup>9</sup> See Ex. 10, MBIA\_NYS0006977-80, at 6978.

on these discussions and my own extensive review of MBIA Corp.'s loss modeling (discussed in detail below), I concluded that its loss modeling conformed to best practices.

### **III. Review of Bridge Findings**

16. One of the initial steps I undertook in reviewing the Transformation application was to review the solvency opinion of Bridge Associates LLC ("Bridge"), an advisory firm that has worked on significant restructurings with Fortune 500 clients. Bridge concluded that, based on MBIA Corp.'s financial statements as of September 30, 2008, MBIA Corp. would remain solvent and able to satisfy all policyholder claims post-Transformation, even given certain stress scenarios. Bridge also concluded that the Transformation complied with relevant solvency provisions of the New York Insurance Law, and that MBIA Corp.'s loss reserving methodologies were reasonable and in conformity with best practices among FGIs as well as other financial institutions.<sup>10</sup>

17. Although I conducted my own review of MBIA Corp.'s financial condition, in my memorandum summarizing my financial review of the Transformation, I compared my findings with IPM's updated stress tests as of December 31, 2008 and against Bridge's stress tests based on MBIA Corp.'s September 30, 2008 financial statements. I noted that IPM's stress tests, which included a stress scenario and, at my direction, an "extreme stress" scenario, projected much more severe losses than Bridge's opinion did, but that, as discussed in further detail below, even under IPM's more severe stress scenarios, MBIA Corp. would continue to maintain a positive surplus to policyholders.<sup>11</sup>

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<sup>10</sup> See Ex. 11, R00063-133, at 85-86, 133.

<sup>11</sup> See Ex. 7, at 2823.

#### **IV. Review of Corporate Governance**

18. Beginning in December 2008, I conducted extensive interviews with MBIA's management team in connection with my review of the Transformation. As noted above, in 2008 the Capital Markets Bureau adopted the "risk focused" examination approach. A component of this approach is to evaluate the operational risks within an insurer based on a review of its "enterprise risk management" practices.<sup>12</sup>

19. From December 15, 2008 to January 23, 2009, I interviewed over a dozen MBIA employees, including most of the company's senior executives, its general counsel and structured finance experts. These meetings, supplemented with other conversations and observations, provided me with insight into the company's risk management philosophy and procedures, and from these meetings I concluded that MBIA's management team had correctly identified the most critical issues facing the company and had developed a sound strategy to meet MBIA Corp.'s financial obligations going forward and help strengthen the overall capital position of the MBIA holding company system.

20. During one of our meetings regarding MBIA Corp.'s loss modeling methodologies, Mr. Pastore identified the various ways in which MBIA Corp. could further strengthen its capital position to bolster its projected \$1.5 billion liquidity "cushion" (in its stress case) post-Transformation, including through further asset sales and higher-yielding investments.<sup>13</sup>

21. More generally, MBIA executives expressed a healthy concern about reputational risks to MBIA resulting from any failure to pay claims of MBIA Corp.'s structured finance policyholders. Mr. Brown stated that, even with the public finance and structured finance

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<sup>12</sup> See Ex. 3, at 7.

<sup>13</sup> See Ex. 12, excerpts from MBIA Interviews, NYSID0001798-1801.

businesses split, a default by MBIA Corp. on a structured finance policy obligation could lead to, among other things, a ratings downgrade for all MBIA Inc. subsidiaries, including National Public Finance Guarantee Corp. (f/k/a MBIA Insurance Corp. of Illinois) ("National").<sup>14</sup> Mr. Chaplin stated that MBIA had a strong incentive to ensure that MBIA Corp. would "pay all its claims" following the Transformation, and therefore maintain MBIA's "good brand."<sup>15</sup>

## **V. My Review of MBIA's RMBS and ABS CDO Portfolios**

### **A. Developing the Approach for My Review**

22. I applied the "risk focused" or "critical path" approach to reviewing MBIA Corp.'s loss modeling methodologies, emphasizing those sectors of MBIA Corp.'s insurance business that exhibited the greatest uncertainty and risk of loss. In that regard, I determined to conduct my review starting with the most underperforming structured finance sectors and ending with the least underperforming of these sectors, *i.e.*, beginning with residential mortgage-backed securities ("RMBS"), then collateralized debt obligations ("CDOs") comprised of asset-backed securities ("ABS") risks, primarily RMBS ("ABS CDOs"), then CDOs comprised of commercial mortgage-backed securities ("CMBS CDOs"), and then, if necessary, other remaining sectors.

23. Simultaneous with my Transformation-related financial review, I was participating in MBIA Corp.'s statutory financial examination as of December 31, 2008 (the "Examination"). The Examination was conducted by several Department professionals, including Glenda Gallardo (the examiner in charge), James Murphy (who led the previous

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<sup>14</sup> See Ex. 13, excerpts from MBIA Interviews, NYSID0001940 ("[i]f you're going to reestablish the model you can't have a lot of very, very discouraged investors . . . . If you're the survivor and you're the company that made sure that all of those payments were made you can reestablish your reputation. [But i]t doesn't happen in a year....").

<sup>15</sup> See Ex. 14, excerpts from MBIA Interviews, NYSID000960-62.

examination of MBIA Corp. as of December 31, 2003),<sup>16</sup> and Karen Gard. Indeed, Ms. Gallardo, Mr. Murphy, and Ms. Gard worked with me throughout my Transformation review, and "attend[ed] virtually all of the meetings" I had with MBIA in connection with that review.<sup>17</sup>

24. On December 19, 2008, in connection with my Transformation review, I traveled to MBIA's Armonk, New York offices and participated in a conference call with Department officials; the Department's outside legal counsel, Fried Frank Harris Shriver & Jacobson LLP ("Fried Frank"); MBIA executives; and MBIA's outside legal counsel, Dewey & LeBoeuf LLP ("Dewey").<sup>18</sup> On December 22, 2008, MBIA Corp.'s IPM group e-mailed me to follow up on items from the December 19, 2008 call that required additional discussion.<sup>19</sup>

25. On December 24, 2008, Mr. McKiernan and I met to discuss my planned "risk focused" review of MBIA Corp.'s loss modeling for its structured finance book. Mr. McKiernan also provided me with several relevant presentations summarizing the main sectors of MBIA Corp.'s structured finance portfolio and its modeling methodologies.

26. Petitioners allege that Mr. McKiernan's December 24, 2008 presentation was misleading as to MBIA Corp.'s modeling of its CMBS portfolio, particularly with respect to "overrides" of standard loss-curve models that reduced MBIA Corp.'s loss projections in the CMBS sector to zero. (Reply Mem. at 67-71.) Petitioners argue that, while MBIA Corp. disclosed to me the existence of such overrides, it failed to disclose the overrides' financial impact. (*Id.* at 69-70.) However, the impact of the overrides was not relevant to me, because – as I discuss below – I believed that the overrides were proper, as I understood that the use of

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<sup>16</sup> See "Association Report on the Examination of MBIA Insurance Corporation as of December 31, 2003" (available at [http://www.ins.state.ny.us/exam\\_rpt/12041f03.pdf](http://www.ins.state.ny.us/exam_rpt/12041f03.pdf)).

<sup>17</sup> See Ex. 15, NYSID0002853-54, at 2854.

<sup>18</sup> See Ex. 16, MBIA\_NYS0004031-37.

<sup>19</sup> See Ex. 17, MBIA\_NYS0004147-48.

loan-level analytics (including overrides) is a common industry practice for CMBS transactions that contain unique cash flow and ownership characteristics, especially with respect to large commercial loans.

27. On December 31, 2008, Mr. McKiernan e-mailed me to discuss how MBIA Corp. would provide me with, among other things, additional information regarding its RMBS modeling methodology.<sup>20</sup> Mr. McKiernan and his IPM team provided me with all information I requested, gave me full and unrestricted access to their structured finance models, and answered any questions I had concerning MBIA Corp.'s loss modeling. MBIA also provided me with office space at its Armonk, New York offices for a several-week period during January and February 2009 to conduct my hands-on review of MBIA Corp.'s loss modeling.

28. On January 9, 2009, I sent an e-mail to Mr. McKiernan laying out the Department's expectations for a "detailed review" of MBIA Corp.'s loss reserves.<sup>21</sup> My e-mail referred to a "top-down" approach, which entailed an aggregate review of MBIA Corp.'s loss reserves and cash flow projections, including discount rate assumptions and stress testing.

29. My proposed review also included a "bottom-up" approach, which contemplated an intensive review of a sample transaction from each of the three structured finance sectors that I had identified as key to my "risk focused" review: RMBS, ABS CDOs, and CMBS CDOs. I chose to focus on RMBS and ABS CDOs because those were the sectors in which MBIA Corp. was already experiencing losses. I chose to focus on CMBS CDOs because, although MBIA Corp. was not yet experiencing losses in that sector, those exposures were of a similar construction as the securities in the sectors in which MBIA Corp. had experienced losses, and the underlying assets were of the same general asset class (real estate) as those sectors as well. I

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<sup>20</sup> See Ex. 18, MBIA\_NYS0004152-53.

<sup>21</sup> See Ex. 19, MBIA\_NYS0004162-64, at 4163.

personally chose the sample RMBS and ABS CDO transactions based on their respective signs of and changes in distress. MBIA Corp. chose the sample CMBS CDO transaction, which I then verified to be a representative CMBS CDO transaction in terms of expected performance. My plan was to follow each of these transactions step-by-step from the raw third-party performance data (from data provider LoanPerformance) through to MBIA Corp.'s loss projections on the transactions, and to use these sample transactions to review and analyze the soundness of MBIA Corp.'s transaction-level modeling assumptions, and thereby verify the loss reserves and financial statements.

30. I laid out this plan in my January 9, 2009 e-mail to Mr. McKiernan, explaining that my goal was to analyze MBIA Corp.'s loss models in a "very hands-on manner," just as an IPM employee would.<sup>22</sup> Petitioners have attempted to distort this e-mail, and its reference to "hand-holding," suggesting that it shows that I lacked significant prior experience with respect to structured finance modeling. (Reply Mem. at 146.) Again, that is inaccurate. My reference to "hand-holding" was simply a request for logistical training from IPM that would enable me to reproduce MBIA Corp.'s results using its software with the same proficiency as an IPM employee, and thereby test the integrity of MBIA Corp.'s models and procedures. Thus, the email demonstrates only that I did not have significant prior experience working with *MBIA Corp.'s modeling software*. By reproducing MBIA Corp.'s process step-by-step I validated that its models and procedures were robust, reasonable, and consistently applied, and that they were in fact how MBIA Corp. produced the financial statements and projections submitted in support of its Transformation application.

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<sup>22</sup> See Ex. 19, at 4163.

31. Using a representative sample of transactions, my review closely scrutinized the RMBS, ABS CDO, and CMBS CDO sectors. I conducted a high-level review of all of MBIA Corp.'s other sectors, because the performance of those sectors – both generally as well as at MBIA Corp. specifically – was such that they were not areas of significant concern. Nevertheless, for those sectors where I did not perform a "deep dive" analysis of individual transactions, I verified MBIA Corp.'s loss modeling methodologies to confirm that they were of comparable rigor and soundness as those I had reviewed in detail.

B. Bottom-Up: Focusing on RMBS and ABS CDOs

32. On January 13, 2009, I met with Mr. McKiernan and his IPM colleagues to discuss MBIA Corp.'s loss reserve methodology in general and determine a course for the implementation of my bottom-up/top-down review.<sup>23</sup> We then discussed two sample transactions – one each for the RMBS and ABS CDO sectors – that I would go on to study in greater depth and that would lay the foundation for my "bottom-up" approach.

33. We began the first session by discussing a "second-lien" RMBS transaction securitized through Countrywide Bank ("Countrywide"), called CWHEQ-2006-E.<sup>24</sup> The IPM team ran the model using what they termed a "conservative stance," including by assuming

[REDACTED]

[REDACTED]<sup>25</sup> Furthermore, IPM's model had conservatively assumed that MBIA Corp. would not make *any* recoveries through the "putback" litigation that it had recently commenced against Countrywide, in which MBIA Corp. alleged

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<sup>23</sup> See Ex. 20, NYSID000987-1062; Ex. 21, NYSID0001063-1116.

<sup>24</sup> See Ex. 20, at 1008.

<sup>25</sup> *Id.* at 1015-17, 1029-32.

that Countrywide had included ineligible loans in its securitizations and, thus, would not be entitled to recover on the insurance policies applicable to those loans.<sup>26</sup>

34. Later that same day, IPM led a similar session relating to one of MBIA Corp.'s CDO transactions, [REDACTED], an ABS CDO that included primarily RMBS first-lien and second-lien collateral. During our meeting that day, IPM also explained what steps MBIA Corp. was taking to reduce its loss exposure on ABS CDOs, such as purchasing credit default swaps and "commuting" transactions by settling with the insured counterparties.

35. On January 16, 2009, I returned to MBIA for another "bottom-up" session on the RMBS portfolio, this time focusing on a model for a transaction called RFC 2007-HSA 2. At this session, I "drove" MBIA Corp.'s models, taking control of the computer and moving through the spreadsheets and data sources while Mr. McKiernan and others explained how they utilized the transaction data and calculated the delinquency and loss rates.

36. I selected the RFC 2007-HSA 2 transaction for a "deep dive" review because its performance had deteriorated rapidly during 2008, it had experienced a high volume of loss activity to date, [REDACTED]

[REDACTED]<sup>27</sup> My objective was to take one of the most severely underperforming RMBS transactions, focus on MBIA Corp.'s loss projections for that transaction under both the "sensitivity" and "stress" cases, and then use that information to validate the loss projections for the remainder of the portfolio.

37. As described in my File Memorandum, I critically analyzed the RFC 2007-HSA 2 transaction by studying the model's "roll-rates" (the rates at which loans become delinquent,

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<sup>26</sup> *Id.* at 1047-48.

<sup>27</sup> *See Ex. 7*, at 2797-98.

more delinquent, or even a total loss) for both current and delinquent loans, as well as the model's cash flow projections.<sup>28</sup>

38. After reviewing RFC 2007-HSA 2 from performance data through loss projections, I found MBIA Corp.'s loss assumptions for the transaction to be reasonable. I then reviewed approximately twenty other transactions (primarily from the Countrywide and RFC series) to verify that the models, procedures, and assumptions used for RFC 2007-HSA 2 were applied consistently across MBIA Corp.'s RMBS portfolio. I then reviewed these assumptions for the entire RMBS sector, and determined that MBIA's overall loss modeling methodology for the RMBS portfolio was reasonable and that a post-Transformation MBIA Corp. could withstand losses from this sector.<sup>29</sup>

C. Top-Down: Understanding the Loss Reserve Methodology for the RMBS/ABS CDO Sectors

39. On January 21, 2009, I exchanged several e-mails with IPM member Sai Uppuluri relating to MBIA Corp.'s loss modeling methodologies.<sup>30</sup> Mr. Uppuluri provided me with further information on how IPM modeled losses on still-current loans. In response to my inquiry concerning whether IPM had monitored the "tracking error" of actual claims versus its projections, Mr. Uppuluri stated that "[t]he actual performance in Q4 has tracked closely to our projections in the loss-reserve analysis." Because MBIA already had set aside additional RMBS loss reserves in the third quarter of 2008, the preliminary fourth quarter results indicated that MBIA Corp. would not need to take additional reserves for its RMBS portfolio in the fourth quarter.

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<sup>28</sup> See Ex. 7, at 2799-2805.

<sup>29</sup> During the January 16, 2009 meeting, I also familiarized myself with IPM's transaction-level performance data software, including LoanPerformance. *Id.* at 2801.

<sup>30</sup> See Ex. 22, MBIA\_NYS0004285-88.

40. On January 23, 2009, I e-mailed Mr. Pastore to request more information concerning "MBIA's capital and long-term cash flow modeling" as part of my "top-down" approach. Mr. Pastore confirmed that he and Mr. Chaplin would address these issues at our meeting scheduled for January 27, 2009.<sup>31</sup>

41. On January 25, 2009, Mr. Chaplin e-mailed me a proposed agenda for that meeting. The planned topics of discussion included fourth quarter financial results, liquidity analysis of MBIA Corp.'s asset management portfolio, "stress" case scenarios for the RMBS and ABS CDO sectors and MBIA Corp.'s post-Transformation balance sheet metrics and cash flow projections.<sup>32</sup>

42. On January 27, 2009, I met with Messrs. Chaplin and Pastore to discuss MBIA Corp.'s fourth quarter 2008 results and updated loss projections.<sup>33</sup> At the meeting, I requested that IPM run an "extreme stress" scenario. My goal with this request was to find out how extreme MBIA Corp.'s assumptions of stress conditions needed to be to cause MBIA Corp.'s post-Transformation surplus to policyholders to fall to zero or below, *regardless* of the probability of that scenario.

43. MBIA Corp.'s "extreme stress" scenario thus assumed what I thought at the time to be highly improbable levels of macroeconomic stress conditions. Specifically, MBIA Corp. ran a scenario on the assumption that the peak loss activity that MBIA Corp. was currently experiencing would continue unabated for an additional 36 months, through 2011. MBIA Corp. informed me that, even under these severe stress conditions (and properly assuming that MBIA

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<sup>31</sup> See Ex. 23, MBIA\_NYS0004296.

<sup>32</sup> See Ex. 24, MBIA\_NYS0004299-4300.

<sup>33</sup> See Ex. 25, MBIA\_NYS0008276-305.

Corp. neither issued dividends nor called its surplus notes<sup>34</sup>), MBIA Corp.'s surplus to policyholders would only fall to approximately \$350 million.<sup>35</sup> I was satisfied that the assumption of a three-year extension of peak loss activity was highly improbable.

44. At our January 27, 2009 meeting, Messrs. Chaplin and Pastore made a presentation to me in which they noted several reasons why they believed MBIA Corp.'s ultimate losses would not exceed its current loss reserves following Transformation. Among these reasons were that 73% of MBIA Corp.'s loss reserves related to Countrywide or RFC transactions, which were subject to "putback" litigation against those companies, and that MBIA Corp. had successfully eliminated over \$3 billion of exposure through commutations during the fourth quarter of 2008.<sup>36</sup>

D. Bottom-Up: Further Focus on ABS CDOs

45. On January 28, 2009, I met with Mr. McKiernan and other IPM members to continue my review of MBIA Corp.'s ABS CDO book. (The "ABS" inside ABS CDOs are not the traditional ABS collateral, such as credit card or automobile receivables, but rather single-A and triple-B tranches of "private label" RMBS, frequently "Alt-A" or sub-prime first-lien mortgages.) As with the RMBS portfolio, MBIA Corp. modeled its ABS CDO transactions conservatively.<sup>37</sup> Mr. McKiernan stated that MBIA Corp. had experienced very few claims with respect to ABS CDO or "CDO-Squared" (CDOs that are backed by other CDOs) policies as of the date of the meeting.<sup>38</sup>

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<sup>34</sup> As I would later indicate in an e-mail memorandum to various Department employees, "we'd not allow either dividends or note redemption along a worse-case path." *See* Ex. 15, at 2854.

<sup>35</sup> *See* Ex. 7, at 2824.

<sup>36</sup> *See* Ex. 25, at 8285, 8292.

<sup>37</sup> *See* Ex. 26, excerpts from MBIA interviews, NYSID0002057-58.

<sup>38</sup> *See* Ex. 26, excerpts from MBIA interviews, NYSID0002046-47.

46. At this meeting, I focused on the [REDACTED] transaction as the "bottom-up" transaction for the ABS CDO book. I selected [REDACTED] [REDACTED]<sup>39</sup> I then compared [REDACTED] results against fourteen similar ABS CDO transactions on MBIA Corp.'s "extreme stress" scenario spreadsheet to verify that these variables were consistently used within the sector.<sup>40</sup> As with the RMBS sector, I was able to compare methodologies and assumptions for the entire ABS CDO portfolio.

47. My study of [REDACTED] included consideration of "base," "stress" and the "extreme stress" cases, with the last scenario assuming up to three years of an elevated level of defaults in the underlying collateral.

48. My analysis of [REDACTED] also incorporated updated performance from the fourth quarter of 2008, during which MBIA Corp. had taken additional loss reserves for the ABS CDO sector.<sup>41</sup>

49. Based on my "bottom up" review and analysis of MBIA Corp.'s loss modeling for the ABS CDO sector, I found its modeling to be reasonable and in agreement with best practices.

## **VI. Reporting to Department Officials on RMBS and ABSCDOs and Roadmap for Reviewing Remaining Sectors**

### **A. Updating the Department on the Status of My Review and Requesting Further Information**

50. After my January 28, 2009 meeting with Mr. McKiernan and the IPM team, I continued my review of the information I had received from MBIA, including the data and models provided to me via a secure internal website. At this point, my meetings with Mr.

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<sup>39</sup> See Ex. 7, at 2797-98.

<sup>40</sup> *Id.* at 2821-22.

<sup>41</sup> See Ex. 27, NYSID0002594-2642, at 2605-07.

McKiernan and IPM and my observation of their various demonstrations had enabled me to verify MBIA Corp.'s models and projections independently. I therefore continued to study the RMBS and ABS CDO portfolio spreadsheets in greater depth based on my experience driving the RFC 2007-HSA 2 and [REDACTED] models.

51. On January 29, 2009, I e-mailed Mr. McKiernan and others on the IPM team requesting further information concerning both RFC 2007-HSA 2 and [REDACTED], as well as access to the Excel spreadsheet files for all transactions within the RMBS and ABS CDO sectors.<sup>42</sup> The next day, MBIA personnel provided me with these materials.<sup>43</sup> I verified samples of their input assumptions (e.g., delinquencies) on several transactions using the Bloomberg Professional Service.

52. On January 30, 2009, I composed a brief memorandum to various Department officials, including Deputy Superintendents Michael Moriarty and Hampton Finer, updating them on the status of my review.<sup>44</sup> In particular, I summarized the progress of my review of the RMBS and ABS CDO portfolios, which constituted the majority of MBIA Corp.'s loss reserves as of the fourth quarter of 2008. I explained how I "followed the 'pig through the python'" by performing a bottom-up analysis of the loss reserves from third-party raw performance data through the analysis of and projections from those figures into MBIA Corp.'s cash flow and balance sheet forecasts. I noted that I had reviewed the various stress scenarios, including requiring them to run an "extreme stress" scenario that extended the peak loss period of the base case by an additional 36 months.

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<sup>42</sup> See Ex. 28, MBIA\_NYS0004370-71.

<sup>43</sup> See Ex. 29, MBIA\_NYS0036708-709.

<sup>44</sup> See Ex. 15.

53. Based on my review of the RMBS and ABS CDO portfolios, my preliminary opinion as of January 30, 2009 was that MBIA Corp. held adequate assets to pay all of its reserved claims as they came due, even assuming substantial adverse developments, and thus would be solvent under the Insurance Law following Transformation.<sup>45</sup> Since the sectors other than RMBS and ABS CDO were experiencing insignificant loss levels at that time, I reasonably believed that my preliminary opinion would not change.

54. I also acknowledged in my January 30, 2009 memorandum that there were reasons for the Department to decide on the Transformation application without "waiting for a full-scale (full scope) examination report," including the need to unfreeze the municipal debt insurance market in order to allow municipalities to secure debt financing through insured bond offerings.<sup>46</sup> Moreover, based on my preliminary findings, I believed that such a full-scale examination would *not* have led to a different conclusion in any event, as I had already performed all of the "critical path" examination and analysis.

55. Indeed, the Examination did not lead to a different conclusion, as the Department ultimately found, in its "Report on Examination of the MBIA Insurance Corporation as of December 31, 2008," dated May 17, 2010, that MBIA Corp. was both solvent and in material compliance with the provisions of the Insurance Law.<sup>47</sup> In fact, to this day, it is my understanding that MBIA Corp. is solvent, as confirmed by (among other things) PwC's most recent audit opinions, and the fact that since the Transformation, to my knowledge, MBIA Corp.

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<sup>45</sup> See Ex. 7, at 2824 (noting that, based on my "top down" review and analysis of MBIA's loss modeling methodologies with respect to the RMBS and ABS CDO sectors, I had found that the company had "reasonably demonstrated" that, following Transformation, MBIA Corp. could "survive a significant and continuing bear market, with a reasonable expectation of viability even under very, if not 'extremely,' distressed conditions").

<sup>46</sup> See Ex. 15, at 2853.

<sup>47</sup> See Ex. 30, "Report on Examination of MBIA Insurance as of December 31, 2008," dated May 17, 2010 (available at [http://www.dfs.ny.gov/insurance/exam\\_rpt/12041f08.pdf](http://www.dfs.ny.gov/insurance/exam_rpt/12041f08.pdf)).

has paid all claims as they have come due, and continues to do so, with substantial assets still in reserve.

56. In my January 30, 2009 memorandum to Messrs. Finer, Moriarty and others, I emphasized that, although MBIA executives had expressed their desire for the Department to make a decision on the Transformation application by January 31, 2009, the Department's duty was "to all policyholders," and my review would not be truncated due to MBIA's "arbitrary" proposed deadline.<sup>48</sup> While I had reviewed the RMBS and ABS CDO sectors as of that date – and these were the two main sources of MBIA Corp.'s loss reserves – Department officials agreed with my conclusion that MBIA's deadline was arbitrary and that I should take the time I deemed necessary to analyze MBIA Corp.'s CMBS and other remaining portfolios to cover "known unknowns."<sup>49</sup> Simply put, no one at the Department gave me a hard deadline for my work, and I had as much time as I needed to complete what I deemed necessary for my review.

57. On February 2, 2009, I received an e-mail from Mr. Chaplin underscoring MBIA's "sense of urgency" in completing the Transformation application process.<sup>50</sup> In his e-mail, Mr. Chaplin referenced the "moribund" state of the municipal bond market and the need to establish a well-capitalized public finance insurer. I responded that day, assuring Mr. Chaplin that "we understand your urgency," but that the Department needed to analyze the "known unknowns" – *i.e.*, the sectors I had yet to review, such as the CMBS portfolio.<sup>51</sup> As far as I was concerned, the Department's review of MBIA Corp.'s post-Transformation financial condition could not be completed until I had performed that analysis.

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<sup>48</sup> See Ex. 15, at 2853.

<sup>49</sup> *Id.* at 2853-54.

<sup>50</sup> See Ex. 31, MBIA\_NYS004535-38, at 4535-36.

<sup>51</sup> *Id.*

58. On February 3, 2009, I questioned Mr. Uppuluri and Mr. McKiernan regarding the RFC 2007-HSA 2 model and the extrapolations from it to the RMBS and ABS CDO sectors. Mr. McKiernan explained why the two sectors contain varying levels of transaction-specific "roll-rate" data and how MBIA Corp. averages performance data within large CDO transactions according to "vintage and type."<sup>52</sup> I agreed that MBIA Corp.'s ABS CDO loss profiling methodology was reasonably tailored given the large number of underlying loans in the transactions.

59. On February 4, 2009, I e-mailed Mr. Chaplin to update him on the status of my review.<sup>53</sup> I noted that I was "satisfied but still filling in a few gaps" regarding the RMBS and ABS CDO sectors. Additionally, I informed Mr. Chaplin that the Department likely would "wait for a review of other suspect sectors" such as CMBS before issuing any formal decision. Mr. Chaplin responded that, while MBIA already had given me a "high level view" of the CMBS sector, IPM was "ready to sit down and go through in more detail on them at any time."<sup>54</sup>

B. Top-Down: CMBS and Remaining Sectors

60. On February 5, 2009, I e-mailed Mr. McKiernan and Mr. Chaplin to schedule a meeting to discuss the remaining sectors.<sup>55</sup> Petitioners have repeatedly cited the "cue up music from Mission Impossible" language in this e-mail as supposed evidence that I felt overmatched in conducting the Transformation review without third-party expert assistance. (*See, e.g.*, Reply Mem. at 146-47.) That is obviously incorrect given the text of that email. It was exactly the opposite. I was referring to the fact that MBIA – much like the team of agents from the "Mission: Impossible" television series – had a series of difficult tasks it needed to complete in

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<sup>52</sup> See Ex. 32, MBIA\_NYS0004889-93, at 4889-90.

<sup>53</sup> See Ex. 33, MBIA\_NYS0004756-59, at 4757-58.

<sup>54</sup> *Id.* at 4756-57.

<sup>55</sup> See Ex. 34, MBIA\_NYS0004998-5001, at 4998.

short order to convince me as to the analytical soundness of its loss modeling methodologies with respect to CMBS CDOs and the other remaining sectors. Indeed, I went on to describe "two ways to prioritize" my review of the remaining structured finance sectors, including the risk-focused approach of going from "worst to best risks."<sup>56</sup>

61. On February 6, 2009, I met with MBIA Corp. personnel to continue my review (and our discussion) of MBIA Corp.'s remaining portfolios. Prior to the meeting, I e-mailed Mr. Chaplin and Mr. McKiernan with some brief thoughts on the inherent limitations of modeling generally. Petitioners have cited this e-mail, and my reference to a "drunk looking for his car keys under the street light,"<sup>57</sup> as supposed evidence that I had "expressed doubt about the scope of [my] work." (Reply Mem. at 50.) Once again, petitioners are incorrect. Here, as one follows the context of the e-mails, the "drunk" analogy was directed specifically at the concept of "value at risk," or "VaR," which had nothing to do with MBIA Corp.'s loss models or my review of the Transformation. (This change in topic is further evidenced by Mr. Chaplin's change in the e-mail's subject line to "I have no life.") My analogy was a reference to the well-known limitations of *any* modeling which relies exclusively on quantitative data (such as VaR). I recognized the potential pitfalls of focusing solely on "normal [and] log-normal distributions ... because they're mathematically tractable and 'close enough' to reality."<sup>58</sup>

62. With this in mind, I discussed the remaining sectors with Mr. McKiernan and IPM. At that time, I also was given a PowerPoint presentation containing the exposure summaries for the remaining sectors.<sup>59</sup>

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<sup>56</sup> *Id.* at 4998.

<sup>57</sup> *See* Ex. 35, MBIA\_NYS0005010-14, at 5010.

<sup>58</sup> *Id.* at 5010.

<sup>59</sup> *See* Ex. 36, MBIA\_NYS0028067-87.

63. The first presentation included a "top down" review of MBIA Corp.'s CMBS portfolio. IPM explained the basis for not having taken loss reserves in the CMBS sector. Unlike residential mortgages, which the bank counterparties (including certain of the petitioners here) often approved with little or no documentation or verification (contrary to their representations and warranties to insurers and investors), the professional underwriting and surveillance of CMBS loans resulted in significantly better performance and lower losses.<sup>60</sup> Also unlike individual homeowners, the owners (mortgagors) of properties collateralized in CMBS often included developers and investors whose equity in their properties provided strong incentives for them to continue to perform on their loan obligations and retain ownership and control of the properties.<sup>61</sup> Similarly, the commercial properties underlying CMBS, unlike residential properties, were almost always income-producing properties, thus reducing the loss in the event of default.<sup>62</sup>

64. IPM stated its belief that, despite the higher quality of the underlying collateral and underwriting standards, the rating agencies were overreacting to the financial guaranty insurance industry's failure to predict past RMBS losses by projecting future losses of similar severity in the CMBS sector.<sup>63</sup> Indeed, MBIA Corp.'s CMBS delinquencies as of January 2009 were only [REDACTED] I agreed with MBIA Corp. that the idiosyncratic behavior of the underlying loans precluded the use of across-the-board loss projections in this sector.<sup>64</sup>

65. After discussing the CMBS sector in a "top-down" fashion, our discussion turned to the other remaining sectors, including high-yield CDO, collateralized loan obligations

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<sup>60</sup> See Ex. 37, excerpts from MBIA interviews, at NYSID0002659-60.

<sup>61</sup> *Id.* at 2667-68.

<sup>62</sup> *Id.* at 2648, 2701.

<sup>63</sup> *Id.* at 2715-16.

<sup>64</sup> *Id.* at 2701, 2712.

("CLOs"), corporate finance, insurance, intellectual property, future cash flows, consumer finance, auto finance, student loans, rental fleets and miscellaneous categories. These sectors, while experiencing isolated losses, generally were performing well. MBIA's exposure to these sectors was also much smaller than its exposure in RMBS, ABS CDOs and CMBS CDOs. I therefore concluded that, although these sectors were of potential concern, they would not have a material impact on MBIA Corp.'s post-Transformation ability to pay claims as they came due.

C. Bottom-Up: Focusing on CMBS

66. On February 9, 2009 and February 10, 2009, I met with MBIA Corp. personnel for modeling sessions devoted to a CMBS CDO transaction called [REDACTED], a securitization that included [REDACTED] underlying CMBS totaling [REDACTED] of notional principal. During those meetings, MBIA Corp. personnel helped me verify how the performance data for [REDACTED] and other CMBS (data that was collected by a third party data provider, Trepp) translated into MBIA Corp.'s loss and cash flow projections. To assist in my study of the CMBS sector, Mr. McKiernan also e-mailed me reports from both Standard & Poor's ("S&P") and Lehman Brothers ("Lehman") which MBIA Corp. had used in constructing their stress tests for CMBS.<sup>65</sup>

67. During the February 10, 2009 meeting, Mr. McKiernan explained IPM's rationale for incorporating stress test scenarios from both the S&P and Lehman sector reports in modeling their CMBS portfolio. Specifically, Mr. McKiernan noted that the S&P model incorporated macroeconomic factors into its stress tests for the CMBS sector, but the Lehman model considered more than just macroeconomic factors. The Lehman model also considered fundamentals such as refinancing ability, demographics, geography, property type, regional

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<sup>65</sup> See Ex. 38, MBIA\_NYS0005195-5205; Ex. 39, MBIA\_NYS0005391-5421.

employment rates, sponsor equity and other variables in its projections.<sup>66</sup> MBIA Corp.'s model thus incorporated "econometric thinking" into its predictions, rather than make assumptions of across-the-board losses.<sup>67</sup> None of the models projected losses on MBIA Corp.'s CMBS portfolio.

68. Mr. McKiernan and the IPM team stated that the [REDACTED] transaction and the rest of the CMBS portfolio currently were experiencing zero losses because MBIA Corp. had insured only the most senior tranches of the CDOs, and losses at that time had only affected the CMBS underlying the more junior, "mezzanine" tranches. After our February 10, 2009 meeting, pursuant to my request, Mr. McKiernan confirmed that the losses in the CMBS sector were underneath the BBB tranches insured by MBIA Corp.

69. Thereafter, on February 12, 2009, IPM team member Daniel Hickey provided me with additional information relating to [REDACTED] and the performance of MBIA's CMBS portfolio relative to the market.<sup>68</sup> By drilling down into the transaction-level data behind these stress tests, I concluded that IPM's modeling of MBIA Corp.'s CMBS book was reasonable and in conformity with FGI industry best practices. Moreover, given that "underwriting standards were maintained" in the CMBS sector as compared to RMBS transactions (and, therefore, also ABS CDO transactions), I concluded that "systemic risk" had largely been avoided in MBIA Corp.'s CMBS book.<sup>69</sup>

70. The IPM team and I also discussed the propriety of using loan-level analysis rather than simply using loss curves in projecting the performance of the CMBS portfolio. I

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<sup>66</sup> See Ex. 40, excerpts of MBIA Interviews, NYSID0001566-82; Ex. 41, excerpts of MBIA Interviews, NYSID0002307-16.

<sup>67</sup> See Ex. 40, at 1567-68, 1603; Ex. 41, at 2310.

<sup>68</sup> See Ex. 42, MBIA\_NYS0007460.

<sup>69</sup> See Ex. 7, at 2811-12.

concluded that MBIA Corp.'s "override" of certain large-loan loss projections based on loan-level analysis was reasonable and standard practice in modeling CMBS portfolios, and that reviewing – as MBIA Corp. was doing – the individual loan structure, collateral, location, sponsorship and other unique variables of these large loans would yield far more accurate loss projections.

71. MBIA Corp.'s use of individual large loan analysis was supported by historical data that demonstrated how the unique characteristics of large loans typically contributed to fewer defaults and much lower loss severities on the loans that did default. Unlike RMBS collateral, the loans securitized in CMBS were more closely monitored and maintained by sophisticated borrowers and lenders alike. Moreover, CMBS large loans were more likely to exhibit unique characteristics with respect to one another than RMBS transactions securitized primarily by residential mortgages. For this reason, my File Memorandum included a detailed discussion of a diverse array of individual commercial loans contained in MBIA Corp.'s CMBS book, including shopping malls, hotels, restaurants, residential developments and other properties.<sup>70</sup>

72. As detailed in my File Memorandum, my review of MBIA Corp.'s CMBS book, and ██████ in particular, was quite "granular."<sup>71</sup> Even among the worst-performing tranches, the most recent February 2009 servicer reports showed no collateral foreclosures and very few delinquencies, most of which were reverting to "current" status within a few months of defaulting. Given the market dislocations that had begun in 2007 and intensified in September 2008, and the impact I expected those to have on the economy, I expected to see deterioration in

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<sup>70</sup> See Ex. 7, at 2813-16.

<sup>71</sup> *Id.* at 2814-16.

CMBS performance. However, I found no basis in the data to project that MBIA Corp.'s CMBS CDOs would begin experiencing losses of any significance to its insured senior tranches.

73. Given my experience with financial modeling and close, loan-level inspection of [REDACTED] and MBIA Corp.'s other CMBS CDO exposures, I believed that the loan-level loss analysis methodology utilized by IPM in its CMBS sector was analytically sound and reasonable.

## **VII. Completing My Review and Reporting to the Department**

74. On February 11, 2009, after my final meetings with MBIA Corp. personnel but before the Department's approval of the Transformation, I composed another memorandum to Department officials updating them on the status of my review, this time focusing on CMBS.<sup>72</sup> I noted that the "task" of reviewing MBIA Corp.'s structured finance book was complex and one that should be continued as part of the ongoing Examination, but also reiterated my opinion that the "risk focused" or "critical path" approach was appropriate for the purpose of reviewing the post-Transformation financial condition of MBIA Corp. I explained my understanding that my charge was to find the "needles-in-haystacks" that could caution against approving such a restructuring (*e.g.*, transactions that had not been properly accounted for in loss reserves), *not* to replicate the full-scope Examination already being undertaken by Ms. Gallardo and her team (including myself).<sup>73</sup>

75. Petitioners have argued that my use of the term "shortcut" in reference to the Transformation review, both in the February 11, 2009 memorandum and in speaking to Mr. McKiernan during one of our meetings,<sup>74</sup> suggests that my financial review of the Transformation application was somehow improperly truncated or abbreviated. (Reply Mem. at

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<sup>72</sup> See Ex. 43, NYSID0002855-56.

<sup>73</sup> *Id.* at 2855.

<sup>74</sup> See Ex. 27, at 2641.

42-52.) This is incorrect. I used the term "shortcut" simply as a reference to the "risk focused" or "critical path" approach I had chosen to take with my review and analysis of MBIA Corp.'s loss modeling, and how taking a risk focused approach allowed me to undertake a bottom-up analysis of a subset of transactions in MBIA Corp.'s key sectors and extrapolate the results of that analysis to the remainder of MBIA Corp.'s book.

76. My February 11, 2009 memorandum summarized the CMBS portfolio as containing no losses "of significance" and therefore not being of material concern, despite the distress just beneath MBIA Corp.'s attachment points (*i.e.*, the level at which MBIA Corp. could face a claim).<sup>75</sup> I noted that I, like any other analyst, had "a limited ability to predict the future" with certainty, but that given the state of the CMBS portfolio, I agreed with MBIA Corp.'s conclusion that the sector did not require loss reserves at that time. In explaining my reasoning, I cited some of the superior characteristics of CMBS compared to RMBS, including professional due diligence, MBIA Corp.'s limitation of its exposure to senior CMBS tranches only, and the ability of special servicers with experience in commercial mortgages to bring delinquent loans back to "current" status.<sup>76</sup>

77. On February 13, 2009, I met with representatives of Moody's to discuss their view of RMBS. In advance of the meeting, I corresponded with Mr. McKiernan concerning Moody's loss modeling approach and how it differed from that of MBIA Corp.<sup>77</sup> I also studied some recent publications of Moody's concerning its modeling methodology, which appeared to rely primarily on "a benchmark, not a deal, approach."<sup>78</sup> Nothing from this meeting or my review of

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<sup>75</sup> See Ex. 43, at 2855.

<sup>76</sup> *Id.* at 2855-56.

<sup>77</sup> See Ex. 44, MBIA\_NYS0026013-15.

<sup>78</sup> *Id.*

the Moody's publications led me to question the analytical soundness of MBIA Corp.'s loss modeling methodologies, or to conclude that these methodologies were inferior to those used by Moody's.

### **VIII. Transformation Approval and the File Memorandum**

78. On February 17, 2009, the Department formally approved MBIA Corp.'s Transformation application.<sup>79</sup> By this time, I had concluded my "risk focused" review of MBIA Corp.'s key activities – *i.e.*, its exposures to RMBS, ABS CDOs and CMBS. Though I continued to communicate with MBIA Corp. personnel regarding these sectors following the Department's approval, the exchanges I had after this date were only for the dual purposes of accurately memorializing my pre-approval findings in the File Memorandum, and accurately documenting the processes and results of my Transformation-related work for the ongoing Examination in which I was participating.

79. Petitioners have asserted in this proceeding that my testimony at my deposition, that I had not reached (or been asked for) any "final conclusions" regarding MBIA Corp.'s post-Transformation solvency by February 17, 2009,<sup>80</sup> somehow suggests that I had not sufficiently completed my Transformation review as of that date. (Reply Mem. at 76.) This is incorrect. What I tried to make clear in my testimony (and what both my colleagues at the Department and I understood) was simply that, since the nature of my analysis and review was to evaluate MBIA Corp.'s predictions of future losses, and the accuracy of such predictions was unknown and *unknowable* in the present, it was impossible for me – or *any* financial analyst, for that matter – to reach a truly "final" conclusion in the present with respect to MBIA Corp.'s future claims-paying ability.

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<sup>79</sup> See Record at R 00971-80.

<sup>80</sup> See Ex. 45 (excerpts from my deposition, dated September 28, 2010, at pp. 102, 147).

80. By February 16, 2009, my work in connection with the Department's review of the Transformation application had lasted over two months, and had included over a dozen visits to MBIA's offices and interviews and meetings with every MBIA executive and employee I deemed relevant to my analysis. During this time, I had access to performance data and loss models on every transaction within MBIA Corp.'s structured finance portfolio and independent access to the IPM staff. With this access, I independently reviewed and confirmed the analytical soundness of MBIA Corp.'s loss modeling methodologies. I also determined (within the limits of modeling and forecasting) that MBIA Corp. would remain solvent under the Insurance Law, even under scenarios of considerable distress. I further concluded that the "extreme stress" scenario required the assumption of stress conditions that I considered to be unrealistically pessimistic and, indeed, near-apocalyptic.

81. Although I did not complete my File Memorandum until several weeks after the Department approved the Transformation, as stated above, before this approval I had concluded that MBIA Corp.'s loss modeling methodologies underlying its statements of financial condition (which reflected that MBIA Corp. would remain solvent post-Transformation) were reasonable, consistently applied and consistent with best practices in the financial guaranty insurance industry. I thus communicated to Department officials (including Mr. Finer) on or before February 16, 2009 my conclusion that, based on my financial review, there was no reason not to approve the Transformation.

82. Following approval of the Transformation, I memorialized in the File Memorandum the work I had performed in connection with my Transformation review. The File Memorandum was dated February 16, 2009 to reflect the fact that it documented my findings concerning the analytical soundness of MBIA Corp.'s loss modeling and statements of financial

condition as of that date. Indeed, the File Memorandum plainly states that its purpose is to document the work I had performed up to, but not beyond, the date of the Department's decision.<sup>81</sup> The File Memorandum thus reflects that, by February 16, 2009, I had concluded that MBIA Corp. would remain solvent following the Transformation, both in terms of having positive statutory capital and being able to pay all its claims as they came due.<sup>82</sup> Following the full-scope Examination of MBIA Corp. in which I participated, I remained convinced that MBIA Corp. was solvent under the Insurance Law.

83. I remain convinced of MBIA Corp.'s solvency under the Insurance Law to this day. As noted above, I was hired by the Department to help launch the Capital Markets Bureau in 2000 and, in my capacity as a non-appointed civil servant, I reviewed the transactions of and conducted examinations of numerous Department-regulated entities with diligence and impartiality. My review of the Transformation was no different, as my conclusions regarding the analytical soundness of MBIA Corp.'s loss modeling were the result of a rigorous, measured and neutral review process that was unburdened by any political considerations.

84. I was recently informed that MBIA Corp. discovered and disclosed to the Department that it had made certain errors in its January 29, 2009 presentation to me regarding the hypothetical results of its "extreme stress" scenario, the only significant one of which was its consideration of 100% of a deferred tax asset as an "admitted asset" rather than only a portion of it, as required by Insurance Law § 1301. My understanding is that correction of these errors would have resulted in MBIA Corp.'s surplus to policyholders, in the hypothetical "extreme stress" scenario, falling to approximately negative \$291 million for year end 2009, before

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<sup>81</sup> See Ex. 7, at 2795 ("This memo covers only items or matters I reviewed up to the date of the Department's February 17, 2009 decision on 'Transformation' and nothing after.").

<sup>82</sup> See Ex. 7, at 2824-25.

eventually becoming positive again in 2011. Had these errors been corrected at the time of my review, it would not have led me to change my conclusion regarding MBIA Corp.'s post-Transformation solvency, for at least two reasons. First, the treatment of the deferred tax asset was a technical issue not reflecting upon the actual value of the asset, but merely the timing of when it could be recognized. Second, and more importantly, I was aware that MBIA Corp. had substantial contingency reserves of over \$1.3 billion, a portion of which the Department would have allowed MBIA Corp. to release in order to restore its surplus during the period of this hypothetical shortfall.

#### **IX. Responses to Certain of Petitioners' Arguments**

85. I have read certain portions of the reply papers submitted by petitioners in this proceeding, and some of petitioners' assertions warrant my specific response.

##### **A. Discount Rate**

86. First, petitioners have asserted that the "discount rate" used by MBIA Corp. in connection with setting its loss reserves (a rate which discounts to present value the estimated value of future claims payments) was improper. (Reply Mem. at 66.) The File Memorandum reflects my understanding as of February 16, 2009 that the "discount rate" set by MBIA Corp. for its "extreme stress" scenario was 5.23%,<sup>83</sup> and I believed that its use of this discount rate was proper.

87. During my review, MBIA Corp. explained that it had calculated its loss reserves using an investment yield assumption of 5% over a 40-year term, an assumption which I considered reasonable based on MBIA Corp.'s then-current yield curves.<sup>84</sup>

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<sup>83</sup> See Ex. 7 at 2822.

<sup>84</sup> The average yield of MBIA Corp.'s invested assets was 5.17%. See Ex. 7, at 2822.

88. While the Department, in connection with the Examination, requested more information from MBIA Corp. concerning its discount rate methodology and noted the company's deviation from the NAIC-listed rate,<sup>85</sup> the Department never concluded – in its Transformation review, the Examination, or otherwise – that MBIA Corp.'s discount rate violated the Insurance Law. In my view, such a conclusion would have been erroneous, as I believe that MBIA Corp.'s methodology was consistent with the principle of Insurance Law § 6903(b) that an insurer should be permitted to make "[a] deduction from loss reserves" to account for "the time value of money."

B. Circular Letter No. 25

89. Petitioners have also asserted that, despite the historically extreme then-existing market conditions, MBIA Corp.'s loss models should have forecast an even further worsening of conditions going forward. In particular, petitioners assert that IPM's loss modeling methodologies somehow violated the recommendations of a Department circular letter which states that "stress scenarios and the resulting impact must be continuously monitored, assessed and updated," and should incorporate certain factors such as interest rate shocks or rating agency downgrades. (*See* Reply Mem. at 72-73 (citing Department Circular Letter No. 25 (Nov. 18, 2008)).) I disagree with these assertions.

90. IPM's stress-testing methods were consistent with Circular Letter No. 25, as they incorporated new data and tweaked assumptions on MBIA Corp.'s ABS CDO portfolio based on fourth quarter 2008 performance. IPM re-calibrated its loss models during the 2008 economic crisis to provide for macroeconomic shocks in line with projections from industry peers, including petitioner Bank of America and former petitioner Barclays, as well as Moody's.

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<sup>85</sup> *See* Ex. 30, at 15.

Conversely, the fact that MBIA did not increase its RMBS loss reserves in the fourth quarter of 2008 was not significant, as IPM's analysis reflected the latest data and reasonably found that fourth quarter 2008 performance was largely contemplated by the projections made in the third quarter of 2008.

91. Moreover, based on Circular Letter No. 25, it was not implausible for MBIA Corp. to project that its losses would not extend to its entire book of business, including CLO, corporate finance, intellectual property, future cash flows, consumer finance, auto finance, student loans and rental fleets. I was fully briefed by MBIA Corp. personnel on each of these sectors of MBIA Corp.'s business, and while isolated transactions in some of these sectors were experiencing losses, there were no signs of systemic distress beyond the three main real estate sectors I reviewed in detail (RMBS, ABS CDOs, and CMBS). To the contrary, MBIA Corp. sufficiently demonstrated to me how each of these other sectors was insulated from experiencing the same severity of losses. The subsequent two and a half years have substantially proven this judgment to have been both reasonable and correct.

  
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JACK R. BUCHMILLER

Sworn to before me this  
21st day of December, 2011

  
\_\_\_\_\_  
Notary Public

**MICHAEL J. CAMPANELLI**  
Notary Public, State of New York  
No. 02-4996425  
Qualified in Suffolk County  
Certificate Filed in New York County  
Commission Expires May 18, 19

2014