STATE OF WISCONSIN | CIRCUIT COURT | DANE COUNTY

In the Matter of the Rehabilitation of:

Segregated Account of Ambac Assurance Corporation

Case No. **10CV1576**

BRIEF IN SUPPORT OF ENTRY OF ORDER FOR REHABILITATION

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The Commissioner of Insurance for the State of Wisconsin ("the Commissioner") submits this brief in support of his accompanying Petition for the rehabilitation of the recently formed segregated account (the "Segregated Account") of Ambac Assurance Corporation ("Ambac" or the "General Account"), a Wisconsin-domiciled insurer. The Commissioner has the consent and support of Ambac's board of directors for the creation and rehabilitation of the Segregated Account and for the implementation of the Plan of Operation for the Segregated Account, which is attached to the Petition at Tab 1. As explained more fully in this brief, the creation and rehabilitation of the Segregated Account offers the greatest protection and most equitable treatment of policyholders, creditors, and the public given the deteriorating financial condition of Ambac and the varying terms and risks associated with the policies allocated to the Segregated Account. The Commissioner respectfully requests that the Court grant the Petition and enter the proposed Order for Rehabilitation in full.

INTRODUCTION

Over the past 25 years, Ambac was one of the largest "monoline" insurers in the world, meaning that it exclusively wrote financial guarantee insurance policies and does not offer property, casualty, life, disability, or other forms of insurance. Generally speaking, it insures investments such as interest-bearing bonds and notes against default.

From its founding in 1970 as a Wisconsin domiciled insurer until the 1990s, Ambac's business was almost exclusively related to traditionally low-risk, low-margin public finance bonds. In the mid-1990s, however, Ambac began to diversify by offering financial guarantee insurance on riskier, higher-margin private "structured-finance" investments, including residential mortgage-backed securities ("RMBS") and collateralized debt obligations of asset-backed securities ("CDOs of ABS").

When the riskier insured investments began to deteriorate *en masse* during the economic crisis of 2008, Ambac's projected future liabilities grew while its credit ratings and statutory surplus plummeted. Consequently, its prospects for generating new business evaporated, it stopped writing new policies, and it initiated an informal run-off.

These events have created a present hazard to policyholders. Ambac's investment portfolio assets have a current market value of approximately $8 to $9 billion, plus the value of future unearned premiums.[1] Many of Ambac's assets would not yield fair value if liquidated today and used to pay short-term claims. The inopportune sale of Ambac's long-term, presently undervalued assets would result in a net loss of claims-paying resources available to all policyholders—a "fire sale" as opposed to a fair and equitable distribution for the benefit of policyholders as a whole.

Absent the restructuring efforts described in the Petition and below, there was an increasing risk that Ambac might not have been able to satisfy all claim made under the Company's in-force policies as they developed over the next thirty years. Without restructuring, there was an increasing risk that policyholders who presented short-tail claims in the next several years would have received payment for a larger percentage of their claims than policyholders who presented claims in the more distant future.

For the past two years, the Commissioner and his staff and advisors have conferred extensively with representatives of Ambac and many policyholders regarding Ambac's increase in present and projected claims payments, the deterioration of its claims-paying resources, various options to protect the interest of the public and the policyholders, and the pros and cons of each option. During that time, the Commissioner has "non-disapproved" Ambac's

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[1] Those unearned premiums are estimated to be worth $1.5 to $2 billion, discounted to present value.

requests (by Form D applications) for permission to commute a number of policies at a fraction of their total projected impairments in order to reduce the potential liabilities facing Ambac. The Commissioner and his staff and advisors also conducted in-depth examinations of the company's books of business and policies and the risks associated with them, and monitored Ambac's deteriorating financial condition. Based on this lengthy and careful review, the Commissioner has worked with Ambac to craft and implement a multi-step restructuring plan designed to maximize its claims-paying resources and to equitably allocate them to compensate actual economic losses of policyholders.

First, with the extensive involvement of the Commissioner, Ambac entered into a non-binding Statement of Intent contemplating a settlement with a number of financial institutions that are parties to credit default swap agreements with an Ambac subsidiary and beneficiaries of related financial guarantee policies issued by Ambac. The parties are preparing the final documentation necessary to close that transaction. The policies at issue constitute a significant portion of Ambac's future liabilities, and the Commissioner believes that the commutation of those policies on equitable terms, as contemplated by the Statement of Intent, will be a meaningful and positive development for all policyholders of both the Segregated and General Accounts.

Second, Ambac created the Segregated Account and allocated to it primarily those policies with material projected impairments that insure the riskier investments described above. The Segregated Account includes the books of business for RMBS, most of which will mature within approximately five years, and those CDOs of ABS policies not subject to the Statement of Intent, most of which will not mature for twenty or more years, as well as certain other policies with provisions that could result in loss of control rights or demands to pay non-economic,

accelerated damages at the expense of other policyholders of Ambac. To support the Segregated Account, Ambac also allocated to it a $2 billion secured note plus a last-dollar reinsurance policy, limited only by the assets of the General Account.[2]

Third, the Commissioner has petitioned the Court to place the Segregated Account into this rehabilitation proceeding to avoid and/or mitigate some of the various negative consequences built into the terms of the policies allocated to the Segregated Account and to implement controls to slow the pace of claims-paying resource consumption by near-term claimants and contractual counterparties. Ambac's surplus and contingency reserves have fallen sharply in the past two years due in large part to dramatic increases in substantial policyholder claims for actual losses, and that trend was projected to continue in the near future absent restructuring and rehabilitation as a number of securities issuers are expected to default. In addition to the growing number of claims for actual losses, certain of the Segregated Account policies or contracts include terms calling for "mark-to-market" damages and/or loss of "control rights" upon the occurrence of certain events, including rehabilitation. Mark-to-market damages are based on the market cost of comparable replacement protection for those investments. Given the crash of the CDO market due to the infection of subprime mortgages within most CDOs, there is no protection to be bought in the market absent the payment of an exorbitant price that would dramatically overstate the actual economic loss (if any) that would be incurred by the counterparties over the full term of those policies. While the consequences of lost control rights vary depending on the policy or agreement at issue, in many instances their loss would eliminate

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[2] As detailed in the Plan of Operations attached to the Petition, the General Account has no obligation to make further payments to the Segregated Account if the surplus of the General Account either falls below the statutory minimum of $100 million or the payment(s) to the Segregated Account would cause the surplus to drop below $100 million. The Plan of Operation for the Segregated Account, which includes copies of the secured note and reinsurance policy as Exhibits G and H, is attached to the Petition at Tab 1.

Ambac's ability to prevent actions relating to the underlying obligations that could result in higher claims liability, such as early terminations and liquidation of undervalued collateral.

The proposed orders and formal plan of rehabilitation to follow would stabilize the volatile and precarious condition of claims-paying resources and avoid unnecessary and detrimental waste of such assets at a time when many of them are undervalued. By protecting and maximizing these resources and coordinating orderly mechanisms for claims processing within the context of a long-term rehabilitation plan, this proceeding will promote the more equitable treatment of all Ambac policyholders, regardless of type.

In this brief, the Commissioner seeks to provide the Court with additional context and legal support for the implementation of this proceeding, as further described in the Petition, the Plan of Operation, the brief in support of the Motion for Temporary Injunctive Relief, and the related proposed orders. This brief begins by discussing the purposes of the rehabilitation statutes and the broad discretion they grant to the Commissioner and this Court to effectuate those purposes. It then offers some background on Ambac's history, its business, its structure, and its presently precarious financial condition. Because Ambac has a complex corporate structure involving numerous subsidiaries, and because this case concerns a host of complicated financial instruments, the Commissioner has created the attached Appendix as a quick reference guide to Ambac's corporate structure, the applicable financial terms and instruments, and the definitions of relevant credit ratings. For general background and context, the Appendix also contains some recent public articles about the industry and Ambac. The Commissioner does not necessarily endorse the statements in these articles; they are provided purely to assist the Court's general understanding of the context of this proceeding.

Finally, the brief elaborates on the substance of the Petition and the proposed orders. It explains the necessity of various provisions in the orders to fairly protect policyholders and the public, and describes how they are designed to protect the interests of all policyholders fairly and equitably, regardless of type, by providing orderly and financially safe mechanisms for treatment of policy claims and other obligations of the Segregated Account while it is undergoing rehabilitation.

To serve the purposes of the rehabilitation statutes and the implementation of the Plan, the Commissioner has submitted two proposed first-day orders. The first proposed order contains standard first-day provisions in rehabilitation proceedings, including the appointment of Kimberly A. Shaul, Deputy Commissioner for the Wisconsin Office of the Commissioner of Insurance, as the Special Deputy Commissioner for the Segregated Account. The second order, which is addressed briefly here and in more detail in the brief and proposed order accompanying the Motion for Temporary Injunctive Relief, includes several provisions that are vital to the orderly administration of this proceeding, the protection of policyholders, and the prevention of collateral damage to the public at large. The Commissioner submits that each of the provisions in its proposed orders are necessary to alleviate the current financial hazards that Ambac presents to policyholders, creditors and the public.

In sum, the legal analysis below demonstrates that the Commissioner has broad authority to implement—and this Court has broad authority to approve and enforce—rehabilitation plans and orders to serve the larger purposes of the insurance rehabilitation statutes. The factual discussion that follows explicates the immediate need to exercise such authority here.

I. REHABILITATION IS WARRANTED.

The Wisconsin Legislature has vested the Commissioner with the power to "administer and enforce" Chapter 645 of the Wisconsin Statutes, Wis. Stat. § 601.41(1), a task that requires him to engage in "the protection of the interests of insureds, creditors, and the public generally" through "[e]arly detection of any potentially dangerous condition in an insurer, and prompt application of appropriate corrective measures," Wis. Stat. § 645.01(4). To facilitate the fulfillment of these responsibilities, the official legislative comments to Chapter 645 repeatedly emphasize the Commissioner's broad discretion to commence rehabilitation actions, as well as the need for streamlined, flexible proceedings without unnecessarily formal legal procedures. *See, e.g.*, Wis. Stat. Ann. § 645.01 cmt. to subdiv. (4)(b) ("Rehabilitation should emphasize the management process, not the legal process. Flexibility, informality and expertise should be encouraged, as they are in this chapter."); Wis. Stat. Ann. § 645.32 cmt. (noting that "the rehabilitator is given broad powers" and "the court's control should be liberal, not strict, and should be provided without cumbersome procedures").

Sections 645.31 and 645.41 of the Wisconsin Statutes enumerate more than twenty different grounds that each independently warrant the entry of an order for rehabilitation of a Wisconsin insurer. Three of those grounds provide a clear basis for the Commissioner to pursue rehabilitation of the Segregated Account, but only one ground need concern the Court today. Section 645.31(14) states that rehabilitation is warranted when two-thirds of the Board of Directors of the insurer consent to it. As noted in the Petition, the Board of Directors of Ambac has granted such consent to the initiation of these proceedings for rehabilitation of the Segregated Account.

In addition, there are at least two further independent grounds for rehabilitation. First, § 645.31(1) states that rehabilitation is appropriate upon the existence of "[a]ny ground on which the Commissioner may apply for an order of liquidation under s. 645.41." Among those grounds is evidence "[t]hat the insurer is in such condition that the further transaction of business would be hazardous, financially or otherwise, to its policyholders, its creditors or the public." Wis. Stat. § 645.41(4). The factual sections of this brief, which follow this argument, offer ample evidence of the fact that further transaction of business by the Segregated Account outside the protective umbrella of this rehabilitation proceeding would be financially hazardous to many policyholders.

Second, within the previous twelve months, Ambac has systematically attempted to compromise and commute policies with certain counterparties on certain books of business now in the Segregated Account on the grounds that it might be unable to pay their claims in full. Such actions "indicate[] a financially disabled insurer" and present yet another independent ground warranting rehabilitation of the Segregated Account. Wis. Stat. Ann. § 645.41(6) & cmt.

In sum, the Segregated Account is in precisely the type of precarious business situation for which the Legislature adopted the rehabilitation procedure. *See* Wis. Stat. § 645.01(4).

II. THE COURT SHOULD GRANT THE COMMISSIONER'S PETITION AND ENTER THE PROPOSED ORDER.

A. The Commissioner has Broad Discretion to Rehabilitate an Insurer he Regulates.

The purposes of rehabilitation are clearly set forth by statute:

> (4) PURPOSE. The purpose of [Chapter 645] is the protection of the interests of insureds, creditors, and the public generally, with minimum interference with the normal prerogatives of proprietors, through:

> (a) Early detection of any potentially dangerous condition in an insurer, and prompt application of appropriate corrective measures, neither unduly harsh nor subject to the kind of publicity that would needlessly damage or destroy the insurer;
>
> (b) Improved methods for rehabilitating insurers, by enlisting the advice and management expertise of the insurance industry; [and]
>
> . . . .
>
> (d) Equitable apportionment of any unavoidable loss[.]

Wis. Stat. § 645.01(4).

The overarching goals of rehabilitation are to save an insurance company from liquidation, to preserve and maximize claims-paying resources, and to treat policyholders equitably while the insurer is in a financially precarious state. *See* Am. Jur. 2d Insurance § 93 (2008) ("Rehabilitation is designed to accomplish the conservation of an insurance company."); 1 Lee R. Russ & Thomas F. Segalla, *Couch on Insurance* § 5:24 (3d ed. 2008) ("In general, the rehabilitation statutes place upon the conservator the responsibility of devising a plan for rehabilitation that will result in the successful continuation of the business of the insurer."). "The rehabilitation statutes intend to preserve the business of an insolvent company, or of a company which is threatened with insolvency, regardless of whether the difficulties of the company were caused by its own mismanagement or by general economic conditions beyond its control." *Id.* § 5:18. In rehabilitation proceedings, it is the duty of the Commissioner of Insurance to "try to remove the causes of [an insurer's] difficulties." *Id.*

The Commissioner "has broad discretion to structure a plan of rehabilitation" to meet these objectives. *Id.* § 5:22. Chapter 645 of the Wisconsin Statutes reinforces the substantial grant of authority to the Commissioner as rehabilitator. Indeed, the Wisconsin legislature has stated that "[s]ubject to court approval, the rehabilitator may take the action he or she deems necessary or expedient to reform and revitalize the insurer[,]" including exercising the

"full power . . . to deal with the property and business of the insurer." Wis. Stat. § 645.33(2). As noted by a New Jersey appellate court operating under rehabilitation statutes similar to those in Wisconsin,

> While the Commissioner's plan for rehabilitation cannot be implemented without a court finding that it is fair and equitable, deference is given to the means the Commissioner chooses to utilize in going forward with rehabilitation. As such, the Rehabilitator's determination concerning the manner in which to proceed will not be set aside unless it is shown to be arbitrary or unreasonable.

LaVecchia v. HIP of N.J., Inc., 734 A.2d 361, 364 (N.J. Super. Ct. Ch. Div. 1999). *See also Matter of Mills v. Fla. Asset Fin. Corp.*, 818 N.Y.S. 2d 333, 333 (N.Y. App. 2006) ("The courts will generally defer to the rehabilitator's business judgment and disapprove the rehabilitator's actions only when they are shown to be arbitrary, capricious, or an abuse of discretion."); *Med. Society of N.J. v. Bakke*, 892 A.2d 728, 735 (N.J. Super. Ct. App. Div. 2006) ("Extending due deference to the Commissioner's expertise in the technical subject matter" of insurance); *Foster v. Mut. Fire, Marine & Inland Ins. Co.*, 614 A.2d 1086, 1091-92 (Pa. 1992) (recognizing the "broad supervisory powers" of the Insurance Commissioner in rehabilitation proceedings, noting that "judicial discretion is not to be substituted for administrative discretion," and holding that "the involvement of the judicial process is limited to the safeguarding of the plan from any potential abuse of the Rehabilitator's discretion"); *Kueckelhan v. Fed. Old Line U.S. Co.*, 418 P.2d 443, 453 (Wash. 1966) ("The court's sole and proper function in rehabilitation proceedings is to direct—that is, to supervise and review—the actions of the Insurance Commissioner while he is operating the seized insurance company."); *cf.* Wis. Stat. 227.57(10) ("Upon such review [of agency actions] due weight shall be accorded the experience, technical competence, and specialized knowledge of the agency involved, as well as discretionary authority conferred upon it.").

In furtherance of the Commissioner's exercise of his authority, the Court also has broad power to implement injunctions to facilitate, and to avoid interference with, a Commissioner's plan for rehabilitation. As stated in Chapter 645, a Court may grant any injunctions deemed necessary and proper to prevent "waste of the insurer's assets," "the institution or further prosecution of any actions or proceedings," and "threatened or contemplated action that might lessen the value of the insurer's assets or prejudice the rights of policyholders, creditors or shareholders, or the administration of the proceeding," among other reasons. Wis. Stat. § 645.05(d), (f), (k). Further description of the specific injunctive relief the Commissioner seeks, together with supporting legal authority, appear in the brief in support of the Motion for Temporary Injunctive Relief and proposed order granting such relief.

B. Third Parties Lack Standing to Interfere With the Commissioner's Decisions About Rehabilitation.

It bears noting that the Wisconsin Legislature has combined third-party standing limitations with the discretion it has afforded to the Commissioner and the Court with regard to rehabilitation proceedings. Chapter 645 grants no right to third parties (such as policyholders or creditors) to question the judgment of the Commissioner in administering the rehabilitation proceeding or in formulating and implementing a rehabilitation plan. In fact, while Chapter 645 expressly permits "any person whose interests are substantially affected" to seek judicial review of a *summary order* issued pursuant to its provisions, Wis. Stat. § 645.21(4), it does not grant a "substantially affected" person any similar right to seek review in rehabilitation proceedings—a factor weighing against such a person's right to challenge the discretion of the Commissioner. *See* 2A Norman J. Singer & J.D. Shambie Singer, *Sutherland on Statutes and Statutory Construction* § 46:5 (7th ed. 2007) ("[W]here the legislature has employed a term in one place and excluded it in another, it should not be implied where excluded."). Had the Wisconsin

legislature wished to grant the same third-party standing to challenge rehabilitation orders, plans, or other discretionary acts of the Commissioner that it granted for challenges to summary orders, it could have done so simply by making Wis. Stat. § 645.21(4) applicable to any "delinquency proceeding," rather than just a "summary order," as the language currently reads. Its failure to do so implies an intent to protect rehabilitation plans from challenges by third parties.

Consistent with the above authority, this Court has previously refused to permit third parties the right to second-guess the judgment of the Commissioner in one of Wisconsin's more recent Chapter 645 cases, in part because such challenges "would jeopardize the interests of all other claimants by forcing [the Commissioner] to address multi-party litigation, at a substantial expense." *In re Liquidation of Am. Star Ins. Co.*, No. 92-CV-4579 (Wis. Cir. Ct. Dane County Nov. 20, 1998) (the Honorable William D. Johnston, presiding by judicial assignment) (adopting the arguments presented in the Liquidator's Brief in Opposition to Motions by Pacific Bank (Dkt. 137 (Oct. 19, 1998)), at 1).

Even if Wisconsin law did create a right for those whose interests were "substantially affected" to challenge the Commissioner's determinations relating to this proceeding, which it does not, outside parties would be unable to meet that high threshold standard—particularly at this early juncture. Mere conjectural fears that the plan or orders may cause some future harm do not suffice to create standing. *See, e.g.*, *Med. Society of N.J.*, 892 A.2d at 733; *see also Waste Mgmt. of Wis., Inc. v. Dep't of Natural Res.*, 144 Wis. 2d 499, 511-12, 424 N.W.2d 685, 690 (1988) (holding that the "mere possibility" of future harm is not sufficient to confer standing to challenge agency actions). Further, such parties do not have the right to usurp the role of the Commissioner by seeking to seeking to challenge, replace, or alter the content of any plans proposed by the Commissioner pertaining to the rehabilitation. *See* 1

Couch on Insurance, *supra* § 5:24 ("[I]n the absence of proof of illegality, abuse of discretion, or gross inequity, the trial court's approval of a particular plan of rehabilitation is not subject to review.") (footnotes omitted) (citing *Carpenter v. Pac. Mut. Life Ins. Co.*, 74 P.2d 761 (Cal. 1937) for the proposition that an appellate court need not evaluate the relative merits of alternative rehabilitation plans); *State ex rel. Hunt v. Green*, 508 P.2d 639, 642 (Okla. 1973) (where the insurance commissioner commences delinquency proceedings against an insurer and applies for the approval of a rehabilitation plan, "[t]he Court . . . cannot, as in this case, put off making a ruling on the [plan] to allow officers of the insolvent insurer to submit a plan of rehabilitation of their own for his approval").

In sum, the Wisconsin legislature has granted broad discretion to the Commissioner to commence rehabilitation proceedings and to take the actions he deems necessary to protect policyholders and the public during rehabilitation. The Legislature also has granted broad discretion to this Court to authorize such actions by the Commissioner, and it has limited the ability of outside parties to challenge the discretionary determinations of either the Commissioner or this Court. *See generally* Wis. Stat. §§ 645.01, 645.02, 645.05. The Court should exercise this discretion by approving the Petition and proposed order in full.

III. AMBAC'S PAST AND PRESENT BUSINESS AND FUTURE FINANCIAL HAZARDS TO POLICYHOLDERS AND THE PUBLIC.

Ambac's current financially hazardous condition is the culmination of several business decisions and economic events that led Ambac from a fledgling company in the 1970s, to one of the largest monoline insurers in the world from the 1980s until 2006, to an insurer that Moody's Investors Service ("Moody's") now rates as having "very poor financial security." For the purpose of providing a fuller context for the grounds for rehabilitation, and to illustrate the need for immediate entry of the proposed orders, the Commissioner offers the following

abbreviated, chronological description of that history. The brief then describes the current financial threats to Ambac.

A. Ambac's History

(i) Ambac's Period of Growth, 1971 to 2006

Ambac is a wholly owned subsidiary of Ambac Financial Group, Inc. ("AFGI"), a holding company incorporated in Delaware, headquartered in New York City, and publicly traded on the New York Stock Exchange.[3] Several other entities are in turn wholly owned subsidiaries of Ambac, as detailed more fully in the attached Appendix and other filings made today. As a Wisconsin-domiciled insurer (NAIC Company Code #18708), Ambac has been subject to the Commissioner's regulatory oversight since its inception.

Ambac essentially founded the financial guarantee industry after it incorporated in Wisconsin as CMI Insurance, Inc. in 1970. It offered financial guarantee insurance on investment debt, protecting holders of fixed-income obligations (such as bonds or other structured debt) against non-payment of those obligations when they became due. In terms of the amount of insured debt, Ambac's insurance of public-finance bonds made up (and continues to make up) the bulk of that portfolio.

Ambac's business grew steadily, particularly after it obtained a AAA credit rating from S&P Financial Services LLP ("S&P") in 1975 and a Aaa rating from Moody's in 1987. Those ratings, combined with some well-publicized municipal defaults in the 1970s and 1980s, jumpstarted the market for Ambac's bond insurance policies. These policies offered at least two benefits to their buyers. First, municipalities could more readily sell the bonds at a lower interest rate because the bonds were "Ambac-wrapped" and therefore guaranteed by Ambac and its optimum credit ratings. Second, initial bond investors were more willing to buy Ambac-

[3] AFGI is not an insurer and is not regulated by the Commissioner.

wrapped bonds because Ambac's strong credit ratings made the bonds more readily transferable in secondary markets. By 1988, more than 25 percent of domestic public finance bond issuances were insured by Ambac.

In the 1990s, however, Ambac began insuring more speculative investments through new branches of its business. In 1992, it added a Financial Services Division to offer investment products to municipalities, including Guaranteed Investment Contracts ("GICs"). In 1994, it added a Specialized Finance Division. This division provided guarantees on CDOs of ABS and other private structured financing, including RMBS. During this time, Ambac also backstopped the credit default swaps entered into by its subsidiary, Ambac Credit Products, LLC. These credit default swaps were essentially insurance policies without insurance regulation; the "protection seller" promised to pay the "protection buyer" upon default of an underlying obligation (usually a CDO) in exchange for a percentage of the periodic interest payments due on such obligations.

Insuring these categories of private investments carried greater risk for Ambac, in that the amount of risk was more difficult to calculate and price through premiums. Rather than evaluating the likelihood that a single municipality would default on any given obligation, Ambac was dealing with the possibility that any number of individuals would default on the credit card payments, mortgages, or other obligations that were bundled into the asset pools[4] that secured and funded the CDO of ABS or RMBS investments.

Finally, Ambac also expanded many aspects of its business internationally through various affiliates. By 2007, more than 10 percent (or roughly $55 billion) of the par

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[4] Other examples of such assets include leases, student and auto loans, and operating assets such as aircraft, vehicle fleets, franchise fees, royalties, and intellectual property.

value[5] of investments insured by Ambac were internationally based. Of that amount, Ambac insured approximately 10 percent directly; the remaining 90% constitutes Ambac's obligations under reinsurance agreements with its overseas subsidiary, Ambac Assurance UK Limited.

(ii) Economic Climate Change, 2007 to Present

Ambac's financial outlook started to deteriorate in 2007, as the effects of subprime lending practices of 2004 through 2006 began to resonate through the financial sector. A sizeable portion of the trillions of dollars of CDOs outstanding at the time the subprime crisis hit were backed by subprime RMBS.[6]

As a result, the major credit rating agencies began to take a harder look at the books of business written by monoline insurers like Ambac to determine the extent of their exposure to subprime-backed securities. In late 2007, both Moody's and S&P revised their standards for maintaining top credit ratings, and Ambac's credit ratings began to drop precipitously. By mid-2009, S&P had dropped Ambac to "CC," a rating level indicating "extremely weak financial security characteristics," while Moody's dropped it to "Caa2," a rating level indicating "very poor financial security." Thus, over the course of a year-and-a-half, Ambac's credit ratings from the two major ratings agencies fell from the highest possible to some of the lowest possible.

As a result of these ratings declines and increases in liabilities, Ambac ceased writing new business, began executing a run-off strategy for policies still in force, and arranged to commute a number of policies when projected liabilities for those policies substantially exceeded the negotiated price of the commutation.

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[5] The term "par value" is described in the glossary included in the appendix to this brief.

[6] Exact figures are difficult to ascertain due to differences in criteria for "subprime" among different evaluating institutions, different methods of estimation, and the fact that more and more RMBS are being exposed as (or becoming) subprime.

(iii) Ambac Present and Potential Liabilities

According to AFGI's Form 10-Q quarterly report for the third quarter of 2009, filed with the Securities and Exchange Commission, Ambac at that time had just over $400 billion in insurance policies or financial guarantees in force, based on the par value of the underlying obligations outstanding.[7]

Approximately sixty percent of Ambac's total third quarter 2009 financial guaranties in force was related to domestic public finance bonds. Insurance premiums on those bonds were generally payable in full at the time Ambac issued the policy. Therefore, because Ambac is no longer writing new business, it no longer has an income stream from issuance of new policies on bonds. At the same time, however, the projected extent of public-finance liabilities is relatively small due to the historically low default rate in this area.

Ambac's remaining policies insure privately issued structured-finance obligations, including CDOs, RMBS, and other complex financial instruments and contracts. Ambac also insures the payments of its subsidiaries, some of which have guaranteed third parties' structured finance obligations through credit default swaps. A great deal of these obligations are now rated below investment grade, many due to subprime lending exposure.

Ambac is presently receiving an income stream from those structured-finance obligations, though the income is relatively small given that competition prior to exposure of the risks of such obligations drove premiums as low as one-tenth of one percent of the par value of the principal, paid annually. The average life of Ambac's insured bonds and structured-finance

[7] Two years prior, Ambac's outstanding obligations were $555 billion, according to its third quarter 2007 Form 10-Q quarterly report. Ambac's total financial guarantee exposure dropped to its present level because it ceased writing new business (and thereby ceased adding new obligations) while certain policies and guarantees came off its books due to expirations, claims payments, and commutation agreements.

obligations is fourteen years. However, the RMBS investments Ambac insures have shorter maturities.

The near-term projected maturity of the bulk of the RMBS that Ambac insures (either through direct insurance or through Ambac's insurance of subsidiary obligations), and the likely inability to pay all claims related to the RMBS in full, pose a risk to Ambac's ability to pay policyholders who insured longer-term investments. Because Ambac had traditionally insured longer-term investments, it also invested heavily in instruments that do not reach full maturation and value until a later date, such as bonds, in order to align potential losses with the dates Ambac's claims-paying resources reach their highest expected value. Ambac also invested heavily in instruments that are presently undervalued in the current market, such as mid-prime RMBS.

The continued flurry of RMBS defaults, coupled with triggers in contracts between certain Ambac subsidiaries and counterparties that required Ambac to transfer some of its claims-paying capital to its subsidiaries, has caused a steep decline in readily available, fairly valued assets for the payment of short-term claims. To pay these claims in full and in cash at this time could require liquidation of longer-term Ambac assets before they reach full value or reestablish their fair value. Thus, immediate payment of expected RMBS and RMBS-related claims over the coming year would jeopardize the financial security of holders of long-term, Ambac-insured investments by disproportionately reducing the cumulative sum of Ambac's claims-paying resources.

In addition, Ambac's guarantees of the credit default swap ("CDS") obligations of its subsidiary loom as an even greater threat to policyholders as a whole, in large part due to contractual triggers that threaten to siphon away resources available to pay policy claims for

actual losses and instead divert them toward payment of the non-economic damages of a limited number of policyholders. CDSs offered by Ambac subsidiary Ambac Credit Products, LLC (and guaranteed by Ambac) were an alternative to the financial guarantees Ambac offered directly on other investments. Under these agreements, if a credit event such as a payment default or bankruptcy of the underlying debtor occurred with regard to a fixed-income obligation held by a counterparty, Ambac Credit Products (and thus Ambac) typically agreed to pay the counterparty the difference between a scheduled payment amount it expected to receive and the amount it actually received. Under most CDS agreements, Ambac was not to pay any more than the shortfall, if any, in periodic payments due under the underlying obligation, unless the collateral backing that obligation had been disposed of and used to satisfy debt-holders. In such a situation, Ambac would pay any shortfall remaining after the disposal of collateral. Because Ambac Credit Products had no significant assets upon the allocation to the Segregated Account of its member interests and the policies related to certain of its CDS, the Segregated Account is essentially responsible for all liabilities under these CDSs as they arise.

Those responsibilities put Ambac's remaining policyholders at risk. Certain of the underlying obligations covered by CDSs guaranteed by Ambac have defaulted on payments already, and many of the obligations still outstanding are currently rated below investment grade, with an elevated risk of default. In addition, the CDSs include termination and liquidated damage provisions triggered upon certain events such as the insolvency of Ambac or Ambac Credit Products, the failure of Ambac Credit Products to make payments when due, or the commencement of bankruptcy or state insolvency proceedings. These termination provisions call for "mark-to-market" damages immediately payable from Ambac Credit Products (and thus from the Segregated Account) based on the market cost of comparable replacement CDS

protection. Such punitive damages would highly overstate the true economic loss (if any) suffered by the counterparties.

IV. THE PROPOSED FIRST-DAY ORDERS ARE REASONABLE AND IMMEDIATELY NECESSARY TO PROTECT POLICYHOLDERS AND THE PUBLIC.

Fair and full payment to policyholders remains possible even in spite of Ambac's presently troubled financial condition. This proceeding is the result of roughly two years of monitoring and engagement by the Commissioner with Ambac and some of its largest policyholders. These restructuring efforts have sought to protect the interests of all policyholders and the public by maximizing policyholder claims payment resources and avoiding punitive termination provisions, by providing an orderly and equitable claims payment process, and by minimizing disruptions in coverage to the greatest possible extent. Key components of the Plan of Operation for the Segregated Account and the proposed orders are generally described below, broken down into the "Injunctive," "Structural" and "Administrative" aspects of the proposed rehabilitation.

A. Injunctive Relief to Protect Policyholders and Rehabilitate Ambac

The Commissioner has requested that the Court provide injunctive relief in various forms in regard to the interests of the Segregated Account to protect against the chaotic assertion of various third-party challenges that would undermine the equity and efficiency that Chapter 645 strives to promote. The Commissioner describes the necessity and legal authority for such relief more fully in his brief in support of the accompanying Motion for Injunctive Relief; the summary below is merely intended to provide context and to briefly explain the way in which this relief fits within his preliminary Plan.

First, the Commissioner seeks to enjoin any Segregated Account beneficiary or party to a contract that Ambac guarantees, or in which Ambac has control rights, from

accelerating, terminating, seizing collateral, or seeking rapid amortization under that contract as a result of the filing of this rehabilitation proceeding, the entry of the Segregated Account into rehabilitation, or any action taken pursuant to this proceeding. These provisions prevent the inequitable scenario described earlier: the exhaustion of Ambac's assets in immediate payment for non-economic losses to a handful of parties at the expense of a multitude of insureds who may face actual losses in the future. Absent this injunction, some parties may attempt to terminate their contracts upon future events arising out of this proceeding, while others may attempt to do so based upon the mere fact of the Segregated Account's entry into rehabilitation. In either instance, mass terminations would jeopardize the rights of creditors and insureds as a whole by exposing Ambac to substantial, immediate liability for non-pecuniary damages.

Second, the Commissioner asks this Court to enjoin claims payments for liabilities of the Segregated Account without the consent of the Commissioner. This is necessary to ensure an orderly transition into rehabilitation, to determine the appropriate timing and form of future claims payments in order to finalize a plan for rehabilitation, and to obtain SEC approval to issue deferred payment certificates as part of future claims payments, as described more fully below.

Third, the Commissioner seeks to maintain the authority to terminate any policy for non-payment and thus prevent counterparties from withholding premiums as a setoff against future claims. To do so would contravene Wisconsin's law against setoff, Wis. Stat. § 645.56(2)(d), deprive the General Account of additional sources of liquid assets without any corresponding reduction in potential liabilities, and, in the event that the General Account's assets prove unable to match those liabilities, unfairly benefit those policyholders who withheld premiums to the detriment of those who paid their premiums up-front.

Fourth, the Commissioner requests that the Court enjoin lawsuits against the Segregated Account or the Rehabilitator while the rehabilitation is ongoing, enjoin any creditors claiming primary interests in the property or assets of the Segregated Account from transferring, wasting, encumbering, or exercising purported rights with regard to those assets, and issue other standard first-day injunctions. These injunctions are also necessary for the orderly payment of claims.

B. Structural Changes to Protect Policyholders and Effect Rehabilitation

As noted above, the current amount of "fair value" assets of the General Account and the timing in which many of its other assets will reach full value do not match the timing of the expected liabilities of the Segregated Account in the coming years. This rehabilitation, as well as structural changes to Ambac immediately prior to the filing of this Petition, endeavor to correct this timing mismatch of Ambac's potential assets and liabilities.

Specifically, Ambac has allocated to the Segregated Account many of the higher-risk, troubled obligations, such as RMBS and those CDOs not involved in the Statement of Intent transaction, as well as policies or contracts with triggers that may adversely impact policyholders as a whole if not subject to the injunctive powers of this Court in a rehabilitation proceeding. To meet these policy obligations, Ambac has provided a $2 billion secured note and a last-dollar reinsurance policy from the General Account to the Segregated Account. Under the terms of the secured note, the Segregated Account will make demands upon the note to pay a percentage of claims in cash as they accrue, in effect drawing on presently mature and fairly valued assets of the General Account. Rather than liquidating non-mature or undervalued General Account assets to the detriment of policyholders as a whole, the Commissioner's final rehabilitation plan will propose reimbursing those portions of valid claims that are not feasible to pay in cash immediately through interest-bearing deferred payment certificates. This re-allocation of assets

and liabilities should inure to the benefit of all policyholders in the aggregate and equitably distribute the risk of exhaustion of claims-paying resources among short-term and long-term policyholders alike. The specifics of this process will be the subject of the plan of rehabilitation the Rehabilitator will bring before the Court in the future for approval and implementation.

Moreover, while it is clear that third parties lack standing to challenge the Commissioner's decisions about rehabilitation, settled law supports his authority as Rehabilitator to defer payment of policyholder claims to alleviate short-term financial pressures and protect long-term policyholders.[8] Deferred payments on claims to policyholders is appropriate "so long as deferment is a reasonable means of dealing with the critical financial situation of the insurer and the plan has the capacity to achieve the desired result of releasing the financial pressures on the corporation." 1 *Couch on Insurance*, *supra* § 5:24. The rehabilitation plan that Pennsylvania courts approved for Mutual Fire, Marine & Inland Insurance Company is instructive on this front. As here, that case involved an insurer that had branched out from its traditional business and thereby stretched its claims-paying resources too thin. *See Grode v. Mut. Fire, Marine, & Inland Ins. Co.*, 572 A.2d 798, 800-01 (Pa. Commw. Ct. 1990), *aff'd in all relevant respects*, 614 A.2d 1086 (Pa. 1992). After noting that "the Insurance Commissioner, as Rehabilitator, is given broader discretion to structure a rehabilitation plan than is given to her as statutory liquidator" and acknowledging the "well-settled principle that judicial discretion may not be substituted for administrative discretion," *id.* at 804, the court approved an insurance rehabilitation plan calling for delayed payments of the rehabilitated company's obligations, *id.* at 805. Later on in the proceeding, the court explained the plan and its rationale in approving it:

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[8] The final form of the plan for rehabilitation is not yet before the Court, and the issue of claims payment mechanisms need not be addressed until such time as the Commissioner seeks finalizes and seeks approval of the plan. The Commissioner raises the issue in this brief as further support for his belief that "the insurer may be successfully rehabilitated without substantial increase in the risk of loss to creditors of the insurer or to the public." Wis. Stat. § 645.31(1).

> Under the proportional payment method, the statutory rehabilitator was to determine, in her expertise and discretion, and on Court review, the percentage to be paid on each adjusted claim, given Mutual Fire's cash available. The percentage would increase cumulatively each year by the record date. For example, if sufficient cash was available, claimants would receive fifteen percent payment of their claims. If collections were such that, at the next record date, a thirty percent payment could be made, claimants whose claims were newly adjusted received thirty percent payment, while those receiving fifteen percent on the previous record date received an additional fifteen percent payment to equalize payment on claims, and the process was to continue, if possible, until one hundred percent payment on all adjusted claims was effected. This methodology obviated the need to wait until every last estate asset was collected in order to ensure equitable distribution of those assets. *It meant immediate, albeit partial, payment on policyholder claims.*

Grode v. Mut. Fire, Marine, & Inland Ins. Co., 688 A.2d 233, 234-35 (Pa. Commw. 1997) (emphasis added).

Like the plan in *Grode*, the Commissioner's plan obviates the need to make full cash payments to Segregated Account claimants until it is clear the General Account will have the long-term resources to fully satisfy such liabilities. This approach is reasonable, necessary, and avoids the inequitable consequences of a fire sale of assets to satisfy near-term claims in cash at the expense of long-term policyholders.

C. Administrative Authority to Protect Policyholders and Rehabilitate Ambac

The proposed Order for Rehabilitation grant the Commissioner (as Rehabilitator) the usual and customary powers in administering the Segregated Account while it is undergoing rehabilitation. These powers are necessary in all rehabilitation proceedings, but are particularly crucial here given the size and scope of the operations, the number and variety of liabilities and risks of collateral damage, the mutually dependent contractual relationship between the Segregated Account and the General Account, and the complexity of and diversity of the financial instruments at issue.

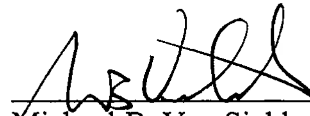
Collectively, the administrative provisions of the proposed order grant the Rehabilitator the authority to take such action as is "necessary or expedient to reform and revitalize" the Segregated Account, Wis. Stat. § 645.33(2), while at the same time causing minimal interruption in policyholder coverage, Wis. Stat. § 645.01(4). The Rehabilitator will continue to evaluate and process policy claims as they arise, will defend or continue to defend legal claims against the Segregated Account or pursue stays of those proceedings to protect the assets of the General Account and ensure efficient and equitable administration, will seek settlements of claims when appropriate, and will authorize payment of necessary expenditures. The Order establishes that the Rehabilitator will control the assets of the Segregated Account to protect them from waste and distribute them equitably to policy claimants, and to make payments of expenses related to the rehabilitation. To improve efficiency and make a smooth transition into rehabilitation, the Order further gives the Rehabilitator the discretion to coordinate with Ambac officers and employees and delegate certain authority to them. All of these provisions are necessary to ease the transition of the Segregated Account into rehabilitation and facilitate its operation by the Rehabilitator.

CONCLUSION

For the foregoing reasons, the Commissioner respectfully requests that this Court grant the Petition for Rehabilitation of the Segregated Account and enter the proposed Order submitted with it. As emphasized in the Petition and proposed Order, this proceeding pertains solely to the Segregated Account. The Commissioner is <u>not</u> asking this Court to place the Ambac General Account into rehabilitation as part of this proceeding.

Dated this 24th day of March, 2010.

FOLEY & LARDNER LLP

By: 

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APPENDIX

AMBAC CORPORATE STRUCTURE GLOSSARY

As shown in the organizational chart in the attached to the Verified Petition, the corporate structure of Ambac Financial Group, Inc. includes more than 25 related entities. This Corporate Structure Glossary offers a brief description of those that are most relevant to the rehabilitation of the segregated account of Ambac Assurance Corporation (the "Segregated Account").

Ambac Financial Group, Inc. ("AFGI"): . AFGI is a publicly traded holding company incorporated in Delaware with principal offices in New York City. Its main operating subsidiary is Ambac Assurance Corporation.

Ambac Assurance Corporation ("Ambac"): Ambac is a Wisconsin-domiciled, stock insurer. Its principal offices are located in New York City.

Ambac Credit Products, LLC ("ACP"): ACP is a wholly owned subsidiary of Ambac whose ownership interests were allocated to the Segregated Account. ACP's primary business was engaging in credit default swap transactions. All of ACP's obligations under these transactions were guaranteed by Ambac, and those guarantee policies have been allocated to the Segregated Account.

Ambac Conduit Funding, Inc. ("ACF"): ACF is a wholly owned subsidiary of Ambac whose ownership interests were allocated to the Segregated Account. ACF holds a 99% ownership interest in Aleutian Investments LLC and Juneau Investments LLC, described below.

Aleutian Investments LLC ("Aleutian") and Juneau Investments LLC ("Juneau"): Aleutian and Juneau are jointly owned subsidiaries of Ambac and ACF whose ownership interests were allocated to the Segregated Account. They are finance companies that issued medium term notes to fund purchases of debt securities. Ambac insures the payment of principal and interest on the notes, as well as payments under most of the debt securities Juneau and Aleutian purchased.

FINANCIAL INSTRUMENTS GLOSSARY

Asset-Backed Securities ("ABS"): A type of security that bundles loans, credit-cards, leases, or other receivables and then draws on their cash flows to make payments to investors. An asset-backed security is similar to a mortgage-backed security except that the assets providing cash flow are loans or receivables not related to real estate. Marc Butler, *The ABCs of the Financial Crisis: A Dictionary of Terms* 6 (Thompson Reuters/West 2008).

Basis Point: A unit of measurement equal to one-hundredth of a percentage point, used to measure very small differences in yields or interest rates. Butler, *supra*, at 6.

Credit Default Swaps ("CDS"): A contract, similar to an insurance policy, under which a "protection buyer" makes a series of payments, like insurance premiums, to a "protection seller" and, in exchange receives a payoff if a credit instrument—such as a bond or loan—goes into default. It is not necessary for the protection buyer to own the underlying credit instrument. Butler, *supra*, at 10. Ambac acted as the protection seller in all CDS transactions in which it participated.

Collateralized Debt Obligation ("CDO"): A financial instrument that pools loans, bonds, asset-backed securities, or mortgage-backed securities into a single portfolio. Butler, *supra*, at 7. Typically, a promoter creates a company to buy and hold collateral, issues company debt to CDO investors, then uses the proceeds of that debt to buy financial assets that will serve as collateral and provide cash flow to service company debt. Debt is sold in at least three different levels of seniority, with payments to junior debt-holders cut off if cash flow falls short or certain covenants are breached. Thus, CDO investors hold the debt of a company whose only major assets are complex (and now deeply troubled) financial instruments. Ambac sold protection to senior CDO investors using credit default swaps, and in exchange Ambac receives a small fraction (in most cases 8-10 basis points) of the annual interest due to the investors on the debt they hold.

Commercial and Consumer Asset-Back Securities ("CABS"): A hybrid of collateralized loan obligations and residential mortgage-backed securities (both defined *infra*) with different types of bundled commercial and consumer assets.

Collateralized Loan Obligation ("CLO"): A type of CDO that pools the receivables from bank loans made to corporations.

Currency Swap: An agreement to exchange a stream of payments in one currency for a stream of payments in another currency.

Financial Guaranty Insurance Policy: An insurance policy covering a creditor for liability resulting from the failure of a debtor to pay its debt.

Guaranteed Investment Contract ("GIC"): An product offered by insurance companies to provide a fixed rate of return on principal, similar to a certificate of deposit with a bank. *See*

Financial Industry Regulatory Authority, "Glossary of 401(k) Terms," *available at* http://apps.finra.org/Investor_information/Smart/401k/401KGlossary.asp#g (last accessed March 21, 2010).

Interest Rate Swap: An agreement to exchange a stream of fixed rate interest payments for a stream of variable rate interest payments.

ISDA Master Agreement: A form agreement published by the International Securities and Derivatives Association that is intended to be used by two parties to govern multiple swap or derivative transactions to be entered into by the parties over an extended period of time. This form is used for credit default swaps, currency swaps, and interest rate swaps.

ISDA Master Agreement - Schedule: A sort of "menu" used by parties to an ISDA Master Agreement to alter the form agreement to better suit the parties' or the transaction's specific needs.

ISDA Master Agreement – Confirmation: A document that records the business terms of a specific swap or derivative transaction entered into by two parties to an existing ISDA Master Agreement.

Mortgage-Backed Security ("MBS"): A type of security that bundles mortgage loans, either commercial or residential, and then draws on their cash flows to make payments to investors. Butler, *supra*, at 16.

Residential Mortgage-Backed Security ("RMBS"): A type of mortgage-backed security that bundles only residential mortgage loans, that is, loans secured by single-family residences.

Swap Transaction ("Swap"): In its classical form, an agreement between two parties to exchange cash streams derived from other investments. For example, a currency swap might involve the exchange of principal and interest in one currency for principal and interest in another currency. Butler, *supra*, at 20.

RATINGS GLOSSARY

Ambac is rated by two major rating agencies—Standard & Poor's and Moody's Investors Service, as described below ("S& P" and "Moody's"). These ratings determine the desirability of the insurance policies that Ambac issues. This is because under various regulations, accounting rules, and negotiated agreements, holders of Ambac-insured financial instruments can recognize those instruments as being rated at the higher of Ambac's or the instrument's rating. For decades, Ambac-insured financial instruments took on Ambac's "triple-A"—the highest possible rating. However, because Ambac's rating has fallen precipitously in the last eighteen months, in almost every case Ambac insurance no longer increases the ratings of the instruments it insures. Currently, Ambac is rated Caa2 by Moody's and CC by S& P.

S&P and Moody's each have a distinct rating system, but the systems are in many ways analogous to one another. Both have a least eight major rating categories beginning with "triple-A,"[1] at the top, which is given to only the most financially secure companies. In addition, each agency's divides its major rating categories into three subcategories. For example, a company rated "double-A" by Moody's might have a rating of Aa1, Aa2, or Aa3.

Below are explanations of each of the major rating categories for Moody's and S&P, and an explanation of each rating system's subcategory modifiers.

Moody's Investors Service: Moody's offers credit ratings for a number of different financial services, including insurance. Its Insurance Financial Strength Ratings scale is as follows:

Aaa	Insurance companies rated Aaa offer exceptional financial security. While the credit profile of these companies is likely to change, such changes as can be visualized are most unlikely to impair their fundamentally strong position.
Aa	Insurance companies rated Aa offer excellent financial security. Together with the Aaa group, they constitute what are generally known as high-grade companies. They are rated lower than Aaa companies because long-term risks appear somewhat larger.
A	Insurance companies rated A offer good financial security. However, elements may be present which suggest a susceptibility to impairment sometime in the future.
Baa	Insurance companies rated Baa offer adequate financial security. However, certain protective elements may be lacking or may be characteristically unreliable over any great length of time.

[1] While Moody's styles its "triple-A" rating "Aaa," Standard & Poor's "triple-A" appears as "AAA."

Ba	Insurance companies rated Ba offer questionable financial security. Often the ability of these companies to meet policyholder obligations may be very moderate and thereby not well safeguarded in the future.
B	Insurance companies rated B offer poor financial security. Assurance of punctual payment of policyholder obligations over any longer period of time is small.
Caa	Insurance companies rated Caa offer very poor financial security. They may be in default on their policyholder obligations or there may be present elements of danger with respect to punctual payment of policyholder obligations and claims.
Ca	Insurance companies rated Ca offer extremely poor financial security. Such companies are often in default on their policyholder obligations or have other marked shortcomings.
C	Obligations rated C are the lowest rated class of insurance company and can be regarding as having extremely poor prospects of every offering financial security.

Within each category from Aa through Caa, Moody's provides numerical modifiers 1, 2, or 3 to the ranking, with 1 being the highest (i.e., the closest to the next-best ranking) and 3 being the lowest.

Source: Moodys.com.

Standard & Poor's: S&P is the second primary ratings agency and has been rating the financial strength of insurance companies since 1971. Its Insurer Financial Strength ratings are as follows:

AAA	An insurer rated 'AAA' has extremely strong financial security characteristics. 'AAA' is the highest insurer financial strength rating assigned by Standard & Poor's.
AA	An insurer rated 'AA' has very strong financial security characteristics, differing only slightly from those rated higher.
A	An insurer rated 'A' has strong financial security characteristics, but is somewhat more likely to be affected by adverse business conditions than are insurers with higher ratings.
BBB	An insurer rated 'BBB' has good financial security characteristics, but is more likely to be affected by adverse business conditions than are higher-rated insurers.

BB	An insurer rated 'BB' or lower is regarded as having vulnerable characteristics that may outweigh its strengths. 'BB' indicates the least degree of vulnerability within the range; 'CC' the highest.
B	An insurer rated 'B' has weak financial security characteristics. Adverse business conditions will likely impair its ability to meet financial commitments.
CCC	An insurer rated 'CCC' has very weak financial security characteristics, and is dependent on favorable business conditions to meet financial commitments.
CC	An insurer rated 'CC' has extremely weak financial security characteristics and is likely not to meet some of its financial commitments.

Ratings within each category from 'AA' to 'CCC' may be modified by the inclusion of a plus or minus sign to show the insurer's relative standing within that category.

Source: Standardandpoors.com

1. "Loan Losses Pit Insurers Vs. Lenders," Carrick Mollenkamp and Serena Ang, WALL STREET JOURNAL, Jan. 13, 2010.

2. "Most Bond Insurers Not Viable Long Term – Credit Sights," Dena Aubin, REUTERS, July 14, 2009.

3. "Ambac Capital Position Improved, But Pressure on Capital and Liquidity Remains," Helen Remeza, Issuer Comment, MOODY'S, November 2009.

4. "S&P Cuts Ambac to CC from BBB," Dan Seymour, THE BOND BUYER, July 28, 2009.

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THE WALL STREET JOURNAL.
WSJ.com

BUSINESS | JANUARY 13, 2010

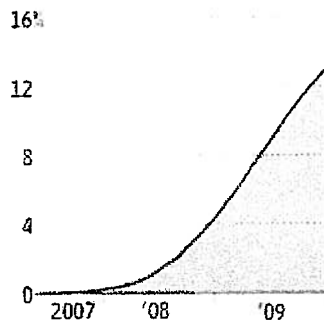
Loan Losses Pit Insurers Vs. Lenders

By CARRICK MOLLENKAMP And SERENA NG

In the slugfest between the banks that created now-busted mortgages and mortgage bonds and the insurance companies that guaranteed them, insurers increasingly believe they can avoid losing billions.

Bond and mortgage insurers, among the hardest hit players in the housing crisis, have hired financial sleuths to comb through thousands of mortgage files. They say lenders and Wall Street firms stuck them with flawed loans marred by poor underwriting and faulty appraisals.

Moody's Investors Service estimates the insurers collectively could save over $10 billion if they succeed in rescinding or recovering claims. Savings would be welcome news for these firms, some of which are facing financial difficulties after making large payouts amid the financial crisis.



Any gain for the insurers would cost the lenders and investment banks. These firms say insurers knew or should have known the risks of the loans and bonds they insured.

The outcome of the showdown is far from certain and may depend on potentially contentious negotiations and litigation that could drag out for years.

Over the past 18 months, bond insurers have sued banks and mortgage lenders in more than a dozen lawsuits. On Tuesday, Ambac Assurance Corp., the bond-insurance unit of Ambac Financial Group Inc., sued a unit of Credit Suisse Group in New York state court.

Ambac alleges the securities firm made "false and misleading" representations about the attributes of home equity lines of credit backing bonds the insurer guaranteed in 2007.

A Credit Suisse spokesman said the firm believes the suit is "without merit, and we intend to defend ourselves vigorously."

During the housing boom, lenders, investment banks and insurers worked together to fuel home sales. Bond insurers agreed to pay investors if bonds backed by home loans defaulted. Mortgage insurers provided coverage in case borrowers defaulted on monthly mortgage bills.

Proving allegations of shoddy loan originations is tedious work. MBIA Inc. said in a third-quarter earnings report that it had hired "loan level forensic review consultants" to review some 26,805 mortgage loans.

That review, MBIA said, led the firm to determine that thousands of loans shouldn't have been put in loan pools backing bonds that MBIA agreed to guarantee.

MBIA has said it believes it can recover $1.2 billion from securities and loans it has reviewed. That allows the company to set aside fewer reserves to cover losses.

$4 Billion in Offsets

Moody's, in a December report, said that bond insurers had as of the end of September amassed $4 billion in offsets to loss reserves. Effectively, that $4 billion represents the current value of the amount that these insurers ultimately expect to recover over time.

Several bond insurers continue to struggle. MBIA Insurance Corp. and other troubled rivals effectively have been unable to sell new bond guarantees for over a year after their ratings were sharply downgraded, and they are facing mounting losses from other mortgage-linked securities.

Meanwhile, mortgage insurance firms are refusing to cover up to as much as 25% of the loans they agreed to cover against loss, Moody's said. That compares with a historical rate of about 7%. Moody's said it estimates that four of the biggest mortgage insurers have avoided paying loss claims totaling $6 billion since January 2008 and that that amount could increase by as much as $4 billion.

The growing pile of litigation—still in an early stage—provides a window into the mortgage-loan industry.

In December, MBIA, based in New York, sued Credit Suisse in New York state court over a $900 million loan pool, a large portion of which MBIA agreed to cover. MBIA said it had relied on Credit Suisse to vet the quality of the loans. As losses increased, MBIA sought access to loan-origination files, the lawsuit claims. MBIA alleges in the complaint that Credit Suisse for months "stonewalled" MBIA's attempts to obtain the files.

When MBIA got the information, it said in the lawsuit, it reviewed 1,798 loans and founded some 85% breached contractual agreements about the quality of the loans. MBIA so far has had to pay out $296 million in claims on the securities. By October 2009, about half of the 15,615 loans in the pool had defaulted, MBIA said in its complaint.

A Credit Suisse spokesman said the lawsuit lacked merit and the bank would fight it.

Countrywide and MGIC

In December, a unit of California lender Countrywide Financial Corp., now owned by Bank of America Corp., sued mortgage insurer Mortgage Guaranty Insurance Corp., or MGIC, in San Francisco county court.

Mortgage-insurance policies insured for lenders like Countrywide that, in the event of borrower default, firms such as MGIC would cover principal and interest payments.

"MGIC now, however, faces the reality of steep financial losses because of a significant economic downturn," the Countrywide complaint alleges. "MGIC has adopted unreasonable interpretations of its mortgage insurance policy language to justify its failure to pay claims."

Spokeswomen for Bank of America and MGIC declined comment.

Countrywide said in its lawsuit that a sizable number of the problem loans were so-called stated-income loans. Those loans enabled borrowers to obtain loans without having to provide income records. They are seen as a big contributor to the mass of defaults in the housing market.

Countrywide claims that MGIC knew that borrower income wouldn't be verified and that "these loans involved increased risk."

Countrywide says that even though MGIC knew the loans had stated income and that MGIC didn't ask for borrower information, MGIC has denied or rescinded loss coverage because MGIC claims the stated income was misrepresented.

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Most bond insurers not viable long term-CreditSights

Tue, Jul 14 2009

By Dena Aubin

NEW YORK, July 14 (Reuters) - Most bond insurers are headed for liquidation or run-off as losses from troubled assets linger, an analyst at independent research firm CreditSights said on Tuesday.

While some insurers, such as MBIA <MBI.N> and Ambac <ABK.N>, are stronger than others, "we think the traditional market leaders' franchises have been permanently impaired," insurance analyst Rob Haines said in a Webcast presentation.

In a run-off, an insurer stops writing new business, but continues to pay out on existing liabilities.

For anyone holding bond insurance, "basically what you have is a very expensive keepsake," especially for structured product holders, Haines said.

Barring a significant rebound in the subprime mortgage market, Ambac could easily become insolvent over time, Haines said.

A spokesman for Ambac could not be reached for comment.

MBIA Insurance Corp could run out of capital by 2012, he said, adding that there were significant caveats to that conclusion since it was based on average trends in the absence of deal-level information on the company's exposures.

"Exposure to troubled assets remains extremely high," with losses from collateralized debt obligations, residential and other types of structured products expected to remain elevated over the next five years, Haines said.

"We do believe that we have adequate capital to meet all of our obligations," MBIA spokesman Kevin Brown said. While losses on mortgage-linked debt have been higher than anyone expected, MBIA has the potential for recovering fairly large amounts from lawsuits it has launched, he added.

MBIA has taken legal action against mortgage lender Countrywide, now controlled by Bank of America <BAC.N>, and GMAC's mortgage unit Residential Capital, accusing the companies of making false representations on mortgage-linked debt that MBIA insured.

DEMAND SEEN FOR MUNI BOND INSURANCE

Brown also said he believes there will be demand for MBIA's new municipal-only bond insurer National Public Finance Guaranty Corp, a unit created to reposition the company to write new business.

Once the two dominant bond insurers, MBIA and Ambac lost market share after devastating forays into structured financial products triggered massive paper losses.

In the municipal area, a normalized market may not return for some time, Haines said. The amount of municipal debt with insurance has declined to about 18 percent after hovering around 50 percent for many years, with many forces behind the trend, including rating downgrades of traditional insurers, he said.

Still, a market continues to exist for insured munis, Haines said. Assured Guaranty <AGO.N> will dominate that market, but there is room for at least two competitors, he added. The possibility of a federal backstop for munis was an unlikely scenario at this time, he also said.

Municipal and Infrastructure Assurance Corp or MIAC, a New York-based insurer formed by Australia's Macquarie Group Ltd <MQG.AX> and Chicago hedge fund Citadel Investment Group, was one insurer that merits attention going forward, Haines said.

"We do think they will be able to capture market share, given they have a legacy-clean balance sheet," he said.

The company, which plans to concentrate on municipal securities and infrastructure projects, is awaiting ratings.

Another relative newcomer to muni insurance, Berkshire Hathaway Assurance Corp, "will not be a long-term competitor in this market," Haines said. The new insurer is a unit of Berkshire Hathaway Inc <BRKa.N>. (Additional reporting by Karen Pierog in Chicago; Editing by Jan Paschal)

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Ambac Capital Position Improved, But Pressure on Capital and Liquidity Remains

Extracted from "Moody's Weekly Credit Outlook", dated November 30, 2009.

Ambac Financial Group surprised the market recently by announcing a USD856 million statutory surplus for the end of the third quarter. Some market participants had expected it to report a capital shortfall relative to its regulatory minimum requirement. Despite the substantial improvement in its third quarter reported statutory capital, Ambac's credit profile is unchanged, and our Caa2 insurance financial strength rating highlights the continued risk of regulatory intervention and possible policyholder losses.

Third quarter earnings benefited from a number of factors. Adjusting for these factors leaves the company with a GAAP operating loss in the third quarter. During the quarter, Ambac reported USD2,188 million GAAP earnings and USD856 million in statutory earnings, but we consider the insurer's core earnings to be materially lower. Several items that boosted the earnings during the quarter included commutations of ABS CDOs for less than reserves, an increase in the estimated recoveries for loan put-backs, and for GAAP reporting the widening of Ambac's own credit spreads based on FAS 157.

Ambac commuted four ABS CDOs, terminating the contracts with its counterparties and removing about USD5 billion of notional risk from its insured book and reversing sizable estimated losses. Also improving the capital was a USD311 million reinsurance commutation. Nevertheless, the success of commutations depends on counterparty willingness.

What is Moody's Weekly Credit Outlook?

Moody's Weekly Credit Outlook provides our research clients with timely opinions on breaking credit market developments and trends. Published every Monday morning, the newsletter will help you start your week informed of Moody's latest opinions from across the organization.

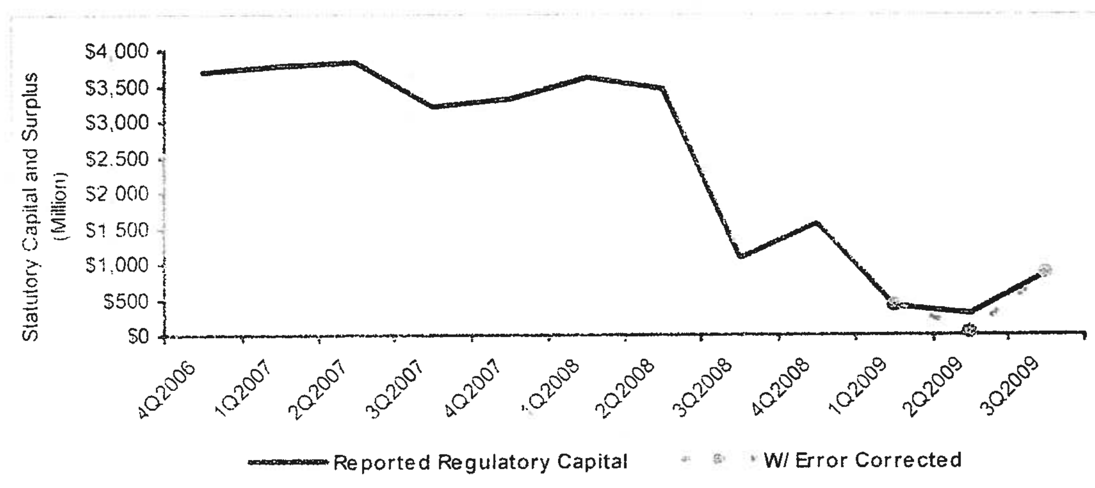
Moody's Investors Service

Ambac Capital Position Improved, But Pressure on Capital and Liquidity Remains

Ambac also increased the estimated remediation recoveries for loan put-backs in the third quarter to USD1.9 billion from USD1.2 billion in the previous quarter. For some RMBS deals it insured, Ambac recorded recoveries from putting back those loans (to lenders) deemed to have breached contractual representations and warranties. So far, the company has collected only about USD60 million, but expects the remainder to be realized within three years.

Ambac's greatest near-term challenge is maintaining statutory capital in excess of the minimum required level. According to its third quarter filings, Ambac understated USD278 million CDS impairment charges in the previous quarter. Statutory capital would have been USD27 million in that quarter, a very thin cushion over its regulatory minimum of USD2 million. Were the company to fall below the threshold, it could lead to regulatory intervention. This in turn could trigger CDS terminations at current market values, resulting in large realized losses.

Ambac's statutory capital has deteriorated significantly since the third quarter 2008, reaching a low of USD305 million in the second quarter of this year, as shown in the chart below.



Interestingly, regulatory accounting rules have helped to keep Ambac above the minimum capital level. In the second quarter, Ambac's regulator approved a reclassification of contingency reserves as capital, thus avoiding a capital shortfall. In addition, Ambac's statutory loss reserves only capture credits that are in default. As of the end of the third quarter, the non-CDO-related statutory loss reserves were about USD1.3 billion. This is only 50% of its GAAP loss reserve for RMBS, which stood at USD2.6 billion net of remediation recoveries. Over time, this gap should narrow. Its gross statutory loss reserves can go up as troubled credits default thereby adversely affecting statutory capital.

Although we see as positive Ambac's avoidance of breaching the regulatory minimum this quarter, we nevertheless believe that capitalization remains stressed due to mortgage-related exposures. The company's high operating leverage means that relatively modest changes in mortgage loss estimates can have substantial effects on capital adequacy. Accordingly, we believe that Ambac's insurance financial strength remains volatile. This will improve or deteriorate over the next year depending on how mortgage losses and related remediation efforts play out.

Ambac Capital Position Improved, But Pressure on Capital and Liquidity Remains

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THE BOND BUYER

THE DAILY NEWSPAPER OF PUBLIC FINANCE

S&P Cuts Ambac to CC From BBB

Tuesday, July 28, 2009

By Dan Seymour

Standard & Poor's Tuesday evening slashed Ambac Assurance Corp.'s financial-strength rating to junk, saying assumed losses on insured mortgage bonds could wipe out the company's equity.

Ambac's rating was cut to CC with a developing outlook from BBB, where it had been on negative credit watch.

Standard & Poor's also cut the counterparty rating on Ambac Financial Group Inc. to CC, with a negative outlook, from BB.

Ambac at the end of March reported policyholders' surplus – or assets in excess of liabilities – of $373 million.

Though $1.18 billion weaker than it was just three months earlier, this was still in compliance with regulatory requirements for policyholders' surplus.

Standard & Poor's wrote Tuesday that it is concerned that "significant deterioration" in Ambac's book of insured residential mortgage-backed bonds could push the policyholders' surplus below zero.

When insurers estimate losses on policies, they have to reserve money to pay claims. Those reserves sap money from assets, thus siphoning money from the policyholders' surplus.

Ambac on Monday said it expects $1.6 billion in impairments to collateralized debt obligations composed of asset-backed securities and increased loss reserves of $800 million.

The result, Standard & Poor's said, could be negative policyholders' surplus as of the quarter that ended June 30.

Ambac insures $413.3 billion of debt, including $231.9 billion in municipal bonds.

Standard & Poor's is concerned about losses in the $7 billion of subprime bonds insured by Ambac.

About a month ago, Standard & Poor's downgraded Ambac to BBB from A, saying the company was effectively in run-off – meaning not writing new business and staying alive only to collect premiums and pay claims on existing policies.

That downgrade came shortly after Ambac delayed indefinitely the launch of Everspan Financial Guaranty Corp., which it had planned to be a muni-only bond insurer. The company had trouble raising enough capital to split the municipal insurance book into the new subsidary.

Like most of the other bond insurers, loss assumptions on structured finance deals have wreaked havoc on Ambac's entire business, including the relatively stable public finance insurance business.

Ambac's stock, which slipped 12 cents Tuesday, sank an additional 3 cents in after-hours trading to 80 cents. The stock had peaked at $96.10 in May 2007.

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Insurer Ratings at a Glance

	Moody's Investors Service	Standard & Poor's	Fitch Ratings
Ambac Assurance Corp.	Ba3 outlook developing	CC developing watch	not rated
Assured Guaranty Corp.	Aa2 under review for downgrade	AAA stable outlook	AA watch evolving
CIFG Assurance North America Inc.	Ba3 outlook developing	CC negative outlook	not rated
Financial Guaranty Insurance Co.	not rated	not rated	not rated
Financial Security Assurance Inc.	Aa3 under review for downgrade	AAA negative outlook	AA-plus negative watch
MBIA Insurance Corp.	B3 negative outlook	BBB negative outlook	not rated
National Public Finance Guarantee Corp. (formerly MBIA Insurance Corp. of Illinois)	Baa1 outlook developing	A outlook developing	not rated
Radian Asset Assurance Inc.	Ba1 stable outlook	BBB-minus negative watch	not rated
Syncora Guarantee Inc. (formerly XL Capital Assurance Inc.)	Ca outlook developing	R	not rated
ACA Financial Guaranty Corp.	not rated	not rated	not rated
Berkshire Hathaway Assurance Corp.	Aa1 stable outlook	AAA negative outlook	not rated

As of July 28, 2009