

In the Matter of the Rehabilitation of:

Case No. 10 CV 1576

Segregated Account of Ambac Assurance Corporation

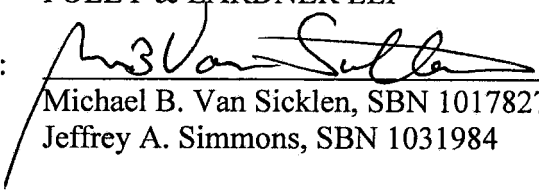
**2014 ANNUAL REPORT ON THE REHABILITATION OF THE
SEGREGATED ACCOUNT OF AMBAC ASSURANCE CORPORATION**

On March 24, 2010, the Circuit Court for Dane County, State of Wisconsin, the Honorable William D. Johnston presiding, entered an order placing the Segregated Account of Ambac Assurance Corporation into rehabilitation pursuant to the provisions of the Wisconsin Insurers Rehabilitation and Liquidation Act. As part of the Decision and Final Order Confirming the Rehabilitator's Plan of Rehabilitation (entered January 24, 2011) (at page 60, ¶ 8), the Court directed the Rehabilitator to file a report each year by June 1st "advising on the status of the rehabilitation."

The Rehabilitator hereby submits the enclosed 2014 Annual Report on the Rehabilitation of the Segregated Account of Ambac Assurance Corporation to advise the Court and all interested parties about certain developments in the rehabilitation proceeding since the filing of the 2013 Annual Report on the Rehabilitation of the Segregated Account of Ambac Assurance Corporation.

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**ANNUAL REPORT ON THE REHABILITATION OF THE SEGREGATED ACCOUNT
OF AMBAC ASSURANCE CORPORATION**

**The Commissioner of Insurance of the State of Wisconsin,
as the Court-Appointed Rehabilitator of the Segregated Account
of Ambac Assurance Corporation**

May 2, 2014

DISCLAIMER

This Annual Report on the Rehabilitation of the Segregated Account of Ambac Assurance Corporation (this “Annual Report”), prepared by the court-appointed Rehabilitator of the Segregated Account, summarizes and describes developments in the Rehabilitation Proceeding since the 2013 Annual Report was submitted to the Rehabilitation Court. It does not contain an exhaustive discussion of the Rehabilitation Proceeding, which is discussed in further detail in the relevant papers and pleadings filed with the Rehabilitation Court. Those papers and pleadings are available for review on the website (the “Website”), <http://www.ambacpolicyholders.com>.

This Annual Report is not required to be prepared in accordance with federal or state securities laws or other applicable law. None of the Securities and Exchange Commission (“SEC”), any state securities commission, or any similar public, governmental or regulatory authority has approved this Annual Report, or has passed on the accuracy or adequacy of the statements contained herein. Persons trading in or otherwise purchasing, selling or transferring securities of the Segregated Account should evaluate this Annual Report in light of the purpose for which it was prepared, and should also consider other publicly available information, including the materials on file with the SEC prepared by Ambac Financial Group, Inc.

No registration statement under the Securities Act of 1933, as amended, or any other federal or state securities or “blue sky” laws has been filed with the SEC or any other agency by the Rehabilitator or the Segregated Account with respect to any securities that may be issued by the Segregated Account.

Except as specifically and expressly stated herein, this Annual Report does not reflect any events that may occur subsequent to the date hereof. Such events may have a material impact on the information contained in this Annual Report. The financial information provided herein or incorporated herein by reference was not prepared with a view toward compliance with published guidelines of the SEC, the American Institute of Certified Public Accountants or Accounting Principles Generally Accepted in the United States of America (“GAAP”), or in accordance with U.S. statutory accounting principles prescribed or permitted by the State of Wisconsin Office of the Commissioner of Insurance.

This Annual Report may not be relied upon for any purpose other than to obtain information about the status of the rehabilitation proceeding generally. Nothing contained herein will constitute an admission of any fact or of any liability by any party with regard to any claim or litigation, including, but not limited to, any proceeding involving the Rehabilitator, the Segregated Account or any other party, or any proceeding with respect to any legal effect of the rehabilitation of the Segregated Account.

None of Ambac Assurance Corporation, the Segregated Account of Ambac Assurance Corporation or the Rehabilitator make any warranty, express or implied, as to the accuracy or completeness of the information contained herein. In particular, events and forces beyond the control of the Rehabilitator may alter the assumptions upon which the disclosures in this Annual Report are based.

This Annual Report may contain statements that are, or may be deemed to be, forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. Such forward-looking statements include those regarding consummation of transactions in conjunction with the Rehabilitation Proceeding. Although the Rehabilitator believes that any such forward-looking statements are reasonable, no assurance can be given that such expectations will prove to have been correct. Any such forward-looking statements involve known and unknown risks, uncertainties, and other factors that may cause the actual results, performance or achievements of the Segregated Account to be different from any future results, performance and achievements expressed or implied by these statements.

The Rehabilitator's Loss Projections (found in Section VI herein) are based upon estimates and assumptions developed in good faith by the Rehabilitator based upon certain materials provided by Ambac Assurance Corporation and other information that was determined to be relevant. THE REHABILITATOR'S LOSS PROJECTIONS AND UNDERLYING ASSUMPTIONS DO NOT REFLECT THE VIEWS OF AMBAC ASSURANCE CORPORATION OR AMBAC FINANCIAL GROUP, INC. OR ITS MANAGEMENT. The estimates and assumptions incorporated in the Rehabilitator's Loss Projections may not be realized and are inherently subject to significant business, economic and competitive uncertainties and contingencies, many of which are beyond the Rehabilitator's control. No representations can be or are made as to whether the actual results will be within the range set forth in the Rehabilitator's Loss Projections. Some assumptions will not materialize and events and circumstances occurring subsequent to the date on which the Rehabilitator's Loss Projections were prepared may be different from those assumed or may be unanticipated, and therefore may affect financial results in a material and possibly adverse manner. Accordingly, due to the inherently unpredictable nature of such projections, no representation can be or is being made with respect to the accuracy of the Rehabilitator's Loss Projections, and the Rehabilitator's Loss Projections, therefore, may not be relied upon as a guarantee or other assurance of the actual results that will occur.

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I. INTRODUCTION

A. Ambac Assurance Corporation

Ambac Assurance Corporation (“AAC”) is a Wisconsin-domiciled insurance company. It was incorporated under the laws of Wisconsin as CMI Credit Insurance, Inc. on February 25, 1970, and is a wholly-owned subsidiary of Ambac Financial Group, Inc. (“AFGI”), a corporation headquartered in New York City.

B. Establishment of the Segregated Account and Petition for Rehabilitation

On March 24, 2010, AAC established the Segregated Account of Ambac Assurance Corporation (the “Segregated Account”). Under Wisconsin insurance law, the Segregated Account is a separate insurer from AAC for purposes of the Rehabilitation Proceeding (as described below). The Commissioner of Insurance for the State of Wisconsin (the “Commissioner”) approved the establishment of the Segregated Account by letter dated March 24, 2010.

AAC allocated the following to the Segregated Account: (i) certain policies insuring or relating to credit default swaps; (ii) policies insuring residential mortgage-backed securities (“RMBS”); (iii) certain student loan policies, some of which were allocated to the Segregated Account on March 24, 2010 (or shortly thereafter), and some of which were allocated on October 8, 2010, after undergoing an assessment process; (iv) certain other policies insuring obligations with substantial projected impairments or relating to transactions which have contractual “triggers” based upon AAC’s financial condition or the commencement of a rehabilitation proceeding, which triggers, if exercised, could have materially and adversely affected AAC’s financial condition; (v) remediation claims, defenses, offsets, and/or credits (except with respect to recoveries arising from remediation efforts or reimbursement or collection rights), if any, in respect of policies allocated to the Segregated Account; (vi) AAC’s disputed, contingent liability, if any, under the long-term lease with One State Street, LLC, and its contingent liability, if any, under the Ambac Assurance UK Limited (“Ambac UK”) lease with British Land; (vii) AAC’s limited liability interests in Ambac Credit Products, LLC (“ACP”), Ambac Conduit Funding, LLC, Aleutian Investments, LLC, and Juneau Investments, LLC (together, the “Allocated Subsidiaries”); (viii) all of AAC’s liabilities as reinsurer under reinsurance agreements (except for reinsurance assumed from Everspan Financial Guarantee Corp.); and (ix) effective November 7, 2010, any liability to AFGI relating to tax refunds and any liability to the Internal Revenue Service (“IRS”) relating to taxes. A list of the insurance policy liabilities allocated to the Segregated Account is available on the Website.

The Segregated Account is operated in accordance with the Plan of Operation for the Segregated Account as it has been amended, and may be further amended from time to time in the future (the “Plan of Operation”). Pursuant to the Plan of Operation, the liabilities of the Segregated Account are supported by the Secured Note and the Aggregate Excess of Loss Reinsurance Agreement (the “Reinsurance Agreement”). AAC issued the Secured Note to the Segregated Account in the initial principal amount of \$2 billion, due in 2050. Pursuant to the Secured Note, the Segregated Account has the ability to demand payment from AAC from time to time to pay claims and other liabilities. Once the Secured Note has been exhausted, which will occur in May 2014, the Segregated Account has the ability to demand payment from time to time under the

Reinsurance Agreement to pay claims and other liabilities. The Secured Note together with the Reinsurance Agreement effectively render all of the claims-paying resources of AAC's General Account (the "General Account") available to pay all claim liabilities of the Segregated Account (including any payments with respect to surplus notes and junior surplus notes), with the exception that AAC is not obligated to make payments on the Secured Note or under the Reinsurance Agreement if its surplus as regards to policyholders is (or would be) less than \$100 million, or such higher amount as the Wisconsin Office of the Insurance Commissioner ("OCI") permits pursuant to a prescribed accounting practice (the "Minimum Surplus Amount"). As long as the surplus as regards to policyholders is not less than the Minimum Surplus Amount, payments by the General Account to the Segregated Account under the Reinsurance Agreement are not capped.

During the Rehabilitation Proceeding of the Segregated Account (as described below), the Commissioner controls the management of the Segregated Account. AAC provides certain management and administrative services to the Segregated Account and the Commissioner as Rehabilitator of the Segregated Account (the "Rehabilitator") pursuant to a Management Services Agreement, including information technology services, credit exposure management, treasury, accounting, tax, management information, risk management, loss management, internal audit services and business continuity services. Services are provided at cost, subject to mutual agreement of the Segregated Account and AAC.

AAC and the Segregated Account have also entered into a Cooperation Agreement, pursuant to which the parties have agreed to certain matters related to decision-making, information sharing, tax compliance and allocation of expenses (including an agreement by AAC to reimburse the Segregated Account for specified expenses to the extent not reimbursed under the Secured Note, subject to the Minimum Surplus Amount). AAC has made certain covenants to the Segregated Account, including an agreement to not enter into any transaction with, or use any asset or property of, any third party involving consideration or other proceeds of more than \$5 million (or such higher amount as is agreed with the Segregated Account) without the Segregated Account's prior written consent (other than policy claim payments made in the ordinary course of business and investments in accordance with AAC's investment policy), and providing the Segregated Account with an annual operating expense budget for AAC and its subsidiaries, as well as quarterly analyses of variances.

On March 24, 2010 (the "Petition Date"), the Commissioner, then Sean Dilweg, petitioned the Wisconsin Circuit Court for Dane County (the "Rehabilitation Court") to place the Segregated Account into rehabilitation pursuant to the provisions of the Wisconsin Insurers Rehabilitation and Liquidation Act. Subsequently on March 24, 2010, the Rehabilitation Court entered the Order for Rehabilitation, by which the Commissioner's petition was granted (the "Rehabilitation Order"). With entry of the order, the Segregated Account was placed into rehabilitation pursuant to Wis. Stat. § 645.32, and the Rehabilitation Court was named the court for all matters relating to the Segregated Account (the "Rehabilitation Proceeding"). The Rehabilitation Court appointed the Commissioner as Rehabilitator of the Segregated Account, with full powers and authority granted pursuant to Wis. Stat. §§ 645.33 to 645.35 and all other applicable laws as are reasonable and necessary to fulfill his duties and responsibilities.

On the Petition Date, the Rehabilitation Court also issued an injunction effective until further order of the Rehabilitation Court enjoining certain actions by Segregated Account policyholders and other counterparties, including, without limitation, the assertion of damages or acceleration of losses based on early termination and the exercise of control rights in transactions that, but for the occurrence of the Rehabilitation Proceeding or the financial condition of AAC, the General Account, the Allocated Subsidiaries or the Segregated Account, would have been exercised by AAC, the Allocated Subsidiaries or the Segregated Account (the "Injunction Order").

Policy obligations not allocated to the Segregated Account are not subject to and, therefore, will not be directly impacted by, the Rehabilitation Proceeding.

C. Bank Settlement Agreement

In the fall of 2009, AAC became aware that several large financial institutions that were parties to credit default swaps with ACP in respect of collateralized debt obligations backed primarily by RMBS ("ABS CDOs") and collateralized loan obligations ("CLOs") and other collateralized debt obligations ("CDOs") were forming a group to negotiate with AAC regarding a global commutation of those exposures (the "Bank Group"). The obligations of ACP under these ABS CDOs, CLOs and CDOs were guaranteed by AAC pursuant to financial guaranty policies. These policies represented the greatest concentration of projected losses to AAC as well as the largest potential source of collateral damage through the possibility of "mark-to-market" damages. The Bank Group eventually consisted of fourteen financial institutions that, together with their direct affiliates, are among the largest financial institutions in the world.

On June 7, 2010, AAC, AFGI, ACP and the Bank Group entered into a settlement agreement which effected the commutation of all of ACP's outstanding credit default swaps in respect of ABS CDOs with respect to the Bank Group, and all of AAC's related financial guaranty exposure (the "Bank Group Settlement"). In exchange for AAC and ACP commuting \$16.5 billion of net par exposure, AAC transferred to the Bank Group, in the aggregate, \$2.6 billion in cash and \$2 billion of surplus notes newly issued by AAC (the "Bank Settlement Notes"). AAC also paid \$96.5 million to the Bank Group to commute certain other obligations, including certain non-ABS CDO obligations, with par amounting to \$1.4 billion, in full satisfaction, but partial payment, of such obligations. Averaging the valuations of AAC's independent appraiser, the Bank Group Settlement ultimately paid the Bank Group 43.3% of the present value of expected losses, with 24.5% in cash and 18.8% in surplus notes.

D. Allocation to the Segregated Account of Liabilities to AFGI and the IRS

On November 3, 2010, the Rehabilitator learned that AFGI had received an "Information Document Request" from the IRS asking AFGI to describe its legal basis for claiming approximately \$700 million of income tax refunds that were subsequently paid to AAC pursuant to a Tax Sharing Agreement between AFGI and AAC (the "Tax Refund Payments"). Out of concern that the IRS might have attempted to impose a levy on the proceeds of the Tax Refund Payments, an action which could have had severe consequences for AAC and the Segregated Account, the AAC board of directors voted, on November 7, 2010, to allocate to the Segregated Account: (i) any liabilities that AAC may have to AFGI in regard to tax refunds including, but not limited to, any preference claim or fraudulent transfer claim pertaining to such subjects

brought by, or on behalf of, AFGI in any bankruptcy proceeding involving AFGI; and (ii) any liabilities that AAC may have to the IRS in regard to certain taxes or tax refunds.

On November 8, 2010, the Rehabilitator filed a motion seeking to supplement the Injunction Order entered on the Petition Date to ensure that, among other things: (i) any disputes regarding claims of AFGI or its bankruptcy creditors or the IRS pertaining to the tax refund payments to AAC will be litigated before the Rehabilitation Court; (ii) any remedies available for such liabilities would be implemented in accordance with the Plan (as described below); and (iii) the federal government's claims receive the appropriate priority under Wisconsin insurance laws. The Rehabilitation Court granted the Rehabilitator's motion by order dated November 8, 2010 (the "Supplemental Injunction").

On April 30, 2013, the Rehabilitator, OCI, the Segregated Account, AFGI, AAC, the Official Committee of Unsecured Creditors of Ambac Financial Group, Inc. (the "Creditors Committee") and the IRS settled the lawsuit brought by AFGI against the IRS seeking: (i) to enjoin the IRS from attempting to levy AFGI's assets in connection with the Tax Refund Payments, and (ii) to determine the amount, if any, of AFGI's tax liability (the "IRS Dispute"). The terms of this settlement (the "IRS Settlement") included: (i) a payment to the IRS by the Segregated Account of \$100 million; (ii) a payment to the IRS by AFGI of \$1.9 million; and (iii) AFGI's consolidated tax group, including AAC and the Segregated Account (the "Ambac Group"), relinquishing its claims to loss carry-forwards resulting from losses on credit default swap contracts arising on or before December 31, 2010 to the extent that such carry-forwards exceed \$3.4 billion. On April 30, 2013, AFGI and the IRS executed a closing agreement for the IRS Settlement. As a result, the IRS Settlement has been consummated and the IRS Dispute is resolved.

E. The Commissioner and Special Deputy Commissioner

On January 3, 2011, Theodore K. Nickel replaced Sean Dilweg as Commissioner. Thereafter, Mr. Nickel assumed all roles and duties as Rehabilitator. References in this Annual Report to the Commissioner or the Rehabilitator are to Mr. Dilweg or Mr. Nickel, as appropriate. Further on January 13, 2011, the Rehabilitator appointed Roger A. Peterson, who at that time served as Deputy Administrator, Division of Regulation and Enforcement for OCI, as Special Deputy Commissioner for the Segregated Account. Mr. Peterson replaced former Special Deputy Commissioner Kimberly A. Shaul, and assumed all authority of the Special Deputy Commissioner as set forth in the Rehabilitation Order. References in this Annual Report to the Special Deputy Commissioner are to Mr. Peterson or Ms. Shaul, as appropriate. On July 8, 2011, the Rehabilitation Court approved the engagement of Mr. Peterson as full-time Special Deputy Commissioner, which has allowed Mr. Peterson to devote his full professional time and attention to the administration of the rehabilitation of the Segregated Account.

II. STATUS OF REHABILITATION PROCEEDING

A. Plan of Rehabilitation

1. Confirmation of the Plan of Rehabilitation

On October 8, 2010, the Rehabilitator filed the Plan of Rehabilitation (the “Plan”), together with a Disclosure Statement Accompanying Plan of Rehabilitation (the “Disclosure Statement”), and a Motion for Confirmation of the Plan in the Rehabilitation Court. The Plan sets forth the terms and conditions for the settlement and payment of claims against the Segregated Account. The Plan provides that holders of permitted policy claims will receive 25% of their permitted claims in cash and 75% in surplus notes issued by the Segregated Account, and that delivery of such cash and surplus notes will constitute satisfaction in full of the Segregated Account’s obligations in respect of each claim.

An evidentiary hearing regarding confirmation of the Plan took place in the Rehabilitation Court during the week of November 15-19, 2010. All policyholders and other parties-in-interest were permitted to attend and were afforded an opportunity to be heard, to call, examine and cross-examine witnesses, and to provide oral argument about confirmation on November 30, 2010. More than 20 parties appeared, examined witnesses, filed written objections to confirmation, and presented oral argument.

The Rehabilitation Court confirmed the Plan by order dated January 24, 2011 (the “Confirmation Order”) finding, among other things, that: (i) the Rehabilitator’s disclosures regarding the Plan were sufficient; (ii) the Plan follows the priority scheme required by Wisconsin insurance law; (iii) the initial cash/note split for policy claims is reasonable and more favorable to policyholders than liquidation; (iv) the Plan’s use of surplus notes is fair; and (v) the Plan is fair and equitable to policyholders.

As of the date of this Annual Report, the Rehabilitator has not taken the steps necessary to make the Plan effective in accordance with Sections 5.01 and 5.02 of the Plan. Following entry of the Confirmation Order, the Rehabilitator has taken steps to address certain risks and uncertainties facing the rehabilitation as discussed more fully in the Rehabilitator’s Motion to Amend the Plan filed with the Court and served on all interested parties on April 21, 2014 (the “Amendments Motion”), which is discussed below in Section II.A.5.

2. Guidelines Issued Pursuant to the Plan of Rehabilitation

Since the Confirmation Order, the Rehabilitator issued two sets of guidelines pursuant to Section 3.02 of the Plan in order to carry out the provisions and purposes of the Plan.

The Guidelines under Plan of Rehabilitation (Claims Processing) (the “2011 Claims Processing Guidelines”) were filed with the Rehabilitation Court on February 18, 2011 in order to promote the prompt evaluation and payment of policy claims following the effective date of the Plan. In developing the 2011 Claims Processing Guidelines, the Rehabilitator requested input from trustees (the “Trustees”) for beneficial holders of the financial instruments insured by many policies that were allocated to the Segregated Account. On February 23, 2011, the 2011 Claims Processing Guidelines, together with the Surplus Note Payment Schedule, Proof of Policy Claim

Form and Claim Schedule, were forwarded to the Trustees in order to facilitate AAC's efforts to process policy claims following the effective date of the Plan.

The Guidelines under Plan of Rehabilitation (Ceded Reinsurance) (the "2011 Reinsurance Guidelines") were filed with the Rehabilitation Court on March 18, 2011 in order to preserve the value of reinsurance in respect of certain policies allocated to the Segregated Account and in recognition of certain requirements imposed by reinsurance contracts to which AAC is a party as a ceding company. The Reinsurance Guidelines were developed over several months with input from the reinsurers under such contracts. In conjunction with the issuance of the Interim Rules (discussed below), the 2011 Reinsurance Guidelines were superseded and replaced by the Rules Governing Ceded Reinsurance Contracts Following June 4, 2012 Interim Cash Payment Order.

The 2011 Claims Processing Guidelines and the 2011 Reinsurance Guidelines (together the "2011 Guidelines") were issued pursuant to the Plan, which is not effective as yet. At present, the Rehabilitator is making Interim Claim Payments (as defined below in Section II.B.1) pursuant to the motion described in Section II.B.1. As part of the commencement of the Interim Claim Payments, the Rehabilitator promulgated the Rules Governing the Submission, Processing and Payment of Partial Payment of Policy Claims in Accordance with the June 4, 2012 Interim Cash Payment Order and the Rules Governing the Submission, Processing and Partial Payment of Claims under Financial Guaranty Policy No. 17548BE in Accordance with June 4, 2012 Interim Cash Payment Order (collectively the "Interim Rules"). The Interim Rules superseded and replaced the 2011 Guidelines, with Interim Claim Payments being made in accordance with the Interim Rules.

3. Development of Claims Processing System

In anticipation of the effective date of the Plan, the Rehabilitator and AAC, in its capacity as management services provider to the Segregated Account, communicated with trustees for beneficial holders of the underlying financial instruments insured by many policies that were allocated to the Segregated Account, as well as the Depository Trust and Clearing Corporation ("DTCC"), in an effort to facilitate the processing of policy claims. Such communications began in August 2010 (before the Plan was filed with the Rehabilitation Court). Such communications facilitated and informed the development of the provisions of the 2011 Guidelines, the Interim Rules, and the Payment Guidelines (see Section II.A.5 for discussion of the Payment Guidelines).

4. Resolution of Tax Uncertainties

A number of potential tax issues arose from the Plan, including: (i) the potential deconsolidation of AAC from the AFGI consolidated tax group for U.S. federal income tax purposes resulting from the treatment of the surplus notes as equity rather than debt, (ii) the imposition of original issue discount treatment on holders of surplus notes, and (iii) AAC's recognition of significant cancellation of indebtedness income with respect to the surplus notes as of the time of their issuance. The Rehabilitator, AAC and AFGI have taken three major actions to mitigate these tax issues and to achieve certainty regarding the tax consequences of the Rehabilitation. First, OCI and the Rehabilitator reached an agreement with AAC, AFGI and The Official Committee of Unsecured Creditors of Ambac Financial Group, Inc. (the "AFGI Settlement") which resolved all

outstanding tax and expense-related issues between AFGI and AAC, and which, among other things, allocated certain net operating losses (“NOLs”) generated by the AFGI consolidated tax group prior to September 30, 2011 to AAC and provided for AAC to compensate AFGI for the use of such NOLs above a defined threshold. The AFGI Settlement is described in detail in motion papers available on the Website and in the 2012 Annual Report. Second, the Rehabilitator and AFGI sought a Private Letter Ruling (the “PLR”) from the IRS to the effect that: (i) the Rehabilitation, the Plan and the Amendments have not and will not result in a disaffiliation of AAC from AFGI for federal tax purposes; (ii) policies allocated to the Segregated Account will continue to be treated as insurance contracts for federal tax purposes; and (iii) the obligations to pay both Cash Payments and Deferred Amounts, including accretion, (both as defined and discussed below) are taken into account in computing “losses incurred” for federal tax purposes. On March 12, 2014, the IRS issued a favorable PLR with respect to all three issues. Finally, the Rehabilitator filed the Amendments Motion with the Rehabilitation Court on April 21, 2014 seeking approval of certain proposed amendments (the “Amendments”) to the Plan, as discussed in detail below.

5. Proposed Amendments to the Plan of Rehabilitation

With the receipt of a favorable PLR from the IRS and the favorable outcome of the appellate proceedings discussed below in Section III, the Rehabilitator moved forward with proposed Amendments. The Amendments will modify the mechanism for handling claims under the Plan. Instead of a combination of cash payments and surplus notes issued by the Segregated Account, holders of permitted policy claims will receive cash payments (“Cash Payments”), and the Company will establish on its books deferred amounts equal to the remaining balance of such claims (“Deferred Amounts”). Payment of Deferred Amounts will be made at such times as the Rehabilitator deems appropriate, in his sole discretion, based on an analysis of estimated liabilities, available claims-paying resources, and other considerations relevant to equitable treatment of claims and the best interests of policyholders. With the exception of adjustments for certain under-collateralized transactions as described below in footnote 1, Deferred Amounts will accrete at an effective annual rate of 5.1%. Additionally, the Company will establish on its books junior deferred amounts accreting at 5.1% per year instead of issuing junior surplus notes bearing interest at 5.1% per year.

The Amendments will require proportionate payments to be applied in redemption of surplus notes issued by the Segregated Account as and when payments are made on Deferred Amounts, including the Deferred Payment to policyholders that have received Interim Claim Payments which is described later in this Section. Pursuant to the Bank Group Settlement, AAC is also required to make proportionate payments in redemption of its surplus notes as and when the Segregated Account makes a payment in redemption of its surplus notes.

The Rehabilitation Court has scheduled a hearing commencing on June 11, 2014 to consider the Amendments Motion.

If and when the Amendments are approved by the Rehabilitation Court, the Rehabilitator intends to increase the portion of permitted policy claims to be paid in cash from the current 25% level to 45%. Accordingly, after the Plan is amended, (i) holders of permitted policy claims will receive Cash Payments equal to 45% of their claims, and (ii) the Segregated Account will record

Deferred Amounts on its books in favor of the respective holders in an amount equal to 55% of such claims, which will accrete at an effective annual rate of 5.1%.¹

Additionally, if and when the Amendments to the Plan are approved by the Rehabilitation Court, the Rehabilitator will implement Payment Guidelines for the Plan of Rehabilitation and LVM Payment Guidelines for the Plan of Rehabilitation (collectively the “Payment Guidelines”), which are based in part on the Interim Rules. The Payment Guidelines were developed with the benefit of consultation with certain Trustees and the DTCC. When implemented, the Payment Guidelines will supersede the Interim Rules.

In order to maintain parity among policyholders after the Amendments are adopted and the Plan is made effective, the Rehabilitator intends to effectuate a Deferred Payment to policyholders that have received Interim Claim Payments (as defined in Section II.B.1) in an amount equal to 26.67% of such holder’s Deferred Amounts, including the value of accretion. This Deferred Payment is the amount necessary to provide policyholders that have received Interim Claim Payments with a total payment of 45% of their permitted policy claim amounts, the amount which will be paid as Cash Payments to policyholders with permitted policy claims after implementation of the Plan. This will result in equal treatment of those policyholders whose permitted policy claims have already been processed under the Interim Rules and policyholders whose policy claims will be processed under the Plan and the Payment Guidelines.

B. Significant Issues Addressed by Motion in the Rehabilitation Proceeding Subsequent to the 2013 Annual Report

1. Interim Cash Payments on Permitted Policy Claims

On June 4, 2012, the Rehabilitation Court approved the Rehabilitator’s Motion for Approval to Commence Making Interim Cash Payments on Permitted Policy Claims. The Rehabilitator has made interim cash payments equal to 25% of the permitted amount of each policy claim, as approved for payment by the Rehabilitator (“Interim Claim Payments”) since September 20, 2012, and such Interim Claim Payments are ongoing, pending the outcome of the Rehabilitation Court’s hearing on the Amendments Motion. The Interim Claim Payments have been made in accordance with the Interim Rules. In connection with the commencement of Interim Claim Payments, the Rehabilitator also issued: (i) Rules Governing Ceded Insurance Contracts Following June 4, 2012 Interim Cash Payment Order on August 28, 2012, and (ii) a statement on September 6, 2012 clarifying that policyholders may not submit claims under the Interim Rules subject to a reservation of rights.

2. Supplemental Payments

On August 2, 2013, the Rehabilitation Court entered, upon the motion of the Rehabilitator, the Order Granting Rehabilitator’s Motion for Approval to Make Supplemental Cash Payments as to Certain Policy Claims For the Purpose of Maximizing Reimbursements for the Benefit of All

¹ There are certain limited situations involving under-collateralized deals where Deferred Amounts may not accrete at an effective annual rate of 5.1%, as set forth in more detail in the Amendments.

Policyholders (the “Supplemental Payments Order”). The Supplemental Payments Order authorizes the Rehabilitator to make payments in excess of the current 25% Interim Claim Payment percentage (“Supplemental Payments”) for certain permitted policy claims for the purpose of maximizing reimbursements payable to AAC. In certain RMBS transactions, AAC is contractually entitled to be reimbursed from various cash flows in the transaction (“Reimbursements”) to the extent that AAC has satisfied claims under the policies issued by it in connection with such transactions. This means that amounts in excess of the Segregated Account’s current 25% cash payments to policyholders would not be reimbursed unless a Supplemental Payment is made in respect of the permitted policy claims on such transactions.

Pursuant to the Supplemental Payments Order, the Rehabilitator may make Supplemental Payments on any policies (the “Supplemental Payment Policies”) for which he believes Supplemental Payments are appropriate from time to time. The Supplemental Payments effectively pay for themselves out of Reimbursements and, as a result, reduce the outstanding unpaid permitted policy claims owed on the Supplemental Payment Policies while maintaining the claims-paying resources available for other Segregated Account policy claimants.

3. RMBS Remediation Claim Settlements

In a February 13, 2014 order (the “RMBS Remediation Order”), the Rehabilitation Court approved the Rehabilitator’s Motion for Approval to Disburse Proceeds and Make Permitted Policy Claim Payments as He Deems Appropriate from Settlement of RMBS Remediation Claims, Including Those Proceeds Received, and to be Received, from a Settlement Memorialized in a Stipulated Order of the Bankruptcy Court Handling the Residential Capital, LLC Cases. The RMBS Remediation Order: (i) authorized the Rehabilitator to allocate and distribute cash and other forms of consideration generated by settlements of RMBS remediation claims (“RMBS Remediation Claims”), and (ii) approved the Rehabilitator’s approach for disbursing certain settlement proceeds and making permitted policy claim payments to specific policyholders in the Rehabilitation Proceeding in accordance with the stipulated order (the “Stipulated Order”) of the United States Bankruptcy Court for the Southern District of New York in the matter of *In re: Residential Capital, LLC, et al.*, Case No. 12-1220. The Stipulated Order reflects the settlement achieved by AAC and the Segregated Account with Residential Capital LLC and certain of its affiliates (collectively, “ResCap”) with respect to certain RMBS Remediation Claims.

To date, the Segregated Account has made special policy payments totaling approximately \$22.6 million to holders of certain policies (the “ResCap Policies”) subject to the Stipulated Order.

4. Improving Mortgage Loan Servicing

Throughout the pendency of the Rehabilitation, the Rehabilitator and the Management Services Provider have pursued various efforts and strategies directed at maximizing claims-paying resources. Those efforts are consistent with the Rehabilitator’s overall effort to improve outcomes for insured policyholders through prompt, efficacious management and administrative strategies. Those efforts have included replacing mortgage loans servicers, either through voluntary agreements or through the exercise of control rights provided in the transactional documents governing the insured securities.

Consistent with the efforts noted above, the Rehabilitator moved the Rehabilitation Court on April 5, 2013 for an order confirming his authority to direct Deutsche Bank National Trust Company (“Deutsche”), in its capacity as a trustee for certain RMBS transactions, to change the servicer for certain trusts. OneWest Bank, F.S.B. (“OneWest”), the servicer for the Deutsche trusts identified in the motion, filed a removal petition with the United States District Court for the Western District of Wisconsin on May 9, 2013 purporting to remove from the Rehabilitation Court to the District Court specified aspects of the Rehabilitation Proceeding. The District Court found that the removal was improper and remanded the action to Rehabilitation Court.

On July 30, 2013, the Rehabilitation Court approved the Rehabilitator’s Motion for an Order Confirming Authority to Terminate Residential Mortgage Loan Servicer and Appoint Successor Servicer (the “Servicing Motion”), which confirmed the Rehabilitator’s power to direct Deutsche Bank National Trust Company, in its capacity as trustee under the Pooling and Servicing Agreement for the IndyMac Certificate Trust 2004-2 and the Sales and Servicing Agreement for the IndyMac Residential Asset-Backed Trust, Series 2004-LH1 to terminate OneWest Bank, F.S.B., as servicer for the trusts and to appoint Green Tree Servicing LLC as the successor servicer for the trusts. That transfer of servicing responsibilities subsequently was effectuated in compliance with the Court’s approval of the Servicing Motion.

III. SUMMARY OF OTHER LITIGATION RELATED TO THE REHABILITATION PROCEEDING

A. Favorable Resolution of All Outstanding Appellate Litigation

By Order dated March 19, 2014, the Wisconsin Supreme Court denied the petitions for review filed by certain of the appellants seeking review of the published decision of the Wisconsin Court of Appeals entered on October 24, 2013. That decision by the Wisconsin Court of Appeals affirmed all of the orders entered by the Rehabilitation Court in favor of the Rehabilitator that were the subject of Appeal Nos. 2010AP1291, 2010AP2022, 2010AP2835 and 2011AP561. The Rehabilitation Court’s Confirmation Order was among the orders of the Rehabilitation Court that were affirmed by the Wisconsin Court of Appeals. *See In the Matter of the Rehabilitation of: Segregated Account of Ambac Assurance Corporation*, 2013 WI App 129, 351 Wis. 2d 539, 841 N.W.2d 482, *review denied* 2014 (the “Court of Appeals Decision”). Following the Wisconsin Supreme Court’s denial of the appellant’s petitions for review, the Court of Appeals Decision is now the controlling law of the case in the Rehabilitation.

B. Litigation Stemming from the Allocation to the Segregated Account of Liabilities to the United States

On December 8, 2010, after the confirmation hearings but before entry of the Confirmation Order, the United States removed the Rehabilitation Proceeding to the United States District Court for the Western District of Wisconsin (the “District Court”), with the stated intent of challenging the Supplemental Injunction. The United States subsequently sought to dissolve the Supplemental Injunction, and OCI sought to remand the Rehabilitation Proceeding. By order dated January 14, 2011, the District Court remanded the Rehabilitation Proceeding to the Rehabilitation Court, concluding that the removal was preempted by the McCarran-Ferguson Act, and that the District Court therefore lacked subject matter jurisdiction over the proceeding.

The United States appealed that decision to the United States Court of Appeals for the Seventh Circuit. On February 9, 2011, the United States filed a complaint and a motion for a preliminary injunction in the District Court seeking, inter alia, to enjoin enforcement of the Supplemental Injunction and the Confirmation Order against the United States in a case captioned United States of America v. Wisconsin State Circuit Court for Dane County, Case No. 11-cv-099. The District Court dismissed that suit for lack of subject matter jurisdiction on February 18, 2011, and the United States filed a notice of appeal on February 22, 2011. The appeals at the Seventh Circuit were captioned as Appeal Nos. 11-1158 and 11-1419 (the “Appeals”).

As a result of the closing of the IRS Settlement (as described in Section I.D), on May 9, 2013 the United States filed an Unopposed Motion to Dismiss the Appeals. The Seventh Circuit ruled on that motion on May 15, 2013 and ordered the United States to request that the District Court indicate whether it is inclined to vacate the orders underlying the Appeals prior to filing a status report with the Seventh Circuit. The District Court vacated all opinions and orders underlying the Appeals by Order dated July 15, 2013.

IV. FINANCIAL REVIEW

With the assistance of his financial advisors, the Rehabilitator provides the following update on the financial condition of the General Account and Segregated Account.

A. General Account Assets

Total claims-paying resources are estimated at approximately \$5.9 billion as of December 31, 2013, a \$0.6 billion increase from estimated claims-paying resources of \$5.3 billion as of December 31, 2012. The primary components of claims-paying resources are (i) \$5.2 billion of investment portfolio assets at statutory carrying value, (ii) \$0.4 billion in net present value of future installment premiums and (iii) \$0.3 billion of statutory value comprising (a) investments in, and loss on guarantees of, subsidiaries, (b) intercompany loans, and (c) miscellaneous assets. The foregoing estimate of claims-paying resources includes certain assumptions and judgments regarding future events that are described more fully below.

1. Investment Portfolio Holdings

As of December 31, 2013, AAC held fixed income investment securities with fair value of approximately \$5.6 billion, statutory carrying value of approximately \$5.2 billion and par value of approximately \$6.0 billion. Certain information regarding AAC’s portfolio holdings is summarized below:

AAC Investment Portfolio by Asset Class as of December 31, 2013^{2,3}

Dollars in Millions	Fair Value	Carrying Value	Par Value	YTM	WAL
Municipal Obligations.....	\$1,264	\$1,183	\$1,275	5.06%	8.7
RMBS.....	1,504	1,304	1,749	30.02%	NA
Corporate Obligations.....	1,417	1,369	1,331	3.47%	4.0
Short-Term.....	180	180	180	0.00%	0.0
U.S. Government, Agency, and GSE Obligations.....	225	220	219	1.66%	1.2
Military Housing.....	344	323	348	7.60%	16.4
ABS, CDO, and Structured Insurance.....	647	637	884	3.97%	2.8
Total	\$5,581	\$5,217	\$5,987	10.65%	5.9

Dollars in Millions	Fair Value	Carrying Value	Par Value
Municipal Obligations.....	23%	23%	21%
RMBS.....	27%	25%	29%
Corporate Obligations.....	25%	26%	22%
Short-Term.....	3%	3%	3%
U.S. Government, Agency, and GSE Obligations.....	4%	4%	4%
Military Housing.....	6%	6%	6%
ABS, CDO, and Structured Insurance.....	12%	12%	15%
Total	100%	100%	100%

Relative to December 31, 2012 levels, aggregate portfolio fair value increased by \$300 million, or 5.7%, while statutory carrying value increased by \$541 million, or 11.6%. AAC's holdings of municipal obligations, short-term instruments, and U.S. Government, Agency and GSE obligations declined from prior-year levels, while the fair value and carrying value of RMBS, corporate obligations, and ABS, CDO, and Structured Insurance increased materially, due to (i)

² On December 16, 2011, AAC entered into a secured loan transaction in which it contributed certain RMBS guaranteed by AAC to a trust as collateral and to fund repayment, in exchange for \$35 million in cash and 100% equity ownership of Orient Bay, LLC, a single-member limited liability company that has interests in two REMIC trusts (the "Secured Borrowing"). The senior certificate in one of the REMIC trusts was owned by third party investors and is no longer outstanding; the remaining certificates are owned by Orient Bay, LLC. As of December 31, 2013, the statutory carrying value of the equity interest was \$242 million while statutory carrying value of the borrowed funds relating to the trusts was approximately \$165 million, including \$82 million in accrued interest, resulting in a net asset of \$77 million. The contributed RMBS remain reported in AAC's investment portfolio. The Company's investment portfolio was reduced as proceeds from contributed RMBS were used to pay the certificate owned by third party investors in the amount of \$15 million during 2013. See Notes 10 and 11 to AAC's 2011, 2012, and 2013 annual statutory financial statements for further information on this set of transactions.

³ Approximately 88% of AAC's non-agency RMBS holdings, as measured by statutory carrying value, are AAC-insured instruments acquired for loss mitigation purposes. Accordingly, the yield to maturity and weighted-average life associated with AAC's non-agency RMBS holdings are necessarily linked to AAC's assumptions regarding the amount and timing of claim payments such holdings will receive under the Rehabilitation Plan.

increased open market purchases of AAC-insured instruments for loss mitigation purposes and (ii) a shift from tax-exempt to taxable instruments.

Portfolio fair value as a percentage of aggregate par value increased from 91% in December 2012 to 93% as of December 2013, with RMBS holdings increasing from 70% of par in December 2012 to 86% in December 2013. Approximately 88% of the Company's RMBS holdings consist of AAC-insured securities purchased for loss mitigation; 12% consists of other non-agency RMBS purchased by one of AAC's affiliates prior to the Petition Date and later transferred to AAC.

As of December 31, 2013, AAC-insured RMBS instruments acquired for loss mitigation accounted for 23% of portfolio fair value, 22% of portfolio carrying value, and 24% of portfolio par value,⁴ compared with 16%, 14%, and 20%, respectively, as of December 31, 2012. The fair value of AAC-insured RMBS holdings acquired through such loss mitigation efforts as a percentage of par value was 88% as of December 31, 2013, compared with 75% as of December 31, 2012. The yield of these holdings was 32% as of December 31, 2013, versus 30% twelve months prior.

As of December 31, 2013, other non-agency RMBS held in AAC's investment portfolio accounted for 4% of portfolio fair value, 3% of portfolio carrying value, and 5% of portfolio par value, compared with 8%, 7%, and 12%, respectively, as of December 31, 2012. The fair value of such non-agency RMBS holdings as a percentage of par value was 76% as of December 31, 2013, compared with 61% as of December 31, 2012. The yield associated with such holdings was 12% as of December 31, 2013, unchanged from twelve months prior.

As of December 31, 2013, investment portfolio holdings representing approximately 69% of aggregate portfolio carrying value had an investment grade rating or may otherwise be considered investment-grade, versus 78% twelve months earlier. AAC-insured instruments purchased as part of loss mitigation efforts account for approximately 82% of all non-investment grade holdings.

The market liquidity profile of AAC's investment portfolio as of December 31, 2013 is summarized as follows:

AAC Investment Portfolio by Market Liquidity Classification as of December 31, 2013

	Fair Value	Carrying Value	Par Value	Fair Value	Carrying Value	Par Value
	(In millions)			(Percentage of Total)		
Highly Liquid	\$1,031	\$1,001	\$995	18%	19%	17%
Medium	2,399	2,292	2,367	43%	44%	40%
Low	139	92	203	2%	2%	3%
Illiquid	2,012	1,833	2,421	36%	35%	40%
Total	\$5,581	\$5,217	\$5,987	100%	100%	100%

⁴ In contrast, all AAC-insured instruments purchased for loss mitigation (including non-RMBS AAC wrapped instruments) accounted for 26% of portfolio fair value, 25% of portfolio carrying value, and 29% of portfolio par value as of December 31, 2013.

1. **Highly Liquid:** Includes widely-held securities with tight bid/ask spreads and transparent markets. Asset classes represented in this category include money market holdings, municipal bonds, and U.S. agencies and treasuries.
2. **Medium Liquid:** Incorporates widely-held securities with broader bid/ask spreads in actively-traded markets. Asset classes represented in this category include asset-backed securities, residential mortgage-backed securities, corporate obligations, and municipal bonds.
3. **Low Liquid:** Incorporates closely-held securities with wide bid/ask spreads. Price changes are primarily credit-driven. Asset classes represented in this category include asset-backed securities, residential mortgage-backed securities, municipal bonds, and corporate obligations. Certain of these securities may generate periodic principal distributions.
4. **Illiquid:** Includes distressed and/or complex securities in specialty asset classes such as CDO/CLOs, corporate obligations, structured insurance, and municipal bonds, as well as securities insured by AAC including residential mortgage-backed securities. Certain of these securities may generate periodic principal distributions.

Securities classified as highly liquid or medium liquid represent 63% of total portfolio carrying value, versus 70% as of December 31, 2012. Securities classified as low liquid or illiquid represent 37% of aggregate carrying value, compared with 30% as of December 31, 2012. The weighted-average book yield for securities classified as either highly liquid or medium liquid was 3.5% as of December 31, 2013. In comparison, the weighted-average book yield for securities classified as either low liquid or illiquid was 22.8% as of December 31, 2013. AAC-insured instruments purchased for loss mitigation account for 68% of the carrying value of all securities classified as low liquid or illiquid.

2. Installment Premiums

Many insurance policies provide for premiums to be paid to AAC over the life of the exposure. Pursuant to the Plan of Operation, installment premiums related to Segregated Account policies are directed to the General Account, but held as security for the Secured Note and the Reinsurance Agreement.

The value attributable to future installment premium receipts is subject to significant uncertainty. Events such as early contract termination, commutation,⁵ faster than expected runoff or prepayment of underlying obligations, and payment default may lead to lower than projected installment premium receipts. In light of these factors, the Rehabilitator's estimate of future installment premium receipts is lower than the aggregate amount of installment premiums that would be received if all policies remain in force until contractual maturity.

After giving effect to such adjustments, the Rehabilitator's estimate of the present value of future installment premiums (net of reinsurance and consummated and pending commutations) is \$0.4 billion as of December 31, 2013 using a 5.1% discount rate, unchanged from our estimate as of December 31, 2012.

⁵ AAC has retained its right to receive installment premiums in respect of certain commuted exposures.

3. Intercompany Loans

As of December 31, 2013, AAC had \$779 million in loans to affiliates, representing a \$129 million decrease from the \$908 million of intercompany loans outstanding as of December 31, 2012. Loans to affiliates comprised (i) \$191 million in unsecured loans to Ambac Capital Funding, Inc. (“ACFI”) and (ii) \$140 million in unsecured loans of securities and \$448 million in unsecured cash loans to Ambac Financial Services, LLC (“AFS”). The decrease in the aggregate balance of inter-company loans receivable between December 2012 and December 2013 is attributable to (i) recovery of collateral and receipt of cash proceeds resulting from swap terminations, and (ii) repayments by ACFI due to the continued runoff of the guaranteed investment contract business.

A portion of the AFS obligation is comprised of \$140 million of loans in the form of marketable securities. In accordance with Statutory Accounting Practices (“SAP”), the statutory carrying value of the loaned securities is included in the investment portfolio totals summarized in Section IV.A.1 above; accordingly, \$140 million is excluded from the intercompany loan component of claims-paying resources, and the net inter-company loan receivable, before impairments, is \$639 million.

a) ACFI Intercompany Loans

The guaranteed investment contract (“GIC”) business operated through ACFI had approximately \$359 million in GICs outstanding as of December 31, 2013, compared with \$363 million as of December 31, 2012.

AAC currently expects a \$183 million impairment of the \$191 million unsecured loan to ACFI, implying a 4% recovery of principal and an \$8 million statutory value for the ACFI intercompany loan. This estimate is based upon various assumptions, including but not limited to assumptions regarding interest rates, portfolio performance, early contract terminations and litigation recoveries. Accordingly, the eventual impairment in respect of this obligation may be materially different from the current estimate.

b) AFS Intercompany Loans

As of December 31, 2013, AFS maintained swap positions with gross notional exposure of approximately \$2.5 billion, compared with \$2.6 billion as of December 31, 2012. These swap obligations are primarily floating-for-fixed interest rate swaps with municipalities and financial institutions as counter-parties.

AAC currently expects a complete impairment of the \$448 million unsecured loan to AFS. Accordingly, no value is attributed to the AFS unsecured loan; furthermore, AAC has established a liability reflecting its projected loss on its guarantee of AFS’s obligations (described below). The rise in impairments were largely the result of adverse interest rate movements and narrower AAC credit spreads employed in valuing swap liabilities, offset somewhat by application of a higher discount rate to calculate the impairment. In addition to the foregoing factors, this impairment estimate is based upon various assumptions, including, but not limited to, forward interest rates, the ability of counterparties to pay when due, early contract terminations and

litigation recoveries. Accordingly, the ultimate impairment realized in respect of this obligation may change, perhaps materially, to the extent future performance differs from such assumptions.

4. Investment in, and Guarantee of, Subsidiaries

As of December 31, 2013, AAC's investment in subsidiaries comprised \$214 million in Everspan Financial Guarantee Corp. ("Everspan"), compared with \$205 million as of December 31, 2012.

Everspan's two remaining insured obligations total approximately \$15 million of net par outstanding, compared with \$40 million as of December 31, 2012. Both exposures are healthcare-related, and one is adversely classified, although no statutory loss reserves have been established. The Rehabilitator believes that AAC's investment in Everspan will ultimately be available to fund Segregated Account and General Account obligations in accordance with the Plan.

AAC guarantees the liabilities of AFS. As of December 31, 2013, AAC recognized a \$57 million loss on its guarantee of AFS' liabilities, indicating that the Company's expects to use claims-paying resources to satisfy the obligations of AFS. Accordingly, this \$57 million loss on AAC's guarantee of AFS obligations is incorporated as a reduction of claims-paying resources for purposes of this analysis.

5. Miscellaneous

Other claims-paying resources include accrued, unpaid interest and cash. As of December 31, 2013, AAC had \$37 million in accrued, unpaid interest, \$54 million in cash, and \$14 million in receivables for securities, none of which are incorporated in the investment portfolio totals summarized above.

B. Policy Liabilities of the General Account and the Segregated Account

1. Summary of Liabilities

The Segregated Account is primarily exposed to RMBS and student loan-related risk. While the General Account is primarily exposed to the U.S. public finance sector on a direct basis, it retains exposure to Segregated Account policies under the terms of the Secured Note and the Reinsurance Agreement. Further information on this subject is contained in AFGI's annual reports on Form 10-K and quarterly reports on Form 10-Q.

2. General Account Exposures

As of December 31, 2013, the General Account had approximately 7,500 policies in force, representing \$133 billion in net par outstanding, compared with approximately 9,000 policies, representing \$172 billion in net par outstanding as of December 31, 2012.⁶ The year-over-year

⁶ All General Account policy, net par outstanding and other General Account information includes Everspan totals.

decline of 22%, or \$39 billion, in net par outstanding is a function of both scheduled terminations (such as maturity of a specific obligation) and unscheduled terminations (such as refinancing transactions).

U.S. public finance exposures represent \$115 billion, or 87%, of aggregate net par outstanding in the General Account, as well as 96% of total General Account policies. See below for a summary of policies and net par outstanding by exposure category.

General Account Policies and Net Par Outstanding as of December 31, 2013

Dollars in Millions	Policies		Net Par Outstanding	
	Amount	Percentage	Amount (In millions)	Percentage
U.S. Public Finance.....	7,214	96%	\$115,126	87%
Other Structured Finance.....	247	3%	9,878	7%
CLOs and other CDOs.....	13	0%	1,227	1%
International.....	44	1%	6,857	5%
Total.....	7,518	100%	\$133,088	100%

a) Credit Profile

Approximately \$10.2 billion, or 7.6%, of General Account exposure is adversely classified, compared with \$7.3 billion, or 4.2%, of General Account net par outstanding as of December 31, 2012. Approximately \$1.3 billion of all adversely classified General Account exposures are currently classified in the more severe III and IV classifications, compared with \$1.8 billion as of December 31, 2012. A summary of adversely classified General Account net par outstanding is shown below.

Net Par Outstanding Associated with Adversely Classified General Account Policies

Dollars in Millions	Adversely Classified NPO	Credit Classification			
		I-A	II (In millions)	III	IV
U.S. Public Finance.....	\$7,120	\$3,168	\$3,294	\$351	\$307
Other Structured Finance.....	\$1,518	418	611	0	489
CLOs and Other CDOs.....	\$0	0	0	0	0
International.....	\$1,535	446	965	124	0
Total.....	\$10,173	\$4,032	\$4,870	\$475	\$796

b) Loss Reserves

Statutory loss reserves, net of reinsurance, reflect AAC management's best estimate of the present value of future loss payments (net of projected subrogation recoveries) for policies that have already defaulted, discounted at the applicable statutory rate (currently 5.1%). As of December 31, 2013, total statutory reserves associated with General Account policies were \$515 million including loss adjustment expenses, compared with \$35 million in the prior-year period.

Pursuant to GAAP accounting requirements, AAC develops estimates of gross claim liability for all policies, whether defaulted or not. The aggregate gross claim liability, gross of reinsurance, associated with all General Account policies was \$901 million as of December 31, 2013, versus \$795 million as of December 31, 2012. As the calculation of gross claim liabilities under GAAP is different from that of statutory loss reserves in certain respects, readers should consult AFGI's annual reports on Form 10-K and quarterly reports on Form 10-Q for a detailed description of GAAP loss calculations.

c) Claim Payments during 2013 and since the Petition Date⁷

AAC paid \$18 million in claims resulting from General Account policies and received \$8 million in recoveries during 2013. AAC paid \$122 million in aggregate General Account payments from the Petition Date through December 31, 2013 and received \$78 million in recoveries.

3. Segregated Account Exposures

a) Overview

Aggregate Segregated Account net par outstanding declined by \$5 billion, or 18%, from \$27 billion as of December 31, 2012 to \$22 billion as of December 31, 2013. RMBS and student loan exposures accounted for 91% of aggregate Segregated Account net par outstanding and 72% of all Segregated Account policies. See below for a summary of Segregated Account policies and net par outstanding.

Segregated Account Policies and Net Par Outstanding as of December 31, 2013

Dollars in Millions	Policies		Net Par Outstanding	
	Amount	Percentage	Amount (In millions)	Percentage
Direct				
RMBS.....	261	58%	\$16,024	72%
U.S. Public Finance.....	106	24%	877	4%
Structured Finance.....	9	2%	122	1%
Student Loans.....	65	14%	4,163	19%
International.....	3	1%	198	1%
ACP.....	6	1%	611	3%
Subtotal.....	450	100%	\$21,995	99%
Assumed.....	5	N/A	248	1%
Total.....	455	100%	\$22,243	100%

⁷ All claim payment data is presented gross of realized recoveries.

b) Credit Profile

Approximately \$20 billion, or 89%, of aggregate Segregated Account net par outstanding is adversely classified, compared with \$23 billion, or 85%, as of December 31, 2012. Approximately \$15.5 billion or 70% of aggregate Segregated Account net par outstanding was allocated to the more severe III and IV risk classifications, compared with \$22.2 billion, or 82%, as of December 31, 2012. A summary of adversely classified Segregated Account net par outstanding is presented below.

Net Par Outstanding Associated with Adversely Classified Segregated Account Policies

Dollars in Millions	Adversely Classified NPO	Credit Classification			
		I-A	II	III	IV
		(In millions)			
<u>Direct</u>					
RMBS.....	\$14,982	\$104	\$2,655	\$2,047	\$10,176
U.S. Public Finance.....	86	0	0	0	86
Structured Finance.....	0	0	0	0	0
Student Loans.....	4,106	46	1,284	2,776	0
International.....	198	0	198	0	0
CDS.....	278	0	0	278	0
Subtotal.....	\$19,650	\$150	\$4,137	\$5,101	\$10,262
Assumed.....	137	0	0	137	0
Total.....	\$19,787	\$150	\$4,137	\$5,238	\$10,262

c) Loss Reserves

As of December 31, 2013, total statutory loss reserves, net of reinsurance, associated with defaulted Segregated Account policies amounted to approximately \$3.0 billion, compared with \$2.9 billion as of December 31, 2012. Statutory loss reserves as of December 31, 2013, include \$3.9 billion of unpaid permitted policy claims and are net of approximately \$2.4 billion of projected remediation recoveries associated with alleged representation and warranty breaches (“R&W Recoveries”) related to certain RMBS transactions.⁸ Excluding R&W Recoveries, aggregate statutory reserves associated with Segregated Account policies are \$5.4 billion as of December 31, 2013, compared with \$5.6 billion as of December 31, 2012.⁹

Statutory loss reserves associated with Segregated Account policies are maintained in the General Account for reporting purposes, in accordance with accounting principles prescribed or permitted by OCI and exclude the effect of the allocation of the policies to the Segregated

⁸ Readers should consult AFGI’s annual reports on Form 10-K and quarterly reports on Form 10-Q for additional disclosure regarding R&W Recoveries.

⁹ R&W Recoveries associated with defaulted RMBS policies and discounted at the statutory discount rate were \$2.4 billion and \$2.7 billion as of December 31, 2013 and December 31, 2012, respectively.

Account. The allocation of the liabilities to the Segregated Account is reflected on the balance sheet of the General Account, prepared in accordance with SAP as “Liabilities Allocated to the Ambac Assurance Segregated Account.” See below for a summary of statutory reserves associated with Segregated Account policies by category.

Statutory Reserves Associated with Segregated Account Policies as of December 31, 2013

Dollars in Millions	Statutory Reserves	
	<u>Statutory Reserves</u>	<u>Excluding R&W Remediation Recoveries</u>
RMBS.....	\$2,831	\$5,236
US Public Finance.....	\$86	\$86
Student Loans.....	\$0	\$0
Loss Adjustment Expense (1).....	98	98
Total	<u>\$3,015</u>	<u>\$5,420</u>

(1) Includes reserves for prospective commutations and other loss adjustment expenses.

As noted above, statutory reserves reflect prospective losses for defaulted policies. As part of GAAP accounting requirements, AAC develops estimates of gross claim liability for all policies, whether defaulted or not. The aggregate gross claim liability, gross of reinsurance, associated with Segregated Account policies was approximately \$4.6 billion as of December 31, 2013, compared with \$5.0 billion as of December 31, 2012. Such estimates include R&W Recoveries (as estimated in accordance with GAAP) of \$2.2 billion as of December 2013 and \$2.5 billion as of December 2012, respectively. If such R&W Recoveries are excluded, aggregate gross claim liabilities associated with Segregated Account policies would be \$6.8 billion as of December 31, 2013, compared with \$7.5 billion as of December 31, 2012. As the calculation of gross claim liabilities, including R&W Recoveries, under GAAP is different than that of statutory loss reserves in many respects, readers should consult AFGI’s annual reports on Form 10-K and quarterly reports on Form 10-Q for further descriptions of GAAP loss calculations.

d) Claims Presented during 2013 and since the Petition Date

Aggregate claims of approximately \$838 million against Segregated Account policies were presented during 2013. Second-lien mortgage-backed claims during this timeframe amounted to approximately \$138 million; first-lien claims amounted to \$691 million.

From the Petition Date to December 31, 2013, aggregate claims of approximately \$5.3 billion were presented against Segregated Account policies, representing an average of \$115 million per month. Such claims are summarized by category as follows:

Segregated Account Claims Presented Since Petition Date

Dollars in Millions	From Petition Date to December 31, 2012	January 1, 2013 to December 31, 2013	Total
1st Lien RMBS	\$2,916	\$691	\$3,607
2nd Lien RMBS	1,518	138	1,656
Other SA Exposures	14	9	23
Total	\$4,448	\$838	\$5,286

e) Claims Payments during 2013 and since the Petition Date

The Company paid \$322 million in Interim Claim Payments in respect of Segregated Account policy claims during 2013. From the Petition Date to December 31, 2013, the Company paid approximately \$1.4 billion in Interim Claim Payments in respect of Segregated Account policy claims. Such claim payments are summarized by category as follows:

Segregated Account Claims Presented, Claims Paid (Interim Payments), and Claims Outstanding¹⁰

Dollars in Millions	Cumulative Claims Presented	Cumulative Claims Paid	Accrued but Unpaid Claims
1st Lien RMBS	\$3,607	\$952	\$2,657
2nd Lien RMBS	1,656	421	1,234
Other SA Exposures	23	10	13
Total	\$5,286	\$1,383	\$3,904

In 2013, AAC received \$321 million in reimbursements in connection with claims paid from time to time (including prior to the Petition Date) by AAC and/or the Segregated Account in respect of policies allocated to the Segregated Account, and \$694 million since the Petition Date.

V. THE REHABILITATOR'S FINANCIAL PROJECTIONS

The Rehabilitator and his financial advisors have developed detailed financial projections (the "Rehabilitator's Financial Projections") to aid in the Rehabilitation. The Rehabilitator's Financial Projections were initially developed prior to the Petition Date, and have been periodically updated and revised since that time. These Projections serve as both (i) a decision-making tool for the Rehabilitator and his team and (ii) a mechanism by which the Rehabilitator

¹⁰ Differences between cumulative claims presented and claims paid at the Interim Payment Percentage rate are primarily attributable to the Supplemental Payment Program.

can update Holders of Policy Claims on the potential recoveries available under certain financial and operating scenarios.

The Rehabilitator's Financial Projections reflect the collective knowledge and informed assessment of the Rehabilitator and his advisors in respect of a range of financial and operating factors that affect the Company's performance and recoveries that may be available to Holders of Policy Claims. The Rehabilitator's Financial Projections are derived from direct involvement in and/or on-going review of these critical factors, including the following:

1. Detailed reviews of adversely classified exposures;
2. Periodic sector reviews addressing both performing and adversely classified exposures;
3. Detailed analysis of loss mitigation strategies and specific transactions;
4. Periodic reviews of investment portfolio strategies, criteria and performance;
5. Detailed reviews of the Company's RMBS litigation strategy and activity; and
6. Detailed analysis and review of the Mediation Agreement and the Private Letter Ruling, which collectively affect AAC's and the Segregated Account's prospective tax liability.

VI. THE REHABILITATOR'S LOSS PROJECTIONS

A central part of the Rehabilitator's Financial Projections are estimates of future losses developed by the Rehabilitator and his financial advisors for both the General Account and Segregated Account, using financial information provided by AAC, including information that may have been prepared for Statutory or GAAP financial statements or at the request of the Rehabilitator. Such loss estimates do not reflect the views of AAC, AFGI, or any of their management.

Two distinct sets of loss estimates, a "base case" and a "stress case," have been developed, based on financial data for the period ending September 30, 2013, as adjusted for certain subsequent events, and employ a 5.1% discount rate in all present value calculations. These projections reflect the netting effect of AAC's loss mitigation investments, *i.e.*, projected losses are reduced to the extent that such losses are "payable" to AAC as a result of its ownership of AAC-wrapped securities. Actual losses attributable to General Account and/or Segregated Account policies may exceed these base case and stress case loss estimates, perhaps materially, and such estimates do not represent a cap on prospective losses.

Base and stress case loss estimates have been developed by employing AAC's second-worst and worst-case loss projections, respectively, for each exposure with any projected loss, without attempting to forecast the probability of a given scenario. Certain adjustments have been made to exposure-level loss estimates to reflect (i) evolving risk assessments and (ii) material events subsequent to September 30, 2013 (including certain transactions related to a whole-business securitization exposure and certain student loan exposures). In light of such adjustments (as well as other factors), we do not believe that the estimates contained herein would differ materially if more recent data were incorporated.

The base case losses for the General Account and the Segregated Account, before any R&W Recoveries and net of certain loss mitigation investments, as of September 30, 2013 are estimated to be, respectively, \$0.6 billion and \$5.9 billion. In general, such base case loss estimates are based upon the Company loss scenario with the second-highest projected loss, subject to certain adjustments described below. This base case Segregated Account loss estimate includes (i) \$3.4 billion in net accrued but unpaid claims, (ii) \$1.7 billion in net projected RMBS losses, (iii) \$0.7 billion in net projected student loan losses, and (iv) \$0.1 billion in losses associated with other Segregated Account exposures. Net accrued but unpaid claims represented 58% of Segregated Account base case losses as of September 30, 2013.

The stress case losses for the General Account and the Segregated Account, before any R&W Recoveries and net of certain loss mitigation investments, as of September 30, 2013, are estimated to be, respectively, \$1.2 billion and \$6.2 billion. In general, such base case loss estimates are based upon the Company loss scenario with the highest projected loss, subject to certain adjustments described below. This stress case Segregated Account loss estimate includes (i) \$3.4 billion in net accrued but unpaid claims, (ii) \$1.9 billion in net projected RMBS losses, (iii) \$0.8 billion in net projected student loan losses, and (iv) \$0.1 billion in losses associated with other Segregated Account exposures. Accrued but unpaid claims represented 55% of Segregated Account base case losses as of September 30, 2013.

AAC had approximately \$2.37 billion of surplus notes outstanding (including accrued and unpaid interest) through September 30, 2013, of which AAC owns approximately \$879 million.¹¹ While the surplus notes are not included in the base case and stress case losses detailed above, OCI has determined that it will treat the surplus notes issued by the Segregated Account as *pari passu* with the initial unpaid portion of permitted policy claims to be provided to the Segregated Account policyholders in the rehabilitation proceeding.¹² Any payment on or redemption of the Segregated Account surplus notes will, pursuant to the terms of the Bank Group Settlement, also require a proportionate payment on, or redemption of, the AAC surplus notes. Based on the foregoing, AAC's surplus note obligations (including accrued but unpaid interest) affect both the financial condition of the Segregated Account and prospective recoveries for Segregated Account policy beneficiaries.

VII. DESCRIPTION OF REHABILITATOR'S FINANCIAL PROJECTIONS SCENARIOS AND PROJECTED RECOVERIES

A. General

Four iterations, or scenarios, of the Rehabilitator's Financial Projections were prepared to demonstrate the sensitivity of Ambac's financial performance, and thus resources available to pay Holders of Policy Claims, under various operating assumptions. These scenarios have

¹¹ Excludes junior surplus notes.

¹² See the Affidavit of Regina Frank in Support of the Rehabilitator's Motion to Approve Purchase of Surplus Notes, dated May 16, 2012.

generally been developed to highlight the effect of certain material variables, specifically loss development and R&W Remediation recoveries, on resources available to pay policyholder Claims

The Rehabilitator's Financial Projections are not intended to project the timing of any (i) further change in the Interim Payment Percentage beyond that contemplated herein or (ii) partial or full recoveries in respect of the Deferred Amounts (which are defined as the sum of Deferred Loss Amounts and the associated Accretion Amounts) and/or the Surplus Notes (and interest accrued thereon) existing under the Plan. Any further changes in the Interim Payment Percentage and associated payments in respect of Deferred Amounts and redemptions of Surplus Notes (and interest accrued thereon) will be determined in accordance with the Plan.

B. Implementation of Change in Interim Payment Percentage

For purposes of this analysis, the Rehabilitator's Financial Projections have been prepared on the assumption that the Plan would become effective on March 31, 2014 (the "Assumed Plan Effective Date"). Certain transactions associated with implementation of the Plan and the change in Interim Payment Percentage, principally the Deferred Payment contemplated in the Amendments Motion, are assumed to occur on the Assumed Plan Effective Date. Although the actual effective date of the Plan will necessarily occur later than the Assumed Plan Effective Date, such later effective date is not expected to have a material effect on the estimates set forth herein.

C. Recovery of Deferred Amounts under the Rehabilitator's Financial Projections

Holders of Permitted Policy Claims will receive Cash Payments, and Deferred Amounts will be established by the Company in respect of Permitted Policy Claims. The ultimate recovery achieved in respect of the Deferred Amounts will vary based upon many factors, including, but not limited to, (i) lifetime losses attributable to the Policies, (ii) the amount and timing of R&W Remediation recoveries received, (iii) operating expenses, and (iv) investment portfolio performance.

For purposes of this analysis only, the Rehabilitator has assumed that the Cash Payment/Deferred Amount ratio remains unchanged at 45% for the duration of the projection period and all Deferred Amounts (and Surplus Notes) remain outstanding until all Policy obligations are extinguished. At that time, all residual claims-paying resources are assumed to be distributed to Deferred Amount and Surplus Note holders up to the then-outstanding amount of such obligations.

D. Scenario One

Scenario One contemplates (i) the Rehabilitator's base case loss estimates for both the General and Segregated Accounts and (ii) realization of R&W Remediation recoveries equal to AAC's estimates. Under Scenario One, beneficiaries of Deferred Amounts would receive approximately 86.2% of their then-outstanding Deferred Amount, with Accretion, at the end of the projection period, which indicates a 92.4% all-in recovery (including actual and prospective interim cash payments received in respect of such policy claims discounted at 5.1%).

E. Scenario Two

Scenario Two contemplates (i) the Rehabilitator's base case loss estimates for both the General and Segregated Accounts and (ii) realization of R&W Remediation recoveries equal to 75% of AAC's estimates. Under Scenario Two, beneficiaries of Deferred Amounts would receive approximately 75.0% of their then-outstanding Deferred Amount, with Accretion, at the end of the projection period, which indicates a 86.2% all-in recovery (including actual and prospective interim cash payments received in respect of such policy claims discounted at 5.1%).

F. Scenario Three

Scenario Three contemplates (i) the Rehabilitator's stress case loss estimates for both the General and Segregated Accounts and (ii) realization of R&W Remediation recoveries equal to AAC's estimates. Under Scenario Three, beneficiaries of Deferred Amounts would receive approximately 67.0% of their then-outstanding Deferred Amount, with Accretion, at the end of the projection period, which indicates a 81.8% all-in recovery (including actual and prospective interim cash payments received in respect of such policy claims discounted at 5.1%).

G. Scenario Four

Scenario Four contemplates (i) the Rehabilitator's stress case loss estimates for both the General and Segregated Accounts and (ii) realization of R&W Remediation recoveries equal to 75% of AAC's estimates. Under Scenario Four, beneficiaries of Deferred Amounts would receive approximately 56.3% of their then-outstanding Deferred Amount, with Accretion, at the end of the projection period, which indicates a 75.9% all-in recovery (including actual and prospective interim cash payments received in respect of such policy claims discounted at 5.1%).