Moody's Investors Service

Credit Opinion: Ambac Assurance Corporation

Global Credit Research - 22 Jan 2010

New York, New York, United States

Ratings

Category	**Moody's Rating**
Rating Outlook	DEV
Insurance Financial Strength	Caa2
Ambac Financial Group, Inc.	
Rating Outlook	NEG(m)
Senior Unsecured	Ca
Junior Subordinate	C

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Key Indicators

[1]Ambac Assurance Corporation

	2008	**2007**	**2006**	**2005**	**2004**
Gross Par Written	**$ 11,298**	**$ 125,977**	**$ 124,457**	**$ 125,278**	**$ 118,106**
Gross Premiums Written	**$ 537**	**$ 1,031**	**$ 997**	**$ 1,096**	**$ 1,048**
Net Par Outstanding	**$ 434,310**	**$ 524,025**	**$ 519,043**	**$ 479,085**	**$ 459,432**
Hard Capital (Statutory)	**$ 12,845**	**$ 12,859**	**$ 11,590**	**$ 10,587**	**$ 9,819**
Net Income (GAAP)	**$ (5,609)**	**$ (3,248)**	**$ 876**	**$ 751**	**$ 725**
Strategy & Franchise Value					
% of Industry Net Par Outstanding	**18.4%**	**19.9%**	**22.3%**	**23.2%**	**24.0%**
% of Industry Gross Par Written	**8.2%**	**19.9%**	**21.7%**	**23.5%**	**25.1%**
Portfolio Characteristics					
Credit Risk Ratio (bps)	**248**	**81**	**47**	**42**	**45**
Tail Risk Ratio (bps)	**395**	**197**	**141**	**132**	**141**
Capital Adequacy					
Aaa Hard Capital Ratio	**0.80x**	**1.22x**	**1.57x**	**1.64x**	**1.51x**
Aaa Total Capital Ratio	**0.72x**	**1.13x**	**1.52x**	**1.58x**	**1.47x**
Par Reinsured	**12.8%**	**14.4%**	**8.6%**	**8.4%**	**8.6%**
Profitability					
Adjusted Return on Equity [2]	**nm**	**-0.6%**	**15.6%**	**14.4%**	**16.2%**
Loss Ratio (SAP) [3]	**528.2%**	**140.8%**	**6.0%**	**9.5%**	**12.2%**
Expense Ratio (SAP)	**29.1%**	**14.5%**	**15.0%**	**12.3%**	**11.1%**
Financial Flexibility					
Earnings Coverage	**nm**	**nm**	**16.9x**	**18.2x**	**18.5x**

Cash Flow Coverage	**0.0x**	**3.9x**	**4.9x**	**6.0x**	**5.9x**
Adjusted Double Leverage	**143.3%**	**119.0%**	**119.4%**	**122.4%**	**121.5%**

[1] Dollar Amounts in Millions [2] Excludes after-tax impact of unrealized mark to market losses on derviatives [3] Adjusted for credit impairments on CDS contracts

Opinion

SUMMARY RATING RATIONALE

Moody's Caa2 insurance financial strength rating on Ambac Assurance Corporation (AAC) and Ambac Assurance UK Limited (together, "Ambac") primarily reflects continued challenges for the company to consistently meet regulatory requirements, greatly diminished franchise value and impaired financial flexibility.

Ambac Assurance Corporation announced $856 million of statutory surplus for the end of the third quarter 2009, a significant improvement over the $305 million reported at the end of June. Although the substantial improvement in its surplus is a positive, Ambac's overall credit profile did not materially change. We believe that Ambac's capitalization remains stressed due to mortgage-related exposures. The company's high operating leverage means that relatively modest changes in mortgage loss estimates can have substantial effects on capital adequacy. Accordingly, we believe that Ambac's insurance financial strength remains volatile and can meaningfully evolve depending on how mortgage losses, remediation efforts and regulatory risks may play out.

Moody's Ca and C ratings for the senior unsecured and subordinated debt of Ambac Financial Group, Inc. (Ambac Financial), respectively, reflect the holding company's limited debt service ability. The substantial regulatory risks further reduces the likelihood that the holding company will be able to access operating company resources over a reasonable timeframe to satisfy its obligations. This raises the risk of distressed exchanges of outstanding debt with moderate-to-high estimated severity due to the holding company's modest cash position, limited other sources of liquidity, and severely strained financial flexibility.

Ambac writes financial guaranty insurance on public finance and structured finance obligations. Ambac's insurance provides an unconditional and irrevocable guaranty to pay scheduled interest and principal in the event of an issuer default.

Credit Strengths

Key credit strengths for the company include:

- Excluding mortgage-related exposures, well-diversified insured portfolio

- Significant value embedded in the firm's public finance portfolio

- Organic capital generation through portfolio amortization

Credit Challenges

Key credit challenges for the company include:

- Significant increase in reserve and impairment charges due to RMBS and ABS CDO losses, pressuring its ability to maintain healthy surplus

- Strained holding company liquidity due to restricted dividend capacity from AAC for the foreseeable future

- Sensitivity of insured portfolios to credit cycle given some large single-name exposures

- Impaired franchise and financial flexibility due to credit losses

Rating Outlook

The developing outlook for Ambac's regulated insurance companies reflects the possibility of positive or negative movement on Ambac's insurance financial strength ratings, depending on the performance of the insured portfolio and including any negotiated settlements over the next year or two.

The negative outlook for Ambac Financial, the holding company, reflects Moody's view of loss severity on senior debt is likely high, particularly if the company's mortgage related risks deteriorate further.

What Could Change the Rating - Up

The following factors could result in an upgrade:

- The ability to consistently maintain healthy statutory surplus above the regulatory threshold

- Substantially reduced uncertainty regarding ultimate mortgage-related losses

- Achieving capital adequacy ratios consistent with a higher rating level

What Could Change the Rating - Down

The following factors could result in a downgrade:

- Regulatory actions including suspension of claims, rehabilitation or liquidation

- Further deterioration in hard and total capital ratios, for example due to meaningful worsening of the expected performance related to mortgage related risks

Recent Results and Developments

In November 2009, Ambac posted an $856 million regulatory surplus for 3Q09, which benefited from a number of factors. Adjusting for these factors leaves the company with a GAAP operating loss in the third quarter. During the quarter, Ambac reported $2,188 million GAAP earnings and $856 million statutory earnings. We consider the insurer's core earnings to be materially lower as several items boosted the earnings during the quarter, including commutations of ABS CDOs for less than reserves, an increase in the estimated recoveries for loan put-backs, and for GAAP reporting the widening of Ambac's own credit spreads based on FAS 157.

Ambac commuted four ABS CDOs, terminating the contracts with its counterparties and removing about $5 billion of notional risk from its insured book and reversing sizable estimated losses. Also improving the capital was a $311 million reinsurance commutation. Nevertheless, the success of commutations depends on counterparty willingness.

Ambac also increased the estimated remediation recoveries for loan put-backs in 3Q 2009 to $1.9 billion from $1.2 billion in 2Q 2009. For some of its insured RMBS, Ambac recorded recoveries from putting back underlying loans to lenders deemed to have breached contractual representations and warranties. So far, the company has collected only about $60 million, but expects the remainder to be realized within three years.

Given the magnitude of stress faced by the company, Ambac's greatest near-term challenge is to consistently maintain healthy statutory surplus above the minimum regulatory level. Interestingly, so far to some extent regulatory accounting rules have helped mitigating the pressure. In Q2 2009, Ambac's regulator approved a reclassification of almost all of its outstanding contingency reserves, about $1.8 billion, greatly enhancing surplus. Also, Ambac's loss reserves are booked only when an insured obligation defaulted. This delays statutory loss recognition relative to GAAP where a reserve is established as soon as a loss is expected. As of the end of 3Q 2009, the non-CDO-related statutory loss reserves were about $1.3 billion. This is only 50% of its GAAP loss reserve for RMBS, which stood at $2.6 billion net of remediation recoveries. Over time, this gap should narrow. Gross statutory loss reserves go up when troubled credits default thereby adversely affecting statutory capital. However, positive earnings would dampen the effect.

Were the company to fall below the threshold, it could lead to regulatory intervention. This in turn could trigger insured CDS terminations at current depressed market values, resulting in large realized losses.

Ambac's 4Q 2009 surplus will be affected by several factors. The company stated that it will record a $440 million tax-loss carry-back credit in 4Q 2009. Additionally, premium and investment income may provide about $300 million in earnings, per quarter, based on historical trends. Offsetting these potential capital enhancements, however, is the likely increase in the gross statutory loss reserves in part due to more mortgage-related defaults, and credit deterioration in the insured portfolio is also a distinct possibility.

DETAILED RATING CONSIDERATIONS

Moody's currently rates Ambac Caa2 for insurance financial strength, which is two notches below Moody's unadjusted scorecard rating of B3 (for additional details, please refer to the "other considerations" section below).

Insurance Financial Strength Rating

The key factors currently influencing the rating and outlook are:

Factor 1 - Franchise Value and Strategy: < Baa

The adjusted scorecard rating is non-investment grade. The company is likely to remain in a state of "hibernation" until pressure on its statutory surplus and mortgage related risks dissipates. Ambac is among the largest financial guarantors as measured by net par outstanding, though the company's primary gross par written market share has fallen precipitously in 2008 and 2009 due to legacy risks overhang.

Factor 2 - Portfolio Characteristics: Baa

Ambac's credit risk and tail risk ratios were 248 basis points and 395 basis points at 2008 year end, respectively, up significantly compared to a year ago. This reflects downward credit migration in the insured portfolio, particularly among mortgage-related exposures. Substantial uncertainty remains about the ultimate performance of the firm's mortgage-related exposures. On the other hand, Ambac's public finance portfolios are diverse, and are performing largely as expected. However, the company's exposure to large single risks, initially low, may have increased as a result of adverse capital developments.

Factor 3 - Capital Adequacy: < Baa

The adjusted scorecard rating is non-investment grade, reflecting Moody's sizable estimated losses for direct RMBS and ABS CDOs, as well as some downward credit rating migration among sectors susceptible to economic slowdowns, such as private student loans and consumer and corporate ABS.

A major reinsurance counterparty of Ambac, Assured Guaranty Re (AGRe), was recently downgraded to A1, from Aa3. AGRe's downgrade, while a negative, does not materially change Moody's view of Ambac's capital profile given the financial strength of the reinsurer relative to Ambac's Caa2 IFSR.

Factor 4 - Profitability: < Baa

While Ambac has historically achieved the highest returns on equity in the financial guaranty industry, the company has recorded significant loss reserves and credit related impairments on its credit derivative portfolio during the last two years. Longer term, core profitability is likely to trend downward as the company de-leverages and holds increased amount of capital to cover potential stress losses from its RMBS and ABS CDOs. Moody's expects continued volatility in Ambac's operating results for 2010.

Factor 5 - Financial Flexibility: < Baa

Ambac's financial flexibility is greatly impaired. In addition to the company's depressed current stock price and wide credit spreads, the uncertainty around its regulatory capital position proves challenging for the company to economically raise capital. The sizable mortgage related losses have resulted in its inability to upstream dividends from Ambac Assurance Corporation, its main operating subsidiary, to the holding company during 2009.

The holding company's ability to access the operating companies' resources continues to be very limited, until regulatory risk abates and AAC becomes profitable again. As of the end of 3Q 2009, the holding company had about $164 million in cash, short-term investments, and bonds to service $1.2 billion of senior debt with an annual interest obligation of $89 million. Fulfilling the $143 million scheduled principal repayment in August 2011 will be challenging, and the risk of distressed exchanges on outstanding debt with moderate-to-high estimated severity remains high.

Other Considerations

Ambac's adjusted scorecard Caa2 insurance financial strength rating also reflects its greatly diminished franchise value, impaired financial flexibility, regulatory uncertainty, and the likelihood that policyholders may receive payments for less than the face value of potential claims.

Rating Factors

Ambac Assurance Corporation

Financial Strength Rating Scorecard [1]	**Aaa**	**Aa**	**A**	**Baa**		**Score**	[2]**Adjusted Score**
Factor 1: Strategy & Franchise Value (25%)						**Aa**	**< Baa**
% of Industry Net Par	**18.4%**						

Outstanding							
% of Industry Gross Par Written		**8.2%**					
Moody's Adjusted Book Value/Book Value	**x**						
Client Concentration	**x**						
Management, Governance & Risk Management Oversight					**x**		
Factor 2: Portfolio Characteristics (20%)						**Baa**	
Credit Risk Ratio					**x**		
Tail Risk Ratio				**395.0**			
% Below Investment Grade				**10.2%**			
S (WCL > 10% of HC) / HC							
Factor 3: Capital Adequacy (30%)							
Hard Capital Ratio					**x**		
Total Capital Ratio					**x**		
Par Reinsured		**12.8%**					
Factor 4: Profitability (15%)							**< Baa**
Return on Equity - 3 year average					**-35.1%**		
Loss Ratio (SAP) - 3-year average					**224.7%**		
Expense Ratio (SAP) - 3-year average	**19.1%**						
Factor 5: Financial Flexibility (10%)							**< Baa**
Earnings Coverage					**x**		
Cash Flow Coverage					**x**		
Adjusted Double Leverage				**143.3%**			
Ease of Access to Capital					**x**		
Aggregate Profile							**Caa2**

[1] Unadjusted scores were as of December 31, 2008 [2] The scorecard rating is an important component of the company's published rating, reflecting the stand-alone financial strength before other considerations (discussed above) are incorporated into the analysis