

June 11, 2008

**Summary:**  
**Ambac Assurance Corp.**

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**Table Of Contents**

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Rationale

## Summary:

# Ambac Assurance Corp.

Local Currency

**Credit Rating:** AA/Watch Neg/--

## Rationale

On June 5, 2008, Standard & Poor's Ratings Services lowered its financial strength rating on Ambac Assurance Corp. (Ambac) to 'AA' from 'AAA'. At the same time, Standard & Poor's lowered its ratings on holding company Ambac Financial Group Inc.'s (Ambac Financial) senior debt and hybrid security to 'A' and 'BBB+' from 'AA' and 'A+', respectively. In addition, Standard & Poor's lowered its ratings on preferred stock issued by Anchorage Finance Sub-Trusts I, II, III, and IV and Dutch Harbor Finance Sub-Trusts I, II, III, and IV (committed capital facilities supported by, and for the benefit of, Ambac) to 'A' from 'AA'. All the ratings were placed on CreditWatch with negative implications.

The rating action on Ambac reflects our belief that the company will face diminished new business flow in its public finance and structured finance divisions, as well as declining financial flexibility. In addition, we believe that continuing deterioration in key areas of the U.S. residential mortgage sector and related collateralized debt obligation (CDO) structures will place increasing pressure on capital adequacy. The 'AA' financial strength rating is supported by currently sound claims-paying ability and liquidity levels, in our opinion.

Resolution of the negative CreditWatch will be dependent on the clarification of ultimate potential losses, future business prospects, the outcome of strategic business decisions, and potential regulatory developments.

## Business Volume

For the first quarter of 2008, total gross par guaranteed declined nearly 85% from 2007 to \$4.9 billion, including a 96% decline in U.S. public finance volume to \$517 million and a 76% decline in U.S. structured finance volume to \$3.8 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. 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 that there is also uncertainty surrounding if or when investors will be willing or able to regain confidence in Ambac.

Our continuing view of the company will be determined in part by its ability to put a plan in place that will generate a profitable stream of revenue that is of sufficient volume and quality to justify the capital employed in the business. In that regard, the company has disclosed that it is investigating the possibility of capitalizing an inactive subsidiary for the purpose of improving its creditworthiness and for writing global municipal and infrastructure business.

## Financial Flexibility

In our view, Ambac's ability to access new capital is currently severely restricted. Indicators of this lack of flexibility include Ambac Financial's common stock price, which is currently more than 95% below its 52-week high and

trading at less than half of book value (as of March 31, 2008), which effectively rules out raising a significant amount of new equity; and very 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.

### **Exposure To Further RMBS And ABS CDO Deterioration**

Standard & Poor's structured finance department continues to monitor the performance of various classes of residential mortgages and the related effects this performance has on CDOs that have exposure to these mortgages. The trend to higher loss expectations has continued since we conducted our last detailed stress test on the bond insurers in February 2008. Specifically, loss expectations have been raised on the 2005 through 2007 vintages of closed-end second mortgages and the 2007 vintage of subprime mortgages. Offsetting this to a small degree was a reduced loss expectation for the 2007 vintage of Alt-A mortgages. The effect of these changes was to increase our projected losses for Ambac by approximately 16%. There is no assurance that loss expectations will not be subject to further upward revision, which would have a negative effect on the company's capital adequacy.

### **Capital Adequacy**

Ambac Financial successfully raised \$1.5 billion in new capital in March 2008, of which \$1.3 billion was invested in Ambac to support its capital adequacy. In addition, the low new business volume -- including a six-month self-imposed hiatus on writing new structured finance business that extends into August 2008 and an election to discontinue writing new business in certain structured finance segments, including CDOs and collateralized loan obligations (CLOs) -- plus the runoff of the existing risk portfolio, accelerated by significant refunding activity, are important offsets to the increased risks in the mortgage and mortgage-related CDO segments of the company's insured portfolio. On balance, we believe that Ambac still exhibits relatively strong capital adequacy.

### **Liquidity**

In our view, Ambac maintains a high-quality, liquid investment portfolio. At March 31, municipal bonds and treasury and agency securities represented more than 92% of the long-term portion of the \$12 billion portfolio, with corporate and foreign sovereign securities accounting for the remainder. Ambac invested \$1 billion of the portfolio in short-term investments. The portfolio is very high quality; its rating profile was 74% 'AAA', 20% 'AA', 5% 'A', and 1% 'BBB' or lower, or not rated.

We believe that Ambac has strong liquidity to pay projected claims in 2008 without needing to sell investments. During the first quarter, Ambac paid claims of \$34 million, compared with net investment income generated of more than \$120 million. Over the balance of the year, the company expects to pay claims totaling \$151 million. This amount can be handled by projected investment income of at least \$375 million. The cash generated by investments' maturing principal and cash received from installment premiums paid on outstanding policies 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 quarter, it received a dividend from Ambac of \$54 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 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.

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