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Ambac Assurance Corp.

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Rationale

On Aug. 14, 2008, Standard & Poor's Ratings Services affirmed its 'AA' financial strength rating on Ambac Assurance Corp. (Ambac) and removed it from CreditWatch Negative. The outlook is negative.

Financial Strength Rating

Local Currency

AA/Negative/--

The negative outlook reflects our view that Ambac's exposure to domestic nonprime mortgages and related exposures to collateralized debt obligations of asset-backed securities (CDO of ABS) has likely damaged its franchise and that the company faces diminished new business flow. Removal of the negative outlook will be dependent on, among other factors, clarification of ultimate potential losses as well as future business prospects, the outcome of strategic business decisions, and potential regulatory developments.

The rating affirmation reflects our assessment of Ambac's:

- Capital position, which we believe to be satisfactory when measured against conservative projections of potential losses;
- Generally successful ongoing efforts to remediate the outstanding mortgage-related exposure; and
- Broad refocusing of the business and risk management intended to position the company to take advantage of any new business opportunities and to meaningfully participate in the credit enhancement industry as quickly as possible, including retaining the necessary management and staff to support these initiatives.

When stressed in Standard & Poor's capital adequacy model, Ambac's existing capital resources, future earnings, and cash flow generated a margin of safety in the 1.1x-1.2x range. The result was adjusted for the \$1.3 billion capital infusion in the first quarter of 2008 and incorporates current loss assumptions for the residential mortgage-backed securities (RMBS) and CDO of ABS exposures. The margin of safety expresses the relationship between theoretical losses generated in the capital adequacy model and capital remaining at the end of a theoretical depression. Ambac's margin of safety in the model exceeds Standard & Poor's minimum requirement of 1.0x for a 'AA' rated company.

We believe Ambac's remediation efforts are starting to bear fruit. The company announced the commutation of a \$1.4 billion ABS CDO ("AA Bespoke") at a cost of \$850 million. This resulted in a gain under GAAP accounting versus the associated mark-to-market charges, as well as a reduction in projected losses under various rating agency capital adequacy models. In our view, completing the transaction also eliminated the potential for future adverse loss development.

Ambac has also been actively pursuing representation and warranty claims against transaction sponsors. Loss reserves at June 30, 2008, reflect more than \$260 million of estimated recoveries on these claims. It is our understanding that the company will remain active in its remediation efforts.

In light of the damage to Ambac's business franchise, the revised business focus appears designed to allow the company to maximize revenue generation, seek opportunities to regain investor acceptance, and begin writing a meaningful amount of new business. To generate revenue, the company is pursuing reinsurance opportunities, continuing to insure transactions from time to time, and seeking opportunities to provide fee-based services. To

regain investor acceptance and generate new business, the company has proposed to increase the capital of a now-dormant subsidiary and enter the global municipal and infrastructure credit enhancement markets. Ambac has been generally successful in retaining managers and staff to support these initiatives.

Outlook

The negative outlook reflects our view that Ambac's exposure to domestic nonprime mortgages and related exposures to CDO of ABS has likely damaged its franchise and that the company faces diminished new business flow. Removal of the negative outlook will be dependent on, among other factors, clarification of ultimate potential losses as well as future business prospects, the outcome of strategic business decisions, and potential regulatory developments.

Management And Corporate Strategy

In the first quarter of 2008, in the wake of the significant market disruption experienced by many bond insurers, Ambac completed a review of all its businesses and implemented some significant changes to its business focus. Going forward, Ambac says it will emphasize its global public finance business while refocusing its structured finance business to emphasize student loans, leasing and asset finance, and structured insurance. At the same time, it has discontinued certain structured finance businesses, including collateralized debt obligations, collateralized loan obligations, mortgage-backed securities, whole business securitizations, auto and credit card securitizations, and emerging-market future flow transactions. It has also discontinued the execution of credit enhancement transactions in credit default swap format. From a risk management perspective, the company appears to be focused on reducing single-risk concentrations across its portfolio.

Ambac understands that it may take a significant period of time before it can regain its former 'AAA' creditworthiness, if that is even possible. Until then, the company claims that it will seek to maximize revenue generation while allowing the existing exposures to pay down, which would likely have the effect of strengthening the capital position.

Ambac's strategy of maximizing revenue generation is based on several presumptions:

- That a 'AA' rated financial guarantor can add value to the markets, particularly as a provider of reinsurance;
- That certain investors still value its deal structuring, due diligence, surveillance, and remediation skills;
- That the international markets may be comparatively more accepting than the domestic market of a 'AA' rated financial guarantor for credit enhancement; and
- That certain sectors in the structured finance market are more efficiently financed using credit enhancement.

Given these beliefs, Ambac's strategy is to:

- Seek out opportunities where it can provide reinsurance to other insurers;
- Continue to offer traditional primary and secondary financial guarantee insurance; and
- Seek opportunities where it can provide services to others.

To date, the company has, in our view, been most successful in offering primary insurance in instances where its deal structuring, due diligence, and surveillance skills have been valuable to investors.

At the same time, Ambac proposes to establish a municipal-only financial guarantee company (NewCo) by injecting capital into a now-dormant subsidiary. Currently, this subsidiary, Connie Lee Insurance Corp., acquired in 1997, has approximately \$150 million of capital. Ambac proposes to inject an additional \$850 million into the company and to write global public finance, infrastructure, and utility business only. No asset-backed finance business will be written. The 'new' company will remain a subsidiary of Ambac. This effort is also an example where Ambac can generate fee income for services since certain functions of the new company are expected to be outsourced back to Ambac.

Finally, Ambac is actively remediating its outstanding exposure to certain poorly performing RMBS and CDO transactions. To date, the most visible successes of these efforts are the inclusion of \$263 million of substantiated representation and warranty breach recoveries in loss reserve estimates for the RMBS portfolio and the commutation of a \$1.4 billion CDO squared transaction. Although the commutation required a payment of \$850 million to the counterparty, it provided relief to the company in various rating agency capital adequacy tests and also allowed Ambac to book a slight gain versus the mark-to-market charges that had been taken on the deal. Also, in our view, Ambac benefits from commuting this deal by eliminating the risk that the transaction could experience adverse loss development.

There have been some significant changes to Ambac's senior management during the past year. In January 2008, then-chairman, president and CEO Robert Genader retired. He was succeeded in each of these roles (president and CEO on an interim basis) by Michael Callen, who has been a member of Ambac's board since 1991. In February, Ambac announced a reorganization of the credit risk function, appointing David Wallis as chief risk officer, responsible for capital and risk analysis, portfolio risk management, and credit risk management. Previously, Mr. Wallis was responsible for portfolio and market risk management. This action centralizes these three functions under one senior executive and is designed to strengthen the underwriting process and the company's focus on risk-driven capital management. Also, in mid-2007 Kathleen McDonough, a co-head of Public Finance retired; in mid-2008, Thomas Gandolfo, responsible for structured credit and capital markets business, left the company; and in early 2008 William McKinnon, who headed credit risk management, retired from the company coincident with the reorganization of the credit risk function.

In addition to Michael Callen and David Wallis, the balance of the senior management team is largely unchanged and includes John Uhlein, who is responsible for U.S. structured finance, utilities, and secondary markets, while Douglas Renfield-Miller is leading the NewCo initiative. Robert Shoback is responsible for public finance, Diana Adams is head of the international business and Kevin Doyle is general counsel. Sean Leonard is CFO, and Gregg Bienstock is chief administrative officer.

Business Review

For the first half of 2008, total gross par guaranteed declined nearly 90% from the 2007 comparable period, to \$7.3 billion. The result reflected a 96% decline in U.S. public finance volume to \$1.2 billion and an 86% decline in U.S. structured finance volume to \$4.9 billion. We believe that the structured finance markets have historically tended to be somewhat less rating sensitive, which may account for the marginally smaller decline in Ambac's structured finance business volume compared with other sectors.

In our view, these lower business volumes reflect a lack of confidence in the company by the market as well as a

general decline in the use of bond insurance. With a continuing lack of clarity regarding the ultimate losses that will be realized from the company's mortgage and related CDO exposures, we believe it is uncertain if or when investors will be willing or able to regain confidence in Ambac.

Despite a decline in new business late in the year, Ambac reported a modest increase in originations in 2007, with gross par written up 1% to \$126 billion. In the U.S., a 25% gain in public finance largely offset a 21% drop in asset-backed finance originations. Combined international public finance and asset-backed volume in 2007 was up 6%, accounting for 16% of the total gross par insured.

With regard to domestic public finance, those sectors with the greatest year-to-year percentage increase were transportation, housing, and utility. The transportation, general obligation, and utility sectors were the significant contributors to the year-to-year increase in dollar volume of new transactions. The higher education and the lease- and tax-backed sectors posted slight year-to-year percentage decreases, but the dollar-volume decrease was not material. The decline in Ambac's domestic structured finance segment was the result of significant year-to-year percentage and dollar-volume declines in the pooled debt and mortgage-backed and home equity line of credit sectors.

Ambac's international business was dominated by large and/or high premium deals that accounted for a significant proportion of any year's originations. This resulted in annual results that varied considerably from year to year based on when a small number of large transactions were completed. Ambac had been building international staff to allow it to fully participate in the substantial opportunities it foresaw in Europe, particularly in the U.K. The company appeared selective regarding emerging-market risk with a disciplined approach to country limits and focused primarily on transactions where sovereign risk was structurally minimized (such as future flow transactions).

Compared with year-end 2004, net par outstanding at year-end 2007 of \$524 billion was up 14.1% despite a late-2007 \$29 billion reinsurance cession of primarily municipal exposure, propelled by a 28.9% increase for combined U.S. and international CDOs and a 17.2% gain for U.S. public finance. Net par for the international segment was up 10.4%, while U.S. structured finance grew a nominal 2.6%. Within these broad classifications, significant changes in net par outstanding over this period were noted for U.S. mortgage-back and home equity, down 18.9%; international mortgage-backed and home equity, down 48.6%; international-originated CDOs, down 56.5%; and U.S. general obligations, up 29.5%. Most significant was the growth in CDO of ABS that contained at least 25% mortgage-backed securities exposure; this segment grew from \$900 million to \$29.1 billion over this period, accounting for 43.7% of the total growth in net par outstanding.

Ambac's speculative-grade exposure was \$29.7 billion as of June 30, 2008, up 163% from the \$11.3 billion reported at Dec. 31, 2007. The change is primarily the result of the negative effects of deteriorated credit quality in the CDO of ABS sector, which now represents nearly 60% of the total speculative-grade exposure. Structured finance transactions represent 92% of the total, while U.S. public finance transactions accounted for only 7% of the total. International transactions represented less than 1% of the total. Total speculative-grade exposure was equal to 6.1% of net par outstanding, or 443% of statutory capital, compared with 2.2% and 176%, respectively, at the end of 2007.

Exposure to second-lien, subprime, and Alt-A mortgage transactions of all vintages at June 30, 2008, was \$29.6 billion, or 5.6% of net par outstanding. Of this total, \$21.2 billion was from the more-problematic 2005, 2006, and

2007 vintages. Although the credit quality of the total nonprime exposure averages in the 'BBB' category, some 23% of the exposure is of speculative-grade quality. Net loss reserves taken on these exposures were \$888 million on transactions that totaled \$7.4 billion of net par outstanding.

Ambac also has exposure to subprime collateral in CDOs that it has guaranteed. As of June 30, 2008, approximately \$28.8 billion of such CDOs have subprime collateral equal to at least 25% of total collateral. A total of \$17.8 billion of these, 15 of the 28 transactions, had speculative-grade ratings. Impairments taken on the CDO of ABS transactions total \$3.1 billion. In addition, Ambac has an outstanding commitment of approximately \$2.9 billion with respect to CDO of ABS, where a portion of the underlying collateral is currently rated speculative grade. Subsequent to June 30, Ambac commuted a below-investment-grade quality \$1.4 billion CDO of ABS transaction for a cash payment of \$850 million.

Table 1

Ambac Assurance Corp. Consolidated Business Statistics					
(Mil \$)	—Year ended Dec. 31—				
	2007	2006	2005	2004	2003
Net par exposure	524,025	519,043	479,085	459,432	425,854
Adjusted Gross Premiums Written*					
U.S. public finance	653	442	613	566	732
U.S. asset-backed and other	353	442	417	355	392
U.S. total	1,006	884	1,030	921	1,124
International public finance	179	228	122	137	202
International asset-backed and other¶	229	183	98	230	163
International total	408	411	220	367	365
Total adjusted gross premiums written	1,414	1,295	1,249	1,288	1,489
Net premiums written	754	893	996	977	1,006
Gross Par Written					
U.S. public finance	60,661	48,515	57,551	48,668	45,095
U.S. asset-backed and other	45,241	56,989	55,051	49,339	48,134
U.S. total	105,902	105,504	112,602	98,007	93,229
International public finance	6,938	6,148	4,262	4,157	3,666
International asset-backed and other	13,137	12,805	8,414	15,942	18,444
International total	20,075	18,953	12,676	20,099	22,110
Total gross par written	125,977	124,457	125,278	118,106	115,339
Net par written	82,414	116,379	116,563	117,253	102,582

*Adjusted gross premiums written include upfront and present value of installment premiums. ¶Includes structured credit derivatives with domestic exposure.

Table 2

Ambac Assurance Corp. Consolidated Insurance Portfolio Statistics						
(Mil \$)	—Year ended Dec. 31—					
	2007 industry average % of par	2007 % of par	2007 par	2006 par	2005 par	2004 par
Public Finance						
GO	19.9	12.2	63,977	62,834	57,982	49,394
Utility	8.6	7.2	37,976	38,313	36,872	36,321

Table 2

Ambac Assurance Corp. Consolidated Insurance Portfolio Statistics(cont.)						
Tax-backed	8.4	8.8	45,948	45,855	40,787	35,671
Hospitals	3.9	5.2	27,161	27,849	27,143	23,977
Transportation	4.6	4.9	25,466	24,979	23,718	21,188
Colleges and universities	3.0	3.9	20,685	22,068	20,054	18,056
Investor-owned utilities	1.2	3.3	17,055	17,345	16,398	15,449
Housing	1.7	2.2	11,531	10,996	10,152	9,163
Special revenue	0.5	0.0	0	0	0	0
Other	3.0	12.7	66,579	49,368	47,358	45,928
Total	54.8	60.4	316,378	299,607	280,464	255,147
Leases contained in above	N/A	8.1	42,199	43,187	41,802	40,340
Domestic Asset-Backed and Corporate Finance						
MBS	3.2	4.6	24,010	35,553	38,436	35,241
Home equity loan	2.6	3.3	17,288	10,686	11,021	17,907
Auto loan	1.6	2.1	10,774	12,563	12,246	8,005
Other consumer asset-backed	2.0	0.5	2,763	21,789	20,529	18,509
Commercial asset-backed	9.9	14.5	75,951	59,435	38,659	30,373
Bank/financial institutions	0.2	0.3	1,319	1,695	1,721	1,761
Other	10.2	0.6	3,168	3,517	5,342	5,210
Total	29.7	25.8	135,273	145,238	127,954	117,006
International						
Public finance	5.3	5.1	26,623	24,239	17,083	14,908
Asset-backed	8.9	8.6	44,968	49,792	53,489	71,247
Other*	1.3	0.1	783	167	94	1,124
Total	15.5	13.8	72,374	74,198	70,666	87,279
Total net par outstanding	100.0	100.0	524,025	519,043	478,084	459,432

*Includes structured credit derivatives with domestic exposure. N/A--Not available.

Affiliates

As a part of its decision to refocus its business, Ambac Financial announced in early 2008 that it has decided to discontinue writing new financial services business, allowing the accumulated exposures to decline over time as the contracts expire. Over the past several years, there has been little emphasis on the growth of the financial services businesses. Ambac's affiliate financial services business lines include investment agreements, along with interest-rate and currency swaps offered through:

- Ambac Capital Funding Inc., which provided investment agreements to municipal and structured finance issuers and had total guaranteed investment agreements outstanding of \$6.7 billion as of June 30, 2008. Total investment agreement balances are projected to decline to under \$6 billion by year-end 2008 and to be 50% smaller within the next five years.
- Ambac Financial Services LLC and Ambac Capital Services LLC, which provided interest-rate, currency, and total return swaps to municipal and structured issuers with a notional amount outstanding of \$9.6 billion as of June 30, 2008. Ambac hedges certain risks with professional counterparties, and such hedge amounts are excluded

from the notional amount shown above.

While the investment agreement and interest-rate and currency swap businesses benefited, in our view, from solid management and conservative risk-management systems and procedures, they were nonetheless inherently riskier than financial guarantee insurance, particularly with regard to liquidity risk. Following rating downgrades of Ambac, these businesses were required to post collateral on certain contracts for the benefit of their counterparties.

Currently, based on the investment agreement book of business outstanding as of June 30, 2008, and as a result of its lowered rating, Ambac posts collateral of \$2.5 billion; if it is downgraded to 'A', the collateral requirement increases to \$5.8 billion. Similarly, terminations to date total \$300 million and would increase to \$700 million if Ambac is downgraded to 'A'. In the scenario where Ambac is downgraded to 'A', the market value of the investment portfolio supporting this business would be \$1.3 billion short of being able to cover all the collateral posting and termination requirements. Should that occur, we understand that Ambac expects to use insurance company resources, through intercompany transactions, to satisfy the requirements, subject to the approval by the Office of the Commissioner of Insurance for the State of Wisconsin. Through the contemplated intercompany transactions, we believe Ambac would likely be able to avoid the forced sale of high-quality assets that are currently trading below par value but are expected to pay out at maturity.

These businesses also generated capital charges that, for the investment agreements business, were higher-than-average municipal and asset-backed capital charges. This occurred because the principal risk of worst-case market value declines for investment agreement financial instruments are more severe relative to worst-case credit default scenarios for investment-grade credits in the Ambac-insured portfolio. Ambac Financial Services and Ambac Capital Services relied on Ambac sureties for purposes of achieving rated counterparty status. Therefore, the capital charge was derived from the underlying credit exposure, which is included in Ambac's insured net par.

Finances

Adjusted gross premiums written rose 9% to \$1.41 billion in 2007. The U.S. public finance sector increased the most, up 48%, and the international asset-backed sector also grew, rising 25%. The U.S. asset-backed and international public finance sectors were both off, declining 21% and 20%, respectively. Adjusted premiums written grew at a faster pace than gross par written. This favorable outcome is the result of improved premium pricing opportunities in the U.S. public finance, U.S. asset-backed, and international public finance markets. The U.S. asset-backed pricing levels improved significantly from 2006 levels.

In 2007, based on statutory financial statements that exclude wholly owned Ambac Assurance UK Ltd., Ambac reported a 13.8% increase in statutory underwriting income, to \$652.8 million, despite wider losses and loss expenses of \$68.5 million. The result came on the strength of a 10.3% increase in premiums earned, and a 17.9% decrease in underwriting expense. Loss expenses were higher in 2007 due to reserves taken on mortgage exposure.

The statutory expense ratio (statutory underwriting expenses including reinsurance commissions divided by net premiums written) in 2007 fell to 15% from 15.5% in 2006, and is still the lowest in the industry. In 2008, we believe this ratio will be higher, reflecting the fact that the drop in new business written will far exceed that of expenses, even though Ambac has made staff reductions in line with its narrowed scope of business. Nevertheless,

Ambac remains focused on cost control, consistent with its longtime reputation as the most cost-efficient major bond insurer.

Ambac's stream of net investment income appears to remain secure, as the high-quality, \$11.8 billion financial guarantee investment portfolio (at June 30, 2008) is conservatively invested in fixed-income assets, of which 58% are rated 'AAA' and 32% are rated 'AA'. Included in the 'AAA' total are \$381 million of securities, or 3.2% of the portfolio, that have been insured by Ambac. The weighted average underlying rating of these obligations is 'BBB+'. In our view, the portfolio is generally liquid, as it contains \$742 million of short-term investments and the overall duration of the portfolio is 5.6 years. At June 30, 2008, the fair value of the portfolio was \$77 million in excess of amortized cost.

Including realized gains and losses, Ambac posted a net investment loss of \$271.1 million, compared with a net investment income of \$549.3 million a year earlier. The dramatic reversal was the result of the impairment of the statutory carrying value of the company's credit default swaps. Excluding the capital gains or losses, investment income was \$480.8 million, down 12% from 2006 due to lower portfolio yields. Ambac reported statutory net income of \$64.7 million in 2007, down 92% from the prior year.

Table 3

Ambac Assurance Corp. Consolidated Financial Statistics					
	—Year ended Dec. 31—				
(Mil \$)	2007	2006	2005	2004	2003
Insurance Company¹					
Total assets	10,817.6	10,036.8	9,122.1	8,439.9	7,353.7
Cash + invested assets	10,604.6	9,833.8	8,948.4	8,307.3	7,234.7
Unearned premiums	3,287.8	3,343.8	3,187.0	2,948.1	2,627.4
Statutory capital	7,180.9	6,386.8	5,693.0	5,264.7	4,526.0
Net premiums earned	834.0	756.0	770.1	665.3	600.9
Losses and LAE*	68.5	45.0	73.1	81.0	36.7
Underwriting expense	112.7	137.3	124.0	109.4	83.7
Investment income including gains	(271.1)	549.3	387.8	435.9	367.0
Net income	64.7	802.3	697.0	676.7	598.0
Loss ratio (%)	8.2	6.0	9.5	12.2	6.1
Underwriting profitability ratio (%) ²	78.3	75.9	74.4	71.4	80.0
Holding Company (Ambac Financial Group Inc.)³					
Total assets	23,565.0	20,267.8	19,725.1	18,749.6	16,747.3
Stockholders' equity	2,279.9	6,184.2	5,372.2	5,024.5	4,254.6
Net income	(3,248.2)	875.9	751.0	724.6	618.9
Debt/capitalization (%) ⁴	27.0	13.8	18.2	13.6	15.7
Hybrid security tolerance ratio (%) ⁵	10.8	0.0	0.0	0.0	0.0
Total hybrid security tolerance ratio (%) ⁶	26.8	10.0	10.9	12.1	13.7
Return on average equity (%)	(76.7)	15.1	14.4	15.6	15.7

1. Statutory basis of accounting. Includes Connie Lee Insurance Co. but does not include AMBAC Assurance UK Ltd. 2. Underwriting profitability ratio = (net earned premiums - underwriting expenses and losses)/net earned premiums. 3. GAAP basis of accounting. 4. (Holding company debt + hybrid securities not qualifying as equity)/(holding company debt + shareholders equity + hybrid securities). 5. Hybrid securities/(Capital [debt + shareholders equity] + hybrid securities). 6. (Hybrid securities + contingent capital)/(Capital + hybrid securities + contingent capital). *LAE--Loss-adjustment expense.

Accounting

Standard & Poor's views Ambac's accounting policies to be generally consistent with industry standards and neutral to the ratings. There were no restatements during 2007.

On May 23, 2008, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) 163, which prescribes loss reserve and recognition practices. Loss reserves are currently established by Ambac based on case-basis reserves (for insured obligations that have already defaulted) and active credit reserves (for probable and estimable losses due to credit deterioration on insured credits that have not yet defaulted). The new statement calls for the insurer to recognize a liability only when it expects a claim loss in excess of the unearned revenue for that contract based on discounted cash flows and may result in significant changes to the manner in which losses are recognized. This change, if adopted, is not expected to have a ratings impact since the reserve methodology for case-basis reserves will not change, and Standard & Poor's places more weight on projected losses in a stress test context versus potential claims in the current environment. Standard & Poor's notes the company's current reserving methodology, which seems to be fairly similar to the one proposed by the FASB, is consistent with industry methodologies and considers its current reserves adequate.

Revenue recognition is also covered by SFAS 163. Currently for Ambac, upfront premiums are earned in proportion to the principal amount guaranteed. Premiums are allocated to each par maturity and earned on a straight-line basis for the period the related par is outstanding. Under the new requirement, earned premium recognition will be slower. This change is not expected to have a rating impact since the fundamental economics of a transaction and the bond insurance model have not changed.

Under SFAS 133, "Accounting for Derivative Instruments and Certain Hedging Activities," Ambac is required to mark credit, total return, and nontrading derivative transactions to market with the changes in fair value recognized in the income statements, notwithstanding the fact that the insurers do not trade these instruments and ultimately the mark will "zero out" in those instances where the underlying credit does not default.

In Standard & Poor's opinion, this concept has introduced an element of earnings volatility that has little bearing on either the likelihood of a potential claim or the intrinsic earnings power of a bond insurer. Calculations that exclude the impact of these mark-to-market gains or losses from credit, total return, and nontrading derivative instruments, excluding impairments, are useful as supplemental earnings measures. The net carrying amount of the credit derivative liability at June 30, 2008, was \$6.8 billion, including impairments of \$3.1 billion. Impairments represent Ambac's estimate of future claims payments on credit derivative contracts on a present value basis.

Ambac adopted SFAS 157, "Fair Value Measurement", on Jan. 1, 2008. This will require the company to take its own nonperformance risk into account as it values its derivative liabilities and certain other financial instruments. At June 30, 2008, the adoption of SFAS 157 resulted in a \$6.8 billion reduction in Ambac's credit derivative liability.

Capitalization

In our view, Ambac's ability to access new capital is severely restricted. This lack of flexibility is reflected in Ambac Financial Group Inc.'s common stock price, which is currently more than 90% below its 52-week high and trading at less than half of adjusted book value (valued as of June 30, 2008), ruling out the possibility of raising a significant

amount of new equity; and wide credit default spreads, which we believe suggest that the company's access to debt markets is questionable at best and, if available, prohibitively expensive.

In March 2008, Ambac Financial Group issued \$1.5 billion of common stock to fund a capital contribution to Ambac. Of the \$1.4 billion proceeds from the offering, \$1.3 billion was contributed to Ambac and the remaining \$100 million was retained at the holding company to enhance its liquidity profile. Historically, Ambac has proactively managed its capital position over time, raising or returning capital as conditions warrant.

When stressed in Standard & Poor's capital adequacy model, Ambac's existing capital resources, future earnings, and cash flow generated a margin of safety, based as of year-end 2007 figures, at the low end of the 1.1x-1.2x range, down from the 1.3x-1.4x range reported for 2006. The 2007 result was adjusted for the \$1.3 billion capital infusion that took place in the first quarter of 2008, the commutation of the \$1.4 billion CDO of ABS transaction in the third quarter of 2008, and the significant runoff of the outstanding portfolio in the first quarter of 2008.

In testing Ambac's capital adequacy, we incorporated a scenario that applies stressful default assumptions to various RMBS-related transactions, including CDO of ABS, that the company insured. We based the default rates for these transactions on stressful cumulative net loss assumptions supplied by our Structured Finance department that vary by asset type and vintage. We have included the Alt-A, subprime, closed-end second, home equity line of credit, and net interest margin asset types with 2005, 2006, and 2007 vintages in this analysis.

For Ambac, these loss assumptions generated \$2.8 billion of direct RMBS losses and \$3.2 billion of CDO of ABS losses. The margin of safety expresses the relationship between theoretical losses generated in the capital adequacy model and capital remaining at the end of a theoretical depression. Ambac's margin of safety exceeds Standard & Poor's 1.0x minimum requirement for a 'AA' rated company. Total theoretical losses, including the \$6 billion RMBS losses discussed above, were \$14 billion and the capital remaining at the end of the theoretical depression was approximately \$1.4 billion.

Regarding the use of contingent capital, Ambac's 14% reliance on soft capital ratio remains well in compliance with Standard & Poor's 'AAA' maximum requirement of 33% and is typical of industry usage, which averages in the mid-teens. In late 2007, Ambac ceded \$29 billion of primarily municipal exposure to 'AA' rated Assured Guaranty Re Ltd. This transaction was the first action taken by Ambac in its attempt to support its capital position in the wake of growing subprime losses. Prior to the Assured Guaranty Re transaction, Ambac consistently was a below-industry-average user of reinsurance. In addition, from time to time, the company has taken back business previously ceded to certain reinsurers. Typically, Ambac has the right to take business back if a reinsurer is downgraded. In early 2006, Ambac took back \$3.9 billion of par exposure from Axa Re Finance S.A. and American Reinsurance Co. In 2004 and 2005, Ambac took back a total of \$15 billion of par exposure that had been ceded to various reinsurers.

Asset-backed capital commitment securities in the amount of \$800 million are a meaningful component of Ambac's claims-paying resources. Auction-rate market securities -- issued under the names of Dutch Harbor Finance Sub-Trusts I, II, III, and IV and Anchorage Finance Sub-Trusts I, II, III, and IV -- were sold to create pools of funds that are available for the purchase of preferred stock that will be issued by Ambac at its discretion. The structure and operating constraints of the transactions eliminate market value risk and minimize credit risk in the asset pool. Key strengths of these arrangements include their perpetual nature, the absence of restrictions governing when Ambac can draw funds or how much can be drawn (subject to the facility limit), and the funded nature of the

agreements that eliminates concerns regarding the willingness and ability of a third party to perform.

Since we give Ambac capital credit in our capital adequacy testing for this claims-paying resource, we believe the company's primary motivation to exercise the put feature of these securities would be to either gain access to cash or to increase the reported statutory capital of the company.

We believe that Ambac has ample liquidity to pay projected claims in 2008 without having to sell investments. During the first half, Ambac paid claims of \$100 million, compared with net investment income of more than \$250 million. Excluding payments on CDO commutations, we believe that Ambac should be able to pay second-half 2008 claims from projected investment income of \$250 million. The cash generated by its investments' maturing principal and cash received from installment premiums paid on outstanding policies may provide additional liquidity.

At the holding-company level, Ambac Financial retained \$100 million of the proceeds of the equity offering completed in March. In addition, during the first and second quarters, it received dividends from Ambac totaling \$109 million. Under Wisconsin insurance laws, the maximum amount of dividends that could be paid in 2008 without regulatory approval is \$332 million. In addition, no quarterly dividend can exceed the dividend paid in the previous year by more than 15% unless Ambac provides 30 days' advance notice to the Wisconsin insurance commissioner. Ambac expects to pay quarterly dividends of \$54 million for the remainder of the year, which we believe should generally be sufficient to pay holding-company expenses, principally interest expense and operating expenses. We understand that Ambac Financial's plan is to have cash on hand equal to approximately two years' debt service requirements by the end of 2008.

In addition to our detailed review of the specific liquidity requirements related to the subprime mortgage and related CDO claims, Standard & Poor's reviews a bond insurer's cash position and its ability to raise additional cash through the sale of liquid assets or the use of securities repurchase agreement capabilities against conservatively defined theoretical payments associated with a company's various product lines. The underlying theory of this analysis is that there could be unexpected liquidity demands on an insurer in periods of economic tranquility as well as stress. Liquidity resources and potential liquidity demands are examined for the current year and several subsequent years. Because this approach focuses on theoretic liquidity needs and balance sheet resources, it is different from the analysis described above that demonstrated subprime-related claims in 2008 could be handled out of cash flow.

Ambac's liquidity ratio as of Dec. 31, 2007, was 2.32x, signifying in our view that the company had ample liquid resources to meet the conservatively defined theoretic liquidity needs. Liquid resources totaled \$2.8 billion at year-end 2007. Of this, \$400 million were existing lines of credit. Against these resources, Ambac has theoretical payments in 2008 totaling \$1.2 billion.

Table 4

Ambac Assurance Corp. Consolidated Capital Statistics					
(Mil \$)	—Year ended Dec. 31—				
	2007	2006	2005	2004	2003
Portfolio Risk					
Municipal insurance weighted average capital charge (% of average annual debt service)	12.6	13.0	13.7	13.6	13.5
Asset-backed capital charge (% of par)	2.2	1.9	2.0	1.9	1.7

Table 4

Ambac Assurance Corp. Consolidated Capital Statistics(cont.)					
Claims-Paying Resources					
Statutory capital	6,422.5	6,397.6	5,693.0	5,264.7	4,526.0
Contingent capital	800.0	800.0	800.0	800.0	800.0
Stop-loss treaty	0.0	0.0	0.0	0.0	0.0
Unearned premiums	3,320.1	3,373.4	3,187.0	2,948.1	2,649.3
Present value of annual premiums	2,887.0	2,404.8	2,165.9	2,059.8	1,555.6
Total	13,429.5	12,975.8	11,845.8	11,072.6	9,530.9
Capital Adequacy					
Capital remaining at end of depression test	1,400-1,450	4,050-4,100	3,500-3,550	3,700-3,750	2,700-2,750
Margin of safety (x)	1.1-1.2	1.3-1.4	1.3-1.4	1.4-1.5	1.3-1.4
Reliance on soft capital (%)	14.0	12.9	13.6	11.4	11.7

Table 5

Ambac Assurance Corp. Consolidated Liquidity Analysis		
	Haircut (%)	Amount (Mil \$)
Assets/Resources as of Dec. 31, 2007		
Cash and short-term investments	0.0	493.2
Treasury and government agency fixed income securities	10.0	1,848.5
Corporate and ABS/MBS bonds	50.0	474.1
Bank lines of credit	0.0	400.0
Other	100.0	119.4
Total		3,335.3
Adjusted cash totals after haircut		2,793.9
Municipal bonds (informational/back-up only)		8,294.3
Potential Uses (Occurring in the Full Year 2008)		
Largest net total payments in 2008 associated with a municipal obligor default		225.9
Largest net bullet maturity default (potentially includes IOUs, international, or "guaranteed" maturity bonds)		303.6
Largest debt service reserve draw		108.2
90 days of payments associated with the largest servicer default		137.3
Largest financial service obligations, such as largest unscheduled draw on a municipal investment contract		211.4
Largest individual "single name" credit default swap or single name in a defaulted synthetic structure		0.0
Holding company debt and dividend servicing needs		216.0
Other		0.0
Total usage		1,202.4
Net (assets - usage)		1,591.6
Liquidity ratio (x)		2.3

Ratings Detail (As Of August 28, 2008)*	
Ambac Assurance Corp.	
Financial Strength Rating	
<i>Local Currency</i>	AA/Negative/--
Counterparty Credit Rating	
<i>Local Currency</i>	AA/Negative/--
Financial Enhancement Rating	
<i>Local Currency</i>	AA/--/--
Related Entities	
Ambac Assurance U.K. Ltd.	
Financial Strength Rating	
<i>Local Currency</i>	AA/Negative/--
Issuer Credit Rating	
<i>Local Currency</i>	AA/Negative/--
Financial Enhancement Rating	
<i>Local Currency</i>	AA/--/--
Ambac Financial Group, Inc.	
Issuer Credit Rating	
<i>Local Currency</i>	A/Negative/--
Senior Unsecured (5 Issues)	A
Subordinated (1 Issue)	BBB+
Anchorage Fin Sub-Trust I	
Preferred Stock (1 Issue)	A
Anchorage Fin Sub-Trust II	
Preferred Stock (1 Issue)	A
Anchorage Fin Sub-Trust III	
Preferred Stock (1 Issue)	A
Anchorage Fin Sub-Trust IV	
Preferred Stock (1 Issue)	A
Connie Lee Insurance Co.	
Financial Strength Rating	
<i>Local Currency</i>	AA/Negative/--
Issuer Credit Rating	
<i>Local Currency</i>	AA/Negative/--
Dutch Harbor Fin Sub-Trust I	
Preferred Stock (1 Issue)	A
Dutch Harbor Fin Sub-Trust II	
Preferred Stock (1 Issue)	A
Dutch Harbor Fin Sub-Trust III	
Preferred Stock (1 Issue)	A
Dutch Harbor Fin Sub-Trust IV	
Preferred Stock (1 Issue)	A
Holding Company	
	Ambac Financial Group, Inc.
Domicile	
	Wisconsin

Ratings Detail (As Of August 28, 2008)* (cont.)

*Unless otherwise noted, all ratings in this report are global scale ratings. Standard & Poor's credit ratings on the global scale are comparable across countries. Standard & Poor's credit ratings on a national scale are relative to obligors or obligations within that specific country.

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