

August 18, 2009

Ambac Assurance Corp.

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Major Rating Factors

Strengths:

- Problem credits within the insured portfolio are currently limited to 2005–2007 vintage residential mortgage-backed securities (RMBS) and collateralized debt obligations (CDOs) of asset-backed securities (ABS).
- Conservative investment philosophy mitigates market volatility and credit quality concerns and supports strong liquidity.

Weaknesses:

- Further reserve strengthening could put pressure on surplus.
- The company is effectively in runoff with limited ability to bolster surplus.
- As the company's book of business runs off, it could become concentrated and lack sufficient sector diversity.

| Financial Strength Rating |
|---------------------------|
| Local Currency |
| CC/Developing/-- |

Rationale

The 'CC' rating on Ambac Assurance Corp. reflects Standard & Poor's Ratings Services' view that the company is effectively in runoff and in a weakened financial position. Although the company has received regulatory approval to release contingency reserves to bolster surplus, the rating reflects our view that there could be additional commutations, which we will view as distressed exchanges. Once a distressed exchange has occurred, we will revise our counterparty credit rating on Ambac to 'SD'. Following the commutation, we will also complete a review that takes into account any benefits the company realized from the commutation as well as any other interim developments, and we will adjust the ratings as necessary.

The rating also reflects our view that further deterioration in Ambac's insured portfolio of nonprime RMBS and related CDO of ABS exposure would require the company to strengthen its reserves to account for higher projected claims. The additional reserves will hurt operating results, which we believe could cause surplus to decline to below regulator-required minimums.

Outlook

The negative outlook on the Ambac counterparty credit rating reflects the possibility that we could revise the rating to 'SD' upon the completion of additional commutations. The outlook on the Ambac financial strength rating is developing because we could raise the rating if the completion of additional commutations strengthens Ambac's financial position.

Corporate Strategy And Management

Management's current strategy is focused on portfolio risk management. The company is actively remediating its outstanding exposure to certain poorly performing RMBS and CDO transactions. Although the commutations typically require a cash payment by Ambac to the counterparty, they could provide relief to the company in

Standard & Poor's capital adequacy test and also allow Ambac to book a slight gain versus the mark-to-market charges that had been taken on the deal. Also, in our view, Ambac might benefit from commuting exposures by eliminating the risk that the transactions could experience further adverse loss development.

As part of its proactive and aggressive remediation strategy, management has established a servicer oversight and surveillance group. Ambac hired five people with extensive experience in servicer evaluation into this group from outside the company. In addition to servicer reviews, this group will review representation and warranty breaches of underlying mortgages.

Management believes that its portfolio management activities might present opportunities to expand Ambac's enterprise and add noncapital intensive sources of revenue. This strategy focuses on leveraging the company's existing skill base by offering analytic services relating to RMBS transactions and other structured finance business to third parties. Although this strategy may be accretive to earnings for Ambac, in our view, it might not have a material impact on the company's financial performance.

On June 1, 2009, management announced that it postponed its plan to establish a municipal-only financial guarantee company. It is our understanding that the strategy was to inject capital into the now-dormant subsidiary Connie Lee Insurance Corp. The company was to write global public finance, infrastructure, and utility business only.

Following significant changes to Ambac's senior management in the first few months of 2008, the management team has remained relatively unchanged. In October 2008, David W. Wallis was named president and CEO of Ambac, succeeding Michael A. Callen, who was named interim president and CEO in January 2008. Mr. Callen remains in his position as executive chairman of the board of directors.

In addition to David Wallis, the balance of the senior management team includes Chief Risk Officer Gregory Raab, Chief Financial Officer Sean Leonard, and Chief Administrative Officer Diane Adams, who is also head of the international business. Kevin Doyle is general counsel, and Tim Stevens is responsible for capital markets.

Insured Portfolio

Ambac's insured portfolio totaled \$411.8 billion as of June 30, 2009, which is approximately 5% less than it was at year-end 2008 and 21% less than what it was at year-end 2007. With minimal new business written in 2008 and prospects for writing new business negligible, the portfolio will continue to deleverage as a result of normal amortization. The commutations of CDO of ABS exposures may accelerate the deleveraging of the portfolio because these transactions tend to have large notional exposures.

Other efforts that might accelerate deleveraging of the portfolio include RMBS representation and warranty breaches leading to possible servicer put backs. Within the CDO portfolio that does not include exposure to 2005–2007 vintage RMBS, downgrades have led to overcollateralization tests being tripped, resulting in diversion of excess spread to pay down Ambac insured tranches.

In terms of the overall portfolio, speculative-grade issues are confined largely to RMBS-related products. There is no exposure to commercial mortgage-backed securities, and there is immaterial exposure to trust preferred securities. High-yield corporate CDOs represent 75% of the approximately \$28 billion CDO portfolio that does not have exposure to 2005–2007 vintage RMBS, and 96% of that is rated 'A' or higher. The \$229 billion U.S. public finance

portfolio has credit quality of 'A' or better, with 65% of the exposure representing general obligation, lease, and tax-backed exposure.

Ambac's speculative-grade exposure was \$53.5 billion as of June 30, 2009. Global structured finance transactions represent approximately 96% of the total, while U.S. public finance transactions accounted for only 4% of the total. The CDO of ABS sector was the dominate component of the speculative-grade structured finance exposure. Total speculative-grade exposure was equal to 13% of net par outstanding.

Table 1

| Ambac Assurance Corp./Insurance Portfolio Statistics | | | | | |
|-------------------------------------------------------------|---------------|----------|----------|----------|----------|
| —Year ended Dec. 31— | | | | | |
| (Mil. \$) | 2008 % of par | 2008 par | 2007 par | 2006 par | 2005 par |
| Public finance | | | | | |
| GO | 13.4 | 58,296 | 63,977 | 62,834 | 57,982 |
| Utility | 7.4 | 32,166 | 37,976 | 38,313 | 36,872 |
| Tax-backed | 9.5 | 41,381 | 45,948 | 45,855 | 40,787 |
| Hospitals | 3.5 | 15,115 | 27,161 | 27,849 | 26,994 |
| Transportation | 5.1 | 22,306 | 25,466 | 24,979 | 23,718 |
| Colleges and universities | 4.1 | 17,959 | 20,685 | 22,068 | 20,202 |
| Investor-owned utilities | 3.4 | 14,651 | 17,055 | 17,345 | 16,398 |
| Housing | 2.5 | 10,862 | 11,531 | 10,996 | 10,152 |
| Other | 13.1 | 56,779 | 66,579 | 67,773 | 63,896 |
| Total | 62.1 | 269,515 | 316,378 | 318,012 | 297,001 |
| Domestic asset-backed and corporate finance | | | | | |
| MBS | 4.8 | 20,883 | 24,010 | 28,143 | 36,188 |
| Home equity loan | 3.4 | 14,728 | 17,288 | 16,424 | 12,682 |
| Auto loan | 1.9 | 8,251 | 10,774 | 12,764 | 12,246 |
| Other consumer asset-backed | 0.4 | 1,659 | 2,763 | 3,350 | 3,301 |
| Commercial asset-backed | 13.8 | 60,094 | 75,951 | 60,940 | 42,703 |
| Bank/financial institutions | 0.2 | 846 | 1,319 | 1,695 | 1,592 |
| Other | 0.6 | 2,654 | 3,168 | 3,517 | 2,704 |
| Total | 25.1 | 109,115 | 135,273 | 126,833 | 111,416 |
| International | | | | | |
| Public finance | 5.1 | 22,079 | 26,623 | 24,421 | 17,316 |
| Asset-backed | 7.6 | 32,836 | 44,968 | 49,571 | 53,204 |
| Other | 0.2 | 766 | 783 | 207 | 147 |
| Total | 12.8 | 55,681 | 72,374 | 74,199 | 70,667 |
| Total net par outstanding | 100.0 | 434,311 | 524,025 | 519,044 | 479,084 |

Affiliates

As a part of its decision to refocus its business, Ambac Financial Group Inc. (Ambac Financial) announced in early 2008 that it decided to discontinue writing new financial services business, allowing the accumulated exposures to

decline over time as the contracts expire. 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 \$1.5 billion as of June 30, 2009.
- 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 \$7.1 billion as of June 30, 2009. Ambac hedges certain risks with professional counterparties, and such hedge amounts are excluded from the notional amount noted above.

Following downgrades of Ambac, these businesses were required to post collateral on certain contracts for the benefit of their counterparties. Approximately 90% of investment agreements are collateralized with government and other high-grade securities. Ambac Financial has used insurance company resources, through intercompany transactions, to satisfy the collateral posting requirements. Through the intercompany transactions, Ambac Financial was able to avoid the forced sale of high-quality assets that were trading below par value but were expected to pay out at maturity.

Finances

As of June 30, 2009, Ambac's unearned premium reserve totaled \$2.5 billion. This reserve represents already collected premiums that will be earned as the underlying exposures run off, typically 20 years. These premiums primarily relate to public finance exposure and will be the primary long-term source of revenue. The company's present value of installment premiums totaled \$2.6 billion. These are premiums that have not yet been collected, but that Ambac has a contractual right to receive. These premiums typically relate to structured finance exposure and may not be collected in their entirety if the exposure is paid down early.

The only other source of income is from the investment portfolio. Ambac's stream of net investment income appears to remain secure, as the high-quality, \$9.0 billion investment portfolio as of June 30, 2009, is conservatively invested in fixed-income assets, of which 25% is rated 'AAA' and 39% is rated 'AA'. Approximately 50% of the portfolio is municipal issuers and 32% is mortgage-backed securities. In our view, the portfolio is generally liquid, as it contains \$844 million of short-term investments and the overall duration of the portfolio is 4.8 years.

Table 2

| Ambac Assurance Corp./Financial Statistics | | | | | |
|---------------------------------------------------|-----------------------------|-------------|-------------|-------------|-------------|
| | —Year ended Dec. 31— | | | | |
| (Mil. \$) | 2008 | 2007 | 2006 | 2005 | 2004 |
| Insurance company* | | | | | |
| Total assets | 10,781 | 10,792 | 10,015 | 8,994 | 8,329 |
| Cash plus invested assets | 10,397 | 10,581 | 9,814 | 8,824 | 8,207 |
| Unearned premiums | 2,700 | 3,275 | 3,328 | 3,165 | 2,918 |
| Statutory capital | 3,469 | 6,409 | 6,371 | 5,649 | 5,225 |
| Net premiums earned | 1,078 | 831 | 750 | 762 | 658 |
| Losses and LAE | 1,623 | 67 | 40 | 44 | 39 |
| Underwriting expense | 144 | 113 | 137 | 124 | 109 |
| Investment income including gains | (3,940) | (280) | 537 | 377 | 424 |

Table 2

| Ambac Assurance Corp./Financial Statistics (cont.) | | | | | |
|----------------------------------------------------|-----------|---------|--------|--------|--------|
| Net income | (4,035) | 54 | 789 | 707 | 693 |
| Loss ratio (%) | 151 | 8 | 5 | 6 | 6 |
| Holding company (Ambac Financial Group Inc.)¶ | | | | | |
| Total assets | 17,256.4 | 23,722 | 20,268 | 18,546 | 16,673 |
| Stockholders' equity | (3,782.3) | 2,280 | 6,190 | 5,388 | 5,035 |
| Net income | (5,609.2) | (3,248) | 876 | 751 | 725 |
| Debt/capitalization (%)§ | 67.2 | 27.0 | 13.8 | 18.2 | 13.6 |
| Hybrid security tolerance ratio (%)** | 11.8 | 10.8 | - | - | - |
| Total hybrid security tolerance ratio (%)¶¶ | 11.8 | 26.8 | 10.0 | 10.9 | 12.1 |
| Return on average equity (%) | NM | NM | 15 | 14 | 16 |

*Pro forma U.S. statutory basis of accounting. ¶U.S. GAAP basis. §(Holding company debt plus hybrid securities not qualifying as equity)/(holding company debt plus shareholders' equity plus hybrid securities). **Hybrid securities/(capital [debt plus shareholders' equity] plus hybrid securities). ¶¶(Hybrid securities plus contingent capital)/(capital plus hybrid securities plus contingent capital). NM—Not meaningful.

Accounting

Standard & Poor's views holding company Ambac Financial's accounting policies as generally consistent with the industry standards and neutral to the ratings. Ambac Financial files consolidated statements according to U.S. GAAP, whereas Ambac files financial statements under Statutory Accounting Principles (SAP). Key accounting issues and standards are:

On May 23, 2008, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standard (SFAS) 163, which prescribes loss reserve and revenue recognition practices for the financial guarantors. Standard & Poor's evaluates the financial strength of the financial guarantors using the financial statements prepared under SAP. Under this accounting method, reserves are booked when a loss is incurred. In addition, Standard & Poor's estimates theoretical losses in severe economic conditions, which may be greater than current losses, to evaluate the adequacy of the claims-paying resources of the bond insurer.

Revenue recognition is also covered by SFAS 163 and became effective on Jan. 1, 2009. Prior to its implementation, Ambac Financial's upfront premiums were earned in proportion to the expiration of related principal balance of the insured obligation. Installment premiums are earned ratably over the installment period. We do not expect the implementation of SFAS 163 to materially change revenue recognition on installment premiums going forward. However, there is a material impact on the recognition of upfront premiums, which are recorded as written at the inception of the policy. Earnings under SFAS 163 will effectively backload the revenue recognition for upfront premiums compared with current industry methodologies. Although the change in premium recognition under SFAS 163 will affect the financial statements, we do not expect it to have an impact on the company's credit profile because the fundamental economics of a transaction or bond insurance business model have not changed.

An issue that adds a degree of volatility to Ambac Financial's earnings is the CDS mark-to-market accounting under FASB No. 133, which requires derivatives to be marked-to-market at each reporting date. In our opinion, this concept, insofar as it relates to the financial guarantee insurance industry, 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. Unlike other financial sectors for which FASB No. 133 may be more relevant, bond insurers' contracts are

not traded, and there is no business intention to realize gains. Therefore, recording a marked-to-market loss because of changing spreads in the marketplace seems inappropriate. We believe that the insurers' loss reserves are the more appropriate indicators of potential claims and that our capital charge evaluations are more appropriate indicators of changes to the credit profile of any of the bond insurers' insured sectors.

Another issue that adds a degree of volatility to Ambac Financial's earnings, in our view, is the nonperformance risk marked-to-market accounting for derivative assets and liabilities under SFAS No. 157 Fair Value Measurement. The valuation of Ambac Financial's derivative liabilities must take into account the market's perception of Ambac Financial's nonperformance risk by incorporating the spreads of Ambac Financial's CDS. From a ratings perspective, the market's perception of Ambac Financial's ability to settle its obligations does not relieve it of its obligation to pay on its obligations and neither can it transfer the obligation at the market value. We do not consider any gains taken from the deterioration in Ambac Financial's own creditworthiness as economic or real for the purposes of our ratings analysis. Furthermore, for our purposes, we reverse any market-based gyrations unrelated to fundamental credit deterioration when evaluating capital and earnings.

Capitalization

Through the use of Standard & Poor's capital adequacy test, Ambac's margin of safety is 0.7x-0.8x. The margin of safety expresses the relationship between theoretical losses generated by the capital adequacy model and capital remaining at the end of a theoretical economic depression. Analytical adjustments made to the model included:

- No new business written.
- Stress period of model starts immediately and lasts for four years.
- No projected refundings.
- Expenses are held constant for all four years.

In addition to Standard & Poor's normal stress assumptions for municipal and non-RMBS asset classes, we tested Ambac's capital adequacy against a scenario that applies stressful default assumptions to various 2005-2007 RMBS-related transactions that the company has insured. We based the default rates for these transactions on stressful cumulative net loss assumptions that vary by asset type and vintage (see "Standard & Poor's Revises U.S. Subprime And Alternative-A RMBS Loss Assumptions For Transactions Issued In 2005, 2006, And 2007," published July 6, 2009, on RatingsDirect). We have included the Alt-A, subprime, closed-end second, HELOC, and NIM asset types with 2005, 2006, and 2007 vintages in this analysis. For Ambac, these loss assumptions generated \$3.9 billion of direct RMBS losses and \$5.3 billion of CDO of ABS losses.

In addition to increased loss assumptions on its 2005–2007 vintage direct RMBS and CDO of ABS, a change in the assumed tax benefit of tax-loss carryforwards also affected capital adequacy. It is our view, based on its tax filing status, that Ambac Financial will not be able to fully realize the tax benefit of Ambac's operating losses. The effective tax rate we used in determining aftertax losses was 17%, compared with the 35% we cited in November 2008.

Table 3

| Ambac Assurance Corp./Capital Statistics | | | | | |
|----------------------------------------------------------------------------------------|----------------------|-------------|-------------|-------------|-------------|
| (Mil. \$) | —Year ended Dec. 31— | | | | |
| | 2008 | 2007 | 2006 | 2005 | 2004 |
| Portfolio risk | | | | | |
| Municipal insurance weighted average capital charge (% of average annual debt service) | 12.2 | 12.6 | 13.0 | 13.7 | 13.6 |
| Asset-backed capital charge (% of par) | 2.3 | 2.2 | 1.9 | 2.0 | 1.9 |
| Claims-paying resources | | | | | |
| Statutory capital | 3,469.1 | 6,409.3 | 6,371.0 | 5,648.8 | 5,224.5 |
| Letters/lines of credit | | | | | |
| Contingent capital facility | 100.0 | 800.0 | 800.0 | 800.0 | 800.0 |
| Stop-loss treaty | | | | | |
| Unearned premiums | 2,699.5 | 3,275.4 | 3,327.6 | 3,164.7 | 2,917.6 |
| Present value of annual premiums | 2,376.7 | 2,887.4 | 2,404.8 | 2,165.9 | 2,059.8 |
| Total | 8,645.3 | 13,372.1 | 12,903.4 | 11,779.4 | 11,001.9 |
| Capital adequacy | | | | | |
| Capital remaining at end of depression test | NM | 1,400-1,450 | 4,050-4,100 | 3,500-3,550 | 3,700-3,750 |
| Margin of safety (x) | 0.7-0.8 | 1.1-1.2 | 1.3-1.4 | 1.3-1.4 | 1.4-1.5 |
| Reliance on soft capital (%) | 10.6 | 14.0 | 12.9 | 13.6 | 11.4 |

NM—Not meaningful.

Factors Specific To Holding Company

The operating performance and debt service needs of Ambac Financial depend on Ambac's ability to pay dividends. In 2009, Ambac cannot pay dividends without specific approval from the Wisconsin Office of Insurance Commissioner. While the holding company currently holds cash in excess of its 2009 debt service and cash expense requirements, resumption of dividends from Ambac in 2010 and beyond, without gaining specific regulatory approval, will be dependent on Ambac's return to meaningful profitability. To help build cash to support debt service, management has announced that it has deferred dividends on Ambac Financial's directly issued subordinated capital securities.

Ratings Detail (As Of August 18, 2009)*

Ambac Assurance Corp.

Financial Strength Rating

Local Currency

CC/Developing/--

Counterparty Credit Rating

Local Currency

CC/Negative/--

Financial Enhancement Rating

Local Currency

CC/--/--

Preferred Stock (8 Issues)

C

Ratings Detail (As Of August 18, 2009)*(cont.)**Related Entities****Ambac Assurance U.K. Ltd.**

Financial Strength Rating

Local Currency

CC/Developing/--

Issuer Credit Rating

Local Currency

CC/Negative/--

Financial Enhancement Rating

Local Currency

CC/--/--

Ambac Financial Group, Inc.

Issuer Credit Rating

Local Currency

CC/Negative/--

Senior Unsecured (5 Issues)

CC

Subordinated (1 Issue)

C

Connie Lee Insurance Co.

Financial Strength Rating

Local Currency

CC/Developing/--

Issuer Credit Rating

Local Currency

CC/Negative/--

Holding Company

Ambac Financial Group, Inc.

Domicile

Wisconsin

*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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