National's Financial Statements – Q&A

By Chris Young – CFO, National Public Finance Guarantee

Does National follow Generally Accepted Accounting Principles (GAAP)?

National follows both GAAP and statutory accounting principles (SAP). All U.S. public companies are required to prepare financial statements in accordance with GAAP. Since National is a subsidiary of a public holding company, MBIA Inc., it maintains GAAP-basis financial statements for inclusion in the MBIA Inc. and Subsidiaries consolidated GAAP financial statements.

National, like all insurance companies in the United States, is also required to prepare statutory-basis financial statements in accordance with SAP. Statutory-basis financial statements are used by state insurance regulators to assess the financial condition and solvency of an insurance company for the protection of policyholders. SAP differs from GAAP in a variety of ways, such as in the timing for recognizing revenues and expenses and in the calculation of capital. Unlike a GAAP balance sheet, which includes all of a company's assets, a statutory balance sheet does not include certain intangible assets or illiquid assets. For example, deferred tax assets in excess of allowable limits and furniture and fixtures are non-admitted assets in statutory accounting – meaning they are not permitted to be given value on the statutory balance sheet.

How does National invest its investment portfolio?

Under National's investment objectives, preservation of capital is the primary objective, subject to an appropriate degree of liquidity, with optimization of after-tax income and total return as secondary objectives. In addition, National must comply with various state laws and regulations which prescribe, among other things, permitted classes and concentrations of investments. Consequently, National invests its $4.2 billion portfolio almost exclusively in investment grade fixed income securities. Within the investment grade universe, the portfolio is primarily invested in highly-rated bonds providing a double-A

national
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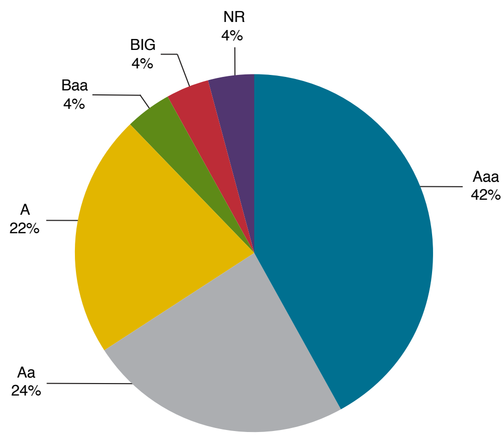
average rating for the investment portfolio. National's high quality and liquid investment portfolio provides the backbone of its significant financial strength and claims-paying resources.

Quality Distribution – Long-Term Fixed Income Securities

as of March 31, 2017



How is National compensated for issuing an insurance policy?

National charges a premium for its insurance policy. Most of National's insurance policies provide that National receive the full premium due for the life of the policy at the time of its issuance (an "upfront" premium). The amount of the premium is based on the credit quality and type of insured obligation and is calculated based on the total debt service insured by National. Premiums received are invested according to the conservative approach outlined above and contribute to National's claims-paying resources.

How are upfront premiums recognized in National's financial statements?

Under both GAAP and SAP, National earns the premium over the life of the insurance policy rather than upfront at the time it is paid.

When National receives an upfront premium, it records an unearned premium revenue liability on both its GAAP and SAP balance sheets. Under GAAP, National is required to recognize on the income statement a proportionate share of the premium received on a financial guarantee insurance policy in the period in which the insurance protection is provided based on a constant rate yield method. As premium revenue is recognized on the income statement, the unearned premium revenue liability on the balance sheet is reduced. Under SAP, upfront premiums are earned proportionately over the life of the insured obligation based on the ratio of each scheduled debt service payment to the total debt service outstanding for the insured obligation.

What is the impact of a refunding of an insured obligation on National?

A refunding occurs when an issuer pays off or legally defeases a portion or all of the outstanding principal and accrued interest on an insured obligation prior to the scheduled payment date, which is typically referred to as a "refunding". National recognizes any remaining unearned premium revenue on the insured obligation as premium revenue in the period the obligation is refunded. National does not control whether or when an insured obligation is refunded. That being said, National generally considers refunding activity to have a positive impact since the effect is a reduction in its insured risk and an increase in the equity, or surplus, available to remaining policyholders due to National immediately earning the remaining unearned premium revenue.

How does National monitor its insured portfolio and quantify and set aside loss reserves?

National's Portfolio Surveillance Group is staffed by professionals with substantial experience in municipal finance who continuously monitor the performance of its insured portfolio. National has a process that increases the frequency of review for transactions deemed to be performing below expectations. Even before a claim or loss is anticipated, as the credit quality of an insured obligation deteriorates National will allocate more capital to it under its internal capital model as well as estimate the impact on its capital under the applicable rating agency capital models.

> **National has a conservative investment strategy designed to preserve capital and maintain liquidity.**

Case basis reserves represent National's estimate of expected losses to be paid under an insurance policy, net of potential recoveries on insured obligations that have defaulted or are expected to default. Case basis loss reserves are established for any insured obligation by calculating the present value of probability-weighted estimated loss payments on the insured obligation, net of estimated recoveries, taking into account different variables and using various assumed outcomes that depend primarily on the nature of the underlying insured obligation. These variables include the nature and creditworthiness of the issuers of the insured obligations, expected recovery rates on the insured obligations and the projected cash flow or market value of any assets pledged as collateral on secured obligations. Factors that may affect the actual ultimate realized losses for any policy include economic conditions and trends, levels of interest rates, rates of inflation, issuer behavior, the salvage values of specific collateral, and National's ability to enforce contractual rights through litigation and otherwise. National's remediation strategy for an insured obligation that has defaulted or is expected to default may also have an impact on the company's loss reserves.

Loss and loss adjustment expense (LAE) reserves represent the out of pocket costs that National expects to incur in connection with an insurance policy with respect to which it has booked a case basis reserve. Loss and LAE reserves are established by a loss reserve committee and include case basis reserves and accruals for LAE incurred.

What is the difference between Statutory Capital and Claims-Paying Resources?

Statutory Capital is a subset of National's total Claims-Paying Resources ("CPR"). Statutory capital is comprised of two components: 1) Policyholders' Surplus – effectively equity available to policyholders, which is the excess of total admitted

CLAIMS-PAYING RESOURCES

$ in Millions	**3/31/17**
Policyholders' Surplus	$2,788
Contingency Reserve	717
Statutory Capital	**3,505**
Unearned Premium Reserve	741
Present Value of Installment Premiums	186
Premium Resources	927
Net Loss and LAE Reserves	(106)
Salvage Reserve	279
Gross Loss and LAE Reserves	173
Total Claims-Paying Resources	**$4,605**

assets over liabilities on the statutory balance sheet; and 2) Contingency Reserves, which are statutory reserves that National must maintain as required by the laws and regulations of New York, California, Connecticut, Florida, Illinois, Iowa, Maryland, New Jersey and Wisconsin. Required contributions to contingency reserves vary by state but are generally a specified percentage of earned or written premiums or a percentage of the principal guaranteed, depending upon the type of obligation insured. Contingency Reserves are calculated for every transaction insured by National, grow over the lifetime of the insured exposure, and are accounted for as a liability on the balance sheet – effectively reducing Policyholder's Surplus. The contribution to, and maintenance of, the contingency reserve limits the amount of earned surplus that might otherwise be available for the payment of dividends. Contingency Reserves are only released when the insured exposure matures or is refunded, or otherwise with the approval of the applicable regulator(s).

CPR is a financial metric used by the financial guarantee industry and is a key measure of the resources available to National to pay claims on its insurance policies. CPR is calculated based upon the total financial resources and reserves of the company, including statutory capital, available to pay claims. In addition to statutory capital, National's CPR includes its unearned premium reserve, the present value of its installment premiums receivable, net loss and LAE reserves and salvage reserves.

How does National manage liquidity?

National uses a liquidity risk management framework to manage its liquidity, the primary objective of which is to match liquidity resources to needs. National monitors its cash and liquid asset resources using daily cash forecasting and stress-scenario testing. Members of senior management meet regularly to review liquidity metrics, discuss contingency plans and establish target liquidity levels. Substantially all of National's insurance policies provide for the payment of the principal and interest owing on insured obligations when due, if the issuer fails to make such payment. Helping to mitigate National's liquidity risk is the fact that its obligation to pay the principal it insures is not typically subject to acceleration, even if the underlying obligation is accelerated, except that National may have the right, at its sole discretion, to pay the accelerated amount of the insured obligations upon default by the issuer. Therefore, if claims arise under a National insurance policy, the company is only required to pay debt service shortfalls as scheduled, reducing the potential for large unexpected cash needs. That said, National maintains a highly rated, liquid investment portfolio which provides the company with the flexibility to manage normal operating cash flow needs while still being able to respond quickly to developing situations which may result in claims to National.

What dividends can National pay to its parent?

The insurance laws of the State of New York provide that New York domestic stock property/casualty insurance companies (such as National) may not declare dividends except out of statutory earned surplus. In addition, dividends during a 12-month period may not exceed the lesser of (a) 10% of policyholders' surplus (equity), or (b) 100% of adjusted net investment income for such 12-month period, unless the Superintendent of the New York State Department of Financial Services, in his/her discretion, approves a greater dividend distribution (an extraordinary dividend) based upon a finding that the insurer will retain sufficient surplus to support its obligations and writings. The Superintendent is under no obligation to approve an extraordinary dividend request. For the foreseeable future, National expects that the amount of dividends it pays to its parent will be limited by the adjusted net investment income calculation.

Can you explain National's taxes and the tax escrow?

National files its U.S. corporate income tax return as part of the MBIA Inc. consolidated tax return. National's Federal tax liability is based on its statutory pretax income, with certain tax adjustments. The National return is prepared on a stand-alone basis for purposes of determining the amount of tax it is required to remit to MBIA Inc. under the terms of the MBIA group's tax sharing agreement. On a quarterly basis, National is required to estimate its full year tax liability and make estimated tax payments to MBIA Inc. such that by year-end the full estimated tax liability will have been paid. Pursuant to New York State insurance regulations, the tax payments paid by National to MBIA Inc. are held in an escrow account. MBIA Inc. is required to hold the tax payments in this escrow account on behalf of National for two tax years after payment. To the extent that National incurs a tax loss during that two year period that entitles it to a tax loss carryback, it can recover all or a portion of the taxes previously paid.

Contacts

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To learn more about building stronger bonds with insurance from National, visit **www.nationalpfg.com**

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