

SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549  
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FORM 8-K

CURRENT REPORT

Pursuant to Section 13 or 15(d) of the Securities  
Exchange Act of 1934

AUGUST 5, 1999  
Date of Report (Date of earliest event reported)

WHITE MOUNTAINS INSURANCE GROUP, INC.  
(Exact name of registrant as specified in its charter)

DELAWARE	1-8993	94-2708455
(State or other jurisdiction of incorporation or organization)	(Commission file number)	(I.R.S. Employer Identification No.)

80 SOUTH MAIN STREET, HANOVER, NEW HAMPSHIRE 03755  
(Address of principal executive offices)

(603) 643-1567  
(Registrant's telephone number, including area code)

ITEM 5. OTHER EVENTS.

White Mountains Insurance Group, Inc. (the "Company") owns a minority interest in Financial Security Assurance Holdings Ltd. ("FSA"), which writes municipal and asset-backed securities credit enhancement insurance. The Company does not consolidate FSA into its financial statements due to its minority ownership position but did include the consolidated financial statements of FSA and the related report of independent accountants as Exhibit 99(b) to its Form 10-K for the year ended December 31, 1998.

During a filing of a shelf registration by FSA in April 1999 and resulting discussions with the Securities and Exchange Commission, FSA revised its accounting with respect to a forward share purchase agreement with two financial institutions which it entered into in 1996. The effect of this change in accounting by FSA served to decrease its shareholders' equity by \$7.3 million, \$6.4 million and \$2.7 million as of December 31, 1998, 1997 and 1996, respectively.

The aggregate impact of the FSA restatement on the Company's December 31, 1998, December 31, 1997 and December 31, 1996 shareholders' equity is less than \$1.0 million and, therefore, the Company does not expect to restate its historical results. The full impact of the FSA restatement has been reflected in the Company's June 30, 1999 financial statements.

On August 5, 1999, FSA filed an amendment to its Form 10-K for the year ended December 31, 1998 to amend and restate its Form 10-K previously filed on March 25, 1999. Exhibit 99 to this Form 8-K filed herein contains the amended and restated consolidated financial statements of FSA and the related report of independent accountants. Exhibit 99 to this Form 8-K amends and supercedes Exhibit 99(b) to the Company's Annual Report on Form 10-K for the year ended December 31, 1998.

ITEM 7. FINANCIAL STATEMENTS AND EXHIBITS.

(c) Exhibits. The following exhibits are filed herewith:

Exhibit No. -----	Description -----
23	Consent of PricewaterhouseCoopers LLP dated September 21, 1999
99	Amended and restated 1998 consolidated financial statements of FSA and the related report of independent accountants

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

WHITE MOUNTAINS INSURANCE GROUP, INC.

Dated: September 22, 1999

By: \_\_\_\_\_ /s/ \_\_\_\_\_  
Michael S. Paquette  
Senior Vice President and  
Controller

CONSENT OF INDEPENDENT ACCOUNTANTS

We consent to the incorporation by reference in the Registration Statements, as amended, pertaining to the Long-Term Incentive Plan (Form S-8, No. 33-5297), Medium-Term Notes Series A (Form S-3, No. 33-54006), Common Stock Warrants (Form S-3, No. 33-54749) and the Folksamerica Holding Company 401(K) Savings and Investment Plan (Form S-8, No. 333-82563) of White Mountain Insurance Group, Inc. (formerly "Fund American Enterprises Holdings, Inc.") of our report dated January 26, 1999, except for the restatements and reclassifications section in Note 2 as to which the date is August 4, 1999, with respect to the consolidated financial statements of Financial Security Assurance Holdings, Ltd. and Subsidiaries as of December 31, 1998 and 1997 and for each of the three years in the period ended December 31, 1998.

PricewaterhouseCoopers LLP

New York, New York  
September 21, 1999

REPORT OF INDEPENDENT ACCOUNTANTS

To the Shareholders and Board of Directors  
of Financial Security Assurance Holdings Ltd.:

In our opinion, the accompanying consolidated balance sheets and the related consolidated statements of income, changes in shareholders' equity, and cash flows present fairly, in all material respects, the financial position of Financial Security Assurance Holdings Ltd. and Subsidiaries (the Company) at December 31, 1998 and 1997, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 1998, in conformity with generally accepted accounting principles. These financial statements are the responsibility of the Company's management; our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits of these statements in accordance with generally accepted auditing standards, which require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for the opinion expressed above.

As indicated in Note 2, the consolidated financial statements at December 31, 1998 and 1997 and for each of the three years in the period ended December 31, 1998 have been revised.

/s/ PricewaterhouseCoopers LLP  
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PRICEWATERHOUSECOOPERS LLP

New York, New York  
January 26, 1999, except for the  
restatements and reclassifications section  
in Note 2 as to which the date  
is August 4, 1999

FINANCIAL SECURITY ASSURANCE HOLDINGS LTD.  
AND SUBSIDIARIES  
CONSOLIDATED BALANCE SHEETS  
(Dollars in thousands, except per share data)

ASSETS	December 31, 1998 -----	December 31, 1997 -----
Bonds at market value (amortized cost of \$1,655,042 and \$1,230,479)	\$ 1,708,040	\$ 1,268,158
Equity investments at market value (cost of \$64,292 and \$29,430)	68,243	30,539
Short-term investments	98,554	132,931
	-----	-----
Total investments	1,874,837	1,431,628
Cash	3,490	12,475
Deferred acquisition costs	199,559	171,098
Prepaid reinsurance premiums	217,096	173,123
Reinsurance recoverable on unpaid losses	3,907	30,618
Receivable for securities sold	1,655	20,623
Investment in unconsolidated affiliates	29,496	--
Other assets	114,166	91,599
	-----	-----
TOTAL ASSETS	\$ 2,444,206 =====	\$ 1,913,164 =====
 LIABILITIES AND MINORITY INTEREST, REDEEMABLE PREFERRED STOCK AND SHAREHOLDERS' EQUITY		
Deferred premium revenue	\$ 721,699	\$ 595,196
Losses and loss adjustment expenses	63,947	75,417
Deferred federal income taxes	87,254	82,786
Ceded reinsurance balances payable	31,502	11,199
Payable for securities purchased	105,859	72,979
Notes payable	230,000	130,000
Minority interest	20,388	--
Accrued expenses and other liabilities	117,421	87,638
	-----	-----
TOTAL LIABILITIES AND MINORITY INTEREST	1,378,070	1,055,215
	-----	-----
 COMMITMENTS AND CONTINGENCIES		
REDEEMABLE PREFERRED STOCK		
Redeemable preferred stock (3,000,000 shares authorized; 2,000,000 issued and outstanding; par value of \$.01 per share)	20	20
Additional paid-in capital - preferred	680	680
	-----	-----
	700	700
Common stock (50,000,000 shares authorized; 32,276,301 issued; par value of \$.01 per share)	323	323
Additional paid-in capital - common	733,442	695,993
Accumulated other comprehensive income (net of deferred income tax provision of \$20,288 and \$13,575)	37,678	25,212
Accumulated earnings	325,150	222,571
Deferred equity compensation	43,946	26,181
Less treasury stock at cost (2,372,839 and 3,521,847 shares held)	(75,103)	(95,031)
	-----	-----
TOTAL SHAREHOLDERS' EQUITY	1,065,436	875,249
	-----	-----
TOTAL LIABILITIES AND MINORITY INTEREST, REDEEMABLE PREFERRED STOCK AND SHAREHOLDERS' EQUITY	\$ 2,444,206 =====	\$ 1,931,164 =====

The accompanying Notes to Consolidated Financial Statements are an integral part of these statements. Each year has been revised. See Note 2 section entitled "Restatements and Reclassifications".

FINANCIAL SECURITY ASSURANCE HOLDINGS LTD.  
AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF INCOME  
(Dollars in thousands, except per share data)

	Year Ended December 31,		
	1998	1997	1996
REVENUES:			
Net premiums written	\$ 219,853	\$ 172,878	\$ 121,000
Increase in deferred premium revenue	(81,926)	(63,367)	(30,552)
Premiums earned	137,927	109,511	90,448
Net investment income	78,823	72,085	65,064
Net realized gains	20,890	11,522	3,189
Other income	474	9,303	297
TOTAL REVENUES	238,114	202,421	158,998
EXPENSES:			
Losses and loss adjustment expenses	3,949	9,156	6,874
Policy acquisition costs	35,439	27,962	23,829
Other operating expenses	40,631	35,755	22,732
TOTAL EXPENSES	80,019	72,873	53,435
Minority interest and equity in earnings of unconsolidated affiliates	(844)	--	--
INCOME BEFORE INCOME TAXES	157,251	129,548	105,563
Provision (benefit) for income taxes:			
Current	44,140	22,966	15,817
Deferred	(2,245)	11,898	11,721
Total provision	41,895	34,864	27,538
NET INCOME	115,356	94,684	78,025
OTHER COMPREHENSIVE INCOME (LOSS), NET OF TAX:			
Unrealized gains (losses) on securities:			
Unrealized holding gains (losses) arising during period (net of deferred income tax provision (benefit) of \$14,024, \$12,701 and \$(4,708))	26,045	23,587	(8,744)
Less: reclassification adjustment for gains included in net income (net of deferred income tax provision of \$7,311, \$4,033 and \$1,116)	(13,579)	(7,489)	(2,073)
Other comprehensive income (loss)	12,466	16,098	(10,817)
COMPREHENSIVE INCOME	\$ 127,822	\$ 110,782	\$ 67,208
As based upon net income:			
Basic earnings per common share	\$ 3.96	\$ 3.16	\$ 2.55
Diluted earnings per common share	\$ 3.77	\$ 3.06	\$ 2.52

The accompanying Notes to Consolidated Financial Statements are an integral part of these statements. Each year has been revised. See Note 2 section entitled "Restatements and Reclassifications".

FINANCIAL SECURITY ASSURANCE HOLDINGS LTD.  
AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY  
(Dollars in thousands, except per share data)

	Common Stock -----	Additional Paid-In Capital - Common -----	Unrealized Gain (Loss) on Investments -----	Accumulated Earnings -----	Deferred Equity Compensation -----	Treasury Stock -----	Total -----
BALANCE, December 31, 1995	\$323	\$696,253	\$19,931	\$72,410	\$ 6,504	\$(18,174)	\$777,247
Net income for the year				78,025			78,025
Net change in accumulated comprehensive income (net of deferred income tax benefit of \$5,823)			(10,817)				(10,817)
Dividends paid on common stock (\$0.35 per share)				(10,536)			(10,536)
Deferred equity compensation					5,565		5,565
Purchase of 1,529,131 shares of common stock						(40,611)	(40,611)
Other common stock transactions		(1,135)					(1,135)
Adjustment to prior-year disposal of Subsidiary	----	-----	-----	87	-----	-----	87
BALANCE, December 31, 1996	323	695,118	9,114	139,986	12,069	(58,785)	797,825
Net income for the year				94,684			94,684
Net change in accumulated comprehensive income (net of deferred income taxes of \$8,667)			16,098				16,098
Dividends paid on common stock (\$0.405 per share)				(12,099)			(12,099)
Deferred equity compensation					17,781		17,781
Deferred equity payout		187			(3,287)	56	(3,044)
Purchase of 162,573 shares of common stock						(5,434)	(5,434)
Issuance of 125,106 shares of treasury stock for options exercised		688			(382)	3,042	3,348
Forward share settlements with counterparties	----	-----	-----	-----	-----	(33,910)	(33,910)
BALANCE, December 31, 1997	323	695,993	25,212	222,571	26,181	(95,031)	875,249
Net income for the year				115,356			115,356
Net change in accumulated comprehensive income (net of deferred income taxes of \$6,713)			12,466				12,466
Dividends paid on common stock (\$0.44 per share)				(12,777)			(12,777)
Deferred equity compensation					23,970		23,970
Deferred equity payout		750			(6,371)	204	(5,417)
Purchase of 496,940 shares of common stock						(23,907)	(23,907)
Issuance of 1,632,653 shares of treasury stock for XL stock		36,721				43,279	80,000
Issuance of 13,295 shares of treasury stock for options exercised	----	(22)	-----	-----	166	352	496
BALANCE, December 31, 1998	\$323 =====	\$733,442 =====	\$37,678 =====	\$325,150 =====	\$43,946 =====	\$(75,103) =====	\$1,065,436 =====

The accompanying Notes to Consolidated Financial Statements are an integral part of these statements. Each year has been revised. See Note 2 section entitled "Restatements and Reclassifications".





FINANCIAL SECURITY ASSURANCE HOLDINGS LTD.  
AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS

(Dollars in thousands)

	Year Ended December 31,		
	1998	1997	1996
Cash flows from operating activities:			
Premiums received, net	\$ 247,229	\$ 171,145	\$ 124,540
Policy acquisition and other operating expenses paid, net	(53,306)	(43,279)	(32,266)
Recoverable advances received (paid)	1,473	(7,629)	10,213
Losses and loss adjustment expenses recovered (paid)	10,989	(6,463)	(15,473)
Net investment income received	70,146	65,662	63,533
Federal income taxes paid	(54,020)	(19,797)	(34,595)
Interest paid	(9,614)	(5,158)	(2,115)
Other	(1,623)	(2,017)	(4,253)
Net cash provided by operating activities	211,274	152,464	109,584
Cash flows from investing activities:			
Proceeds from sales of bonds	1,908,098	1,074,658	1,117,473
Proceeds from sales of equity investments	33,613	3,568	--
Proceeds from maturities of bonds	--	32,468	2,965
Purchases of bonds	(2,257,947)	(1,229,612)	(1,141,688)
Purchases of equity investments	(48,475)	(24,662)	(8,336)
Net gain on sale of subsidiaries	--	7,986	--
Purchases of property and equipment	(1,168)	(3,097)	(2,188)
Net decrease (increase) in short-term investments	39,513	(55,551)	(18,586)
Other investments	(14,610)	--	--
Net cash used for investing activities	(340,976)	(194,242)	(50,360)
Cash flows from financing activities:			
Issuance of notes payable, net	96,850	125,905	--
Repayment of notes payable	--	(30,000)	--
Dividends paid	(12,777)	(12,099)	(10,536)
Treasury stock, net	(23,686)	(36,246)	(41,660)
Issuance of stock for acquisition of subsidiary (a)	60,000	--	--
Other	330	(1,453)	--
Net cash provided by (used for) financing Activities	120,717	46,107	(52,196)
Net increase (decrease) in cash	(8,985)	4,329	7,028
Cash at beginning of year	12,475	8,146	1,118
Cash at end of year	\$ 3,490	\$ 12,475	\$ 8,146

Continued

(a) The Company exchanged \$20,000 of its stock at fair market value for \$20,000 of XL stock at fair market value. The accompanying Notes to Consolidated Financial Statements are an integral part of these statements. Each year has been revised. See Note 2 section entitled "Restatements and Reclassifications".

FINANCIAL SECURITY ASSURANCE HOLDINGS LTD.  
AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS, CONTINUED

(Dollars in thousands)

	Year Ended December 31,		
	1998	1997	1996
Reconciliation of net income to net cash flows from operating activities:			
Net income	\$115,356	\$ 94,684	\$ 78,025
Increase in accrued investment income	(3,613)	(2,504)	(578)
Increase in deferred premium revenue and related foreign exchange adjustment	82,530	62,101	29,622
Increase in deferred acquisition costs	(28,461)	(24,865)	(13,282)
Increase (decrease) in current federal income taxes payable	(1,674)	7,891	(7,368)
Increase (decrease) in unpaid losses and loss adjustment expenses	15,240	2,596	(8,023)
Increase in amounts withheld for others	82	133	52
Provision (benefit) for deferred income taxes	(2,245)	15,170	11,721
Net realized gains on investments	(20,890)	(11,522)	(3,189)
Deferred equity compensation	17,765	14,299	5,565
Depreciation and accretion of bond discount	(4,523)	(2,802)	(1,735)
Minority interest and equity in earnings of unconsolidated affiliates	844	--	--
Net gain on sale of subsidiaries	--	(7,986)	--
Change in other assets and liabilities	40,863	5,269	18,774
Cash provided by operating activities	\$211,274	\$152,464	\$109,584

The accompanying Notes to Consolidated Financial Statements are an integral part of these statements. Each year has been revised. See Note 2 section entitled "Restatements and Reclassifications".

FINANCIAL SECURITY ASSURANCE HOLDINGS LTD.  
AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

FOR THE YEARS ENDED DECEMBER 31, 1998, 1997 AND 1996

1. ORGANIZATION AND OWNERSHIP

Financial Security Assurance Holdings Ltd. (the Company) is a holding company incorporated in the State of New York. The Company is principally engaged (through its insurance company subsidiaries) in providing financial guaranty insurance on asset-backed and municipal obligations. The Company's underwriting policy is to insure asset-backed and municipal obligations that it determines would be of investment-grade quality without the benefit of the Company's insurance. The asset-backed obligations insured by the Company are generally issued in structured transactions and are backed by pools of assets such as residential mortgage loans, consumer or trade receivables, securities or other assets having an ascertainable cash flow or market value. The municipal obligations insured by the Company consist primarily of general obligation bonds that are supported by the issuers' taxing power and of special revenue bonds and other special obligations of states and local governments that are supported by the issuers' ability to impose and collect fees and charges for public services or specific projects. Financial guaranty insurance written by the Company guarantees scheduled payments on an issuer's obligation. In the case of a payment default on an insured obligation, the Company is generally required to pay the principal, interest or other amounts due in accordance with the obligation's original payment schedule or, at its option, to pay such amounts on an accelerated basis.

The Company expects to continue to emphasize a diversified insured portfolio characterized by insurance of both asset-backed and municipal obligations, with a broad geographic distribution and a variety of revenue sources and transaction structures. The Company's insured portfolio consists primarily of asset-backed and municipal obligations originated in the United States, but the Company has also written and continues to pursue business in Europe and the Asia Pacific region.

At December 31, 1996, the Company was owned 40.4% by U S WEST Capital Corporation (U S WEST), 11.5% by Fund American Enterprises Holdings, Inc. (Fund American), 6.4% by The Tokio Marine and Fire Insurance Co., Ltd. (Tokio Marine) and 41.7% by the public and employees. At December 31, 1997, the Company was owned 42.1% by U S WEST, 12.0% by Fund American, 6.7% by Tokio Marine and 39.2% by the public and employees. On November 3, 1998, the Company issued 1,632,653 common shares out of treasury to XL Capital Ltd (XL), which was named EXEL Limited until February 1999, in exchange for \$80,000,000 of XL's common stock in conjunction with the creation of a new subsidiary (see Note 7). At December 31, 1998, the Company was owned 40.5% by MediaOne Capital Corporation (MediaOne), formerly U S WEST, 11.6% by Fund American, 6.4% by Tokio Marine, 5.5% by XL and 36.0% by the public and employees. These percentages are calculated based upon outstanding shares, which are reduced by treasury shares as presented in these financial statements.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

The accompanying financial statements have been prepared in accordance with generally accepted accounting principles (GAAP), which, for the insurance company subsidiaries, differ in certain material respects from the accounting practices prescribed or permitted by insurance regulatory authorities (see Note 5). The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities in the Company's consolidated balance sheets at December 31, 1998 and 1997 and the reported amounts of revenues and expenses in the consolidated statements of income during the years ended December 31, 1998, 1997 and 1996. Such estimates and assumptions include, but are not limited to, losses and loss adjustment expenses and the deferral and amortization of deferred policy acquisition costs. Actual results may differ from those estimates. Significant accounting policies under GAAP are as follows:

## Basis of Presentation

The consolidated financial statements include the accounts of the Company and its direct and indirect subsidiaries, FSA Portfolio Management Inc., Transaction Services Corporation, Financial Security Assurance Inc. (FSA), FSA Insurance Company, Financial Security Assurance International Ltd., Financial Security Assurance of Oklahoma, Inc. and Financial Security Assurance (U.K.) Limited (collectively, the Subsidiaries). All intercompany accounts and transactions have been eliminated. Certain prior-year balances have been reclassified to conform to the 1998 presentation.

## Investments

Investments in debt securities designated as available for sale are carried at market value. Equity investments are carried at market value. Any resulting unrealized gain or loss is reflected as a separate component of shareholders' equity, net of applicable deferred income taxes. Except as specified in Note 20, all of the Company's long-term investments are classified as available for sale.

Bond discounts and premiums are amortized on the effective yield method over the remaining terms of the securities acquired. For mortgage-backed securities, and any other holdings for which prepayment risk may be significant, assumptions regarding prepayments are evaluated periodically and revised as necessary. Any adjustments required due to the resulting change in effective yields are recognized in current income. Short-term investments, which are those investments with a maturity of less than one year at time of purchase, are carried at market value, which approximates cost. Realized gains or losses on sale of investments are determined on the basis of specific identification. Investment income is recorded as earned.

The Company holds derivative securities, including U.S. Treasury bond futures contracts and call option contracts, that are not accounted for as hedges and are marked-to-market on a daily basis. Any gains or losses are included in capital gains or losses.

Investments in unconsolidated affiliates are carried on the equity basis (see Note 20).

## Premium Revenue Recognition

Gross and ceded premiums are earned in proportion to the amount of risk outstanding over the expected period of coverage. The amount of risk outstanding is equal to the sum of the par amount of debt insured. Deferred premium revenue and prepaid reinsurance premiums represent the portion of premium that is applicable to coverage of risk to be provided in the future on policies in force. When an insured issue is retired or defeased prior to the end of the expected period of coverage, the remaining deferred premium revenue and prepaid reinsurance premium, less any amount credited to a refunding issue insured by the Company, are recognized.

## Losses and Loss Adjustment Expenses

A case basis reserve for unpaid losses and loss adjustment expenses is recorded at the present value of the estimated loss when, in management's opinion, the likelihood of a future loss is probable and determinable at the balance sheet date. The estimated loss on a transaction is discounted using current risk-free rates ranging from 5.5% to 6.1%.

The general reserve is calculated by applying a loss factor to the total net par amount outstanding of the Company's insured obligations over the term of such insured obligations and discounting the result at risk-free rates. The loss factor used for this purpose has been determined based upon an independent rating agency study of bond defaults and the Company's portfolio characteristics and history. The general reserve is available to be applied against future additions or accretions to existing case basis reserves or to new case basis reserves to be established in the future.

Management of the Company periodically evaluates its estimates for losses and loss adjustment expenses and establishes reserves that management believes are adequate to cover the present value of the ultimate net cost of claims. The reserves are necessarily based on estimates, and there can be no assurance that the ultimate liability will not differ from such estimates. The Company will, on an ongoing basis, monitor these reserves and may

periodically adjust such reserves based on the Company's actual loss experience, its future mix of business, and future economic conditions.

#### Deferred Acquisition Costs

Deferred acquisition costs comprise those expenses that vary with and are primarily related to the production of business, including commissions paid on reinsurance assumed, compensation and related costs of underwriting and marketing personnel, certain rating agency fees, premium taxes and certain other underwriting expenses, reduced by ceding commission income on premiums ceded to reinsurers. Deferred acquisition costs and the cost of acquired business are amortized over the period in which the related premiums are earned. Recoverability of deferred acquisition costs is determined by considering anticipated losses and loss adjustment expenses.

#### Federal Income Taxes

The provision for income taxes consists of an amount for taxes currently payable and a provision for tax consequences deferred to future periods reflected at current income tax rates.

#### Earnings per Common Share

In 1997, the Company adopted Statement of Financial Accounting Standards (SFAS) No. 128, Earnings Per Share (EPS), specifying the computation, presentation and disclosure requirements for EPS (see Note 18). The new standard defines "basic" and "diluted" earnings per share. Basic earnings per share are based on average basic shares outstanding, which is calculated by adding shares earned but not issued under the Company's equity bonus and performance share programs to the average common shares outstanding. Diluted earnings per share are based on average diluted shares outstanding, which is calculated by adding shares contingently issuable under stock options, the performance share program and the Company's redeemable preferred stock to the average basic shares outstanding. All earnings per share have been restated to reflect the adoption of SFAS No. 128.

#### Segment Reporting

In 1997, the Financial Accounting Standards Board issued SFAS No. 131, Disclosure about Segments of an Enterprise and Related Information, establishing standards for the way that public business enterprises report information about operating segments in annual and interim financial statements and requiring presentation of a measure of profit or loss, certain specific revenue and expense items and segment assets. The Company has no reportable operating segments as a monoline financial guaranty insurer.

#### Restatements and Reclassifications:

In May 1996, the Company entered into a forward share purchase agreement with two financial institutions, under which it had the ability to acquire up to 1,750,000 shares of its stock for \$26.50 plus accumulated financing charges. The Company retained the economic interest in 1,000,000 shares and passed both the economic risk and reward in the remaining 750,000 shares on to a group of the Company's employees and directors, who were required to post collateral against the risk of a decline in market value of the shares

The Company accounted for the 1,000,000 share obligation under the "permanent equity" provisions of EITF 96-13, which resulted in no impact on the Company's financial statements until the shares were acquired as treasury stock in December 1997. With regard to the 750,000 shares made available to employees and directors, of which 529,122 shares remain outstanding, the Company offset the gain on the forward share agreement against the corresponding increased liability to the employees and directors, resulting in no net impact on the Company's financial statements until settlement. At settlement, the Company's paid-in surplus is credited with the tax savings resulting from the transaction.

During a review of the Company's shelf registration statement in April 1999, the Securities and Exchange Commission (SEC) staff advised the Company that, in its opinion, the gain on the forward purchase agreement should not be used to offset the additional liability to the employees and directors. After discussion with the SEC staff, the Company has revised its accounting to recognize the liability as incurred and to recognize the offsetting gain on the forward purchase agreement as an addition to paid-in surplus upon settlement (assuming cash

settlement).

The effect of this change in accounting for the forward share purchase agreements was to (decrease) the amounts previously reported as shown below (in thousands, except per share data):

	1998 ----	1997 ----	1996 ----
Income before income taxes	(\$2,495)	(\$8,951)	(\$4,208)
Net Income	(1,622)	(5,818)	(2,735)
EPS - Basic	(.06)	(.19)	(.09)
EPS - Diluted	(.05)	(.19)	(.09)
Shareholder's Equity	(7,300)	(6,411)	

In addition, the Company reclassified the redeemable preferred stock outside of shareholder's equity, which decreased shareholder's equity as of December 31, 1998 and 1997 by \$700,000.

Historically, purchases of tax and loss bonds were treated as charges to current tax expense with a corresponding benefit to deferred taxes by setting up tax and loss bonds as a deferred tax asset (i.e., reduction of the deferred tax liability). These purchases have been reclassified to be treated as prepaid federal income taxes and, as a consequence, tax and loss bonds have been classified as an asset on the balance sheet and not as a reduction of the deferred tax liability. Accordingly, the change had the effect of increasing both assets and liabilities by \$38,726,000 and \$30,520,000 at December 31, 1998 and 1997, respectively. This reclassification has no effect on the Company's net income or shareholders' equity.

### 3. INVESTMENTS

Bonds at amortized cost of \$11,481,000 and \$11,025,000 at December 31, 1998 and 1997, respectively, were on deposit with state regulatory authorities as required by insurance regulations.

Consolidated net investment income consisted of the following (in thousands):

	Year Ended December 31,		
	1998 ----	1997 ----	1996 ----
Bonds	\$ 71,888	\$ 65,422	\$ 61,740
Equity investments	1,075	1,393	928
Short-term investments	8,391	7,206	3,966
Investment expenses	(2,531)	(1,936)	(1,570)
	-----	-----	-----
Net investment income	\$ 78,823 =====	\$ 72,085 =====	\$ 65,064 =====

The credit quality of the fixed-income investment portfolio at December 31, 1998 was as follows:

Rating -----	Percent of Fixed-Income Investment Portfolio -----
AAA	66.0%
AA	20.4
A	12.9
BBB	0.4
Other	0.3

The amortized cost and estimated market value of bonds were as follows (in thousands):

December 31, 1998	Amortized Cost -----	Gross Unrealized Gains -----	Gross Unrealized Losses -----	Estimated Market Value -----
U.S. Treasury securities and obligations of U.S. government corporations and agencies	\$ 148,669	\$ 2,432	\$ (336)	\$ 150,765
Obligations of states and political subdivisions	1,041,718	42,265	(637)	1,083,346
Mortgage-backed securities	266,770	3,920	(190)	270,500
Corporate securities	164,697	5,539	(463)	169,773
Asset-backed securities	33,188	494	(26)	33,656
	-----	-----	-----	-----
Total	\$1,655,042	\$ 54,650	\$ (1,652)	\$1,708,040
	=====	=====	=====	=====
December 31, 1997				
U.S. Treasury securities and obligations of U.S. government corporations and agencies	\$ 122,817	\$ 799	\$ (454)	\$ 123,162
Obligations of states and political subdivisions	777,042	40,187	(135)	817,094
Foreign securities	48,078	--	(6,126)	41,952
Mortgage-backed securities	195,567	2,213	(27)	197,753
Corporate securities	66,014	1,375	(501)	66,888
Asset-backed securities	20,961	349	(1)	21,309
	-----	-----	-----	-----
Total	\$1,230,479	\$ 44,923	\$ (7,244)	\$1,268,158
	=====	=====	=====	=====

The change in net unrealized gains (losses) consisted of (in thousands):

	Year Ended December 31,		
	1998 -----	1997 -----	1996 -----
Bonds	\$ 15,319	\$ 23,657	\$(16,640)
Equity investments	2,842	1,109	--
Other	1,017	--	--
	-----	-----	-----
Change in net unrealized gains (losses)	\$ 19,178	\$ 24,766	\$(16,640)
	=====	=====	=====



The amortized cost and estimated market value of bonds at December 31, 1998, by contractual maturity, are shown below (in thousands). Actual maturities could differ from contractual maturities because borrowers have the right to call or prepay certain obligations with or without call or prepayment penalties.

	Amortized Cost -----	Estimated Market Value -----
Due in one year or less	\$ 1,002	\$ 1,006
Due after one year through five years	137,094	139,642
Due after five years through ten years	225,259	233,080
Due after ten years	991,729	1,030,156
Mortgage-backed securities (stated maturities of 1 to 30 years)	266,770	270,500
Asset-backed securities (stated maturities of 25 to 30 years)	33,188	33,656
	-----	-----
Total	\$1,655,042	\$1,708,040
	=====	=====

Proceeds from sales of bonds during 1998, 1997 and 1996 were \$1,889,130,000, \$1,127,749,000 and \$1,118,112,000, respectively. Gross gains of \$28,322,000, \$12,627,000 and \$15,335,000 and gross losses of \$8,585,000, \$1,433,000 and \$12,146,000 were realized on sales in 1998, 1997 and 1996, respectively.

Proceeds from sales of equity investments during 1998 and 1997 were \$33,613,000 and \$3,568,000, respectively. Gross gains of \$2,684,000 and \$33,000 and gross losses of \$1,331,000 and \$7,000 were realized on sales in 1998 and 1997, respectively.

The Company held open positions in U.S. Treasury bond futures contracts with an aggregate notional amount of \$57,700,000 and \$33,300,000 as of December 31, 1998 and 1997, respectively. The Company also held open positions in Eurodollar futures contracts with an aggregate notional amount of \$1,000,000 as of December 31, 1998. Such positions are marked-to-market on a daily basis and, for the years ended December 31, 1998, 1997 and 1996, resulted in net realized gains of \$883,000, \$190,000 and \$923,000, respectively, which are included in gross realized capital gains, above.

#### 4. DEFERRED ACQUISITION COSTS

Acquisition costs deferred for amortization against future income and the related amortization charged to expenses are as follows (in thousands):

	Year Ended December 31, -----		
	1998 ----	1997 ----	1996 ----
Balance, beginning of period	\$171,098	\$146,233	\$132,951
	-----	-----	-----
Costs deferred during the period:			
Ceding commission income	(27,693)	(18,956)	(15,956)
Assumed commission expense	22	31	38
Premium taxes	8,081	5,554	3,718
Compensation and other acquisition costs	83,490	66,198	49,311
	-----	-----	-----
Total	63,900	52,827	37,111
	-----	-----	-----
Costs amortized during the period	(35,439)	(27,962)	(23,829)
	-----	-----	-----
Balance, end of period	\$199,559	\$171,098	\$146,233
	=====	=====	=====

## 5. STATUTORY ACCOUNTING PRACTICES

GAAP for the Subsidiaries differs in certain significant respects from accounting practices prescribed or permitted by insurance regulatory authorities. The principal differences result from the following statutory accounting practices:

- Upfront premiums on municipal business are recognized as earned when related principal and interest have expired rather than over the expected coverage period;
- Acquisition costs are charged to operations as incurred rather than as related premiums are earned;
- A contingency reserve (rather than a general reserve) is computed based on the following statutory requirements:
  - (i) For all policies written prior to July 1, 1989, an amount equal to 50% of cumulative earned premiums less permitted reductions, plus;
  - (ii) For all policies written on or after July 1, 1989, an amount equal to the greater of 50% of premiums written for each category of insured obligation or a designated percentage of principal guaranteed for that category. These amounts are provided each quarter as either 1/60th or 1/80th of the total required for each category, less permitted reductions;
- Certain assets designated as "non-admitted assets" are charged directly to statutory surplus but are reflected as assets under GAAP;
- Federal income taxes are provided only on taxable income for which income taxes are currently payable, including the purchase of tax and loss bonds;
- Accruals for deferred compensation are not recognized;
- Purchase accounting adjustments are not recognized;
- Bonds are carried at amortized cost;
- Surplus notes are recognized as surplus rather than a liability.

A reconciliation of net income for the calendar years 1998, 1997 and 1996 and shareholders' equity at December 31, 1998 and 1997, reported by the Company on a GAAP basis, to the amounts reported by the Subsidiaries on a statutory basis, is as follows (in thousands):

Net Income:	1998	1997	1996
	----	----	----
GAAP BASIS	\$115,356	\$ 94,684	\$ 78,025
Non-insurance companies net loss (gain)	5,461	5,575	2,830
Premium revenue recognition	(16,411)	(23,130)	(5,518)
Losses and loss adjustment expenses incurred	12,938	4,653	(2,138)
Deferred acquisition costs	(28,461)	(24,865)	(12,482)
Deferred income tax provision	167	16,019	12,321
Current income tax	(8,206)	(7,994)	(11,410)
Amortization of bonds	--	56	566
Accrual of deferred compensation, net	33,268	26,681	12,737
Other	100	(61)	1,404
	-----	-----	-----
STATUTORY BASIS	\$114,212	\$ 91,618	\$ 76,335
	=====	=====	=====

	December 31,	
	-----	-----
Shareholders' Equity:	1998	1997
	----	----
GAAP BASIS	\$1,065,436	\$ 875,249
Non-insurance companies liabilities, net	39,155	22,611
Premium revenue recognition	(91,297)	(74,863)
Loss and loss adjustment expense reserves	47,250	34,313
Deferred acquisition costs	(199,559)	(171,098)
Contingency reserve	(367,454)	(287,694)
Unrealized gain on investments, net of tax	(55,851)	(43,027)
Deferred income taxes	95,398	90,387
Tax and loss bonds	(38,726)	(30,520)
Accrual of deferred compensation	70,022	41,451
Surplus notes	120,000	50,000
Other	(14,118)	(12,841)
	-----	-----
STATUTORY BASIS SURPLUS	\$ 670,256	\$ 493,968
	=====	=====
SURPLUS PLUS CONTINGENCY RESERVE	\$1,037,710	\$ 781,661
	=====	=====

#### 6. FEDERAL INCOME TAXES

The Company and its Subsidiaries (except Financial Security Assurance International Ltd.) file a consolidated federal income tax return. The calculation of each member's tax benefit or liability is controlled by a tax sharing agreement that bases the allocation of such benefit or liability upon a separate return calculation.

Prior to 1998, purchases of tax and loss bonds were treated as charges to current tax expense with a corresponding benefit to deferred taxes by setting up tax and loss bonds as a deferred tax asset (i.e., reduction of the deferred tax liability). Beginning in 1998, these purchases have been treated as prepaid federal income taxes and, as a consequence, tax and loss bonds have been treated as an asset on the balance sheet and not as a reduction of the deferred tax liability. Accordingly, the change had the effect of increasing both assets and liabilities by \$38,726,000 and \$30,520,000 at December 31, 1998 and 1997, respectively. In addition, this change had the effect of increasing the deferred tax provision and decreasing the current tax provision by \$8,206,000, \$7,994,000, and \$11,410,000 for the years ended December 31, 1998, 1997 and 1996, respectively.

The cumulative balance sheet effects of deferred tax consequences are (in thousands):

	December 31,	
	-----	-----
	1998	1997
	----	----
Deferred acquisition costs	\$ 69,079	\$ 59,884
Deferred premium revenue adjustments	10,354	8,424
Unrealized capital gains	21,134	15,618
Contingency reserves	46,260	38,037
	-----	-----
Total deferred tax liabilities	146,827	121,963
	-----	-----
Loss and loss adjustment expense reserves	(16,613)	(12,009)
Deferred compensation	(41,545)	(26,109)
Other, net	(1,415)	(1,059)
	-----	-----
Total deferred tax assets	(59,573)	(39,177)
	-----	-----
Total deferred income taxes	\$ 87,254	\$ 82,786
	=====	=====

No valuation allowance was necessary at December 31, 1998 or 1997.

A reconciliation of the effective tax rate with the federal statutory rate follows:

	Year Ended December 31,		
	1998	1997	1996
Tax at statutory rate	35.0%	35.0%	35.0%
Tax-exempt interest	(8.6)	(8.4)	(9.3)
Other	0.3	0.3	0.4
	----	----	----
Provision for income taxes	26.7%	26.9%	26.1%
	====	====	====

#### 7. SHAREHOLDERS' EQUITY AND REDEEMABLE PREFERRED STOCK

On September 2, 1994, the Company issued to Fund American 2,000,000 shares of Series A, non-dividend paying, voting, redeemable preferred stock having an aggregate liquidation preference of \$700,000. The preferred stock is redeemable, at the option of the holder upon payment of the conversion price therefor, into an equal number of shares of common stock (subject to anti-dilutive adjustment). The conversion price per share (subject to anti-dilutive adjustment) is \$29.65. The preferred stock will be redeemed (if then outstanding) on May 13, 2004 at a redemption price of \$0.35 per share. Fund American is entitled to one vote per share of redeemable preferred stock, voting together as a single class with the holders of common stock on all matters upon which holders of common stock are entitled to vote. As the holder of the redeemable preferred stock, Fund American is not entitled to receive dividends or other distributions of any kind payable to shareholders of the Company, except that, in the event of the liquidation, dissolution or winding up of the Company, it is entitled to receive out of the assets of the Company available therefor, before any distribution or payment is made to the holders of common stock or to any other class of capital stock of the Company ranking junior to the Company's preferred stock, liquidation payments in the amount of \$0.35 per share. Fund American may not transfer the redeemable preferred stock, except to one of its majority-owned subsidiaries.

In May 1996, the Company repurchased 1,000,000 shares of its common stock from U S WEST for a purchase price of \$26.50 per share. At the same time, the Company also entered into forward agreements with two financial institutions (the Counterparties) in respect of 1,750,000 shares (the Forward Shares) of the Company's common stock. Under the forward agreements, the Company has the obligation either: (i) to purchase the Forward Shares from the Counterparties for a price equal to \$26.50 per share plus carrying costs or (ii) to direct the Counterparties to sell the Forward Shares, with the Company receiving any excess or making up any shortfall between the sale proceeds and \$26.50 per share plus carrying costs in cash or additional shares, at its option. At the same time it entered into the forward agreements, the Company made the economic benefit and risk of 750,000 of these shares available for subscription by certain of the Company's employees and directors. When an individual participant exercises Forward Shares under the subscription program, the Company settles with the participant but does not necessarily close out the corresponding forward share position with the Counterparties. These settlements during 1998 and 1997 were \$733,000 and \$2,142,000, respectively. By the fourth quarter of 1997, such exercises by participants had increased the number of shares allocated to the Company from 1,000,000 shares to 1,187,800 shares. During the fourth quarter of 1997, the Company purchased 1,187,800 Forward Shares for \$33,910,000 by exercising rights under the forward agreements. At December 31, 1998, 562,200 Forward Shares remained in the program. Of these, 33,078 shares were held for the benefit of the Company as a result of the repurchase of Forward Shares from employees and directors, and 529,122 shares continued to be held for the benefit of employees and directors. The Company has recognized compensation expense for the difference between the carrying cost and the market value at December 31, 1998, 1997 and 1996 of \$2,495,000, \$8,951,000 and \$4,208,000, respectively.

On November 3, 1998, the Company and XL closed a transaction to create two new Bermuda-based financial guaranty insurance companies. Each of the new companies has been initially capitalized with approximately \$100,000,000. One company, Financial Security Assurance International Ltd., is an indirect subsidiary of FSA, and the other company, XL Financial Assurance Ltd, is a subsidiary of XL. The Company has a minority interest in the XL subsidiary, and XL has a minority interest in the FSA indirect subsidiary. In conjunction with forming the new companies, the Company and XL exchanged \$80,000,000 of their respective common shares, with the Company delivering to XL 1,632,653 common shares out of treasury. Prior to the closing of the transaction with XL, the Company had entered into an agreement with an unrelated third party to sell for cash, at no gain or loss,

\$60,000,000 of the XL shares. This \$60,000,000 was used to fund, in part, the Company's investment in Financial Security Assurance International Ltd.

#### 8. DIVIDENDS AND CAPITAL REQUIREMENTS

Under New York Insurance Law, FSA may pay a dividend to the Company without the prior approval of the Superintendent of the New York State Insurance Department only from earned surplus subject to the maintenance of a minimum capital requirement. In addition, the dividend, together with all dividends declared or distributed by FSA during the preceding twelve months, may not exceed the lesser of 10% of its policyholders' surplus shown on FSA's last filed statement, or adjusted net investment income, as defined, for such twelve-month period. As of December 31, 1998, FSA had \$65,726,000 available for the payment of dividends over the next twelve months. In addition, the Company holds \$120,000,000 of surplus notes of FSA. Payments of principal or interest on such notes may be made with the approval of the New York Insurance Department.

In 1998, FSA repurchased \$8,500,000 of its shares from its parent, representing the balance remaining of \$75,000,000 that had been approved for repurchase by the New York Insurance Department.

#### 9. CREDIT ARRANGEMENTS AND ADDITIONAL CLAIMS-PAYING RESOURCES

FSA has a credit arrangement aggregating \$150,000,000 at December 31, 1998, which is provided by commercial banks and intended for general application to transactions insured by the Subsidiaries. At December 31, 1998, there were no borrowings under this arrangement, which expires on November 23, 1999. In addition, there are credit arrangements assigned to specific insured transactions. In August 1994, FSA entered into a facility agreement with Canadian Global Funding Corporation and Hambros Bank Limited. Under the agreement, which expires in August 2004, FSA can arrange financing for transactions subject to certain conditions. The amount of this facility was \$186,911,000, of which \$44,974,000 was unutilized at December 31, 1998.

FSA has a standby line of credit commitment in the amount of \$240,000,000 with a group of international Aaa/AAA-rated banks to provide loans to FSA after it has incurred, during the term of the facility, cumulative municipal losses (net of any recoveries) in excess of the greater of \$230,000,000 or 5.75% of average annual debt service of the covered portfolio. The obligation to repay loans made under this agreement is a limited recourse obligation payable solely from, and collateralized by, a pledge of recoveries realized on defaulted insured obligations in the covered portfolio, including certain installment premiums and other collateral. This commitment has a term beginning on April 30, 1997 and expiring on April 30, 2004 and contains an annual renewal provision subject to approval by the banks. No amounts have been utilized under this commitment as of December 31, 1998.

On September 18, 1997, the Company issued \$130,000,000 of 7.375% Senior Quarterly Income Debt Securities (Senior QUIDS) due September 30, 2097 and callable without premium or penalty on or after September 18, 2002. Interest on these notes is paid quarterly beginning on December 31, 1997. Debt issuance costs of \$4,320,000 are being amortized over the life of the debt. The Company used the proceeds to repay \$30,000,000 of outstanding notes, to augment capital in the Subsidiaries, to repurchase Forward Shares (see Note 7) and for general corporate purposes.

On November 13, 1998, the Company issued \$100,000,000 of 6.95% Senior QUIDS due November 1, 2098 and callable without premium or penalty on or after November 1, 2003. Interest is paid quarterly beginning on February 1, 1999. Debt issuance costs of \$3,375,000 are being amortized over the life of the debt. The Company used the proceeds to augment capital in the Subsidiaries and for general corporate purposes.

#### 10. EMPLOYEE BENEFIT PLANS

The Subsidiaries maintain both a qualified and a non-qualified non-contributory defined contribution pension plan for the benefit of all eligible employees. The Subsidiaries' contributions are based upon a fixed percentage of employee compensation. Pension expense, which is funded as accrued, amounted to \$2,584,000, \$2,535,000 and \$2,215,000 for the years ended December 31, 1998, 1997 and 1996, respectively.

The Subsidiaries have an employee retirement savings plan for the benefit of all eligible employees. The plan permits employees to contribute a percentage of their salaries up to limits prescribed by the Internal Revenue Service (IRS Code, Section 401(k)). The Subsidiaries' contributions are discretionary, and none have been made.

Pursuant to the 1993 Equity Participation Plan, 1,810,780 shares of common stock, subject to anti-dilutive adjustment, were reserved for awards of options, restricted shares of common stock, and performance shares to employees for the purpose of providing, through the grant of long-term incentives, a means to attract and retain key personnel and to provide to participating officers and other key employees long-term incentives for sustained high levels of performance. Shares available under the 1993 Equity Participation Plan were increased from 1,810,780 to 2,110,780 in December 1995. The 1993 Equity Participation Plan also contains provisions that permit the Human Resources Committee to pay all or a portion of employees' bonuses in the form of shares of common stock credited to the employees at a 15% discount from current market value and paid to employees five years from the date of award. Up to an aggregate of 10,000,000 shares may be allocated to such equity bonuses. Common stock to pay performance shares, stock options and equity bonus awards is acquired by the Company through open-market purchases by a trust established for such purpose.

Performance shares are awarded under the Company's 1993 Equity Participation Plan. The Plan authorizes the discretionary grant of performance shares by the Human Resources Committee to key employees of the Company and its subsidiaries. The number of shares of the Company's common stock earned for each performance share depends upon the attainment by the Company of certain growth rates of adjusted book value per outstanding share over a three-year period. At each payout date, each performance share is adjusted to pay out from zero up to two common shares. No common shares are paid out if the compound annual growth rate of the Company's adjusted book value per outstanding share was less than 7%. Two common shares per performance share are paid out if the compound annual growth rate was 19% or greater. Payout percentages are interpolated for compound annual growth rates between 7% and 19%.

Performance shares granted under the 1993 Equity Participation Plan were as follows:

	Outstanding at Beginning of Year -----	Granted During the Year -----	Earned During the Year -----	Forfeited During the Year -----	Outstanding at End of Year -----	Market Price at Grant Date -----
1996	1,109,150	282,490	--	17,300	1,374,340	\$25.2500
1997	1,374,340	253,057	201,769	59,253	1,366,375	35.5000
1998	1,366,375	273,656	229,378	26,145	1,384,508	46.0625

The Company applies APB Opinion 25 and related Interpretations in accounting for its performance shares. The Company estimates the final cost of these performance shares and accrues for this expense over the performance period. The accrued expense for the performance shares was \$40,862,000, \$29,500,000 and \$13,741,000 for the years ended December 31, 1998, 1997 and 1996, respectively. In tandem with this accrued expense, the Company estimates those performance shares that it expects to settle in stock and records this amount in shareholders' equity as deferred compensation. The remainder of the accrual, which represents the amount of performance shares that the Company estimates it will settle in cash, is recorded in accrued expenses and other liabilities. In 1996, the Company adopted disclosure provisions of SFAS No. 123. Had the compensation cost for the Company's performance shares been determined based upon the provisions of SFAS No. 123, there would have been no effect on the Company's reported net income and earnings per share.

In November 1994, the Company appointed an independent trustee authorized to purchase shares of the Company's common stock in open market transactions, at times and prices determined by the trustee. These purchases are intended to fund future obligations relating to equity bonuses, performance shares and stock options under the 1993 Equity Participation Plan and other employee benefit plans and are presented as treasury stock in these financial statements. During 1998, 1997 and 1996, the total number of shares purchased by the trust was 496,940, 162,573 and 529,131, respectively, at a cost of \$23,907,000, \$5,434,000 and \$14,111,000, respectively. In 1996, the Company also repurchased stock from its employees in satisfaction of withholding taxes on shares distributed under its restricted stock plan.

The Company does not currently provide post-retirement benefits, other than under its defined contribution plans, to its employees, nor does it provide post-employment benefits to former employees other than under its severance plans.

#### 11. COMMITMENTS AND CONTINGENCIES

The Company and its Subsidiaries lease office space and equipment under non-cancelable operating leases, which expire at various dates through 2005.

Future minimum rental payments are as follows (in thousands):

Year Ended December 31, -----	
1999	\$ 2,489
2000	2,327
2001	2,014
2002	1,739
2003	1,739
Thereafter	3,333
	-----
Total	\$13,641
	=====

Rent expense for the years ended December 31, 1998, 1997 and 1996 was \$4,372,000, \$4,067,000 and \$3,816,000, respectively.

During the ordinary course of business, the Company and its Subsidiaries become parties to certain litigation. Management believes that these matters will be resolved with no material impact on the Company's financial position, results of operations or cash flows.

#### 12. REINSURANCE

The Subsidiaries reinsure portions of their risks with affiliated (see Note 14) and unaffiliated reinsurers under quota share and first-loss treaties and on a facultative basis. The Subsidiaries' principal ceded reinsurance program consisted in 1998 of two quota share treaties, one first-loss treaty and four automatic facultative facilities. One treaty covered all of the Subsidiaries' approved regular lines of business, except U.S. municipal obligation insurance. Under this treaty in 1998, the Subsidiaries ceded 6.75% of each covered policy, up to a maximum of \$13,500,000 insured principal per policy. At their sole option, the Subsidiaries could have increased, and in certain instances did increase, the ceding percentage to 13.5% up to \$27,000,000 of each covered policy. A second treaty covered the Subsidiaries' U.S. municipal obligation insurance business. Under this treaty in 1998, the Subsidiaries ceded 6% of each covered policy that is classified by the Subsidiaries as providing U.S. municipal bond insurance as defined by Article 69 of the New York Insurance Law up to a limit of \$16,000,000 per single risk, which is defined by revenue source. At their sole option, the Subsidiaries could have increased, and in certain instances did increase, the ceding percentage to 30% up to \$80,000,000 per single risk. These cession percentages under both treaties were reduced on smaller-sized transactions. The first-loss treaty applied to qualifying U.S. mortgage-backed transactions. Under the four automatic facultative facilities in 1998, the Subsidiaries at their option could allocate up to a specified amount for each reinsurer (ranging from \$4,000,000 to \$40,000,000 depending on the reinsurer) for each transaction, subject to limits and exclusions, in exchange for which the Subsidiaries agreed to cede in the aggregate a specified percentage of gross par insured by the Subsidiaries. Each of the quota share treaties and automatic facultative facilities allowed the Subsidiaries to withhold a ceding commission to defray their expenses. The Subsidiaries also employed non-treaty quota share and first-loss facultative reinsurance on various transactions in 1998.

In the event (which management considers to be highly unlikely) that any or all of the reinsuring companies were unable to meet their obligations to the Subsidiaries, the Subsidiaries would be liable for such defaulted

amounts. The Subsidiaries have also assumed reinsurance of municipal obligations from unaffiliated insurers.

Amounts reinsured were as follows (in thousands):

	Year Ended December 31,		
	1998	1997	1996
Written premiums ceded	\$99,413	\$63,513	\$55,965
Written premiums assumed	935	1,352	1,873
Earned premiums ceded	55,939	41,713	38,723
Earned premiums assumed	4,271	5,121	6,020
Loss and loss adjustment expense payments ceded	22,619	2,862	29,408
Loss and loss adjustment expense payments assumed	3	2	3
Incurred (recovered) losses and loss adjustment expenses ceded	(4,673)	3,605	(2,249)
Incurred (recovered) losses and loss adjustment expenses assumed	(139)	161	38

	December 31,	
	1998	1997
Principal outstanding ceded	\$32,914,844	\$24,547,361
Principal outstanding assumed	1,360,916	1,670,468
Deferred premium revenue ceded	217,096	173,123
Deferred premium revenue assumed	10,799	14,128
Loss and loss adjustment expense reserves ceded	3,907	30,618
Loss and loss adjustment expense reserves assumed	723	865

### 13. OUTSTANDING EXPOSURE AND COLLATERAL

The Company's policies insure the scheduled payments of principal and interest on asset-backed and municipal obligations. The principal amount insured (in millions) as of December 31, 1998 and 1997 (net of amounts ceded to other insurers) and the terms to maturity are as follows:

Terms to Maturity	December 31, 1998		December 31, 1997	
	Asset-Backed	Municipal	Asset-Backed	Municipal
0 to 5 Years	\$ 8,468	\$ 2,756	\$ 7,553	\$ 2,230
5 to 10 Years	7,516	7,495	5,637	5,683
10 to 15 Years	5,661	12,427	2,858	8,257
15 to 20 Years	670	20,265	524	14,340
20 Years and Above	15,308	24,107	11,917	16,479
Total	\$37,623	\$67,050	\$28,489	\$46,989

The principal amount ceded as of December 31, 1998 and 1997 and the terms to maturity are as follows (in millions):

Terms to Maturity	December 31, 1998		December 31, 1997	
	Asset-Backed	Municipal	Asset-Backed	Municipal
0 to 5 Years	\$ 2,727	\$ 1,157	\$ 3,828	\$ 965
5 to 10 Years	1,859	2,143	2,118	1,693
10 to 15 Years	1,116	3,022	553	2,078
15 to 20 Years	591	4,852	257	3,005



20 Years and Above	3,230	12,218	3,373	6,677
	-----	-----	-----	-----
Total	\$ 9,523	\$23,392	\$10,129	\$14,418
	=====	=====	=====	=====

The Company limits its exposure to losses from writing financial guarantees by underwriting investment-grade obligations, diversifying its portfolio and maintaining rigorous collateral requirements on asset-backed obligations, as well as through reinsurance. The gross principal amounts of insured obligations in the asset-backed insured portfolio are backed by the following types of collateral (in millions):

Types of Collateral	Net of Amounts Ceded		Ceded	
	December 31,		December 31,	
	1998	1997	1998	1997
Residential mortgages	\$15,647	\$12,928	\$ 3,324	\$ 3,665
Consumer receivables	12,539	10,659	3,663	4,601
Government securities	821	787	267	120
Pooled corporate obligations	6,776	3,004	1,388	540
Commercial mortgage portfolio:				
Commercial real estate	15	98	49	418
Corporate secured	42	55	314	481
Investor-owned utility obligations	757	643	464	229
Other asset-backed obligations	1,026	315	54	75
	-----	-----	-----	-----
Total asset-backed obligations	\$37,623	\$28,489	\$ 9,523	\$10,129
	=====	=====	=====	=====

The asset-backed insured portfolio, which aggregated \$47,146,604,000 of principal before reinsurance at December 31, 1998, was collateralized by assets with an estimated fair value of \$53,754,485,000. At December 31, 1997, it aggregated \$38,618,244,000 of principal before reinsurance and was collateralized by assets with an estimated fair value of \$44,382,716,000. Such estimates of fair value are calculated at the inception of each insurance policy and are changed only in proportion to changes in exposure. At December 31, 1998, the estimated fair value of collateral and reserves over the principal insured averaged from 110% for commercial real estate to 181% for corporate secured obligations. At December 31, 1997, the estimated fair value of collateral and reserves over the principal insured averaged from 100% for commercial real estate to 172% for corporate secured obligations. Collateral for specific transactions is generally not available to pay claims related to other transactions. The amounts of losses ceded to reinsurers are determined net of collateral.

The gross principal amount of insured obligations in the municipal insured portfolio includes the following types of issues (in millions):

Types of Issues	Net of Amounts Ceded		Ceded	
	December 31,		December 31,	
	1998	1997	1998	1997
General obligation bonds	\$25,337	\$17,101	\$ 4,517	\$ 3,182
Housing revenue bonds	2,509	1,770	1,108	955
Municipal utility revenue bonds	9,218	5,892	5,489	2,294
Health care revenue bonds	5,812	3,924	3,348	2,175
Tax-supported bonds (non-general obligation)	14,731	11,210	5,238	3,526
Transportation revenue bonds	2,937	1,972	2,154	1,041
Other municipal bonds	6,506	5,120	1,538	1,245
	-----	-----	-----	-----
Total municipal obligations	\$67,050	\$46,989	\$23,392	\$14,418
	=====	=====	=====	=====

In its asset-backed business, the Company considers geographic concentration as a factor in underwriting insurance covering securitizations of pools of such assets as residential mortgages or consumer receivables. However, after the initial issuance of an insurance policy relating to such securitization, the geographic

concentration of the underlying assets may not remain fixed over the life of the policy. In addition, in writing insurance for other types of asset-backed obligations, such as securities primarily backed by government or corporate debt, geographic concentration is not deemed by the Company to be significant given other more relevant measures of diversification such as issuer or industry.

The Company seeks to maintain a diversified portfolio of insured municipal obligations designed to spread its risk across a number of geographic areas. The following table sets forth, by state, those states in which municipalities located therein issued an aggregate of 2% or more of the Company's net par amount outstanding of insured municipal securities as of December 31, 1998:

State	Number of Issues	Net Par Amount Outstanding (in millions)	Percent of Total Municipal Net Par Amount Outstanding	Ceded Par Amount Outstanding (in millions)
California	517	\$10,233	15.3%	\$ 3,103
New York	388	5,836	8.7	4,137
Pennsylvania	356	4,821	7.2	834
Texas	414	4,128	6.1	1,441
Florida	130	4,091	6.1	1,616
New Jersey	275	3,475	5.2	1,486
Illinois	359	3,125	4.7	628
Massachusetts	126	2,259	3.4	976
Michigan	217	2,161	3.2	511
Wisconsin	252	1,685	2.5	228
Indiana	103	1,461	2.2	162
Minnesota	146	1,340	2.0	191
All Other States	1,453	20,993	31.3	6,812
Non-U.S	32	1,442	2.1	1,267
	-----	-----	-----	-----
Total	4,768	\$67,050	100.0%	\$23,392
	=====	=====	=====	=====

#### 14. RELATED PARTY TRANSACTIONS

The Subsidiaries ceded premiums of \$23,838,000, \$21,216,000 and \$19,890,000 to Tokio Marine for the years ended December 31, 1998, 1997 and 1996, respectively. The amounts included in prepaid reinsurance premiums at December 31, 1998 and 1997 for reinsurance ceded to Tokio Marine were \$62,422,000 and \$53,603,000, respectively. Reinsurance recoverable on unpaid losses ceded to Tokio Marine was \$612,000 and \$613,000 at December 31, 1998 and 1997, respectively. The Subsidiaries ceded losses and loss adjustment expenses of \$603,000, \$1,095,000 and \$232,000 to Tokio Marine for the years ended December 31, 1998, 1997 and 1996, respectively. The Subsidiaries ceded premiums of \$7,297,000 and \$15,000 to X.L. Insurance Company, Ltd., a subsidiary of XL, for the years ended December 31, 1998 and 1997, respectively. The amounts included in prepaid reinsurance premiums at December 31, 1998 and 1997 for reinsurance ceded to X.L. Insurance Company, Ltd. were \$5,306,000 and \$6,000, respectively.

The Subsidiaries ceded premiums of \$25,862,000, \$16,890,000 and \$15,409,000 on a quota share basis to affiliates of MediaOne (Enhance Reinsurance Company, Asset Guaranty Insurance Company and Commercial Reinsurance Company) for the years ended December 31, 1998, 1997 and 1996, respectively. The amounts included in prepaid reinsurance premiums for reinsurance ceded to these affiliates were \$61,088,000 and \$51,980,000 at December 31, 1998 and 1997, respectively. The amounts of reinsurance recoverable on unpaid losses ceded to these affiliates at December 31, 1998 and 1997 were \$1,755,000 and \$24,195,000, respectively. The Subsidiaries ceded losses and loss adjustment expenses (recoveries) of \$(11,956,000), \$2,105,000 and \$(3,316,000) to these affiliates for the years ended December 31, 1998, 1997 and 1996, respectively.

#### 15. DISCLOSURES ABOUT FAIR VALUE OF FINANCIAL INSTRUMENTS

The following estimated fair values have been determined by the Company using available market information and appropriate valuation methodologies. However, considerable judgment is necessary to interpret the data to develop the estimates of fair value. Accordingly, the estimates presented herein are not necessarily indicative of the amount the Company could realize in a current market exchange. The use of different market assumptions and/or estimation methodologies may have a material effect on the estimated fair value amounts.

Bonds -- The carrying amount of bonds represents fair value. The fair value of bonds is based upon quoted market price.

Short-term investments -- The carrying amount is fair value, which approximates cost due to the short maturity of these instruments.

Cash, receivable for investments sold and payable for investments purchased -- The carrying amount approximates fair value because of the short maturity of these instruments.

Investments in unconsolidated affiliates -- The carrying amount is fair value due to accounting for these investments on the equity basis.

Deferred premium revenue, net of prepaid reinsurance premiums -- The carrying amount of deferred premium revenue, net of prepaid reinsurance premiums, represents the Company's future premium revenue, net of reinsurance, on policies where the premium was received at the inception of the insurance contract. The fair value of deferred premium revenue, net of prepaid reinsurance premiums, is an estimate of the premiums that would be paid under a reinsurance agreement with a third party to transfer the Company's financial guaranty risk, net of that portion of the premiums retained by the Company to compensate it for originating and servicing the insurance contract.

Installment premiums -- Consistent with industry practice, there is no carrying amount for installment premiums since the Company will receive premiums on an installment basis over the term of the insurance contract. Similar to deferred premium revenue, the fair value of installment premiums is the estimated present value of the future contractual premium revenues that would be paid under a reinsurance agreement with a third party to transfer the Company's financial guaranty risk, net of that portion of the premium retained by the Company to compensate it for originating and servicing the insurance contract.

Losses and loss adjustment expenses, net of reinsurance recoverable on unpaid losses -- The carrying amount is fair value, which is the present value of the expected cash flows for specifically identified claims and potential losses in the Company's insured portfolio.

(In thousands)	December 31, 1998		December 31, 1997	
	Carrying Amount	Estimated Fair Value	Carrying Amount	Estimated Fair Value
<b>Assets:</b>				
Bonds	\$1,708,040	\$1,708,040	\$1,268,158	\$1,268,158
Short-term investments	98,554	98,554	132,931	132,931
Cash	3,490	3,490	12,475	12,475
Receivable for securities sold	1,655	1,655	20,623	20,623
Investment in unconsolidated affiliates	29,496	29,496	--	--
<b>Liabilities:</b>				
Deferred premium revenue, net of prepaid reinsurance premiums	504,603	417,130	422,073	347,855
Losses and loss adjustment expenses, net of reinsurance recoverable on unpaid losses	60,040	60,040	44,799	44,799
Notes payable	230,000	232,736	130,000	131,612
Payable for investments purchased	105,859	105,859	72,979	72,979
<b>Off-balance-sheet instruments:</b>				
Installment premiums	--	163,239	--	116,888

16. LIABILITY FOR LOSSES AND LOSS ADJUSTMENT EXPENSES

The Company's liability for losses and loss adjustment expenses consists of the case basis and general reserves. Activity in the liability for losses and loss adjustment expenses is summarized as follows (in thousands):

	Year Ended December 31,		
	1998	1997	1996
Balance at January 1	\$ 75,417	\$ 72,079	\$111,759
Less reinsurance recoverable	30,618	29,875	61,532
Net balance at January 1	44,799	42,204	50,227
Incurred losses and loss adjustment expenses:			
Current year	8,049	5,400	5,300
Prior years	(4,100)	3,756	1,574
Recovered (paid) losses and loss adjustment expenses:			
Current year	(192)	(2,850)	--
Prior years	11,484	(3,711)	(14,897)
Net balance December 31	60,040	44,799	42,204
Plus reinsurance recoverable	3,907	30,618	29,875
Balance at December 31	\$ 63,947	\$ 75,417	\$ 72,079

During 1996, the Company increased its general reserve by \$6,874,000, of which \$5,300,000 was for originations of new business and \$1,574,000 was to reestablish a portion of the general reserve that had previously been transferred to case basis reserves. During 1996, the Company transferred \$9,012,000 from its general reserve to case basis reserves associated predominantly with certain residential mortgage and timeshare receivables transactions. Giving effect to these transfers, the general reserve totaled \$29,660,000 at December 31, 1996.

During 1997, the Company increased its general reserve by \$9,156,000, of which \$5,400,000 was for originations of new business and \$3,756,000 was to reestablish a portion of the general reserve that had previously been transferred to case basis reserves. During 1997, the Company transferred \$4,503,000 from its general reserve to case basis reserves associated predominantly with certain residential mortgage transactions. Giving effect to these transfers, the general reserve totaled \$34,313,000 at December 31, 1997.

During 1998, the Company increased its general reserve by \$3,949,000, of which \$8,049,000 was for originations of new business offset by a \$4,100,000 decrease in the amount needed to fund the general loss reserve because of recoveries on certain commercial mortgage transactions. During 1998, the Company transferred \$18,403,000 to its general reserve from case basis reserves due to those recoveries on commercial mortgage transactions. Also during 1998, the Company transferred \$9,414,000 from its general reserve to case basis reserves associated predominantly with certain consumer receivable transactions. Giving effect to these transfers, the general reserve totaled \$47,251,000 at December 31, 1998.

Reserves for losses and loss adjustment expenses are discounted at risk-free rates for the general reserve and for the case basis reserves at rates between 5.5% and 6.1%. The amount of discount taken was approximately \$16,029,000, \$19,779,000 and \$17,944,000 at December 31, 1998, 1997 and 1996, respectively.

17. QUARTERLY FINANCIAL INFORMATION (UNAUDITED) (1)

(In thousands, except share data)	First -----	Second -----	Third -----	Fourth -----	Full Year -----
1998					
Gross premiums written	\$54,338	\$89,242	\$77,024	\$98,662	\$319,266
Net premiums written	37,947	62,121	54,462	65,323	219,853
Net premiums earned	31,921	32,452	32,618	40,936	137,927
Net investment income	18,683	19,255	19,710	21,175	78,823
Losses and loss adjustment expenses	1,047	1,047	1,046	809	3,949
Income before taxes	32,817	36,184	48,016	40,234	157,251
Net income	24,314	26,739	34,604	29,699	115,356
Basic earnings per common share	0.84	0.92	1.20	1.00	3.96
Diluted earnings per common share	0.81	0.88	1.15	0.96	3.77
1997					
Gross premiums written	\$41,111	\$90,995	\$42,470	\$61,815	\$236,391
Net premiums written	27,184	67,495	28,911	49,288	172,878
Net premiums earned	24,774	27,561	27,204	29,972	109,511
Net investment income	16,361	17,121	17,920	20,683	72,085
Losses and loss adjustment expenses	2,285	2,156	2,426	2,289	9,156
Income before taxes	27,054	31,517	31,680	39,297	129,548
Net income	20,113	22,931	23,183	28,457	94,684
Basic earnings per common share	0.67	0.76	0.77	0.95	3.16
Diluted earnings per common share	0.65	0.75	0.75	0.92	3.06

(1) See Note 2 regarding the restatement of the financial statements relating to the accounting for the forward share purchase agreements. The effect of the restatement was to (decrease) increase the amounts previously reported as shown:

(in thousands, except share data)	First	Second	Third	Fourth
1998				
Income before taxes	(\$3,277)	(\$2,019)	\$5,566	(\$2,765)
Net income	(2,130)	(1,313)	3,618	(1,797)
Basic earnings per common share	(.07)	(.05)	.12	(.06)
Diluted earnings per common share	(.07)	(.04)	.12	(.06)
1997				
Income before taxes	(\$213)	(3,540)	(6,218)	1,020
Net income	(138)	(2,301)	(4,041)	663
Basic earnings per common share	-	(.08)	(.14)	.02
Diluted earnings per common share	(.01)	(.07)	(.13)	.02

18. EARNINGS PER SHARE

In 1997, the Company adopted SFAS No. 128 specifying the computation, presentation and disclosure requirements for EPS. The new standard defines "basic" and "diluted" earnings per share. Basic earnings per share are based on average basic shares outstanding, which is calculated by adding shares earned but not issued under the Company's equity bonus and performance share programs to the average common shares outstanding. Diluted earnings per share are based on average diluted shares outstanding, which is calculated by adding shares contingently issuable under stock options, the performance share program and the Company's redeemable preferred stock to the average basic shares outstanding. The calculations of average basic and diluted common shares outstanding are as follows (in thousands):

	Year Ended December 31,		
	1998	1997	1996
Average common shares outstanding	28,854	29,858	30,547
Shares earned but unissued under stock-based compensation plans	248	170	80
Average basic common shares outstanding	29,102	30,028	30,627
Shares contingently issuable under:			
Stock-based compensation plans	622	395	268
Redeemable preferred stock	875	490	--
Average diluted common shares outstanding	30,599	30,913	30,895

#### 19. RECENTLY ISSUED ACCOUNTING STANDARD

In June 1998, the Financial Accounting Standards Board issued SFAS No. 133, Accounting for Derivative Instruments and Hedging Activities. SFAS No. 133 establishes accounting and reporting standards for derivative instruments, including certain derivative instruments embedded in other contracts, and hedging activities. It requires that an entity recognize all derivatives as either assets or liabilities in the statement of financial position and measure those instruments at fair value. SFAS No. 133 is effective January 1, 2000.

The Company is in the process of determining the effect of these standards on its financial statements, but management does not believe that it will have a material effect on the Company's financial condition.

#### 20. INVESTMENTS IN UNCONSOLIDATED AFFILIATES

The Company accounts for investments in two companies on the equity basis. In June 1998, the Company invested \$10,000,000 to purchase a 25% interest in Fairbanks Capital Holding Corp., which buys, sells and services residential mortgages. In November 1998, the Company invested \$19,900,000 to purchase a 19.9% interest in XL Financial Assurance Ltd, a financial guaranty insurance subsidiary of XL (see Note 7). In 1998, the Company recognized equity losses of \$548,000 and goodwill amortization of \$240,000 on its Fairbanks Capital Holding Corp. investment and equity income of \$332,000 on its XL Financial Assurance Ltd investment.

#### 21. MINORITY INTEREST IN SUBSIDIARY

In November 1998, the Company sold to XL, for \$20,000,000, a 20% interest in Financial Security Assurance International Ltd., FSA's newly formed Bermuda-based financial guaranty subsidiary (see Note 7). This interest is in the form of Cumulative Participating Voting Preferred Shares, which in total have a minimum fixed dividend of \$1,000,000 per annum. For the period ended December 31, 1998, the Company recognized minority interest of \$388,000.