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

-- x

ABN AMRO BANK N.V.; BARCLAYS BANK PLC; BNP PARIBAS; CALYON; CANADIAN IMPERIAL BANK OF COMMERCE; CITIBANK, N.A.; HSBC BANK USA, N.A.; JPMORGAN CHASE BANK, N.A.; KBC INVESTMENTS CAYMAN ISLANDS V LTD.; MERRILL LYNCH INTERNATIONAL; BANK OF AMERICA, N.A.; MORGAN STANLEY CAPITAL SERVICES INC.; NATIXIS; NATIXIS FINANCIAL PRODUCTS INC.; COOPERATIEVE CENTRALE RAIFFEISEN-BOERENLEENBANK B.A., NEW YORK BRANCH; ROYAL BANK OF CANADA; THE ROYAL BANK OF SCOTLAND PLC; SMBC CAPITAL MARKETS LIMITED; SOCIETE GENERALE; UBS AG, LONDON BRANCH; and WACHOVIA BANK, N.A.,

Petitioners,

- against –

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 NATIONAL PUBLIC FINANCE GUARANTEE CORPORATION (f/k/a MBIA INSURANCE CORP. OF ILLINOIS),

Respondents.

-- x

Index No. 601846/09

Hon. Barbara R. Kapnick

SUR-REPLY AFFIDAVIT OF
C. EDWARD CHAPLIN

C. EDWARD CHAPLIN, being duly sworn, deposes and says:

1. I am the President, Chief Administrative Officer and Chief Financial Officer of MBIA Inc. and Vice Chairman and Chief Financial Officer of respondent MBIA Insurance Corporation ("MBIA Insurance"). I submit this affidavit on behalf of respondents MBIA Inc.,

MBIA Insurance, and National Finance Guarantee Corporation ("National," f/k/a MBIA Insurance Corporation of Illinois) (collectively, "MBIA"), in further opposition to the Article 78 petition of the petitioners (the "Banks"). This affidavit is based on my personal knowledge and review of certain documents maintained by MBIA, as well as my discussions with other employees of MBIA, and is submitted as a supplement to my prior affidavit submitted in this matter (Affidavit of C. Edward Chaplin, sworn to November 24, 2009 (the "prior affidavit" or "Chaplin Aff.").)

2. This affidavit is intended to (a) clarify statements made in and materials attached to my prior affidavit; (b) to provide corrected versions of certain materials contained in the record; and (c) to address certain issues raised by the Banks in their reply and memorandum of law (Banks' Reply and Memorandum of Law in further support of their verified petition, March 11, 2011 (the "Banks' Reply").)

A. <u>Corrections to Materials in the Record</u>

3. During the preparation of its Sur-reply papers and its experts' submissions, MBIA and its experts identified certain information that had been erroneously reported in the record MBIA submitted to the New York State Insurance Department ("NYID") in support of its December 5, 2008 Transformation application (the "Application"), and which was also submitted in the record in this action. None of these errors impact the Department's conclusion that MBIA Insurance would be solvent after Transformation. The net impact of the corrections identified herein is that while the errors negatively impact policyholders' surplus in the early years of the "stress" and "extreme stress" projections, but not in the expected case, the corrected projections reflect an increase in MBIA's assets available to pay claims after Transformation and over time.

4. ***Tax Impact of Losses.*** The projections of certain financial data in scenarios including hypothetical "stress" and "extreme stress" losses that were provided to the NYID included errors in calculating the amount of allowable tax benefit of projected losses in these scenarios under statutory accounting principles. In its projections in those scenarios, MBIA incorrectly assumed that all of the deferred tax benefits of the hypothetical increased losses would be included in MBIA Insurance's admitted assets. Although MBIA Insurance, in most scenarios, would be able to realize the economic benefit of the tax deductibility of those losses, Insurance Law § 1301 limits the amount of such deferred tax assets that may be included in admitted assets each year. The impact of the foregoing errors was to overstate MBIA Insurance's policyholders' surplus and statutory capital in MBIA's projections of hypothetical "stress" and "extreme stress" losses in MBIA's October 30 and December 3, 2008 presentations to the NYID, MBIA's December 5, 2008 Transformation application (the "Application"), MBIA's January 27 and 29, 2009 presentations to the NYID, and the statutory forecasting model native excel files that MBIA provided to the NYID on MBIA's SharePoint site.[1]

5. ***Expected Loss Projections.*** In those same hypothetical "stress" and "extreme stress" loss projections, MBIA incorrectly assumed future loss payments that were higher than expected payments net of salvage that were projected in establishing its actual December 31, 2008 loss reserves. The net result of this error was to overstate the incremental losses incurred that were assumed to occur in 2009 in the financial modeling resulting from the hypothetical "stress" and "extreme stress" losses in the January 27 and 29 presentations, and in the statutory forecasting model native excel files containing those scenarios that MBIA provided to the NYID on MBIA's SharePoint site. Thus, MBIA Insurance's invested assets, policyholders' surplus and

[1] MBIA also applied inconsistent tax rates between 28% and 35% in the January 27 and 29 presentations, and the native excel files provided to the NYID on SharePoint. In the corrected models, MBIA consistently used a 35% tax rate, which was proper as of the time of the presentations.

statutory capital were understated.[2] This error also understated the projected near-term cash flow in the "stress" and "extreme stress" scenarios in the January 27 and 29 presentations, as well as the native cash flow excel files provided to the NYID on MBIA's SharePoint site.[3]

6. ***Reinsurance Assumptions.*** In its submissions to the NYID, MBIA applied a conservative assumption that MBIA Insurance would have commuted all of its reinsurance policies and reassumed all of the insured exposure it ceded to third-party reinsurers by year-end 2008, prior to the onset of the hypothetical "stress" and "extreme stress" losses. However, the submissions did not properly reflect the effects of such commutations, which would have included (a) the increase in assets, unearned premium reserve liability, and contingency reserves that would result from commuting the reinsured exposure; (b) the return to the reinsurer of the remaining ceding commissions resulting from such commutations; and (c) the benefit of a first loss reinsurance policy on a specific transaction insured by MBIA Insurance. In addition, MBIA effectively double-counted the increase in loss reserves from the commuted reinsurance exposure. These errors resulted in an understatement of MBIA Insurance's invested assets, contingency reserves, and policyholders' surplus in the hypothetical "stress" and "extreme stress" losses in the January 27 and 29 presentations, and the statutory forecasting model native excel files containing the those scenarios that MBIA provided to the NYID on MBIA's SharePoint site. This error also understated the projected near-term cash flow in the "stress" and "extreme stress" scenarios in the January 27 and 29 presentations, as well as the native cash flow excel files provided to the NYID on MBIA's SharePoint site.

---

2 The financial modeling for the hypothetical stress scenario in the January 27 presentation also understated the stress loss projections for certain transactions, but those projections were properly reflected in the native excel file for the stress scenario that was provided to the NYID on MBIA's SharePoint site.

3 In addition, in the presentation of the gross loss payment scenarios in the January 29 presentation, MBIA incorrectly reported the impact of the "Treasury Assumptions" on the loss payments for 2009 through 2012.

7. ***Contingency Reserves.*** In those same submissions and models, except in the January 29 presentation, MBIA failed to include an assumption that certain contingency reserves on MBIA Insurance's balance sheet associated with the policies for which increased hypothetical "stress" and "extreme stress" losses were assumed would be released in accordance with the Insurance Law. Until corrected, such errors understated policyholders' surplus in those scenarios.

8. ***Asset Swap.*** MBIA's reporting of its investment income, dividends, and policyholders' surplus in the Bridge Associates' coverage ratio table included with the Application, in the "stress" scenario loss coverage ratio tables in the January 27 presentation and the Bridge Associates coverage ratio model that was provided to the NYID on MBIA's SharePoint site were also overstated as a result of effectively double-counting the investment income from an asset swap transaction that, prior to the Transformation, MBIA Insurance had with MBIA Inc. In addition, MBIA overstated its assets in the coverage ratio tables in the Application, the "stress" scenario loss coverage ratios in the January 27 presentation, and the Bridge Associates coverage ratio model provided to the NYID on MBIA's SharePoint site by not reflecting expected amortization of the asset swap over time. These errors do not appear in the financial modeling for the hypothetical "extreme stress" loss projections in the January 29 presentation, or the statutory forecasting model native excel files for the "stress" and "extreme stress" scenarios that were provided to the NYID on MBIA's SharePoint site.

9. ***MBIA UK Unearned Premium Reserve.*** In its submissions to the NYID, MBIA applied an assumption in order to fully capture the growth in value of its investment in its subsidiary, MBIA UK Insurance Limited ("MBIA UK") -- it "grossed up" the assets of MBIA Insurance by amounts related to the surplus and loss reserve of MBIA UK. However, it failed to

increase assets by the amount of the unearned premium liability. This error resulted in an understatement of MBIA Insurance's invested assets and unearned premium reserve liability in the hypothetical "stress" and "extreme stress" losses in the January 27 and 29 presentations, and the statutory forecasting model native excel files that MBIA provided to the NYID on MBIA's SharePoint site.

10. ***Other Financial Modeling Errors.*** MBIA made other insignificant errors in its financial modeling in the "stress" and "extreme stress" loss scenarios in the January 29 presentation and the excel files provided to the NYID on MBIA's SharePoint site:[4]

- MBIA understated MBIA Insurance's assets, investment income and policyholders' surplus in certain years in the projections because it failed to properly account for cash flows and gains in connection with salvage assets MBIA obtained in a commutation of one of its insured transactions. This error is found only in the "extreme stress" scenarios in the January 29 presentation and the statutory forecasting model native excel file provided to the NYID on MBIA's SharePoint site;

- MBIA understated MBIA Insurance's invested assets and investment income because it failed to properly account for the proceeds of the redemption of certain Tax and Loss bonds it owned. This error is found only in the statutory forecasting model native excel files for the "stress" and "extreme stress" scenarios that were provided to the NYID on MBIA's SharePoint site; and

- MBIA incorrectly calculated certain investment yields and premiums earned because of formula errors in the excel files that were utilized for MBIA's January 27 and 29 presentations.[5] These errors resulted in the understatement of investment income in certain years in each of the financial models. Additionally, MBIA incorrectly calculated surplus note interest payment for two payment periods because of formula errors in the excel files that were utilized for MBIA's January 27 and 29 presentations.

11. All of these errors have been corrected in the replacement slides and files that are attached hereto as Exhibits 1 through 13. Specifically, (a) attached as Exhibit 1 is

---

4 MBIA's January 27 presentation to the NYID also contained certain inaccuracies that were corrected either in the January 29 presentation or in the native excel files that were provided to the NYID on MBIA's SharePoint site. Specifically, MBIA Insurance's statutory surplus was overstated due to double counting of the preferred stock that MBIA Insurance previously repurchased.

5 Additionally, the native excel files that MBIA provided to the NYID on MBIA's SharePoint site included the formula error related to the investment income yield assumption.

MBIA_NYS0490945 -- a corrected copy of page 10 of Exhibit 7 to the Chaplin Aff.; (b) attached as Exhibit 2 is MBIA_NYS0490946 -- a corrected copy of page 10 of Exhibit 8 to the Chaplin Aff.; (c) attached as Exhibit 3 is MBIA_NYS0490944 -- a corrected copy of Appendix 4 to Exhibit B to MBIA's Transformation Application, which was previously attached as Exhibit 9 to the Chaplin Aff.; (d) attached as Exhibit 4 are MBIA_NYS0490947-950 -- corrected copies of pages 27-29 of Exhibit 24 to the Chaplin Aff.; (e) attached as Exhibit 5 are MBIA_NYS0490951-961 -- corrected copies of pages 19-28 of Exhibit 26 to the Chaplin Aff.; (f) attached as Exhibit 6 is MBIA_NYS_NATIVE_175 -- a corrected copy of the native excel file "Corp Post-transformation YE 2008 stress scenario" previously attached as Exhibit 32 to the Chaplin Aff. and previously bates stamped as MBIA_NYS_NATIVE_049, MBIA_NYS0007468-639; (g) attached as Exhibit 7 is MBIA_NYS_NATIVE_176 -- a corrected copy of the native excel file "Extreme Loss Scenario -- Corp Post-transformation YE 2008" previously attached as Exhibit 33 to the Chaplin Aff. and previously bates stamped as MBIA_NYS_ NATIVE_050, MBIA_NYS0007640-821; (h) attached as Exhibit 8 is MBIA_NYS_NATIVE_182 -- a corrected copy of the native excel file "Model Sent to Bridge and Assoc" previously bates stamped as MBIA_NYS_NATIVE124; (i) attached as Exhibit 9 is MBIA_NYS_NATIVE_177 -- a corrected copy of the native excel file "Forecast Gross Loss Pymts Extreme Loss Scenario" previously attached as Exhibit 28 to the Chaplin Aff. and previously bates stamped as MBIA_NYS_NATIVE_051, MBIA_NYS0007826-947; (j) attached as Exhibit 10 is MBIA_NYS_NATIVE_178 -- a corrected copy of the native excel file "Forecast Gross Loss Pymts Stress Scenario" previously attached as Exhibit 29 to the Chaplin Aff. and previously bates stamped as MBIA_NYS_NATIVE_052, MBIA_NYS0007948-8044; (k) attached as Exhibit 11 is MBIA_NYS_NATIVE_179 -- a corrected copy of the native excel file

"Insur Co Cash Flow Forecast w Treasury Loss Assumptions" previously attached as Exhibit 30 to the Chaplin Aff. and previously bates stamped as MBIA_NYS_NATIVE_053, MBIA_NYS0008122-98; (l) attached as Exhibit 12 is MBIA_NYS_NATIVE_180 -- a corrected copy of the native excel file "Insur Co Cash Flow with Extreme Stressed Loss Assumptions" previously attached as Exhibit 31 to the Chaplin Aff. and previously bates stamped as MBIA_NYS_NATIVE_054, MBIA_NYS0007640-821; and (m) attached as Exhibit 13 is MBIA_NYS_NATIVE_181 -- a corrected copy of the native excel file "MBIA Trans Bal Sheet Anls Ratio tests_No 3rd Party Cap_Rev_NYS Pres1_30_09 incl 32A" previously attached as Exhibit 35 to the Chaplin Aff. and previously bates stamped as MBIA_NYS0008306-40.

12. In addition, the statement on page 6 of the Application Letter that "As demonstrated on these tests, (see Appendix 4 to Exhibit B), MBIA anticipates that it could withstand additional stress of approximately $3.2 billion in losses immediately following Transformation (in addition to the approximately $4.5 billion in statutory reserves on its balance sheet) while still maintaining statutory surplus above the level required by the New York Insurance Law," should be amended as follows: "As demonstrated on these tests, (see Appendix 4 to Exhibit B), MBIA anticipates that it could withstand additional stress of over $2 billion in losses immediately following Transformation (in addition to the approximately $4.5 billion in statutory reserves on its balance sheet) while still maintaining statutory surplus above the level required by the New York Insurance Law."

13. The overall impact of the corrections of these errors is that while, in the "extreme stress" scenario, the projection of MBIA Insurance's policyholders' surplus at year-end 2009 has been corrected to project to be approximately negative $291 million rather than approximately positive $362 million, MBIA Insurance is still projected to have over $1 billion positive statutory

capital given approximately $1.3 billion in projected contingency reserves. Notably, in that hypothetical scenario, such contingency reserves could be released with the approval of the NYID to keep MBIA Insurance's policyholders' surplus positive and in excess of the statutory minimum requirement of $65 million under the Insurance Law to do business in New York. Further, also in the "extreme stress" scenario, the projection of MBIA Insurance's invested assets at year end 2009 has been corrected to project a positive approximately $5.7 billion rather than a positive approximately $5.1 billion, thus providing MBIA Insurance with more assets available to satisfy claims as they come due than under the prior calculations. Moreover, the long-term projections in the "stress" and "extreme stress" scenarios, indicate assets, reserves and coverage ratios, *and* policyholders' surplus and statutory capital, well in excess of the original presented projections.

14. Notably, MBIA's financial modeling -- even as corrected -- continues to be a conservative projection of MBIA Insurance's policyholders' surplus and statutory capital in the "stress" and "extreme stress" scenarios. For example, MBIA's financial models do not recognize any recoveries for "putbacks" of ineligible loans to specific transaction sponsors, including some of the petitioners in this action. To date, MBIA Insurance has booked approximately $2.8 billion of "putback" recoveries, and just a short time after the Transformation, at the end of the second quarter of 2009, had booked approximately $1 billion of "putback" recoveries, which, of course, if accounted for in the projections, would make its policyholders' surplus positive in all of the corrected scenarios.[6]

[6] MBIA's financial models also conservatively assumed that MBIA Insurance would commute all of its reinsurance policies by year-end 2008. If the models assumed that MBIA Insurance retained its reinsurance through year-end 2009 -- MBIA did in fact retain several reinsurance policies through 2009 and 2010 -- policyholders' surplus would be positively impacted.

B. <u>The Banks' Mischaracterizations of the Record</u>

15. The Banks argue that the Transformation was unfair and inequitable to MBIA Insurance and its policyholders. (Banks' Reply 131.) In support of this contention, the Banks repeatedly cite to an e-mail I sent, in which I stated: "[G]enerally I understand the point that [surplus note] holders will also be standing in line of those claiming unfairness as we attempt to transform. Leaving them behind with the [structured finance] book will not be consistent with what they signed up for." (Banks' Reply 32 (citing MBIA_NYS0032853-54).) The Banks mischaracterize this e-mail as a "privat[e] discuss[ion of] the inherent unfairness of MBIA's proposed Transformation to structured-finance policyholders and holders of MBIA Insurance 'surplus notes.'" (Banks' Reply 32 (citing MBIA_NYS0032853-54).) It is nothing of the sort.

16. In asserting that a split of the structured finance and municipal bond books of business would "not be consistent with what [MBIA Insurance surplus note holders] signed up for," I was merely noting that splitting the structured finance book from the public finance book was an unanticipated evolution in MBIA's business structure, necessitated by the financial crisis. That said, when structured finance policyholders, such as the Banks, voluntarily entered into contracts with MBIA Insurance, neither those contracts nor the New York Insurance Law prohibited MBIA from restructuring its insurance business. The communication was not, as the Banks contend, a "privat[e] discuss[ion of] the inherent unfairness of MBIA's proposed Transformation," but was instead a realistic assessment of the reactions MBIA might face following a restructuring that was not only lawful and fair, but was a necessary business decision undertaken by a company facing unprecedented circumstances.

17. The Banks likewise cite to various statements made by me and other MBIA executives as evidence that MBIA Insurance policyholders were harmed by the Transformation.

For instance, the Banks repeatedly cite to my use of the term "leavebehindco" in reference to MBIA Insurance as evidence of MBIA's purported intention to leave MBIA Insurance an insolvent entity in the wake of the Transformation. (Banks' Reply 3, 42.)

18. My use of the term "leavebehindco" stands as nothing more than an acknowledgment that following the Transformation, certain of MBIA Insurance's policyholders would remain at the company while others would move to MBIA Illinois, which would also no longer be a subsidiary of MBIA Insurance and now would be a "sister-company." The Banks' assertion that the use of the term "leavebehindco" somehow implies that MBIA intended to abandon MBIA Insurance is false and is not supported by the facts. As the record in this action makes clear, MBIA intended to have the Transformation, and in fact it did, leave MBIA Insurance as a solvent entity with more than sufficient capital to pay all claims as they came due. Notably, MBIA Insurance -- the "leavebehindco" in the referenced email -- was left with approximately $10 billion of claims paying resources after the Transformation -- well over half of the assets of the combined company pre-Transformation.

19. The Banks contend that Superintendent Dinallo "impermissibly prejudged" MBIA's Transformation application before it was filed, alleging that Mr. Dinallo gave MBIA "the okay" to file its application as early as October 2008. (Banks' Reply 164.) In support of their argument, the Banks cite to an e-mail dated October 28, 2008, in which I described to other MBIA executives a discussion I had with NYID Deputy Superintendent Hampton Finer. (Banks' Reply 33 (citing MBIA_NYS0239604).)To understand the e-mail to which the Banks cite, it is necessary to note that, prior to my discussion with Mr. Finer, MBIA had discussed with the NYID a plan that included: (1) the restructuring of MBIA to create a new public finance bond insurance company; (2) the injection of capital and liquidity support into the new company via

TARP; and (3) industry-wide restructuring and consolidation. The e-mail to which the Banks cite concerned the NYID's plan to propose that the United States Treasury contribute funds to MBIA's reorganization plan. I stated: "I think the Department is most interested in the financial support piece and consolidation, and is talking about transformation only because we have said it's critical to make optimal use of the other 2 pieces." (MBIA_NYS0239604.)

20. The Banks seize upon this statement as purported evidence that the NYID was exclusively concerned with injecting capital into the municipal bond industry -- the implication being that the NYID was unconcerned with the details of MBIA's proposed reorganization since they already had "rubber-stamped" the Transformation. The e-mail exchange, however, pertained only to the role of the U.S. Treasury in the proposed plan. As I went on to explain in the same e-mail, the NYID was "trying to fashion a request of the Treasury, whose purview is really the financial support piece. The financial support in our 'roadmap' is necessary to drive industry consolidation, so that's why those two go together. The transformation is really within the NYID's purview . . . ." (*Id.*) Indeed, the NYID seemed interested in a role for the U.S. Treasury as a potential alternative to Transformation that could also "unfreeze" the municipal bond market at that time. Of course, the U.S. Treasury decided not to provide any financial support to the monolines, and MBIA pursued and the NYID ultimately approved the Transformation.

C. EDWARD CHAPLIN

Sworn to before me
this 16 th day of November, 2011

Notary Public

Shelia M. Lieberman
Notary Public State of New York
No. 4998416
Qualified in Westchester County
Commission Expires June 29, 20 14