MOODY'S INVESTORS SERVICE

CREDIT ANALYSIS

Ambac Assurance Corporation

New York, New York, United States

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This Credit Analysis provides an in-depth discussion of credit rating(s) for Ambac Assurance Corporation and should be read in conjunction with Moody's most recent Credit Opinion and rating information available on Moody's website.

Summary Rating Rationale

Ambac's Caa2 rating for insurance financial strength (on review for possible upgrade) reflects the company's weakened capital profile, significantly diminished franchise and its impaired financial flexibility.

The review for upgrade of the financial strength rating of Ambac Assurance Corporation (AAC) reflects the enhanced credit profile of its General Account policyholders following the group's restructuring. As a result of the restructuring, AAC's riskier insured exposures were removed from the General Account and placed into a Segregated Account, and most ABS CDOs would be commuted. The Segregated Account is capitalized by $2 billion secured notes and some surplus notes issued by AAC. In our view, policies allocated to the Segregated Account have been effectively subordinated to the policies remaining in the General Account. The General Account's insured book contains mainly public finance and performing structured securities, free of RMBS and ABS CDOs. AAC's large and diverse insured portfolio contains a high level of embedded earnings and cash flows that will be realized over time, absent significant losses.

The potential for upward rating movement is tempered, however, by limited capital, potential legal challenges to restructuring, and AAC's inability to write new business without regulatory approval before the full repayment of the surplus notes. During its review, Moody's will evaluate more fully the impact of the restructuring on AAC's financial strength, including the extent to which policyholders of the General Account are actually insulated from Segregated Account losses and expenses.

Group Overview

Ambac Financial Group, Inc. ("Ambac", NYSE: ABK), based in New York, New York, is a holding company whose subsidiaries provide financial guaranty and other financial services to clients in both the public and private sectors worldwide. Ambac Assurance Corporation ("AAC"), the company's main operating subsidiary, and its wholly-owned subsidiary Ambac Assurance UK Limited ("Ambac UK"), write financial guaranty insurance on public finance and structured finance obligations. Ambac's insurance provides an unconditional and irrevocable guaranty to pay interest and principal in the event of an issuer default.

Through its financial services subsidiaries, Ambac provides financial and investment products including investment agreements, funding conduits, interest rate swaps, currency swaps and total return swaps to issuers. The issuers includes mainly municipalities and other public entities, health care firms, asset-backed and structured finance issuers. In early 2008, Ambac announced that it would discontinue writing new business in financial services. Since this announcement, the company has significantly reduced its exposure as a result of terminations and other settlements, particularly with respect to investment agreements (GICs). As of year-end 2009, the GIC portfolio was further reduced to $1.2 billion from $2.6 billion in prior year, with a weighted average life of approximately 4.8 years.

While Ambac has historically held a strong position in the financial guaranty market, the company's large losses among mortgage-related exposures have resulted in meaningful erosion in the company's franchise value and strategic position. The company did not write any new business in 2009. As of year-end 2009, Ambac had $387 billion in net par outstanding and claims paying resources of approximately $10.8 billion.

Recent Developments – Financial Restructuring

On March 24, 2010, AAC established a Segregated Account to contain its most risky exposures such as RMBS and Las Vegas Monorail. The Office of the Commissioner of Insurance of the State of Wisconsin (OCI), Ambac's regulator, has placed the Segregated Account under rehabilitation. AAC also entered into a non-binding agreement to commute almost all of its remaining ABS CDOs. Other insured risks remain in AAC's General Account. These actions are expected to improve the credit standing of AAC's General Account policyholders by settling or segregating the insurer's most risky exposures, and effectively subordinating Segregated Account policyholders.

The Segregated Account is capitalized by $2 billion in secured notes and some surplus notes issued by AAC. The secured notes are collateralized by installment premiums, reinsurance premiums and certain recoveries related to the policies in the Segregated Account. All claims payments related to the Segregated Account are suspended, until the court approves the Segregated Account Rehabilitation Plan. The OCI has indicated that the court approval may take about six months. The rehabilitation plan calls for the future payment of claims out of the Segregated Account to be made with a combination of cash (from putting part of the secured notes back to AAC) and surplus notes.

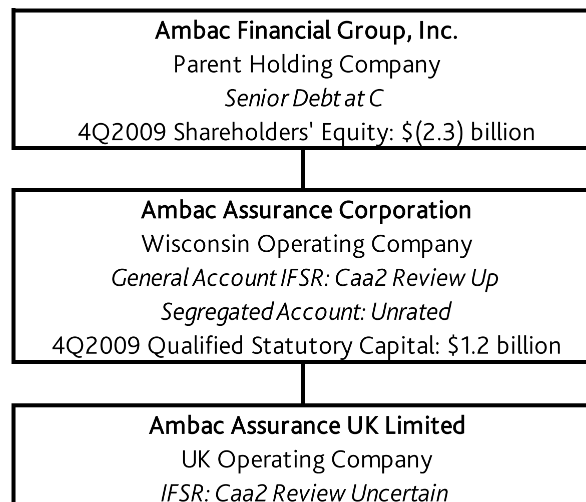
Ambac also reached a non-binding agreement to settle or commute ABS CDOs with counterparties. In exchange for the termination of the ABS CDO obligations, AAC would pay the counterparties $2.6 billion in cash, and $2 billion in surplus notes issued by AAC. The surplus notes would have the same terms as the ones issued as part of the rehabilitation plan. Given the non-cash component of the payments and their size as compared to the losses that would have likely been sustained from these contracts, Moody's considers this transaction to represent a distressed exchange. As of year-end 2009, Ambac had about $17.5 billion ABS CDO outstanding.

In addition, AUK sent AAC notices of termination with respect to AUK's reinsurance agreement from AAC, but AAC has not agreed or accepted that the purported termination was valid, per its Form 10-K filling as of April 9, 2010. AUK has demanded payment of unearned premium reserves, loss reserves, contingency reserves and loss adjustment expense reserves related to the reinsured policies, less ceding commissions and certain adjustments. While the dispute has not been resolved, the liabilities of AAC under the AUK reinsurance agreement are currently allocated to the Segregated Account.

Analysis of Rating Considerations

The credit crisis that began with a spark during 2Q2007 became a full-fledged conflagration during 2008, with the financial guaranty insurance industry facing its biggest stress in its 30+ year history. Both the financial and business fundamentals of the industry have been profoundly altered since the financial crisis, with meaningful implications for Moody's views on the key rating factors of Ambac and its peers.[1]

The chart below shows a simplified corporate structure for Ambac, and Moody's rating levels.



Recent Restructuring Differentiates Among Policyholders

The recent restructuring has implications that differ for the distinct sets of policyholders, as follows:

It is credit positive for policyholders that remain in the General Account (e.g., municipal bonds and some performing structured securities). They will effectively enjoy senior status to those policies moved to the Segregated Account. In addition, by eliminating almost all RMBS and ABS CDOs, the insured portfolio is less risky. By contrast, the capital access for the Segregated Account policyholders is on a deferred and subordinated basis through the secured and surplus notes, both of which are deferrable.

It is credit positive for policyholders of the Segregated Account with expected claims payable further in the future (e.g., some subprime RMBS and CLOs). They are less at risk of current claimants draining AAC's resources prior to their claims becoming effective. In addition, Segregated Account policyholders will still have access to AAC's long-term claims paying resources, and their effective

[1] "Financial Guaranty Insurance Industry: 2009 Review and 2010 Outlook", Moody's Industry Outlook, February 2010. "The Changing Business of Financial Guaranty Insurance", Moody's Special Comment, November 2008.

subordination to the General Account insurance obligations is mitigated by limited loss expectation from the insured book of the General Account.

It is credit negative for policyholders of the Segregated Account with current claims. They (e.g., 2nd-lien RMBS, Alt-A) had been receiving full payments, but their payments are suspended and will be mostly in surplus notes when payments resume.

Although we expect credit improvement for AAC's General Account, the benefits are tempered by the insurer's limited capital, by risks associated with potential legal challenges, and by AAC's inability to write new business without regulatory approval before the full repayment of the secured and surplus notes.

Strategy & Franchise Value

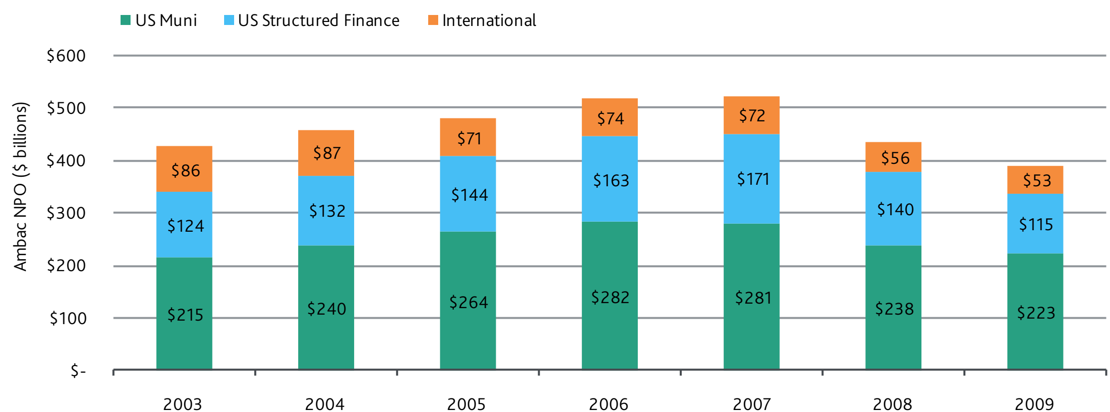
Ambac Is Effectively in Runoff

The company has not been able to write meaningful new business since 2008. As a result, primary gross par written market share has fallen precipitously (Exhibit 1). Ambac's net par outstanding (NPO) declined meaningfully by 10% for 2009 (versus 17% for 2008), as the impact of portfolio amortization, refunding activity and policy commutations/cancellations greatly exceeded new business production (in fact no new production for 2009) and the re-assumption of previously ceded exposures. However, absent larger than expected losses, Moody's anticipates that Ambac's insured book would continue to amortize, improving capital adequacy.

Given the recent regulatory actions, it is highly unlikely that AAC can write new business in the foreseeable future. The firm is effectively in runoff.

EXHIBIT 1

Ambac's Insured Book Has Been Running Off



Portfolio Characteristics

Ambac is one of the largest financial guarantors as measured by net par outstanding (NPO), which totaled approximately $387 billion as of year-end 2009 with 57% in U.S municipal and 29% in structured risks. Ambac has minimal CMBS exposure, and no exposure to CRE CDOs.

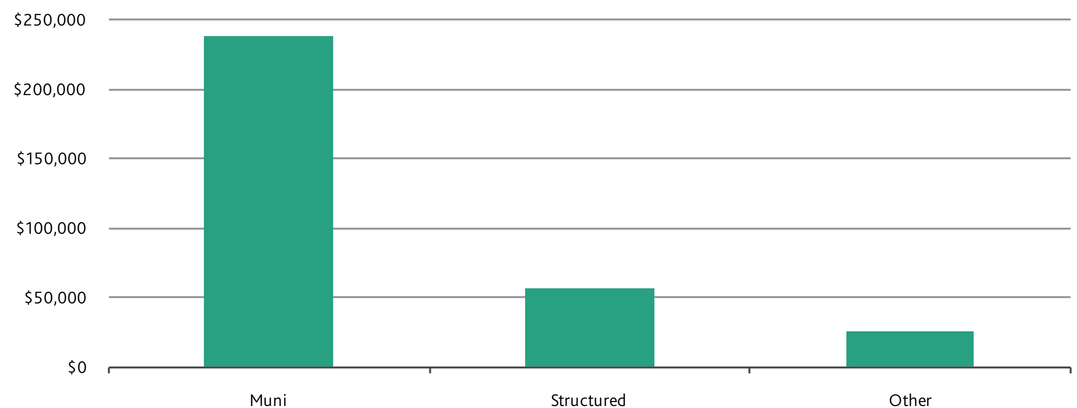
General Account Contains Mainly Municipal and Some Structured Exposures

The credit quality for the General Account ($320 billion) has improved, as some of the worst performing exposures have been moved to the Segregated Account. We note that in this section all NPO for the General Account and Segregated Account is based on year-end 2009 data, though the structuring took place in March 2010.

The General Account contains a large share of public finance exposure (74%), some structured risks (17%), and other (Exhibit 2).[2] The General Account's public finance portfolio is diverse (Exhibit 3). Other types of risks in the General Account include corporate CDOs, student loans and infrastructure (Exhibit 4).

EXHIBIT 2

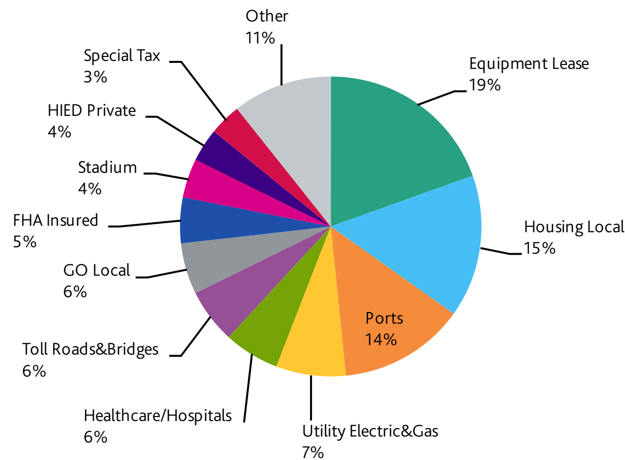
General Account Insured Risk Composition ($mm)



[2] Within the General Account, if the exposures are in CDS form, the counterparty has agreed to forebear on the right for a mark to market termination.

EXHIBIT 3

Municipal Risks in the General Account



Interestingly, Jefferson County exposures remain in the General Account. The General account had approximately $406 million exposure in Jefferson County, Alabama (based on year-end 2009 data), including

» $299 million limited obligation school warrants issued by the County (B3 Stable)

» $51 million lease revenue bonds issued by the Jefferson County Building Authority (Caa2 Negative)

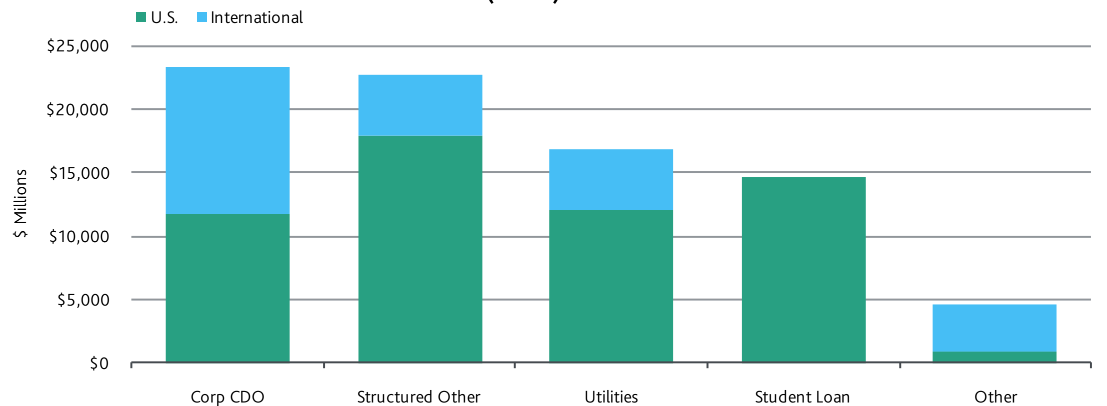
» $37 million special tax bonds issued by the Birmingham Jefferson Civic Center Authority (B3 Stable)

» $19.2 million General Obligation debt of the County (Caa1 Negative)

These bonds have been substantially and adversely impacted by financial problems and debt payment default of the County's sewer system. Moody's believes that there is a risk that Jefferson County may seek to either restructure some of the debt or seek federal bankruptcy protection. AAC had recorded some modest loss reserves for these policies. Ambac does not have any direct exposure to Jefferson County's sewer system.

EXHIBIT 4

Other Insured Risks in the General Account ($mm)



RMBS and Las Vegas Monorail Were Moved to the Segregated Account

Almost all remaining RMBS exposures reside in the Segregated Account (Exhibit 5). It also contains some contracts written in CDS form, for which the counterparties did not forebear on the right for a mark to market termination.[3] In addition, currently all AUK's reinsurance obligations ($23.9 billion) also reside in the Segregated Account.

EXHIBIT 5

Segregated Account Composition ($mm)

As of year-end 2009, the Segregated Account has $464.5 million exposures to the Nevada Department of Business and Industry's troubled Las Vegas Monorail project 1st Tier Series 2000 Revenue Bonds (rated C by Moody's) and a small amount of surety bonds. The rating reflects the weak operational performance of the project, and in Moody's view the recovery on the bonds is likely to be very low. The Las Vegas Monorail Corporation filed for bankruptcy protection on January 13, 2010. Ambac has paid some claims related to the Project and recorded significant statutory loss reserves.

[3] For the CDS insured by AAC, mark to market termination was triggered, because ISDA called a credit event on AAC as a result of the regulatory actions. To be eligible for the General Account, as requested by the regulator, insured CDS must forebear on their mark to market termination right.

Capital Adequacy

Ambac's capital adequacy deteriorated significantly as estimated losses for RMBS and ABS CDOs mounted, and as sectors susceptible to economic slowdowns (such as private student loans and consumer and corporate ABS) were negatively affected by the financial crisis.

The Rehabilitation Plan Helps Preserve AAC's Long-Term Capital Resources

The rehabilitation plan seeks to impose greater fairness in the way the company's policyholders are treated, rather than to follow a "first-come, first-served" approach in a situation where aggregate resources may ultimately prove to be inadequate to cover all claims. To that end, the plan also helps preserve AAC's long-term capital resources for the following reasons:

1. Limiting cash claim payments mitigates AAC's overall liquidity pressure. The cash drain from shorter-term RMBS claims will slow because the rehabilitation plan limits cash payments and shifts the balance to surplus notes for claims made by Segregated Account policyholders. Less cash drain eases liquidity pressure, reducing the need to sell assets in the company's investment portfolio at depressed market prices which would have further weakened its capital resources.

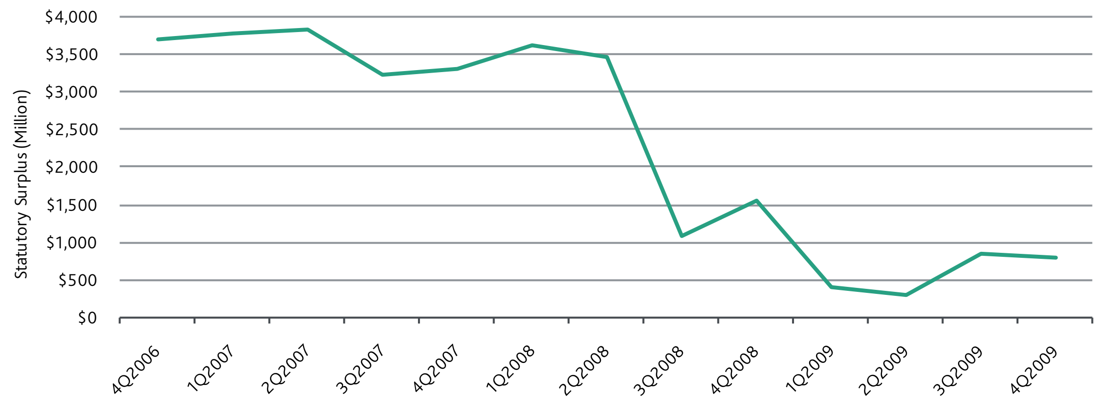
2. ABS CDO commutation enhances AAC's overall capital position. The commutation, scheduled to close within 60 days of the restructuring, will terminate and remove a significant source of uncertainty related to future losses. In addition, the terms of the proposed ABS CDO commutation call for a settlement at a discount to our loss estimates related to these exposures.

Losses from the Segregated Account, however, would continue to negatively affect AAC's overall capital resources. Although under the recent restructuring, the worst performing risks were either transferred to the Segregated Account or are to be commuted, policyholders within the Segregated Account have maintained access to AAC's capital resources, albeit mainly on a deferred and subordinated basis.

For the last couple of years, one of Ambac's challenges has been maintaining statutory capital in excess of the minimum required level (Exhibit 6). However, for the last two quarters of 2009, Ambac reported a greater than $800 million statutory surplus, benefiting from CDO commutations and tax loss carry back. Post the restructuring, AAC is not obligated to pay the surplus notes, should its statutory surplus falls below $100 million. The company has not yet provided separate statutory filings for the General and Segregated Account.

EXHIBIT 6

Ambac's Statutory Surplus Declined Dramatically Since 2008*



* Ambac understated $278 million CDS impairment charges in Q3 2009. With the error corrected, statutory capital would have been $27 million in that quarter, a very thin cushion over its regulatory minimum of $2 million

Remediation Credit Offsets on RMBS Reserves Are Substantial

Ambac increased the estimated RMBS remediation recoveries related to material representation and warranty breaches to $2,026.3 million in Q4 2009 from $1,902.8 million as of Q3 2009, primarily as a result of breaches identified during the re-underwriting of additional transactions. According to Ambac, such recoveries are expected to take several years for ultimate collection.

To the extent these claim mitigation strategies are successful, ultimate losses from defaulted mortgages for Ambac could be meaningfully lower than expected claims, with positive effects on Ambac's credit profiles. Ultimate recoveries, however, remain highly uncertain, and could be materially different from the company's current estimates.[4]

Significant Reinsurance Settlements

Ambac has typically been a moderate user of reinsurance to manage large single risks and reduce concentrations in particular issuers or sectors. Since 2008, Ambac commuted treaties with several of its reinsurance counterparties, further reducing its reinsurance utilization. By taking back ceded exposures from reinsurers, Ambac also recaptures associated unearned premiums and future installment premiums.

During 2009, Ambac terminated all reinsurance agreements with Financial Guarantee Insurance Company ("FGIC"), RAM Reinsurance Company Ltd. ("Ram Re"), Swiss Reinsurance Company ("Swiss Re"), Assured Guaranty Municipal Corp. (formerly Financial Security Assurance Inc., "AGMC"), and all but one reinsurance contracts with Radian Asset Assurance Inc ("Radian") and MBIA Insurance Corporation ("MBIA"). These terminations led to a net recapture of approximately $22.3 billion in reinsurance par outstanding, and a net settlement payment to Ambac of $541 million, and a pre-tax income of approximately $316.7 million during 2009.

[4] "Monoline Insurers Push Back on Mortgage Claims," Moody's Special Report, December 2009.

Profitability

Embedded Earnings Stream Remains Strong

AAC benefits from the large embedded earnings on its in-force portfolio, including $2.4 billion of statutory unearned premiums (on balance sheet) and a company-estimated additional $2.3 billion of future installment premiums (on a present value basis) as of year-end 2009. To the extent Ambac's loss reserve and claims payment stabilize, this embedded earnings stream will provide additional regulatory capital and surplus for the company to support the remaining risks in the insured portfolio.

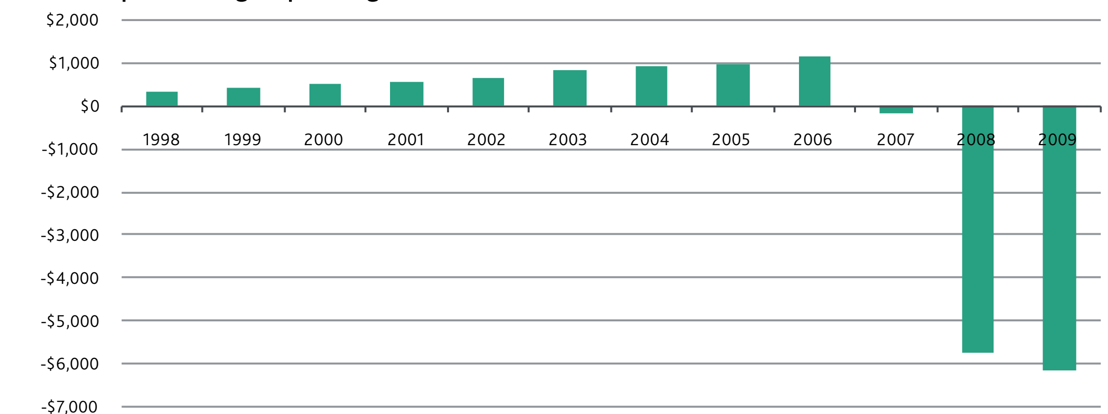
Mortgage Losses Continue to Impact Earnings

While Ambac historically achieved the highest returns on equity in the financial guaranty industry, the company has recorded significant loss reserves and credit derivative impairments during 2008 and 2009. During the last several quarters, Ambac reported large operating losses. Because of large charges related to loss reserve and credit derivatives impairment, the company had pre-tax operating losses of approximately $5.7 billion and $6.1 billion, respectively, in 2008 and 2009 (Exhibit 7). These large losses effectively erased all pre-tax operating earnings at the company since 1999.

The earnings volatility related to ABS CDOs will largely subside as Ambac is scheduled to commute most of its remaining ABS CDOs. However, AAC's profitability will continue to be negatively affected by AAC's obligation to support Segregated Account claims such as from RMBS, by the lack of new business volume, and also by potential legal challenges related to the restructuring.

EXHIBIT 7

Ambac Reported Large Operating Losses Since 2008



Financial Flexibility

Financial Flexibility Is Impaired

The extreme sensitivity of a financial guarantor's franchise value to changes in its risk profile also affects financial flexibility because prospective investors recognize that the value of their investment will depend on the guarantor's ability to write profitable new business going forward. Ambac's financial flexibility suffered in the face of stress from its mortgage-related exposures. Given the company's depressed stock price and wide credit spreads, it is currently unable to raise capital at a reasonable cost.

Lack of Dividend Capacity Strains Holding Company Liquidity

Cash, short-term securities and bonds at Ambac Financial, the holding company, amounted to $136.5 million as of December 31, 2009. Ambac's annual debt service costs are approximately $89.0 million. As a result of the recent regulatory actions, it is highly unlikely that AAC will be able to make dividend payments to Ambac Financial for the foreseeable future. As a result, Ambac Financial may be unable to pay off its August 2011 debt on schedule.

Investment Portfolio Would Face Less Liquidity Pressure

The credit quality of Ambac's financial guarantee investment portfolio has deteriorated significantly, as a result of the liquidity support provided by AAC to its financial service affiliates. AAC's investment portfolio now contains substantial amounts of illiquid RMBS and higher risk assets, with certain securities likely to sustain credit losses over time. At year-end 2009, 63% of the portfolio was rated Aa or better (versus 99% at year-end 2007), with 12% of the portfolio rated below investment grade.

Despite the sizable investment portfolio, weaker credit quality and cash drains from paying mainly 2nd-lien RMBS claims posed significant challenges for AAC's liquidity. During 2009, RMBS claim payments were significant, at about $300-400 million a quarter. Should AAC run out of liquid and high quality investments, it may have to sell investment assets at distressed market prices to meet claim payments. Post restructuring, only a portion of the claims payment to Segregated Account policyholders is expected to be in cash, limiting near term cash outflows. This reduces liquidity pressures and investment losses related to liquidation.

Other Credit Considerations

GIC and Swap Business Largely Stabilized

The recent rehabilitation plan left guaranteed investment contracts (GIC) in the General Account. This is credit positive for GIC investors. The GICs outstanding amount was reduced to $1.2 billion as of year-end 2009, from $2.6 billion at the year-end of 2008 and $7.7 billion at the year-end of 2007.

Historically, Ambac's GIC business provided a stable stream of modest earnings to the company. During 2008, however, the market value of Ambac's assets backing its GIC liabilities declined substantially (a large percentage of these assets consisted of illiquid Alt-A RMBS), resulting in a material funding gap in its GIC business. A liquidity problem occurred when ratings based collateral posting requirements and terminations among GICs and swaps threatened to overwhelm available liquid resources and postable collateral. With the approval of the Wisconsin regulator, Ambac was able to put into place various inter-company liquidity support arrangements, including loans and asset purchases, which were effective in meeting all liquidity calls.

We do not expect the liquidity problems related to GIC worsen because most GICs are currently collateralized and ratings based triggers have already been breached.

Everspan Launch Postponed

In June 2009, Ambac postponed its efforts to launch Everspan Financial Guarantee Corp. (Everspan), wholly-owned by AAC. Everspan, formerly Connie Lee Insurance Company, was positioned to take advantage of unmet demand for financial guaranty insurance in the U.S. public finance market. However, Everspan may be taking on new business with an infusion of new outside capital, and if approved by the board of directors of AAC, including a majority of the unaffiliated directors.

Moody's believe bond insurance currently fills some existing market needs. As seen in 2009, some public finance issuers and investors continued to utilize bond insurance. However, insurer penetration is less than 10% as of year-end 2009, down from more than 50% a few years back, reflecting both the lower supply of financial guaranty insurance and the lessened demand for the product. In our view, there is also greater receptivity for guarantors with higher risk profiles than in the past. However, there is also a lower perceived value to their insurance -- and thus narrower market opportunities. Should asset spreads normalize and competitive pressures increase, this situation may weaken guarantors' future pricing power and profitability.

Company Annual Statistics

Ambac Assurance Corporation

FINANCIAL RATIOS ($ MILLIONS)	2009	2008	2007	2006	2005	2004
Insured Portfolio:						
Gross Exposure Outstanding	677,552	811,178	995,032	887,448	801,085	757,037
Net Exposure Outstanding	619,566	695,954	833,303	802,694	726,612	685,234
Gross Par Outstanding	422,237	497,960	612,075	567,578	523,247	502,657
Net Par Outstanding (NPO)	390,406	434,310	524,025	519,043	479,085	459,432
Gross Par Written	0	11,298	125,977	124,457	125,278	118,106
Net Par Written	0	17,133	82,414	116,379	116,563	117,253
Claims Paying Resources (SAP):						
Policyholders' Surplus	802	1,554	3,316	3,712	3,441	3,199
Contingency Reserve	352	1,930	3,106	2,686	2,365	2,066
Qualified Statutory Capital	1,154	3,484	6,422	6,398	5,807	5,265
Capital Charges	-335	-157	-233	-204	-179	-206
Unearned Premiums	2,390	2,733	3,320	3,373	3,208	2,972
Loss Reserves & CDS Impairments	4,983	4,521	867	42	103	117
Present Value of Future Installment Premiums	2,313	2,663	2,921	2,331	2,073	1,968
Hard Capital	10,158	13,244	12,859	11,590	10,701	9,820
Soft Capital	0	100	800	800	800	800
Total Capital	10,158	13,344	13,659	12,390	11,501	10,620
Key Statutory Data:						
Total Assets	8,553	7,793	10,043	10,037	9,122	8,440
Cash and Invested Assets	8,011	10,397	10,581	9,834	8,948	8,307
Gross Premiums Written	357	558	1,057	1,018	1,110	1,059
Net Premiums Written	461	502	778	919	1,009	986
Net Premiums Earned	796	1,078	831	756	770	665
Loss and Loss Adj. Expenses Incurred	1,509	1,623	67	45	73	81
Other Underwriting Expenses Incurred	113	144	113	137	124	110
Net Underwriting Gain	-477	-689	651	574	573	475
Net Investment Income Earned	468	461	472	545	385	411
Realized Capital Gains (Losses)	-3,027	-4,401	-752	4	3	25
Pre-Tax Operating Income	64	-524	1,128	1,132	967	916
Net Income	-2,479	-4,035	54	802	697	677
Dividends Paid to Stockholders	13	219	190	136	353	103
Operating Cash Flow	-1,606	-1,424	961	1,070	963	1,069

Moody's Related Research

Company Reports:

» Ambac Capital Position Improved, But Pressure on Capital and Liquidity Remains, November 2009 (121470)

» Credit Opinion Ambac Assurance Corporation, January 2010 (600010209)

» Ambac's Restructuring Differentiates Among Policyholders, April 2010 (124219)

Rating Methodologies:

» Moody's Rating Methodology for the Financial Guaranty Insurance Industry, September 2006 (98408)

» Assignment of Wrapped Ratings When Financial Guarantor Falls Below Investment Grade, May 2008 (108924)

» Rating of Transactions Wrapped by Financial Guarantors: Frequently Asked Questions, December 2007 (105934)

Special Comments:

» Financial Guaranty Insurance Industry: 2009 Review and 2010 Outlook, February 2010 (122526)

» Monoline Insurers Push Back on Mortgage Claims, December 2009 (111340)

» Financial Guaranty Policies -- What Is Needed For Credit Substitution?, March 2009 (55948)

» Financial Guarantors' Subprime Risks: From RMBS to ABS CDOs, September 2007 (104811)

» Credit Implications of FAS 163 - FASB Guidance on Financial Guarantee Industry Accounting, July 2008 (109837)

» Interpreting Financial Guarantors' Mark-to-Market Losses, July 2008 (105498)

» Moody's Financial Guaranty Update: Frequently Asked Questions, August 2008 (110375)

» Credit Uncertainties: Global Financial Institutions, January 2009 (114064)

» The Changing Business of Financial Guaranty Insurance, November 2008 (111991)

To access any of these reports, click on the entry above. Note that these references are current as of the date of publication of this report and that more recent reports may be available. All research may not be available to all clients.

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