



AMBAC ASSURANCE CORPORATION
(A Wholly Owned Subsidiary of Ambac Financial Group, Inc.)

Statutory Financial Statements and Schedules

December 31, 2009 and 2008

(With Independent Auditors' Report Thereon)



KPMG LLP
345 Park Avenue
New York, NY 10154-0102

Independent Auditors' Report

The Board of Directors
Ambac Assurance Corporation:

We have audited the accompanying statutory statements of admitted assets, liabilities, and capital and surplus of Ambac Assurance Corporation (wholly owned subsidiary of Ambac Financial Group, Inc.) (the "Company") as of December 31, 2009 and 2008, and the related statutory statements of operations, changes in capital and surplus, and cash flow for the years then ended. These statutory financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these statutory financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the statutory financial statements are free of material misstatement. An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As described more fully in Note 2, the Company prepared these statutory financial statements using accounting practices prescribed or permitted by the Office of the Commissioner of Insurance of the State of Wisconsin (the "OCI"), which practices differ from U.S. generally accepted accounting principles. The effects on the statutory financial statements of the variances between the statutory basis of accounting and U.S. generally accepted accounting principles also are described in Note 14.

In our opinion, except for the effects of the matter discussed in the preceding paragraph, the statutory financial statements referred to above present fairly, in all material respects, the financial position of Ambac Assurance Corporation as of December 31, 2009 and 2008, and the results of its operations or its cash flow for the years then ended.

Also, in our opinion, the statutory financial statements referred to above present fairly, in all material respects, the admitted assets, liabilities, and capital and surplus of Ambac Assurance Corporation as of December 31, 2009 and 2008, and the results of its operations and its cash flow for the years then ended, on the basis of accounting described in Note 2.

The accompanying statutory financial statements have been prepared assuming that the Company will continue as a going concern. As discussed in Note 1 to the financial statements, significant deterioration of the guaranteed portfolio coupled with the inability to write new financial guarantees has adversely impacted the business, results of operations and financial condition of the Company. The Company is subject to significant regulatory oversight by the OCI, including the recent establishment and rehabilitation of a segregated account of the Company. Such factors raise substantial doubt about the Company's ability to continue as a going concern. Management's plans in regard to these matters are also describe in Note 1. The statutory financial statements do not include any adjustments that might result from the outcome of this uncertainty.



Our audits were made for the purpose of forming an opinion on the basic financial statements taken as a whole. The supplementary information included on the supplemental schedules of reinsurance interrogatories, investment risk interrogatories and summary of investments schedule is presented for purposes of additional analysis and is not a required part of the basic financial statements. Such information has been subjected to the auditing procedures applied in the audits of the basic financial statements and, in our opinion, is fairly stated in all material respects in relation to the basic financial statements taken as a whole.

KPMG LLP

May 28, 2010

AMBAC ASSURANCE CORPORATION
(A Wholly Owned Subsidiary of Ambac Financial Group, Inc.)
Statutory Statements of
Admitted Assets, Liabilities and Capital and Surplus
December 31, 2009 and 2008
(Dollar amounts in thousands)

Admitted Assets	2009	2008
Cash and invested assets:		
Bonds	\$ 6,104,258	\$ 7,792,665
Common stocks	341,318	238,540
Short-term investments	619,101	1,163,645
Cash and cash equivalents	6,255	15,186
Inter-company loans with affiliates	835,918	1,173,000
Other Invested Assets	8,931	—
Receivable for securities	2,251	13,575
Total cash and invested assets	7,918,032	10,396,611
Investment income due and accrued	58,539	71,157
Premium receivable balances	30,382	27,641
Current income taxes	425,821	217,395
Receivable from parent, subsidiaries and affiliates	6,734	19,009
Reinsurance recoverables	2,684	22,746
Other assets	95	26,497
Total admitted assets	\$ 8,442,287	\$ 10,781,056
Liabilities and Capital and Surplus		
Liabilities:		
Unearned premiums	\$ 2,364,519	\$ 2,699,491
Mandatory contingency reserve	336,056	1,914,597
Estimated impairment losses on subsidiary guarantees & commitments	3,841,324	3,352,129
Taxes, licenses and fees (excluding federal and foreign income taxes)	2,045	—
Loss and loss expenses	1,136,984	1,160,303
Accounts payable and other liabilities	36,318	73,629
Ceded reinsurance premiums payable	1,462	15,302
Provision for reinsurance	4,364	—
Payable to parent, subsidiaries and affiliates	6,500	1,709
Payable for securities	2,070	9,447
Total liabilities	7,731,642	9,226,607
Capital and surplus:		
Common stock	82,000	82,000
Preferred stock	26,411	28,000
Additional paid-in capital	3,526,088	3,424,427
Unassigned surplus	(2,923,854)	(1,979,978)
Total capital and surplus	710,645	1,554,449
Total liabilities and capital and surplus	\$ 8,442,287	\$ 10,781,056

See accompanying notes to Statutory Financial Statements.

AMBAC ASSURANCE CORPORATION
(A Wholly Owned Subsidiary of Ambac Financial Group, Inc.)

Statutory Statements of Operations

Years Ended December 31, 2009 and 2008

(Dollar amounts in thousands)

	<u>2009</u>	<u>2008</u>
Revenues:		
Net premiums earned	\$ 796,372	\$ 1,078,222
Net investment income	467,509	460,961
Net realized losses (net of tax of \$0 and \$0)	(3,126,610)	(4,373,079)
Gains on reinsurance commutations	348,390	—
Other income	31,894	4,669
Total revenues	<u>(1,482,445)</u>	<u>(2,829,227)</u>
Expenses:		
Loss and loss expenses incurred	1,508,698	1,623,422
Other underwriting expenses incurred	113,274	144,288
Provision for uncollectible loan with affiliates	(41,600)	300,000
Total expenses	<u>1,580,372</u>	<u>2,067,710</u>
Loss before income taxes	(3,062,817)	(4,896,937)
Income taxes	<u>(483,521)</u>	<u>(862,271)</u>
Net loss	<u>\$ (2,579,296)</u>	<u>\$ (4,034,666)</u>

See accompanying notes to Statutory Financial Statements.

AMBAC ASSURANCE CORPORATION
(A Wholly Owned Subsidiary of Ambac Financial Group, Inc.)
Statutory Statements of Changes in Capital and Surplus
Years ended December 31, 2009 and 2008
(Dollar amounts in thousands)

	Common stock	Preferred stock	Additional paid-in capital	Unassigned surplus	Total
Balance at December 31, 2007	\$ 82,000	\$ —	\$ 1,417,339	\$ 1,816,804	\$ 3,316,143
Net loss	—	—	—	(4,034,666)	(4,034,666)
Net unrealized capital gains	—	—	—	(269,428)	(269,428)
Net unrealized foreign exchange capital gain	—	—	—	(49,004)	(49,004)
Change in net deferred income tax	—	—	—	1,649,319	1,649,319
Change in nonadmitted assets	—	—	—	(1,668,158)	(1,668,158)
Tax cost on the exercise of stock options	—	—	—	(13,538)	(13,538)
Tax and loss bonds benefit reversal	—	—	—	(371,371)	(371,371)
Issuance of stock	—	28,000	672,000	—	700,000
Capital contribution	—	—	1,335,088	—	1,335,088
Dividends paid	—	—	—	(218,540)	(218,540)
Provision for mandatory contingency reserve	—	—	—	1,178,604	1,178,604
Balance at December 31, 2008	82,000	28,000	3,424,427	(1,979,978)	1,554,449
Net loss	—	—	—	(2,579,296)	(2,579,296)
Net unrealized capital gains	—	—	—	5,765	5,765
Net unrealized foreign exchange capital gain	—	—	—	23,736	23,736
Change in net deferred income tax	—	—	—	(2,065,386)	(2,065,386)
Change in nonadmitted assets	—	—	—	2,144,737	2,144,737
Change in provision for reinsurance	—	—	—	(4,364)	(4,364)
Retirement of shares	—	(4,686)	—	—	(4,686)
Issuance of stock	—	3,097	101,661	—	104,758
Dividends paid	—	—	—	(12,509)	(12,509)
Provision for mandatory contingency reserve	—	—	—	1,578,541	1,578,541
Other	—	—	—	(35,100)	(35,100)
Balance at December 31, 2009	\$ 82,000	\$ 26,411	\$ 3,526,088	\$ (2,923,854)	\$ 710,645

See accompanying notes to Statutory Financial Statements.

AMBAC ASSURANCE CORPORATION

(A Wholly Owned Subsidiary of Ambac Financial Group, Inc.)

Statutory Statements of Cash Flow

Years ended December 31, 2009 and 2008

(Dollars in thousands)

	2009	2008
Cash from operations:		
Premiums collected, net of reinsurance	\$ 443,070	\$ 493,807
Net investment income	295,112	533,586
Losses paid	(1,377,023)	(589,186)
Payments on subsidiary guarantees and commitments	(1,379,928)	(1,850,000)
Underwriting expenses paid	63,689	136,747
Federal taxes paid	275,096	146,453
Other	31,894	4,669
Net cash used for operations	<u>(1,648,090)</u>	<u>(1,123,924)</u>
Cash from investments:		
Proceeds from investments sold, matured or repaid:		
Bonds	2,396,097	7,609,931
Intercompany Loans with affiliates	378,682	—
Stocks	487	3,433
Other invested assets (affiliates)	156,701	835
Other	2,892	(1,985)
Total investment proceeds	<u>2,934,859</u>	<u>7,612,214</u>
Cost of investments acquired:		
Bonds	1,801,973	5,357,006
Intercompany Loans with affiliates	—	1,473,000
Stocks	487	1,805
Other invested assets and loans (affiliates)	165,975	216,549
Total investments acquired	<u>1,968,435</u>	<u>7,048,360</u>
Net cash from investments	<u>966,424</u>	<u>563,854</u>
Cash from financing and miscellaneous sources:		
Capital contributions	—	1,333,554
Issuance of preferred stock	90,404	700,000
Net transfers to affiliates	17,066	(16,721)
Net amount withheld or retained for account of others	(5,598)	(1,366)
Other cash provided	24,666	(27,291)
Dividends paid	(12,509)	(218,540)
Other applications	14,162	(299,824)
Net cash used from financing and miscellaneous sources	<u>128,191</u>	<u>1,469,812</u>
Net change in cash and short-term investments	<u>(553,475)</u>	<u>909,742</u>
Cash and short-term investments, beginning of year	1,178,831	269,089
Cash and short-term investments, end of year	<u>\$ 625,356</u>	<u>\$ 1,178,831</u>

See accompanying notes to Statutory Financial Statements.

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Notes to Statutory Financial Statements

December 31, 2009 and 2008

(Dollar amounts in thousands, except share and per share data)

(1) Background

Ambac Assurance Corporation (the "Company" or "Ambac Assurance") has historically provided financial guarantee insurance for public and structured finance obligations. The financial results for 2009 and 2008 were impacted by exposure to residential mortgages and other financial market disruption-related losses. Ambac has experienced significant losses within its financial guarantee business (both insurance policies and credit derivatives transactions) which, beginning 2008, led to rating downgrades of Ambac Assurance by the independent rating agencies. These rating downgrades have contributed to Ambac Assurance's inability to generate meaningful amounts of new financial guarantee business beginning in late 2007. The investment portfolio has suffered other-than-temporary impairment losses, especially among residential mortgage backed securities, due to both credit impairments and management's intent to sell securities which have fair values below their original cost basis. Ambac Assurance's financial strength ratings were downgraded beginning in 2008, and as a result, Ambac Assurance currently has a Caa2, under review for upgrade, financial strength rating from Moody's Investors Services, Inc. ("Moody's") and is rated R (Regulatory Intervention) from Standard & Poor's Ratings Service, a division of the McGraw-Hill Companies, Inc. ("S&P").

Insurance policies insured by Ambac Assurance guarantee payment when due of the principal and interest on the obligation guaranteed. Ambac Assurance is a wholly owned subsidiary of Ambac Financial Group, Inc. ("Ambac"), a holding company whose subsidiaries provided financial guarantees and financial services to clients in both the public and private sectors around the world.

The Company owns 100% of the common stock of Ambac Assurance UK Limited ("Ambac UK"), an insurance company licensed in the United Kingdom; Connie Lee Holdings, Inc. ("CLHI"), a financial guarantee holding company; Ambac Japan Co. Ltd., a Japan service company; and Ambac Capital Corporation ("ACC"), a provider of investment agreements, primarily to issuers of asset-backed, structured finance and municipal issuers.

The Company is the sole member of the following limited liability corporations: Ambac Credit Products, LLC ("ACP"), an entity that provided credit protection in the global markets in the form of structured credit derivatives; Ambac Private Holdings, LLC ("APH"), an investment holding company; Ambac Capital Services, LLC ("ACS"), an entity that provided total return swaps; Ambac Financial Services, LLC ("AFS"), an entity that provided interest rate and currency swaps; SP Aircraft Holdings, LLC ("SPAH"), a dormant aircraft holding company; and Ambac Conduit Funding LLC ("ACFL"). At December 31, 2009, the Company had 1% interest in Juneau Investments, LLC ("Juneau"), and Aleutian Investments, LLC ("Aleutian"), respectively. Juneau and Aleutian are special purpose entities that provided the Company's financial guarantee clients with funding for their debt obligations. Effective March 17, 2010, Ambac Assurance became the sole member of ACFL, an entity which owns the remaining 99% of the membership interests in Juneau and Aleutian. See Recent Developments below for the allocation of certain LLC interests to the Segregated Account of Ambac Assurance.

Ambac Assurance's principal business strategy going forward is to increase the residual value of our financial guarantee business by mitigating losses on poorly performing transactions and increasing the yield on our investment portfolio. The execution of such strategy with respect to Segregated Account Policies will be subject to the authority of the rehabilitator of the Segregated Account to control the management of the Segregated Account (see "Recent Developments" section below). Prior to June 2009, Ambac Assurance had intended to

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reactivate Everspan Financial Guarantee Corp. (doing business as Connie Lee Insurance Company in Virginia) ("Everspan") for purposes of writing financial guarantee insurance in the U.S. public finance market; however, Ambac Assurance's financial condition and market conditions hampered the Company's efforts to raise third party capital. Since Ambac Assurance has been unable to raise capital for Everspan, it has postponed indefinitely its efforts to reactivate Everspan for this purpose. Moreover, Ambac Assurance's ability to reactivate Everspan would be subject to the restrictions imposed by the proposed settlement agreement, if executed, as described below in "Recent Developments."

Given the constraints imposed upon Ambac Assurance by the covenants made for the benefit of the Segregated Account and, if the Settlement Agreement is executed, the Counterparties (as described below in "Recent Developments"), and the authority of the rehabilitator of the Segregated Account to control the management of the Segregated Account (see "Recent Developments" section below), there can be no assurance that Ambac Assurance will be successful in realizing any of the foregoing strategies. As a result of uncertainties associated with the aforementioned factors, management has concluded that there is substantial doubt about the ability of the Company to continue as a going concern. The Company's financial statements as of December 31, 2009 and 2008 and for the years ended December 31, 2009 and 2008 are prepared assuming the Company continues as a going concern and do not include any adjustment that might result from its inability to continue as a going concern.

Recent Developments

Segregated Account

On March 24, 2010, Ambac Assurance established a Segregated Account pursuant to Wisc. Stat. §611.24(2) (the "Segregated Account"). Under Wisconsin insurance law, the Segregated Account is a separate insurer from Ambac Assurance for purposes of the Segregated Account Rehabilitation Proceedings (as defined below). The purpose of the Segregated Account is to segregate certain segments of Ambac Assurance's liabilities, and in connection with such segregation Ambac Assurance has allocated to the Segregated Account (i) certain policies insuring or relating to credit default swaps, (ii) all residential mortgage-backed securities ("RMBS") policies, (iii) certain other identified policies, including those relating to Las Vegas Monorail Company, and (iv) certain Student Loan Policies (as defined below) (collectively, the "Segregated Account Policies"). The Segregated Account Rehabilitation Plan will, if approved, provide that Ambac Assurance may, with the approval of the OCI, cause additional Student Loan Policies to be transferred to the Segregated Account. Ambac Assurance also allocated the following to the Segregated Account: (i) all remediation claims, defenses, offsets, and/or credits (but excluding recoveries arising from remediation efforts or reimbursement or collection rights with respect to policies allocated to the Segregated Account), if any, in respect of the Segregated Account Policies, (ii) Ambac Assurance's disputed contingent liability, if any, under the long-term lease with One State Street, LLC, and its contingent liability (as guarantor), if any, under the Ambac Assurance UK Limited ("Ambac UK") lease with British Land, (iii) Ambac Assurance's limited liability interests in Ambac Credit Products, LLC ("ACP"), Ambac Conduit Funding LLC, Aleutian Investments LLC and Juneau Investments LLC and (iv) all of Ambac Assurance's liabilities as reinsurer under reinsurance agreements (except for reinsurance assumed from Everspan). Net par exposure allocated to the Segregated Account is \$64,012,000 as of March 31, 2010, which is inclusive of net par exposures assumed under reinsurance contracts, primarily from Ambac UK, in an aggregate amount of \$22,770,000.

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On March 24, 2010, the Office of the Commissioner of Insurance of the state of Wisconsin ("OCI") commenced rehabilitation proceedings with respect to the Segregated Account (the "Segregated Account Rehabilitation Proceedings") in order to permit the OCI to facilitate an orderly run-off and/or settlement of the liabilities allocated to the Segregated Account pursuant to the provisions of the Wisconsin Insurers Rehabilitation and Liquidation Act. On March 24, 2010, the rehabilitation court also issued an injunction effective until further order of the court enjoining certain actions by Segregated Account policyholders and other counterparties, including the assertion of damages or acceleration of losses based on early termination and the loss of control rights in insured transactions. Pursuant to the Verified Petition filed in Wisconsin in connection with such proceedings, the OCI has stated that it will seek the approval of the rehabilitation court for a plan of rehabilitation with respect to the Segregated Account (the "Segregated Account Rehabilitation Plan"). The Verified Petition states that the Segregated Account Rehabilitation Plan will, if approved, provide, among other things, that the holders of Segregated Account Policies shall receive in respect of claims made a combination of (i) cash and (ii) surplus notes. The Surplus Notes shall have a maturity date of ten years from their issue date. Interest on the Surplus Notes shall be payable annually at the annual rate of 5.1%. All payments of principal and interest on the Surplus Notes shall be subject to the prior approval of OCI. If the OCI does not approve the payment of interest on the Surplus Notes, such interest will accrue and compound annually until paid or otherwise. Until the Segregated Account Rehabilitation Plan is approved, which OCI has indicated will be filed in six months, it is anticipated that no claims will be paid on Segregated Account Policies, except as approved by the rehabilitation court.

The Segregated Account has no cash or securities, but has the ability to demand payment from time to time to pay claims and other liabilities of up to \$2 billion under a secured note due 2050 issued by Ambac Assurance (the "Secured Note"). In addition, once the Secured Note has been exhausted, the Segregated Account has the ability to demand payment from time to time under an aggregate excess of loss reinsurance agreement provided by Ambac Assurance (the "Reinsurance Agreement") to pay claims and other liabilities. Ambac Assurance is not obligated to make payments on the Secured Note or under the Reinsurance Agreement if its surplus as regards policyholders is (or would be) less than \$100 million, or such higher amount as the OCI permits pursuant to a prescribed accounting practice (the "Minimum Surplus Amount"). As long as the surplus as regards 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. In addition, the Plan of Operation (as defined below) provides that Ambac Assurance's General Account may issue surplus notes directly to holders of Segregated Account Policies to satisfy the portion of claim liability not paid by the Segregated Account in cash or in Segregated Account Surplus Notes.

Pursuant to the terms of the Plan of Operation, defined below, assets and investments, if any, allocated to the Segregated Account will be available and used solely to satisfy costs, expenses, charges, and liabilities attributable to the business placed therein. Such assets and investments, if any, will not be charged with any costs, expenses, charges, or liabilities arising out of any other business of Ambac Assurance, except as otherwise provided in the Secured Note or the Reinsurance Agreement. Likewise, assets and investments in Ambac Assurance's General Account will not be charged with any costs, expenses, charges, or liabilities arising out of the direct business allocated to the Segregated Account, except as otherwise provided in the Secured Note or the Cooperation Agreement (as defined and described below).

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The Secured Note will be subject to mandatory prepayment on demand in an amount equal to (i) the cash portion of claim liabilities, loss settlements, commutations and purchases of Segregated Account Policies (or related insured obligations) due and payable by the Segregated Account ("Segregated Account Policy Cash Payments"), amounts due and payable by the Segregated Account arising out of the non-policy obligations allocated thereto, and any cash interest payment and cash principal repayment under any Segregated Account Surplus Notes in connection with any of the foregoing, provided in each case such amounts due and payable are in accordance with the Segregated Account Rehabilitation Plan (as defined below) and not otherwise disapproved by the rehabilitator of the Segregated Account plus (ii) amounts due and payable by the Segregated Account in respect of specified administrative expenses of the Segregated Account plus (iii) other amounts directed to be paid by the rehabilitator of the Segregated Account in conjunction with the rehabilitation proceeding, minus (iv) the amount of the Segregated Account's liquid assets as determined by the Segregated Account. In addition, if an event of default occurs under the Secured Note, the Segregated Account is entitled to accelerate the outstanding principal amount due under the Secured Note.

Interest on the Secured Note accrues at the rate of 4.5% per annum, and accrued interest will be added to principal quarterly. Ambac Assurance has secured its obligations under the Secured Note and the Reinsurance Agreement by granting to the Segregated Account a security interest in all of Ambac Assurance's right, title and interest in installment premiums received in respect of the Segregated Account Policies; reinsurance premiums received in respect of assumed reinsurance agreements with respect to which the liabilities of Ambac Assurance have been allocated to the Segregated Account; recoveries under third party reinsurance agreements in respect of the Segregated Account Policies; and any recoveries arising from remediation efforts or reimbursement or collection rights with respect to policies allocated to the Segregated Account. Pursuant to the Secured Note, Ambac Assurance has made certain covenants to the Segregated Account, including covenants that Ambac Assurance will not, (i) without the Segregated Account's consent (not to be unreasonably withheld), amend its investment policies if doing so would have a material adverse effect on Ambac Assurance's ability to perform its obligations under the Secured Note, the Reinsurance Agreement and the documents relating thereto or under any other material agreement to which it is a party, (ii) without the prior approval of the OCI and the rehabilitator of the Segregated Account, directly or indirectly make any distribution to its shareholder or redeem any of its securities and, (iii) without the Segregated Account's consent (not to be unreasonably withheld), enter into any transaction other than pursuant to the reasonable requirements of Ambac Assurance's business and which Ambac Assurance reasonably believes are fair and reasonable terms and provisions.

Pursuant to the Reinsurance Agreement, Ambac Assurance has agreed to pay Segregated Account Policy Cash Payments, any cash interest payment and cash principal repayment under any Segregated Account Surplus Notes in connection with any of the foregoing and other amounts directed to be paid by the rehabilitator of the Segregated Account in conjunction with the rehabilitation proceeding, minus the amount of the Segregated Account's liquid assets as determined by the Segregated Account. Ambac Assurance's liability under the Reinsurance Agreement will attach only after all principal under the Secured Note has been paid. The Reinsurance Agreement contains the same covenants for the benefit of the Segregated Account as those that appear in the Secured Note, as described in the preceding paragraph.

Policy obligations not transferred to the Segregated Account remain in the general account of Ambac Assurance (the "General Account"), and such policies in the General Account are not subject to and, therefore, will not be

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directly impacted by, the Segregated Account Rehabilitation Plan. Ambac Assurance is not, itself, in rehabilitation proceedings.

The Segregated Account will be operated in accordance with a Plan of Operation (the "Plan of Operation") and certain operative documents relating thereto (which include the Secured Note, the Reinsurance Agreement, the Management Services Agreement and the Cooperation Agreement). These operative documents provide that the Segregated Account will act exclusively through the rehabilitator.

During the Segregated Account Rehabilitation Proceedings, the rehabilitator of the Segregated Account has the authority to control the management of the Segregated Account. Ambac Assurance will provide certain management and administrative services to the Segregated Account and the rehabilitator pursuant to a Management Services Agreement (the "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 will be provided at cost, subject to mutual agreement of the Segregated Account and Ambac Assurance. Either party may terminate the Management Services Agreement for cause upon 120 days written notice (or such shorter period as the rehabilitator may determine) and the Segregated Account may terminate without cause at any time upon at least 30 days prior notice. If the Segregated Account elects to terminate the Management Services Agreement, Ambac Assurance will not have the right to consent to the replacement services provider.

Ambac Assurance and the Segregated Account have also entered into a Cooperation Agreement (the "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 Ambac Assurance to reimburse the Segregated Account for specified expenses to the extent not reimbursed under the Secured Note, subject to the Minimum Surplus Amount). Ambac Assurance has made certain covenants to the Segregated Account, including an agreement to not enter into any transaction involving more than \$5 million (or such higher amount as is agreed with the rehabilitator) without the Segregated Account's prior consent (other than policy claim payments made in the ordinary course of business and investments in accordance with Ambac Assurance's investment policy), and providing the Segregated Account with an annual budget and projection for Ambac Assurance and its subsidiaries for the forthcoming fiscal year, as well as quarterly updates thereto. The Cooperation Agreement also addresses Ambac Assurance's rights in the event Ambac Assurance is no longer the management and administrative services provider to the Segregated Account as described above.

Outline of Proposed Settlement Agreement

On March 24, 2010, Ambac Assurance reached a non-binding agreement (the "Proposed Settlement") with certain counterparties (the "Counterparties") to outstanding credit default swaps with ACP that were guaranteed by Ambac Assurance. The Proposed Settlement provides that Ambac Assurance will enter into a settlement agreement (the "Settlement Agreement") with the Counterparties, pursuant to which it will commute substantially all of the ABS CDO transactions insured by Ambac Assurance (the "Commuted ABS CDO Obligations"). The Proposed Settlement is not a binding agreement, and there can be no assurance that a definitive agreement will be executed or that a definitive agreement will be reached with all Counterparties. In addition, the terms of the Proposed Settlement, as negotiated to date, may change prior to the Closing Date (as defined below), or the

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transactions contemplated by the Proposed Settlement may not be consummated at all. Pursuant to the terms of the Proposed Settlement, in exchange for the termination of the Commuted ABS CDO Obligations, Ambac Assurance shall transfer to the Counterparties in the aggregate (i) \$2.6 billion in cash and (ii) \$2 billion of newly issued surplus notes of Ambac Assurance (the "Ambac Assurance Surplus Notes"). Each of the Counterparties, on the one hand, and Ambac Assurance and the Company, on the other hand, has agreed to provide a release of the other party relating to any credit default swaps or financial guaranty insurance policies commuted pursuant to the Proposed Settlement. In addition, each of the Counterparties, on the one hand, and Ambac Assurance and the Company, on the other hand, has agreed to negotiate in good faith a general release relating to all actions taken or omitted to be taken prior to the Closing Date, subject to certain exceptions. In addition to the commutation of the Commuted ABS CDO Obligations, Ambac Assurance will also commute certain additional obligations (the "Additional Commuted Obligations").

The Ambac Assurance Surplus Notes shall have a maturity date of ten years from the Closing Date. Interest on the Ambac Assurance Surplus Notes shall be payable annually at the annual rate of 5.1%. All payments of principal and interest on the Ambac Assurance Surplus Notes shall be subject to the prior approval of OCI. If the OCI does not approve the payment of interest on the Ambac Assurance Surplus Notes, such interest will accrue and compound annually until paid or otherwise. Ambac Assurance and the Counterparties have agreed to negotiate in good faith (but shall be under no obligation to agree to) bilateral redemption provisions applicable to the Ambac Assurance Surplus Notes. The parties to the Proposed Settlement shall also agree to consider in good faith any alternative proposal intended to mitigate the risk that the issuance of the Ambac Assurance Surplus Notes will adversely impact the preservation of Ambac Assurance's net operating losses (the "NOLs"), so long as implementation of such alternative proposal would not adversely affect the interests of the Counterparties.

The Settlement Agreement shall provide that Ambac Assurance's payment obligations relating to financial guarantee insurance policies on bonds, certificates, notes or other securities payable from certain specified student loan assets ("Student Loan Policies") shall be transferred to the Segregated Account. The Segregated Account Rehabilitation Plan will, if approved, provide that Ambac Assurance may, with the approval of the OCI, cause additional Student Loan Policies to be transferred to the Segregated Account.

Counterparties to credit default swaps with ACP with respect to which policies remain in the General Account have agreed to temporarily forbear from terminating or accelerating the obligations of ACP under such credit default swaps or asserting any claims against Ambac Assurance or any affiliate thereof based upon the Segregated Account Rehabilitation Proceedings or events relating thereto until the earlier of (i) May 23, 2010, unless otherwise extended, and (ii) the occurrence of certain termination events (the "Forbearance Period"). Effective on the date of the closing of the transactions contemplated by the Settlement Agreement (the "Closing Date"), the credit default swaps remaining in the General Account (primarily, credit default swaps with respect to certain collateralized loan obligations) will be amended to remove certain events of default and termination events, including those arising from the Segregated Account Rehabilitation Proceedings.

Assumed reinsurance obligations of Ambac Assurance (except for reinsurance assumed from Everspan) shall be allocated to the Segregated Account and, pursuant to the Segregated Account Rehabilitation Plan when it is approved shall be treated consistent with the junior priority of such obligations in liquidation.

It is expected that, on or prior to the Closing Date and the consummation of the Proposed Settlement, the articles of incorporation of Ambac Assurance shall be amended to provide that, not later than 120 days after the Closing

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Date, the board of directors of Ambac Assurance shall be reconstituted (whether by the appointment of additional directors, the resignation of current directors to be replaced with new directors, or a combination of the foregoing) so that at all times thereafter at least one-third of the total number of members of the board (and not less than three such members) are independent, qualified and unaffiliated with Ambac Assurance ("Unaffiliated Directors"), any Counterparty or any of their respective affiliates. Unaffiliated Directors will not include directors, if any, appointed by the holders of Ambac Assurance's Auction Market Preferred Shares.

The Settlement Agreement is also expected to include covenants that shall remain in force until the redemption of all of the Ambac Assurance Surplus Notes as approved by OCI, and can be amended or waived with (i) the consent of 50% in face amount of the Ambac Assurance Surplus Notes that cast a ballot and (ii) the approval of OCI. The Settlement Agreement may include the following covenants:

- At all times after the 120th day after the Closing Date and prior to the expiration of the Covenants, at least one-third of the board of directors of Ambac Assurance shall be Unaffiliated Directors;
- Ambac Assurance shall not write new business or guarantee or reinsure any new Everspan business (including under any existing treaties) so long as any Ambac Assurance Surplus Notes held by Counterparties remain outstanding, unless approved by OCI and Ambac Assurance has a financial strength rating of at least A (and is not on negative watch for downgrade) from at least two nationally recognized rating agencies. New business may be undertaken by Everspan with an infusion of new outside capital, if approved by the board of directors of Ambac Assurance, including a majority of the Unaffiliated Directors;
- Except as expressly contemplated by the Settlement Agreement, Ambac Assurance shall not issue or assume any surplus notes, policies or other material obligations that are *pari passu* with or senior to the Ambac Assurance Surplus Notes (including, without limitation, debt instruments of affiliates that are structurally senior to the Ambac Assurance Surplus Notes), other than the Segregated Account Surplus Notes or any other surplus notes approved for issuance by the rehabilitation court in satisfaction or partial satisfaction of any liabilities of the Segregated Account;
- While the Ambac Assurance Surplus Notes are outstanding, all other surplus notes issued by Ambac Assurance shall be on terms no more favorable to the noteholder than the Ambac Assurance Surplus Notes;
- Ambac Assurance shall provide Counterparties who are holders of Ambac Assurance Surplus Notes with quarterly financial information, as specified in the Settlement Agreement;
- No mergers, sales, pledges or other transfers of 10% or more of Ambac Assurance's assets (in one transaction, a series of related transactions or a series of unrelated transactions that occur within a 6-month time period), dividends, cedes of material business, or investments shall be permitted, in each case, whether such transaction is with an affiliate or a third party, except as follows:

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- Transactions by the Segregated Account approved by the rehabilitation court pursuant to a final and non-appealable order of the rehabilitation court or a plan of rehabilitation approved by a final and non-appealable order of the rehabilitation court;
- Dividends or loans (approved by OCI) in an amount (i) up to \$52 million per annum solely to pay interest on indebtedness outstanding as of March 15, 2010 (at the rate of interest applicable on March 15, 2010) that remains outstanding at the time of such dividend or loan, to the extent allowed by OCI, and (ii) up to \$7.5 million per annum solely to pay operating expenses of Ambac, to the extent allowed by OCI; provided, that, concurrently with any such permitted dividend or loan, the total principal amount of all outstanding surplus notes shall be prepaid on a pro rata basis by an amount equal to the amount of such permitted payment;
- Investments in accordance with investment guidelines as required by statutory accounting principles and as approved by OCI, provided, that Ambac Assurance's investment plan and performance shall be reviewed at least annually by its board of directors and modified as necessary and approved by the board of directors of Ambac Assurance (including a majority of the Unaffiliated Directors);
- Calls or purchases of Ambac Assurance Surplus Notes on a non-pro rata basis or redemptions of Ambac Assurance Surplus Notes on a pro rata basis funded solely with new equity capital or Ambac Assurance funds, in each case subject to the approval of OCI;
- Transactions related to and arising from the ongoing RMBS liability remediation efforts and any other loss mitigation activities approved by the rehabilitation court;
- Bulk cession(s) of liabilities to direct or indirect subsidiaries together with a transfer of corresponding assets and necessary capital as approved by OCI; and
- Transactions otherwise not permitted by the Covenants if approved by OCI and if, after giving effect thereto, Ambac Assurance has a financial strength rating of at least A (and is not on negative watch for downgrade) from at least two nationally recognized rating agencies.
- With respect to any financial guaranty insurance policy commuted or credit default swap terminated pursuant to the Settlement Agreement, Ambac Assurance shall cooperate with any reasonable requests of the Counterparties to assist in the restructuring of the underlying insured transactions, including, without limitation, by transferring any voting or consent rights held by Ambac Assurance to such Counterparty to the extent permitted by the transaction documents;
- Ambac Assurance shall not enter into any tax-sharing agreement with Ambac or any of its affiliates adverse to Ambac Assurance. Without limiting the generality of the foregoing, immediately prior to the Closing Date, the existing tax sharing agreement among the members of the consolidated tax group of which Ambac is the common parent shall be terminated as to

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Ambac Assurance and its subsidiaries, including Everspan (the "Ambac Assurance Subgroup"), and shall be replaced by an agreement that recognizes the consolidated NOL of the group as an asset of the Ambac Assurance Subgroup and that requires Ambac to compensate Ambac Assurance on a current basis for use of any portion of that asset, except that Ambac shall not be required to compensate Ambac Assurance for Ambac's use of net operating losses in connection with cancellation of debt ("COD") income associated with restructurings of its bonds outstanding as of March 15, 2010;

- The Counterparties shall be entitled pursuant to the Settlement Agreement to specific enforcement of the foregoing covenants; and
- All transactions between Ambac Assurance and its affiliates shall be approved by a majority of the Unaffiliated Directors.

Depending upon the final terms of the Ambac Assurance Surplus Notes and the final terms of the Settlement Agreement, it is possible the Ambac Assurance Surplus Notes may be characterized as equity of Ambac Assurance for U.S. federal income tax purposes. If the Ambac Assurance Surplus Notes are characterized as equity of Ambac Assurance and it is determined the Ambac Assurance Surplus Notes represent more than 20% of the total value of the stock of Ambac Assurance, Ambac Assurance may no longer be characterized as an includable corporation that is affiliated with Ambac. As a result, Ambac Assurance may no longer be characterized as a member of the U.S. federal income tax consolidated group of which Ambac is the common parent (the "Company Consolidated Tax Group") and Ambac Assurance would be required to file a separate consolidated tax return as the common parent of a new U.S. federal income tax consolidated group including Ambac Assurance as the new common parent and Ambac Assurance's affiliated subsidiaries (the "Ambac Assurance Consolidated Tax Group").

To the extent Ambac Assurance is no longer a member of the Company Consolidated Tax Group, Ambac Assurance's NOL (and certain other available tax attributes of Ambac Assurance and the other members of the Ambac Assurance Consolidated Tax Group) may no longer be available for use by the Company or any of the remaining members of the Company Consolidated Tax Group to reduce the U.S. federal income tax liabilities of the Company Consolidated Tax Group. This could result in a material increase in the tax liabilities of the Company Consolidated Tax Group. In addition, certain other benefits resulting from U.S. federal income tax consolidation may no longer be available to the Company Consolidated Tax Group, including certain favorable rules relating to transactions occurring between members of the Company Consolidated Tax Group and members of the Ambac Assurance Consolidated Tax Group.

If the Ambac Assurance Surplus Notes are characterized as equity of Ambac Assurance and it is determined the Ambac Assurance Surplus Notes represent more than 50% of the total value of the stock of Ambac Assurance, the Ambac Assurance NOL (and certain other tax attributes or tax benefits of the Ambac Assurance Consolidated Tax Group) may be subject to limitation including the limitation provided by Section 382 of the Internal Revenue Code of 1986, as amended (the "Code"). If Section 382 were applicable with respect to the Ambac Assurance Consolidated Tax Group, in general the Ambac Assurance Consolidated Tax Group annual use of the group's NOL may be limited to an amount equal to the product of (i) the value of the Ambac Assurance Consolidated Tax

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Group's stock and (ii) the applicable federal long term tax exempt interest rate. However, certain exemptions to the Code Section 382 limitation may be applicable. In light of these potential exemptions, the parties to the Settlement Agreement have agreed to consider in good faith certain alternative proposals intended to mitigate the risk that the issuance of the Ambac Assurance Surplus Notes will adversely impact the preservation of Ambac Assurance's NOL, so long as implementation of such alternative proposal would not adversely affect the interest of the Counterparties.

Furthermore, to the extent Ambac Assurance is no longer characterized as a member of the Company Consolidated Tax Group, the Ambac Assurance Consolidated Tax Group may not reconsolidate with the Company Consolidated Tax Group for a period of five years following such event, even if the Company were to be characterized as reacquiring or owning 80% or more of the stock of the Ambac Assurance Consolidated Tax Group following any deconsolidation. In addition, depending upon certain facts related to the potential deconsolidation of the Ambac Assurance Consolidated Tax Group and any reconsolidation with the Company Consolidated Tax Group, the acquisition by the Company Consolidated Tax Group of additional value with respect to the stock of the Ambac Assurance Consolidated Tax Group may also result in the imposition of a Code Section 382 limitation with respect to the Ambac Assurance Consolidated Tax Group's NOL reducing or eliminating the potential tax benefit of the NOLs to the Company Consolidated Tax Group.

Since the commencement of the Segregated Account Rehabilitation Proceedings, several applications have been made to the rehabilitation court challenging the propriety of the allocation of certain policies to the Segregated Account. The first of these applications was brought by Wells Fargo Bank National Association, acting as Trustee for certain Las Vegas Monorail bondholders holding policies allocated to the Segregated Account. The rehabilitation court has set a hearing on this application for July 9, 2010. A second application was made on April 30, 2010 by certain policyholders of residential mortgage backed securities ("RMBS Policyholders"). The RMBS Policyholders claim that the Order for Temporary Injunctive Relief granted by the rehabilitation court on March 24, 2010 should be modified by enjoining Ambac Assurance from entering into the Proposed Settlement described above. The RMBS Policyholders also requested that the rehabilitation court remove from the Segregated Account those policies held by the RMBS Policyholders and return those policies to the general account of Ambac Assurance, and that an order be entered declaring the establishment of the Segregated Account was invalid due to non-compliance with the Wisconsin Insurance Statutes and the Constitutions of the United States and Wisconsin. At a hearing held on May 25, 2010, the rehabilitation court ruled from the bench that it intended to deny the RMBS Policyholders' applications, though a formal order has not been issued. On May 26, 2010 the RMBS Policyholders filed an Emergency Motion for Injunction Pending Appeal with the Court of Appeals of Wisconsin, District IV, seeking to enjoin consummation of the Proposed Settlement. On May 5, 2010 certain Las Vegas Monorail bondholders filed an application in the rehabilitation court seeking relief similar to that sought by the RMBS Policyholders.

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Ambac UK

Pursuant to the Amended and Restated 1997 Reinsurance Agreement between Ambac UK and Ambac Assurance (the "AUK Reinsurance Agreement"), Ambac Assurance reinsures on a quota share basis 90% of the liabilities under policies issued by Ambac UK, and reinsures on an excess of loss basis Ambac UK policy liabilities in excess of £500,000. Ambac UK has sent Ambac Assurance notices of termination with respect to the AUK Reinsurance Agreement in which Ambac UK demands payment of unearned premium reserves, loss reserves and loss adjustment expense reserves related to the reinsured policies, less ceding commissions and certain adjustments. Ambac Assurance has not agreed or accepted that the purported termination of the AUK Reinsurance Agreement was valid.

Pursuant to the Segregated Account Rehabilitation Proceedings, the liabilities of Ambac Assurance under the AUK Reinsurance Agreement have been allocated to the Segregated Account; as such, the rehabilitator of the Segregated Account will determine the actions, if any, to be taken in respect of the AUK Reinsurance Agreement.

(2) Significant Accounting Policies

The accompanying financial statements of Ambac Assurance have been prepared on the basis of accounting practices prescribed or permitted by the OCI.

The OCI recognizes only statutory accounting practices prescribed or permitted by the State of Wisconsin for determining and reporting the financial condition and results of operations of an insurance company for determining its solvency under Wisconsin Insurance Law. The National Association of Insurance Commissioners ("NAIC") Accounting Practices and Procedures manual ("NAIC SAP") has been adopted as a component of prescribed practices by the State of Wisconsin.

Prescribed Practice

The OCI has prescribed an accounting practice that differs from NAIC SAP. Paragraph 7 of Statement of Statutory Accounting Principles No. 60 "Financial Guaranty Insurance" ("SSAP 60") allows for a deduction from loss reserves for the time value of money by application of a discount rate equal to the average rate of return on the admitted assets of the financial guaranty insurer as of the date of the computation of the reserve. Additionally, in accordance with paragraph 7 of Statutory Accounting Principles No. 5 "Liabilities, Contingencies and Impairments of Assets", Ambac records probable losses on its subsidiaries credit derivative contracts, using a discount rate equal to the average rate of return on its admitted assets as of the date of the computation of the contingent liability. The Company's average rate of return on its admitted assets for the year ended December 31, 2009 was 6.74%. The OCI has directed the Company to utilize a prescribed discount rate of 5.10% for the purpose of discounting both its loss reserves and its estimated impairment losses on subsidiary guarantees. Net income for 2009 and statutory surplus at December 31, 2009 was lower by \$1,515,691 than if the Company had reported such amounts in accordance with NAIC SAP.

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Permitted Practices

Under NAIC SAP, investments in foreign insurance subsidiaries are reported at their audited US GAAP equity value adjusted to a statutory basis of accounting as provided for in paragraph 9 of SSAP 97, *Investments in Subsidiary, Controlled and Affiliated Entities*. Ambac Assurance and Ambac Assurance UK Ltd, wholly owned foreign insurance subsidiary of the Ambac Assurance, are party to intercompany reinsurance contracts whereby Ambac Assurance assumes 90% of all risks on a quota share basis as well as all paid losses in excess of an attachment point of £500,000 per annum. The Company received permission of the OCI on May 10, 2010 to adjust the carrying value of its common stock investment in Ambac Assurance UK Ltd. to exclude any impairment that Ambac Assurance UK Ltd. recorded on its reinsurance recoverables from Ambac Assurance. Surplus as of December 31, 2009 is \$172,455 higher than if the Company had reported its investment in Ambac Assurance UK Ltd in accordance with NAIC SAP. Net income for the year ended December 31, 2009 is the same using each of these accounting practices.

Wisconsin accounting practices for changes to contingency reserves differ from NAIC SAP. Under NAIC SAP, contributions to and releases from the contingency reserve are recorded via a direct charge or credit to surplus. Under section 3.08(7)(b) of the Wisconsin Administrative Code, contributions to and releases from the contingency reserve are to be recorded through underwriting income. The Company received permission of the OCI on December 16, 2002 to record contributions to and releases from the contingency reserve and the related tax and loss bond impact, in accordance with NAIC SAP. Statutory surplus is the same using each of these accounting practices. Net income for the years 2009 and 2008 are lower by \$1,578,541 and \$807,233, respectively than if the Company had reported the contributions to the contingency reserve in accordance with the Wisconsin Administrative Code.

The following reconciles statutory net income and statutory surplus determined in accordance with prescribed and permitted practices by the OCI to NAIC SAP:

	2009	2008
Net loss, Wisconsin basis	\$ (2,516,446)	\$ (3,227,433)
Effect of Wisconsin prescribed practice:	1,515,691	—
Effect of Wisconsin permitted practices:	(1,578,541)	(807,233)
Net loss, NAIC SAP	<u>\$ (2,579,296)</u>	<u>\$ (4,034,666)</u>
Statutory Surplus, Wisconsin Basis	\$ 710,645	\$ 1,554,449
Effect of Wisconsin prescribed practice:	1,515,691	—
Effect of Wisconsin permitted practices:	172,455	—
Statutory Surplus, NAIC SAP	<u>\$ 2,398,791</u>	<u>\$ 1,554,449</u>

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The preparation of financial statements in conformity with statutory accounting practices prescribed or permitted by the State of Wisconsin requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures of contingent assets and liabilities at the date of the statutory financial statements, and the reported revenues and expenses during the reporting period. Such estimates are used in connection with certain fair value measurements, the evaluation of other than temporary impairments on investments and case basis loss reserves. Current market conditions increase the risk and complexity of the judgments in estimates. Actual results could differ from those estimates.

The below reconciliation is performed to reconcile the net admitted assets, capital and surplus and net loss between the 2009 audited statutory financial statements and the 2009 annual statement, the difference is related to the recording of other-than-temporary impairment credit losses and the reclassification of unrealized capital loss from unassigned surplus as a result of OCI's rehabilitation and claim moratorium on the Segregated Account of Ambac Assurance. At December 31, 2009 Ambac Assurance held investments in Ambac Assurance guaranteed securities that were allocated to the Segregated Account. Accordingly, estimated cash flows on such securities have been adversely impacted. This results in other-than-temporary impairment credit losses recorded in the Statement of Operations of \$99,684 which includes a reclassification of unrealized capital loss from unassigned surplus of \$8,460 for Ambac Assurance's investment portfolio relating to holdings in such securities.

The following reconciles the net admitted assets, capital and surplus and net loss to the Annual Statement:

Net Admitted Assets per Annual Statement pg. 2	\$	8,533,511
Reclassification of Bonds		(91,224)
Net Admitted Assets per financial statements herein	\$	<u>8,442,287</u>

Total Capital and Surplus per Annual Statement pg 3.	\$	801,869
Reclassification of unassigned surplus		(91,224)
Capital and Surplus per financial statements herein	\$	<u>710,645</u>

Total Net Loss per Annual Statement pg. 4	\$	(2,479,612)
Reclassification of Net realized losses		(99,684)
Net Loss per financial statements herein	\$	<u>(2,579,296)</u>

Total Capital and Surplus per Annual Statement pg. 4	\$	801,869
Reclassification of Net Loss		(99,684)
Reclassification of Net unrealized Capital Gains		8,460
Capital and Surplus per financial statements herein	\$	<u>710,645</u>

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(a) *Differences between U.S. GAAP and NAIC SAP*

The significant differences from U.S. GAAP are that under NAIC SAP:

- Case basis loss reserves are only established for losses on guaranteed obligations that have already defaulted in an amount that is sufficient to cover the present value of the anticipated defaulted debt service payments over the expected period of default, less estimated recoveries under subrogation rights. Under U.S. GAAP, in addition to the establishment of case basis loss reserves for defaulted obligations, active credit reserves are established for obligations that have experienced credit deterioration, but have not yet defaulted. Under U.S. GAAP, claim reserves are established for all: i.) adversely classified credits (Class IA through V) and, ii.) non-adversely classified credits (Class I and SL) which had an internal rating downgrade since the transaction's inception, for which there is an expected loss. The claim reserve established under U.S. GAAP is equal to the excess, if any, of the present value of the expected loss over the credit's UPR.
- A mandatory contingency reserve is required based upon the type of obligation insured. Under U.S. GAAP, reserves are not prescribed based upon the type of obligation insured; however, a reserve for probable debt service defaults resulting from credit deterioration is established;
- Deferred tax assets are reduced by a statutory valuation allowance if it is more likely than not that some or all of the deferred tax asset will not be realized; any remaining net deferred tax asset is then subject to an admissibility test; whereas US GAAP only requires a valuation allowance if it is more likely than not that the deferred tax asset will not be realized;
- Bonds that have an NAIC designation of 1 or 2 are stated at amortized cost; bonds that have an NAIC designation of 3 to 6 are reported at the lower of amortized cost or fair value. Under U.S. GAAP, all bonds are reported at fair value;
- Costs related to the acquisition of new business are expensed as incurred, whereas under U.S. GAAP, the related costs are expensed over the periods in which the related premiums are earned;
- Upfront premiums written are earned on a basis proportionate to the remaining scheduled debt service to the original total principal and interest insured. Under U.S. GAAP, the premiums are earned pro rata over the life of the financial guarantee contract in proportion to the insured principal outstanding;
- Unearned premiums and loss reserves are reflected net of ceded amounts, while under U.S. GAAP, they are reflected gross of ceded amounts;
- Assets must be included in the statutory statements of admitted assets, liabilities and capital and surplus at "admitted asset value", and "nonadmitted assets" are excluded through a charge against capital and surplus. Under U.S. GAAP, an allowance is recorded only if the realization of asset value is doubtful;

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- Wholly owned subsidiaries are not consolidated; rather they are carried under the equity basis of accounting and are subject to an admissibility test. When the Company's share of losses exceeds the carrying amount of a wholly owned subsidiary, the Company discontinues applying the equity method when the investment is reduced to zero. For those subsidiaries that have insufficient claims paying resources, the Company records an estimated impairment loss for probable losses which are in excess of the subsidiaries' claims paying resources. Under U.S. GAAP wholly owned subsidiaries are consolidated.
- For stock options granted, no expense is recognized in the Statement of Operations if the strike price is equal to the market price at the measurement date, whereas under U.S. GAAP, the estimated grant date fair values of the stock options are recognized over the vesting period.

(b) Investments

Short-term investments and cash equivalents are stated at amortized cost, net of any unrealized foreign exchange gains or losses, which approximate fair value.

Investments in long-term bonds with an NAIC designation of 1 or 2 that are not backed by other loans are reported at amortized cost; amortized cost is computed via the effective interest method. For bonds purchased at a price below par value, discounts are accreted over the remaining term of the bond. For bonds purchased at a price above par value, which have call features, premiums are amortized to the call date that produces the lowest yield. For premium bonds that do not have call features, such premiums are amortized over the remaining term of the bonds. Bonds with a NAIC designation of bonds 1 or 2 are generally rated investment grade by a nationally recognized statistical rating organization.

Investments in long-term bonds that have an NAIC designation of 3 to 6 that are not backed by other loans are reported at the lower of amortized cost (as described above) or fair value as determined by the NAIC's Securities Valuation Office ("SVO"). In the event the SVO has not determined the fair value of a security, fair value amounts are determined by using independent market sources, when available, and appropriate valuation methodologies when market quotes were not available. In cases where specific market quotes are unavailable, interpreting market data and estimating market values require considerable judgment by management. Accordingly, the estimates presented are not necessarily indicative of the amount Ambac could realize in the market.

Ambac Assurance has a formal review process for all securities in its investment portfolio, including a review for impairment losses. Ambac Assurance conducts a review each quarter to identify and evaluate investments that have indications of possible other than temporary impairment. If we believe a decline is "other than temporary", we write-down the carrying value of the investment and record a realized loss. In addition, for securities that management has the intent to sell, the amortized cost of the securities is written down to fair value and the other than temporary impairment charge is recognized in earnings. An investment in a debt security is impaired if its fair value falls below its amortized cost and the decline is considered "other than temporary." Factors considered when

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assessing impairment include: (i) securities whose fair values have declined by 20% or more below amortized cost; (ii) securities whose market values have declined by 5% or more but less than 20% below amortized cost for a continuous period of at least six months; (iii) recent downgrades by rating agencies; (iv) the financial condition of the issuer; (v) whether scheduled interest payments are past due; and (vi) whether Ambac Assurance has the ability and intent to hold the security for a sufficient period of time to allow for anticipated recoveries in fair value. If we believe the decline is "other than temporary", we write-down the carrying value of the investment to the present value of the cash flows expected to be received and record a realized loss in the statement of income (regardless of the NAIC designation). Ambac Assurance's assessment of a decline in value includes management's current judgment of the factors noted above. If that judgment changes in the future, Ambac Assurance may ultimately record a loss after having originally concluded that the decline in value was temporary.

On July 1, 2009, the Company adopted Statement of Statutory Accounting Principles No. 43 – Revised, *Loan-backed and Structured Securities* ("SSAP 43R"). SSAP 43R revised the valuation and impairment requirements for mortgage-backed and structured securities based on the cash flows expected to be collected for the securities, rather than fair value. Prior to SSAP 43R, if a mortgage-backed or structured security was deemed to be other-than-temporarily impaired, the security was written down to the fair value at the time the other-than-temporary impairment was identified. Under SSAP 43R, impairment to fair value is recognized only if there is an intent to sell the security, or if a reporting entity cannot assert that they have the intent and ability to retain the investment for a period of time sufficient to recover the amortized cost basis. The adoption of SSAP 43R had no impact on surplus

Non-agency RMBS loan-backed and structured securities, including beneficial interests in securitizations ("loan-backed securities") with an NAIC designation of 1 or 2 are reported at amortized cost. Non-agency RMBS loan-backed securities with an NAIC designation of 3 to 6 are reported at the lower of amortized cost or fair value. In December 2009, the NAIC amended SSAP No. 43R to incorporate new guidance to determine the designation for non-agency RMBS. For non-agency RMBS securities, the NAIC contracted with PIMCO, an independent third party, to model the underlying cash flows of non-agency RMBS. To establish the initial NAIC designation, the current amortized cost of each security is compared to the six NAIC designations (each of which has an ascribed value modeled by PIMCO) to determine the initial NAIC designation. If based on that first step, the initial NAIC designation is 3 or above, the final NAIC designation is determined by comparing the fair value of a security to the range of values assigned to the six NAIC designations. This final NAIC designation is applicable for all statutory and reporting purposes.

Changes in currently estimated cash flows, including the effect of prepayment assumptions, on loan-backed securities are reviewed periodically. Prepayment assumptions are applied consistently across portfolios to all securities backed by similar collateral. Loan-backed securities are revalued using the currently estimated cash flows, including new prepayment assumptions using the retrospective adjustment method. Prepayment assumptions for single class and multi-class loan-backed securities were obtained from publicly available sources.

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For loan-backed and structured securities where the collection of all contractual cash flows is not probable, the Company shall recognize the excess of all cash flows expected at acquisition over the initial investment in the loan-backed or structured security as the accretable yield. Any excess of contractually required cash flows over the cash flows expected to be collected is the non-accretable difference. Expected prepayments are treated consistently for determining cash flows expected to be collected and projections of contractual cash flows such that the non-accretable difference is not affected.

For beneficial interests, if it is probable that there is a favorable change in estimated cash flows from the cash flows previously projected, the Company will recalculate the accretable yield. If the fair value of the beneficial interest has declined below its amortized cost basis the Company shall determine whether the decline is other than temporary. If it is probable that there has been an adverse change in estimated cash flows then an other than temporary impairment will be considered to have occurred and the beneficial interest will be written down to the current estimate of cash flows discounted at a rate equal to the current book yield with the resulting change being recognized as a realized loss. Determining whether there has been a favorable or adverse change in estimated cash flows from the cash flows previously projected involves comparing the present value of the remaining flows as estimated at the previous reporting date against the present value of the cash flows estimated at the current reporting date.

Realized gains and losses on the sale of investments are determined on the basis of specific identification.

The Company nets securities purchased under agreements to resell and securities sold under agreements to repurchase that are executed with the same counterparty under legally enforceable netting agreements that meet the applicable netting criteria. Ambac Assurance takes possession of securities purchased under agreements to resell, makes delivery of securities sold under agreements to repurchase, monitors the market value of these securities on a daily basis and delivers or obtains additional collateral as appropriate. Both the Company and counterparties have identical rights to pledge and rehypothecate the securities received under these agreements. At December 31, 2009, the Company has no outstanding balances on securities purchased under agreements to resell and securities sold under agreements to purchase.

Investments insurance subsidiaries domiciled in the United States are reported at their audited statutory book values, adjusted for unamortized goodwill, in accordance with the statutory equity method. Investments in foreign insurance subsidiaries are reported at their audited US GAAP equity value adjusted to a statutory basis of accounting as provided for in paragraph 9 of SSAP 97, *Investments in Subsidiary, Controlled and Affiliated Entities*, subject to the permitted practices for Ambac's investment in Ambac UK. Admitted investments are included in common stocks in the statutory statement of admitted assets, liabilities and capital and surplus.

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Investments in non-insurance limited liability companies ("LLCs") and non-insurance subsidiaries are recorded based on the audited US GAAP equity of the investee. Investments in unaudited companies are non-admitted.

Ambac Assurance is party to Insurance and Indemnity agreements whereby it guarantees timely payment by certain non-insurance LLC subsidiaries under credit derivative, interest rate and total return swap contracts. For these subsidiaries, when the Company's share of losses exceeds the carrying amount of the investment, the Company discontinues applying the equity method when the investment is reduced to zero. For subsidiaries where Ambac Assurance guarantees the obligations of the subsidiary that have insufficient claims paying resources, the Company records an estimated impairment loss for probable losses which are in excess of the subsidiaries' claims paying resources and are included within net realized (losses) gains in the statements of operations. As a result of significant losses from ACP's credit derivative portfolio, Ambac Assurance has established such a liability. At December 31, 2009, such payments are discounted using a discount rate of 5.10%, as prescribed by OCI. At December 31, 2008, the rate utilized for the purpose of discounting the estimated impairment losses was 4.50%, which represents the approximate the average rate of return on admitted assets for the year ended December 31, 2008.

(c) Premium Revenue Recognition

Net up-front written premiums are earned on a basis proportionate to the remaining scheduled periodic maturity of principal and payment of interest (debt service) to the original total principal and interest insured. Net installment premiums are collected periodically, and are reflected in income pro rata over the period covered by the premium payment. When an issue insured by Ambac Assurance has been refunded or called, the remaining unrecognized premium (net of refunding credits, if any) is earned at that time.

Premiums ceded to reinsurers reduce the amount of premiums earned the Company will recognize from its insurance policies. For both up-front and installment premiums, ceded premiums written are primarily recognized in earnings in proportion to and at the same time the related gross premium revenue is recognized.

(d) Reserve for Loss and Loss Expenses

Case basis loss reserves are established for losses on guaranteed obligations that have already defaulted in an amount that is sufficient to cover the present value of the anticipated defaulted debt service payments over the expected period of default and estimated expenses associated with the settling the claims, less estimated recoveries under subrogation rights. The Company generally discounts the liabilities for unpaid losses for financial guaranty claims on a non-tabular basis by application of a discount rate which approximates the average rate of return on admitted assets, in accordance with SSAP 60. The Company does not discount unpaid loss expenses. The Company's average rate of return on its admitted assets for the year ended December 31, 2009 was 6.74%. The OCI has directed the Company to utilize a prescribed discount rate of 5.10% for the purpose of discounting its December 31, 2009 loss reserves. At December 31, 2008 the rate utilized for the

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purpose of discounting loss reserves was 4.50%, which represents the approximate the average rate of return on admitted assets for the year ended December 31, 2008. The amount of the discount as of December 31, 2009 and 2008 was \$879,396 and \$389,630, respectively. For assumed transactions, we consider the information provided by the ceding reinsurer to evaluate whether a loss reserve should be established.

Management believes that the reserves for losses and loss expenses are adequate to cover the ultimate net cost of claims arising from issues currently in default, but the reserves are necessarily based on estimates and there can be no assurance that the ultimate liability will not exceed such estimates.

Ambac Assurance's loss reserves are based on management's on-going review of the non-derivative financial guarantee credit portfolio. Active surveillance of the insured portfolio enables Ambac Assurance's surveillance group to track credit migration of insured obligations from period to period and update internal classifications and credit ratings for each transaction. Non-adversely classified credits are assigned a Class I or Survey List ("SL") rating while adversely classified credits are assigned a rating of Class IA through Class V. The criteria for an exposure to be assigned an adversely classified credit rating includes the deterioration of an issuer's financial condition, underperformance of the underlying collateral (for collateral dependent transactions such as mortgage-backed securitizations), poor performance by the servicer of the underlying collateral and other adverse economic events or trends. The servicer of the underlying collateral of an insured securitization transaction is a consideration in assessing credit quality because the servicer's performance can directly impact the performance of the related issue. For example, a servicer of a mortgage-backed securitization that does not remain current in its collection loss mitigation efforts could cause an increase in the delinquency and potential default of the underlying obligation. Similarly, loss severities increase when a servicer does not effectively handle loss mitigation activities such as (i) the advancing of delinquent principal and interest and of default related expenses which are deemed to be recoverable by the servicer, (ii) pursuit of loan charge-offs which maximize cash flows from the mortgage loan pool, and (iii) foreclosure and real estate owned disposition strategies and timelines.

One of two approaches is generally utilized to estimate case basis loss reserves. The first approach is a statistical expected loss approach, which considers the likelihood of all possible outcomes. The "base case" statistical expected loss is the product of: (i) the net par outstanding on the credit; (ii) internally developed historical default information (taking into consideration internal ratings and average life of an obligation); (iii) internally developed loss severities; and (iv) a discount factor. The loss severities and default information are based on rating agency information, are specific to each bond type and are established and approved by Ambac Assurance's Enterprise Risk Management Committee ("ERMC"), which is comprised of Ambac Assurance's senior risk management professionals and other senior management. For certain credit exposures, Ambac Assurance's additional monitoring and loss remediation efforts may provide information relevant to adjust this estimate of "base case" statistical expected losses. As such, ERMC-approved loss severities used in estimating the "base case" statistical expected losses may be adjusted based on the professional judgment of the surveillance analyst monitoring the credit with the approval of senior management.

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Analysts may utilize the “base case” statistical expected loss as the best estimate of expected loss or adjust the severity to determine an adjusted statistical expected loss that better reflects a given transaction’s potential severity and expected loss.

The second approach entails the use of more precise estimates of expected net cash outflows (future claim payments, net of potential recoveries, expected to be paid to the holder of the insured financial obligation). Ambac Assurance’s surveillance group will consider the likelihood of all possible outcomes and develop cash flow scenarios. In this approach the scenario with the highest probability is utilized to develop loss reserves.

Additional remediation activities applied to adversely classified credits can include various actions by Ambac Assurance. The most common actions include obtaining detailed appraisal information on collateral, more frequent meetings with the issuer’s or servicer’s management to review operations, financial condition and financial forecasts and more frequent analysis of the issuer’s financial statements. Senior management meets at least quarterly with the surveillance group to review the status of their work to determine the adequacy of Ambac Assurance’s case basis loss reserves and make any necessary adjustments.

Case basis loss reserves are established for losses on guaranteed obligations that have already defaulted. All credits are assigned risk classifications by the Surveillance Group using the following guidelines:

CLASS I – “Fully Performing – Meets Ambac Criteria with Remote Probability of Claim”

Credits that demonstrate adequate security and structural protection with a strong capacity to pay interest, repay principal and perform as underwritten. Factors supporting debt service payment and performance are considered unlikely to change and any such change would not have a negative impact upon the fundamental credit quality.

SURVEY LIST (SL) – “Investigation of Specific Condition or Weakness Underway”

Credits that require additional analysis to determine if adverse classification is warranted. These credits may lack information or demonstrate a weakness but further deterioration is not expected.

CLASS IA – “Potential Problem with Risks to be Dimensioned”

Credits that are fully current and monetary default or claims-payment are not anticipated. The payor’s or issuer’s financial condition may be deteriorating or the credits may lack adequate collateral. A structured financing may also evidence weakness in its fundamental credit quality as evidenced by its under-performance relative to its modeled projections at underwriting, issues related to the servicer’s ability to perform, or questions about the structural integrity of the transaction. While these credits may still retain an investment grade rating, they usually have experienced or are vulnerable to a ratings downgrade. Further investigation is required to dimension and correct any

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deficiencies. A complete legal review of documents may be required. An action plan should be developed with triggers for future classification changes upward or downward.

CLASS II – “Substandard Requiring Intervention”

Credits whose fundamental credit quality has deteriorated to the point that timely payment of debt service may be jeopardized by adversely developing trends of a financial, economic, structural, managerial or political nature. No claim payment is currently foreseen but the probability of loss or claim payment over the life of the transaction is now existent (10% or greater probability). Class II credits may be borderline or below investment grade (BBB- to B). Prompt and sustained action must be taken to execute a comprehensive loss mitigation plan and correct deficiencies.

CLASS III – “Doubtful with Clear Potential for Loss”

Credits whose fundamental credit quality has deteriorated to the point that timely payment of debt service has been or will be jeopardized by adverse trends of a financial, economic, structural, managerial or political nature which, in the absence of positive change or corrective action, are likely to result in a loss. The probability of monetary default or claims paying over the life of the transaction is 50% or greater. Full exercise of all available remedial actions is required to avert or minimize losses. Class III credits will generally be rated below investment grade (B to CCC).

CLASS IV – “Imminent Default or Defaulted”

Monetary default or claims payment has occurred or is expected imminently. Class IV credits are generally rated D.

CLASS V – “Fully Reserved”

The credit has defaulted and payments have occurred. The claim payments are scheduled and known, and reserves have been established to fully cover such claims.

(e) *Mandatory Contingency Reserve*

The Company is required to establish a mandatory contingency reserve in accordance with the NAIC Accounting Practices and Procedures manual and the Wisconsin Administrative Code. The mandatory contingency reserve is an additional liability established to protect policyholders against the effect of adverse economic developments or cycles or other unforeseen circumstances. Under NAIC SAP, financial guarantors are required to establish a contingency reserve equal to the greater of 50% of premiums written or a stated percentage of the principal guaranteed depending on the category of obligation insured. NAIC SAP contributions are required to be made in equal quarterly installments over a period of 20 years for municipal bonds and 15 years for all other obligations. Such contributions may be discontinued if the total reserve established for all categories exceeds the sum of the stated percentages contained therein multiplied by the unpaid principal balance. This reserve must be maintained for the periods specified above, except that the guarantor may be

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permitted to release reserves under specified circumstances in the event that actual loss experience exceeds certain thresholds or if the reserve accumulated is deemed excessive in relation to the guarantor's outstanding guaranteed obligations, with notice to or approval by the insurance commissioner. Under the Wisconsin Administrative Code, a municipal bond insurer is required to establish a contingency reserve consisting of 50% of earned premiums on policies of municipal bond insurance. The only exemption is when another jurisdiction in which the insurer is licensed requires a larger contingency reserve than required by the Wisconsin Administrative Code. Accordingly, Ambac will calculate contingency reserves based on the above noted rules as well as other jurisdictions that have contingency reserve regulations, such as California, and record the highest contribution amount.

The NAIC SAP mandatory contingency reserve may be released on a first-in, first-out basis through unassigned surplus in the following circumstances:

- For contingency reserves required to be maintained for 15 or 20 years, any year in which actual incurred losses exceed 65% or 35%, respectively, of the corresponding earned premiums, with commissioner approval;
- For contingency reserves required to be maintained for 15 or 20 years, if the reserve has been in existence less than 30 quarters or 40 quarters, respectively, upon demonstration that the amount is excessive in relation to the outstanding obligations under the insurer's financial guarantees, with commissioner approval;
- For contingency reserves required to be maintained for 15 or 20 years, if the reserve has been in existence more than 30 quarters or 40 quarters, respectively, upon demonstration that the amount is excessive in relation to the outstanding obligations under the insurer's financial guarantees, upon 30 days prior written notice to the commissioner.

Ambac Assurance requested and received approvals from OCI to release contingency reserves in both 2008 and 2009. The 2008 approval allowed for Ambac Assurance to (a) release its non-municipal contingency reserves (including contingency reserves for credit default swap contracts issued by Ambac Assurance's subsidiary, ACP) in consideration of incurred losses in excess of 65% of earned premiums; and (b) cease making further contributions to the contingency reserves with respect to such insurance policies. The 2009 approval allowed for Ambac Assurance to (a) release contingency reserves for municipal financial guarantee insurance policies to reduce such reserves to equal to our estimate of expected losses; and (b) cease making further contributions to the contingency reserves with respect to expired or defaulted municipal financial guarantee insurance policies. Ambac Assurance will continue to compute expected losses on non-defaulted municipal financial guarantee insurance policies, as well as the contingency reserves required by the regulations of each state in

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which it is authorized and will record contingency reserves equal to the highest calculated result.

(f) *Income Taxes*

Pursuant to a written tax-sharing agreement approved by both the OCI and the Company's Board of Directors, the Company is included in AFGI's consolidated Federal income tax return, which includes the following taxable entities: AFGI, Ambac Assurance, Ambac (Bermuda) Limited, Ambac Capital Corporation, Ambac Investments Inc., Ambac Capital Funding, Inc., RangeMark Financial Services Inc., Ambac Asset Funding Corporation, Ambac AII Corporation, Connie Lee Holdings Inc., and Everspan.

The method of allocation between the companies provides for the determination of tax expense or benefit based on the contribution of the Company to AFGI's consolidated Federal income tax liability, computed as if the Company filed a separate income tax return. The tax liability is settled quarterly, with a final settlement taking place after the filing of the Federal consolidated tax return.

The Internal Revenue Code permits financial guarantee insurance companies to deduct from taxable income, subject to certain limitations, the amounts added to the mandatory contingency reserve for municipal obligations during the year. The deduction taken is allowed only to the extent that U.S. Treasury non-interest-bearing tax and loss bonds are purchased in an amount equal to the tax benefit attributable to such deductions. The amounts deducted must be included in taxable income when the contingency reserve is released, at which time the Company may redeem the tax and loss bonds to satisfy the additional tax liability. Tax benefits relating to such deductions are recognized as a direct adjustment to unassigned surplus of the Company. The Company purchased \$0 of tax and loss bonds in 2009 and 2008.

Deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The change in deferred tax assets and liabilities is charged directly to unassigned surplus. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in the period that includes the enactment date.

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In November 2009, the NAIC issued new guidance pertaining to accounting requirements for income taxes, which increases the potential admittance of deferred tax assets. It provides an increase in the admissibility limitation from 10% to 15% of surplus and an increase in the reversal/realization periods from one to three years. It requires gross deferred tax assets to be reduced by a statutory valuation allowance if it is more likely than not that some portion or all of the gross deferred tax assets will not be realized. Significant disclosures are required, including disclosing the deferred tax asset and deferred tax liability by character, regardless of whether the company is eligible for the enhanced deferred tax asset admissibility standard. This guidance was issued as Statement of Statutory Accounting Principles ("SSAP") No. 10R, "Income Taxes-Revised, A Temporary Replacement of SSAP No.10," and is effective for 2009 annual statements and 2010 interim and annual statements. In the event subsequent deferred tax asset admission guidance is not adopted by the end of this statement's effective period, SSAP No. 10 is reinstated as authoritative guidance for accounting and reporting of income taxes for statutory financial statements.

(g) Foreign Currency Transactions

Transactions denominated in foreign currencies are recorded at their U.S. dollar equivalent value based on the foreign currency exchange rate as of the transaction date. Foreign assets and liabilities are translated to U.S. dollars using exchange rates at the balance sheet date. Changes in balance sheet asset and liability values resulting from fluctuations in foreign currency exchange rates are recorded as unrealized capital gains and losses (a component of surplus) until the asset is sold or exchanged or the liability is settled. Upon settlement, the previously recorded unrealized capital gains and losses are reversed and recognized in the statutory statement of operations.

(h) Reclassifications

Certain reclassifications have been made to prior years' amounts to confirm to the current year's presentation.

(3) Accounting Changes and Corrections of Errors

Ambac Assurance is party to Insurance and Indemnity agreements with the swap counterparties of ACP, a wholly owned subsidiary, whereby the Company guarantees timely payment of ACP's obligations under credit default swaps primarily on collateralized debt obligations.

During 2009, management discovered errors relating to the data entered into models utilized to calculate the Company's estimated impairment liability relating to these credit default swaps.

In the Financial Statements for the year ended December 31, 2009, the correction of this error was reported as a reduction to surplus of \$35,100 for the prior period overstatement.

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(4) Investments

The admitted value and NAIC estimated fair value of investments in bonds at December 31, 2009 and 2008 are as follows:

	2009			
	<u>Admitted value</u>	<u>Unrealized gains</u>	<u>Unrealized losses</u>	<u>NAIC estimated fair value</u>
U.S. government	\$ 236,191	\$ 6,751	\$ 1,293	\$ 241,649
All other governments	51,653	1,049	74	52,628
States, territories and possessions (direct and guaranteed)	217,322	8,684	—	226,006
Political subdivisions of states, territories and possessions (direct and guaranteed)	746,893	33,823	—	780,716
Special revenue and special assessment obligations and all nonguaranteed obligations of agencies and authorities of governments and their political subdivisions	2,145,150	81,066	25,072	2,201,144
Industrial and miscellaneous (unaffiliated)	<u>2,707,049</u>	<u>168,210</u>	<u>228,004</u>	<u>2,647,255</u>
	<u><u>\$ 6,104,258</u></u>	<u><u>\$ 299,583</u></u>	<u><u>\$ 254,443</u></u>	<u><u>\$ 6,149,398</u></u>

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	2008			
	<u>Admitted value</u>	<u>Unrealized gains</u>	<u>Unrealized losses</u>	<u>NAIC estimated fair value</u>
U.S. government	\$ 227,962	\$ 11,829	\$	\$ 239,791
All other governments	36,397	1,792		38,189
States, territories and possessions (direct and guaranteed)	303,259	2,354	4,968	300,645
Political subdivisions of states, territories and possessions (direct and guaranteed)	1,234,782	9,548	37,712	1,206,618
Special revenue and special assessment obligations and all nonguaranteed obligations of agencies and authorities of governments and their political subdivisions	2,863,464	29,599	166,219	2,726,844
Public utilities (unaffiliated)	56,471	85	9,959	46,597
Industrial and miscellaneous (unaffiliated)	3,070,330	7,633	1,542,370	1,535,593
	<u>\$ 7,792,665</u>	<u>\$ 62,840</u>	<u>\$ 1,761,228</u>	<u>\$ 6,094,277</u>

Of the \$254,443 of gross unrealized losses at December 31, 2009, \$193,292 has been in an unrealized loss position for more than one year. At December 31, 2009 the fair value of securities in an unrealized loss position for less than one year and more than one year is \$656,056 and \$861,469, respectively. Management has determined that the unrealized losses reflected in the table above are temporary in nature as of December 31, 2009 and 2008 based upon (i) no principal and interest payment defaults on these securities; (ii) analysis of the creditworthiness of the issuer and financial guarantor, as applicable, and analysis of projected defaults on the underlying collateral; (iii) management has no intent to sell these investments in debt securities; and (iv) it is not more likely than not that Ambac Assurance will be required to sell these debt securities before the anticipated recovery of its amortized cost basis. The assessment under (iv) is based on a comparison of future available liquidity from the fixed income investment portfolio against the projected net cash outflow from operating activities and debt service. For purposes of this assessment, available liquidity from the fixed income investment portfolio is comprised of the fair value of securities for which management has asserted its intent to sell plus the scheduled maturities and interest payments from the remaining securities in the portfolio. As of December 31, 2009, for securities that have indications of possible other-than-temporary impairment but which management does not intend to sell and will not more likely than not be required to sell, management compared the present value of cash flows expected to be collected to the amortized cost basis of the securities to assess whether the amortized cost will be recovered. Management has concluded that there are no other than temporary impairments on these securities at December 31, 2009. Cash flows were discounted at the effective interest rate implicit in the security at the

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date of acquisition. For floating rate securities, future cash flows and the discount rate used were both adjusted to reflect changes in the index rate applicable to each security as of the evaluation date.

Net pre-tax realized investment losses were \$3,126,610 and \$4,373,079 in 2009 and 2008, respectively. The proceeds from the sale of bonds were \$2,385,258 and \$7,603,917 in 2009 and 2008, respectively. The following table details amounts included in net realized gains:

	<u>2009</u>	<u>2008</u>
Estimated impairment losses on subsidiary guarantees and commitments (discussed in note 9)	\$ (1,834,023)	\$ (4,445,415)
Gross realized gains on securities sold	106,500	124,419
Gross realized losses on securities sold	(17,883)	(38,288)
Other-than-temporary impairments on securities	(1,382,883)	(9,702)
Foreign exchange gains on investments	<u>1,679</u>	<u>(4,093)</u>
Net pre-tax realized losses	\$ <u>(3,126,610)</u>	\$ <u>(4,373,079)</u>

For the year ended December 31, 2009, other-than-temporary impairments included charges of \$1,283,199 to write-down the amortized cost basis of tax-exempt municipal bonds and most residential mortgage-backed securities to fair value at their respective impairment dates as a result of management's intent to sell securities in connection with plans to reposition the investment portfolio and to meet general liquidity needs. Additionally, other-than-temporary impairment charges to earnings in 2009 included \$99,684 in credit losses on securities guaranteed by Ambac Assurance. As further described in Note 1, on March 24, 2010, the OCI commenced Segregated Account Rehabilitation Proceedings in order to permit the OCI to facilitate an orderly run-off and/or settlement of the liabilities allocated to the Segregated Account. As a result of actions taken by OCI, financial guarantee payments on securities guaranteed by Ambac Assurance which have been placed in the Segregated Account are no longer under the control of Ambac management. Accordingly, estimated cash flows on such securities have been adversely impacted resulting in credit losses as of December 31, 2009. The amortized cost basis and market value prior to the other-than-temporary impairment on credit-impaired securities was \$297,823 and \$212,202, respectively. The amortized cost basis after the credit impairment was \$198,139. Other-than-temporary impairment charges were \$9,702 for the year ended December 31, 2008. Charges in 2008 included \$7,825 related to write-downs of certain securities that were believed to be credit impaired and \$1,877 related to securities that management had the intent to sell primarily to meet financial services liquidity needs at that time.

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The admitted value and NAIC estimated fair value of bonds at December 31, 2009, by contractual maturity, are shown below. Expected maturities may differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

	<u>Admitted value</u>	<u>NAIC Estimated fair fair value</u>
Due in one year or less	\$ 99,499	\$ 100,826
Due after one year through five years	807,759	813,456
Due after five years through ten years	854,801	843,393
Due after ten years	<u>4,342,199</u>	<u>4,391,723</u>
Total investments	<u>\$ 6,104,258</u>	<u>\$ 6,149,398</u>

The invested assets include bonds having an amortized cost of \$3,555 and \$3,176 on deposit with state regulatory authorities as required by law at December 31, 2009 and 2008, respectively. The invested assets include bonds, having an amortized cost of \$194,890, that were loaned to the swap business at December 31, 2009.

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Ambac's fixed income portfolio included securities covered by guarantees issued by Ambac and other financial guarantors (insured securities). The published ratings on these securities reflect the higher of the financial strength of the financial guarantor or the rating of the underlying issuer by Moody's and S&P. Rating agencies generally do not publish separate underlying ratings (those ratings excluding the insurance by the financial guarantor) because the insurance cannot be legally separated from the underlying security by the insurer. Ambac obtains underlying ratings through ongoing dialog with rating agencies and other sources. In the event these underlying ratings are not updated or simply not available from the rating agencies, Ambac will assign an internal rating. The following table represents the carrying amount and weighted average underlying rating, excluding the financial guarantee, of the insured securities at December 31, 2009:

	<u>Municipal obligations</u>	<u>Corporate obligations</u>	<u>Mortgage and asset backed securities</u>	<u>Other</u>	<u>Total</u>	<u>Weighted average underlying rating⁽¹⁾</u>
National Public Finance						
Guarantee Corporation ⁽²⁾	\$ 1,475,132	\$ 22,710	\$ —	\$ —	\$ 1,497,842	A+
Ambac Assurance Corporation	58,372	22,598	754,653	1,178	836,801	BB
Assured Guaranty Municipal Corporation ⁽³⁾	617,906	93,841	35,388	—	747,135	A+
Financial Guarantee						
Insurance Corporation	15,334	—	29,616	—	44,950	BBB+
MBIA Insurance Corporation	—	20,431	14,719	—	35,150	BBB-
Assured Guaranty Corporation	—	—	32,382	—	32,382	D
Total	<u>\$ 2,166,744</u>	<u>\$ 159,580</u>	<u>\$ 866,758</u>	<u>\$ 1,178</u>	<u>\$ 3,194,260</u>	<u>A-</u>

(1) Ratings represent the lower underlying rating assigned by S&P or Moody's. If unavailable, Ambac's internal rating is used.

(2) National Public Finance Guarantee Corporation contains all public finance exposures underwritten by MBIA Insurance Corporation and Financial Guarantee Insurance Corporation.

(3) Assured Guaranty Municipal Corporation contains all exposures previously underwritten by Financial Security Assurance Inc.

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(5) Reinsurance

Selected information regarding reinsurance is as follows:

	2009		2008	
	Written	Earned	Written	Earned
Direct	\$ 325,198	\$ 718,279	\$ 440,552	\$ 1,207,111
Assumed	31,827	175,964	117,608	127,090
Ceded	104,374	(97,871)	(55,828)	(255,979)
Net premiums	<u>\$ 461,399</u>	<u>\$ 796,372</u>	<u>\$ 502,332</u>	<u>\$ 1,078,222</u>

Ceded Reinsurance

The Company ceded exposures under various reinsurance contracts primarily designed to diversity risk, increase underwriting capacity, manage capital needs and strengthen financial ratios. The reinsurance of risk does not relieve the ceding insurer of its original liability to its policyholders. In the event that all or any of the reinsurers are unable to meet their obligation to the Company under the existing reinsurance agreements, the Company would, nonetheless, be liable to its policyholders in the full amount of the policy. To minimize exposure to significant losses from reinsurer insolvencies, the Company (i) monitors the financial condition of its reinsurers; (ii) is entitled to receive collateral from its reinsurance counterparties in certain reinsurance contracts, and (iii) has certain cancellation rights that can be exercised by the Company in the event of a financial strength rating downgrade of a reinsurer. Given the financial strength of its reinsurers at the inception of each reinsurance contract, Ambac Assurance requires collateral from reinsurers primarily to (i) receive statutory credit for the reinsurance for foreign reinsurers, (ii) provide liquidity to Ambac Assurance in the event of claims on the reinsured exposures, and (iii) enhance rating agency credit for the reinsurance. At December 31, 2009, the Company held letters of credit and collateral amounting to approximately \$366,823 from its reinsurers to cover liabilities ceded under the aforementioned reinsurance contracts. Unsecured reinsurance balances in excess of 3% of policyholders' surplus with any one reinsurer at December 31, 2009 and 2008 were \$0 and \$73,637, respectively.

Assumed Reinsurance

As a result of the significant downgrades of Ambac Assurance the vast majority of assumed reinsurance contracts were cancelled in 2009, reducing our net par outstanding by \$4,011,853 to \$589,005 as of December 31, 2009. Under the provisions of each of the remaining reinsurance agreements, the ceding company has cancellation rights that can be currently exercisable and, accordingly, the ceding insurer has the ability to terminate and recapture the reinsured exposure. The cost of such termination is based on the provisions of each reinsurance contract and amounts may be higher than the amount of liabilities (loss reserves and unearned premium reserves) included in the financial statements.

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The following table summarizes assumed and ceded unearned premiums and the related commission equity at December 31, 2009.

	Assumed		Ceded		Assumed less ceded	
	Unearned premiums	Commission equity	Unearned premiums	Commission equity	Unearned premiums	Commission equity
Affiliated	\$ 177,107	\$ 17,711	\$ 6,714	\$ 671	\$ 170,393	\$ 17,040
All other	2,796	214	147,042	35,019	(144,246)	(34,805)
Total	<u>\$ 179,903</u>	<u>\$ 17,925</u>	<u>\$ 153,756</u>	<u>\$ 35,690</u>	<u>\$ 26,147</u>	<u>\$ (17,765)</u>

The direct unearned premium reserves at December 31, 2009 and 2008 were \$2,338,372 and \$2,731,453, respectively. Ceded unearned premiums were \$153,756 and \$356,001 at December 31, 2009 and 2008, respectively. Ceded loss and loss expense reserves at December 31, 2009 and 2008, were \$16,359 and \$136,102, respectively. For the years ended December 31, 2009 and 2008, reinsurance recoveries, which reduced loss and loss expenses incurred, amounted to \$247,259 and \$178,374, respectively. Contingent commission assumed and ceded during 2009 was \$0 and \$21 respectively.

The Company pledged cash and fixed income securities to foreign insurers with carrying values of \$0 and \$15,369 at December 31, 2009 and 2008, respectively, related to business assumed from those reinsurers. These assumed reinsurance contracts were cancelled in 2009.

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During 2009, Ambac Assurance terminated all reinsurance agreements with Financial Guarantee Insurance Company ("FGIC"), RAM Reinsurance Company Ltd. ("Ram Re"), Swiss Reinsurance Company ("Swiss Re"), Assured Guaranty Municipal Corp. (formerly Financial Security Assurance Inc., "AGMC"), and all but one reinsurance contracts with Radian Asset Assurance Inc ("Radian") and MBIA Insurance Corporation ("MBIA"). The terminations reflect a net recapture of approximately \$22.3 billion of par outstanding. The economic result was net settlement payments to Ambac Assurance of \$541 million. In connection with the terminations Ambac Assurance recorded pre-tax income of approximately \$316.7 million in the Statement of Operations during the year ended December 31, 2009. The components of the impact on the Statement of Operations are shown below:

Amounts in \$ millions	<u>FGIC</u>	<u>Ram Re</u>	<u>MBIA</u>	<u>Radian</u>	<u>Swiss Re</u>	<u>AGMC</u>	<u>Total</u>
Ceded Written Premium	\$ 0.3	\$ 35.8	\$ 27.8	\$ 54.3	\$ 34.0	\$ 11.2	\$ 163.4
Change in UPR	(0.3)	(35.8)	(27.8)	(54.3)	(34.0)	(11.2)	(163.4)
Premiums Earned	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -
Ceded Paid Losses	\$ 45.9	\$ 32.6	\$ -	\$ 45.8	\$ 11.1	\$ -	\$ 135.4
Change in Loss Reserves	(45.9)	(32.6)	-	(45.8)	(11.1)	-	(135.4)
Losses Incurred	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -
Return of Ceding Commission	\$ (0.1)	\$ -	\$ (1.2)	\$ -	\$ -	\$ (2.4)	\$ (3.7)
Other Income	-	24.6	-	(2.0)	315.0	(17.2)	320.4
Total Pre-Tax Income	\$ (0.1)	\$ 24.6	\$ (1.2)	\$ (2.0)	\$ 315.0	\$ (19.6)	\$ 316.7

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(6) Loss and Loss Expenses

As discussed in note 2(e), the Company's liability for loss and loss expenses consists of case basis loss reserves. Following is a summary of the activity in the case basis loss and loss expense reserve accounts:

	<u>2009</u>	<u>2008</u>
Case basis reserves at January 1	\$ 1,296,404	\$ 120,893
Less reinsurance recoverables	<u>136,101</u>	<u>11,088</u>
Net case basis reserves at January 1	<u>1,160,303</u>	<u>109,805</u>
Incurred related to:		
Current year	1,659,047	959,990
Prior years	<u>(150,349)</u>	<u>663,432</u>
Total incurred	<u>1,508,698</u>	<u>1,623,422</u>
Paid related to:		
Current year	619,167	237,059
Prior years	<u>912,850</u>	<u>335,865</u>
Total paid	<u>1,532,017</u>	<u>572,924</u>
Net case basis reserves at December 31	1,136,984	1,160,303
Add reinsurance recoverables	<u>16,359</u>	<u>136,101</u>
Case basis reserves at December 31	\$ <u>1,153,343</u>	\$ <u>1,296,404</u>

The terms "current year" and "prior years" in the foregoing table refer to the year in which case basis loss reserves were initially established.

Both the 2009 and 2008 current year incurred losses and paid losses were primarily due to defaults on mortgage-backed securities.

The favorable development in prior years incurred losses and paid losses during 2009 was primarily due to the recognition of additional subrogation recoveries on residential mortgage-backed security transactions that defaulted prior to 2009. The adverse development in prior years incurred losses and paid losses during 2008 was primarily due to increases in reserves for residential mortgage-backed security transactions. Estimated recoveries (gross of discount) under subrogation rights at December 31, 2009 and 2008 were \$2,572,491 and \$1,079,208, respectively.

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(7) Capital and Surplus

The Company is authorized to issue 40,000,000 shares of common stock, par value \$2.50 per share and 285,000 shares of serial preferred stock, par value \$1,000 per share. Issued and outstanding common stock shares were 32,800,000 at December 31, 2009 and 2008. Issued and outstanding preferred stock shares were 26,411 and 28,000 at December 31, 2009 and 2008, respectively.

On December 3, 2008, the Company sent put exercise notices to each trust that created a vehicle for providing capital support to the Company under the contingent capital facility. The counterparty to these put options were trusts established by a major investment bank. The trusts were created as a vehicle for providing capital support to Ambac Assurance by allowing it to obtain immediate access to new capital at its sole discretion at any time through the exercise of the put option. Ambac Assurance received \$800,000 from issuing 32,000 of its Auction Market Preferred Shares in return for the issuance of the preferred stock, \$700,000 of which was received by December 31, 2008. The remaining \$100,000 was received January 2, 2009. During 2009 Ambac Assurance retired 4,686 shares of preferred stock; of which 3,097 shares were acquired. The preferred stock gives investors the rights of an equity investor in Ambac Assurance. Such rights are subordinate to insurance claims, as well as to the general unsecured creditors of Ambac Assurance. Dividend payments on the preferred stock are cumulative, only if Ambac Assurance pays dividends on its common stock. The auction for these securities occurs every 28 days. Due to the dislocation in the auction rate markets and Ambac Assurance's downgrade below triple-A by Moody's and S&P, the dividend rate on the auction market preferred has continuously been reset at the maximum rate of one-month LIBOR plus 200 bps. In July 2009, Ambac Assurance's board suspended dividends on the preferred stock. Subsequently, Ambac Assurance's board declared a dividend for the period December 23, 2009 through January 2010. Total dividend payments on the preferred stock were \$12,509 in 2009.

Unassigned surplus included net unrealized (losses) gains of \$(170,306) and \$(199,806) and nonadmitted assets of \$(19,409) and \$(1,494,037) as of December 31, 2009 and 2008, respectively.

(8) Insurance Regulatory Restrictions

Ambac Assurance (exclusive of the Segregated Account which is under the control of OCI via the Segregated Account Rehabilitation Plan) is subject to the insurance laws and regulations of each jurisdiction in which it is licensed, some of which are described below. Failure to comply with applicable insurance laws and regulations (including, without limitation, minimum surplus requirements, aggregate risk limits and single risk limits) could expose Ambac Assurance to fines, the loss of insurance licenses in certain jurisdictions, the imposition of orders by regulators with respect to the conduct of business by Ambac Assurance and/or the inability of Ambac Assurance to dividend monies to Ambac, all of which could have an adverse impact on our business results and prospects.

Section 3.08 of the Wisconsin Administrative Code prohibits the Company from having total net liability in respect of any one issue of municipal bonds in excess of an amount representing 10% of its qualified

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statutory capital. Total net liability, as defined by the Wisconsin Administrative Code, means the average annual amount due, net of reinsurance, for principal and interest on the insured amount of any one issue of municipal bonds. Additionally, Section 3.08 of the Wisconsin Administrative Code prohibits the Company from having outstanding cumulative net liability, under inforce policies of municipal bond insurance in an amount which exceeds qualified statutory capital. Cumulative net liability, as defined by the Wisconsin Administrative Code, means one-third of one percent of the insured unpaid principal and insured unpaid interest covered by inforce policies of municipal bond insurance.

The New York financial guarantee insurance law establishes single risk limits applicable to obligations insured by financial guarantee insurers. Additionally, the laws of the states of California, Connecticut and Maryland include single risk limits applicable to financial guarantee insurers which are similar to the corresponding provisions of New York law. The single risk limits are specific to the type of insured obligation (for example, municipal or asset-backed). The limits require that the insured net par outstanding and/or average annual debt service, net of reinsurance and collateral, for a single risk not be greater than the insurer's qualified statutory capital. New York law also establishes aggregate risk limits on the basis of aggregate net liability and policyholders' surplus requirements. Aggregate net liability is defined as the aggregate of the outstanding insured principal, interest and other payments of guaranteed obligations, net of reinsurance and collateral. Under these limits, qualified statutory capital must at least equal a percentage of aggregate net liability that is equal to the sum of various percentages of aggregate net liability for various categories of specified obligations. The percentage varies from 0.33% for municipal bonds to 4.00% for certain non-investment grade obligations. California, Connecticut and Maryland laws also include aggregate risk limits which are similar to the corresponding provisions of New York law.

As a result of the reduction in statutory capital and surplus and qualified statutory capital during 2008 and 2009, Ambac Assurance is not in compliance with any of the above single and aggregate risk limits. Ambac will seek to reduce its exposure to no more than the permitted amounts.

Ambac Assurance's ability to pay dividends is generally restricted by law and subject to approval by OCI. Wisconsin insurance law restricts the payment of dividends in any 12-month period without regulatory approval to the lesser of (a) 10% of policyholders' surplus as of the preceding December 31, and (b) the greater of (i) statutory net income (loss) for the calendar year preceding the date of dividend, minus realized capital gains for that calendar year or (ii) the aggregate of statutory net income (loss) for three calendar years preceding the date of the dividend, minus realized capital gains for those calendar years and minus dividends paid or credited within the first two of the three preceding calendar years. In connection with the termination of reinsurance contracts, OCI requires adjustments to the dividend calculation for any surplus or net income gains recognized. Additionally, no quarterly dividend may exceed the dividend paid in the corresponding quarter of the preceding year by more than 15% without notifying OCI 30 days in advance of payment. Based upon these restrictions, at December 31, 2009, Ambac Assurance will not be able to pay dividends during 2010, without regulatory approval. As a result of the rehabilitation of the Segregated Account as discussed in Note 1, it is highly unlikely that Ambac Assurance will be able to make dividend payments to Ambac for the foreseeable future. Ambac Assurance paid ordinary cash dividends of \$0 and \$218,540 on its common stock in 2009 and 2008, respectively.

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Under New York law, a monoline financial guarantee insurer must have at least \$75 million paid of paid-in capital and surplus and maintain thereafter at least \$65 million of policyholders' surplus. A similar law in California imposes a \$100 million minimum capital and surplus requirement, with a maintenance requirement thereafter of \$75 million.

(9) Related Party Transactions

The Company is party to a reinsurance agreement with Ambac UK whereby the Company provides quota share reinsurance of 90% of all financial guarantee insurance policies written by Ambac UK in each calendar year. In addition to the quota share provision, the Company provides excess of loss protection to provide financial guaranty insurance policies and commitments to issue financial guarantee insurance policies for the aggregate of all incurred losses in excess of an attachment point of £500,000 per annum. Premiums assumed under the quota share provision were \$89,269 and \$99,205, respectively, during 2009 and 2008. Premiums assumed under the excess of loss reinsurance provision were \$919 and \$548, respectively, during 2009 and 2008. Losses incurred (recovered) under the quota share reinsurance agreement during 2009 and 2008 were \$26,247 and \$206,900, respectively. Losses incurred under the excess of loss agreement during 2009 and 2008 were \$(536) and \$23,000, respectively. The Company is also party to a management services agreement and asset management agreement with Ambac UK. During 2009, the Company incurred or paid on behalf of Ambac UK a total of \$3,321 and \$127 for services provided under the management services and asset management agreements, respectively.

The Company is party to a reinsurance agreement with Everspan whereby the Company provides excess of loss reinsurance for the aggregate of all incurred losses of Everspan in excess of an attachment point. The attachment point is defined as an amount which would provide for the surplus of Everspan to not fall below \$75,000. Premiums assumed under this agreement were \$128 and \$139, respectively, in 2009 and 2008. No losses were incurred under this agreement during 2009 and 2008.

The Company is party to a reinsurance agreement with Ambac (Bermuda) Limited ("Ambac Bermuda") whereby the Company cedes facultative reinsurance of financial guarantee insurance policies on a pro-rata or excess of loss basis to Ambac Bermuda. Premiums ceded under the facultative agreement were \$7,971 and \$146 respectively, during 2009 and 2008. There were no losses incurred under this agreement during 2009 and 2008.

During 2009 and 2008, Ambac Assurance guaranteed the timely payment of principal and interest on obligations under investment agreements and repurchase agreements issued by its affiliates. As of December 31, 2009 and 2008, the principal amount of investment agreements and investment repurchase agreements insured was \$1,220,443 and \$2,657,131, respectively, including accrued interest. The insurance policies are collateralized by investment securities, accrued interest receivable, securities purchased under agreements to resell, cash and cash equivalents, and other financial assets which as of December 31, 2009 and 2008 had an aggregate fair value of \$1,463,723 and \$2,735,200 respectively. Certain investment agreements may be terminated at fair value. During 2009 and 2008, Ambac Assurance recorded gross

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premiums written of \$1,756 and \$6,218 and gross premiums earned of \$2,707 and \$14,699 respectively, related to these agreements. There were no losses incurred under these agreements during 2009 and 2008.

During 2009 and 2008, Ambac Assurance provided a \$360,000 liquidity facility to a reinsurance company which acts as reinsurer with respect to a portfolio of life insurance policies. The liquidity facility, which is guaranteed by Ambac Assurance, provides temporary funding in the event that the reinsurance company's capital is insufficient to make payments under the reinsurance agreement. The reinsurance company is required to repay all amounts drawn under the liquidity facility. During 2009, \$8,940 was drawn on this liquidity facility; at December 31, 2009, the undrawn balance was \$351,060. The Company recorded gross premiums written and earned of \$2,915 and \$2,904 for the years ended December 31, 2009 and 2008, respectively. There were no losses incurred under this agreement during 2009 and 2008.

During 2009, the Company loaned securities to AFS pursuant to a revolving credit facility approved by the OCI. At December 31, 2009, securities loaned by the Company to AFS, which were classified as investments, had an admitted carrying value of \$194,890. There is no collateral for the loan.

Pursuant to Insurance and Indemnity agreements between AFS and Ambac Assurance, AFS' swap agreements are guaranteed by Ambac Assurance. During 2009 and 2008, Ambac recorded gross premiums written of \$1,066 and \$1,693 and gross premiums earned of \$1,066 and \$1,693 respectively, related to these agreements. The total notional amount under these agreements was \$9,726,620 and \$25,881,525 at December 31, 2009 and 2008, respectively. There were no losses incurred under these agreements during 2009 and 2008.

Ambac Assurance is party to Insurance and Indemnity agreements with the swap counterparties of ACP, whereby the Company guarantees timely payment of ACP's obligations under credit default swaps primarily on collateralized debt obligations ("CDOs"). The total notional amount of these structured credit default swaps was approximately \$43,300,000 and \$53,900,000 at December 31, 2009 and 2008, respectively. At December 31, 2009, the Company recorded estimated impairment losses of \$3,841,324 in connection with its guarantees of ACP's obligations under credit default swaps. During 2009, ACP commuted eight CDO exposures with an aggregate of approximately \$8,619,800 notional outstanding, in exchange for a total cash payment by the Company of \$1,380,628. During 2009 and 2008, Ambac Assurance recorded gross premiums written of \$16,087 and \$19,377 and gross premiums earned of \$17,250 and \$19,990 respectively, related to these agreements.

Ambac Assurance was party to Insurance and Indemnity agreements with ACS, whereby the Company guarantees ACS's total return swaps. Ambac Assurance recorded gross premiums written and gross premiums earned of \$116 and \$420 during 2009 and 2008, respectively related to these agreements. During the third quarter of 2009, Ambac Assurance terminated the remaining total return swaps. No losses were incurred under these agreements during 2009 or 2008.

Ambac Assurance is party to a service agreement with Ambac Japan Co. Ltd. Under this agreement Ambac Assurance bears all costs and expenses plus a service fee equal to 5% of such costs and expenses of Ambac Japan Co. Ltd. Ambac paid \$1,283 in 2009 under this agreement.

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Ambac Assurance made the following capital contributions and received the following dividends and capital distributions during 2009 and 2008:

		2009		
		<u>Capital contributions</u>	<u>Dividends</u>	<u>Capital distributions</u>
Affiliate:				
Ambac UK	\$	432	\$	—
APH		—	—	(9,501)
ACS		10,184	—	—
AFS		19	—	—
SPAH		—	—	—
	\$	<u>10,635</u>	\$	<u>(9,501)</u>

		2008		
		<u>Capital contributions</u>	<u>Dividends</u>	<u>Capital distributions</u>
Affiliate:				
Ambac UK	\$	1,389	\$	—
APH		—	1,236	464
ACS		101,549	—	—
AFS		115,145	—	—
SPAH		—	69	371
	\$	<u>218,083</u>	\$	<u>1,305</u>
			\$	<u>835</u>

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AFGI and its affiliates are party to an Expense Sharing and Cost Allocation Agreement whereby all shared expenses are charged to affiliated companies. Amounts due under this agreement are settled net in cash on a quarterly basis. The Company charged affiliates \$18,315 and \$21,961 under this agreement during 2009 and 2008, respectively.

The Company received from AFGI a total of \$275,200 during 2009 for a refund of federal income tax.

Amounts due from (to) related parties as of December 31, 2009 and 2008 are as follows:

	December 31	
	2009	2008
Related party:		
AFGI	\$ 4,019	\$ 15,981
RangeMark	1,556	—
Everspan	753	21
Ambac Japan Co. Ltd.	375	(58)
SP Aircrafts Holding, LLC	27	—
Ambac (Bermuda) Limited	3	100
SP Note Investor, LLC	—	730
ACS	—	168
RangeMark Cpaital Markets, Inc.	—	7
Ambac Investments, Inc.	(110)	55
AFS	(284)	47
Ambac Asset Funding Corporation	(324)	(324)
Ambac Capital Corporation	(1,090)	1,365
Ambac UK	(1,595)	(1,326)
ACP	(3,096)	534
Total	\$ 234	\$ 17,300

Net amounts due to/from related parties are settled net in cash where the right of offset exists.

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During 2004, Ambac UK entered into a lease for the rental of office space in London, England; the lease agreement expires in January 2011. Ambac Assurance has guaranteed Ambac UK's performance under the lease agreement. An estimate of the future net minimum lease payments in each of the remaining years ending December 31, and the periods thereafter, is as follows:

	<u>Amount</u>
Year:	
2010	\$ 2,496
2011	<u>183</u>
Total	<u>\$ 2,679</u>

(10) Commitments and Contingencies

The Company is responsible for leases on the rental of office space, principally at One State Street Plaza, New York, NY. The lease agreements, which expire in 2019, contain provisions for scheduled periodic rent increases and are accounted for as operating leases. Rental expense for the years ended December 31, 2009 and 2008 was \$8,131 and \$7,924, respectively.

An estimate of future net minimum lease payments in each of the next five years ending December 31, and the periods thereafter, is as follows:

	<u>Amount</u>
Year:	
2010	8,755
2011	8,774
2012	8,794
2013	9,040
All later years	<u>55,487</u>
Total	<u>\$ 90,850</u>

Ambac Assurance has been named in lawsuits filed by the Cities of Los Angeles, California ("Los Angeles"), Stockton, California ("Stockton"), Oakland, California, Sacramento, California and Riverside, California, the City and County of San Francisco, the Counties of San Mateo, Alameda and Contra Costa, California, the City of Los Angeles Department of Water and Power, Los Angeles World Airports and Sacramento Municipal Utility District. The complaints make similar allegations, including (1) Ambac Assurance and the other defendants colluded with Moody's Investors Service, Standard & Poor's Corporation and Fitch, Inc. (the "Rating Agencies") to perpetuate a "dual rating system" pursuant to which the Rating Agencies rated the debt obligations of municipal issuers differently from corporate debt

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obligations, thereby keeping municipal ratings artificially low relative to corporate ratings; (2) Ambac Assurance issued false and misleading financial statements which failed to disclose the extent of its exposures to mortgage backed securities and collateralized debt obligations; and (3) as a result of these actions, the plaintiffs incurred higher interest costs and bond insurance premiums in respect of their bond issues.

Ambac Assurance has been named in a lawsuit initially filed on July 17, 2008 by the City of New Orleans ("New Orleans") in connection with its participation in a New Orleans bond issue. New Orleans issued variable rate demand obligations ("VRDOs"), which were insured by Ambac Assurance, and entered into an interest rate swap agreement with PaineWebber, Inc. in order to "synthetically fix" its interest rate on the VRDOs. PaineWebber in turn entered into an interest rate swap agreement with Ambac Financial Services with terms that mirrored those of the New Orleans/Paine Webber swap. On December 23, 2009, the City filed an Amended Complaint in which it seeks damages against Ambac Assurance and Ambac Financial Services alleging the following causes of action: (1) breach of written agreement for credit enhancement; (2) breach of financial guarantee policy; (3) error in the principal cause; (4) fraud in the inducement of contract; (5) negligent misrepresentation; (7) breach of policy/third-party beneficiary to policy agreement; (8) breach of the swap; (9) tortious interference with the swap; (10) tortious interference with remarketing agreement; and (11) detrimental reliance.

Ambac Assurance has been named in a lawsuit filed by the administrator of certain pooled loan programs involving health care institutions. Ambac Assurance insured bonds which financed the pooled loan programs. The administrator claims that Ambac Assurance breached a contractual obligation to pay certain fees to the administrator. Ambac Assurance's motion to dismiss the complaint was granted on March 15, 2010. The plaintiff has filed a notice of appeal.

Ambac Assurance and certain of its subsidiaries have been named in or threatened with lawsuits by issuers and other counterparties in transactions insured by Ambac Assurance. Generally, these lawsuits and threatened lawsuits involve claims by the counterparties that they incurred losses as a result of Ambac Assurance's deteriorated financial position and alleged failures by Ambac Assurance to disclose its exposure to CDOs and RMBS and its financial condition.

Ambac Assurance has also received various regulatory inquiries and requests for information. These include a subpoena duces tecum and interrogatories from the Securities Division of the Office of the Secretary of the Commonwealth of Massachusetts, dated January 18, 2008, that seeks certain information and documents concerning "Massachusetts Public Issuer Bonds." Ambac Assurance has also received subpoenas from the Office of the Attorney General, State of Connecticut (the "Connecticut Attorney General") with respect to the Connecticut Attorney General's investigation into municipal bond rating practices employed by the credit rating agencies. The focus of the investigation appears to be the disparity in ratings with respect to municipal and corporate credits, respectively. Insofar as Ambac Assurance is concerned, the Connecticut Attorney General has sought information with respect to communications between the credit rating agencies and the financial guarantee insurance industry (acting through the Association of Financial Guaranty Insurers, the industry trade association) in relation to proposals by the Rating Agencies to implement a corporate equivalency rating system with respect to municipal credits.

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Ambac Assurance has also received a subpoena duces tecum and interrogatories from the Attorney General of California (the "California Attorney General") dated December 15, 2008 related to the California Attorney General's investigation of credit rating agencies in the rating of municipal bonds issued by the State of California and its related issuers. The subpoena requests that Ambac Assurance produce a wide range of documents and information. Ambac has also received a subpoena and interrogatories from the Attorney General of West Virginia (the "WVAG"), dated June 17, 2009, with respect to the WVAG's investigation of possible antitrust violations in connection with the use of swaps, guaranteed investment contracts and other derivatives and investment vehicles related to municipal bonds issued by West Virginia governmental entities. The WVAG has sought, among other things, information and documents relating to any such swaps, guaranteed investment contracts and other derivatives and investment vehicles sold by Ambac Assurance to a West Virginia governmental entity or for which Ambac Assurance submitted a bid or offer that was not the winning bid.

Ambac Assurance has been named in lawsuits filed by certain policyholders seeking to enjoin Ambac Assurance from entering into the Proposed Settlement Agreement discussed above in Ambac's "Recent Developments" section contained in this Report and to request the rehabilitation court to remove from the Segregated Account certain policies and return these policies to the general account of Ambac Assurance. For more details on these lawsuits, please see above the "Recent Developments" section contained in this Report.

Ambac Assurance is involved from time to time in various routine legal proceedings, including proceedings related to litigation with present or former employees. Although Ambac Assurance's litigation with present or former employees is routine and incidental to the conduct of its business, such litigation can result in large monetary awards when a civil jury is allowed to determine compensatory and/or punitive damages for, among other things, termination of employment that is wrongful or in violation of implied contracts.

In the ordinary course of their businesses, Ambac Assurance and certain of Ambac Assurance's subsidiaries assert claims in legal proceedings against third parties to recover losses already paid and/or mitigate future losses. The amounts recovered and/or losses avoided which may be result from these proceedings is uncertain, although recoveries and/or losses avoided in any one or more of these proceedings during any quarter or fiscal year could be material to Ambac Assurance's results of operations in that quarter or fiscal year.

It is not possible to predict whether additional suits will be filed or whether additional inquiries or requests for information will be made, and it is also not possible to predict the outcome of litigation, inquiries or requests for information. It is possible that there could be unfavorable outcomes in these or other proceedings. Management is unable to make a meaningful estimate of the amount or range of loss that could result from unfavorable outcomes but, under some circumstances, adverse results in any such proceedings could be material to our business, operations, financial position, profitability or cash flows. The Company believes that it has substantial defenses to the claims raised in these lawsuits and intends to defend itself vigorously; however, the Company is not able to predict the outcome of this action.

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(11) Income Taxes

In November 2009, *The Worker, Homeownership, and Business Assistance Act of 2009* ("2009 Act") was enacted. Under the 2009 Act, net operating losses (NOLs) from tax years beginning or ending in either 2008 or 2009 may be carried back for up to five years, instead of the general two-year carryback. Ambac Assurance adopted the 2009 Act effective fourth quarter of 2009. Ambac Assurance recognized a receivable of \$443,900 for the tax refund and a corresponding tax benefit in the Statement of Operations upon the adoption of the 2009 Act.

The Company adopted SSAP 10R effective December 31, 2009. The December 31, 2009 balances and related disclosure are calculated and presented pursuant to SSAP 10R. The December 31, 2008 balances and related disclosures are calculated and presented pursuant to SSAP 10 prior to its modification by SSAP 10R.

The net deferred tax asset/(liability) at December 31 and the change from the prior year are comprised of the following components:

	12/31/2009			12/31/2008	
	<u>Ordinary</u>	<u>Capital</u>	<u>Total</u>	<u>Total</u>	<u>Change</u>
Total gross deferred tax assets	\$ 1,914,498	\$ 331,587	\$ 2,246,085	\$ 2,074,256	\$ 171,829
Valuation allowance adjustment	(1,880,689)	(331,587)	(2,212,276)	-	(2,212,276)
Adjusted gross deferred tax assets	\$ 33,809	\$ -	\$ 33,809	\$ 2,074,256	\$ (2,040,447)
Total gross deferred tax liabilities	(33,809)	-	(33,809)	(8,870)	(24,939)
Net deferred tax assets/(liabilities)	\$ -	\$ -	\$ -	\$ 2,065,386	\$ (2,065,386)
Total deferred tax assets nonadmitted	-	-	-	(2,065,386)	2,065,386
Net admitted deferred tax assets/(liabilities)	\$ -	\$ -	\$ -	\$ -	\$ -
Net change in total DTAs nonadmitted	<u>\$ 2,065,386</u>				

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The net deferred tax asset/ (liability) at December 31 and the change from the prior year are comprised of the following components:

	<u>Ordinary</u>	<u>12/31/2009</u> <u>Capital</u>	<u>Total</u>	<u>12/31/2008</u> <u>Total</u>	<u>Change</u>
Deferred tax assets:					
Unearned Premium Reserve	\$ 92,630	\$ -	\$ 92,630	\$ 103,973	\$ (11,343)
Net Operating Loss Carryforward	1,622,277	-	1,622,277	1,209,457	412,820
Contingency Reserve	117,620	-	117,620	670,109	(552,489)
Loss Reserve Discounting	38,118	-	38,118	42,137	(4,019)
Alternative Minimum Tax	24,076	-	24,076	24,076	-
Unrealized (Gains) Losses	-	331,587	331,587	-	331,587
Other	19,777	-	19,777	24,504	(4,727)
Total gross deferred tax assets	\$1,914,498	\$331,587	\$2,246,085	\$2,074,256	\$ 171,829
Valuation Allowance Adjustment	(1,880,689)	(331,587)	(2,212,276)	-	(2,212,276)
Total adjusted gross deferred tax assets	\$ 33,809	\$ -	\$ 33,809	\$2,074,256	\$(2,040,447)
Nonadmitted deferred tax assets	-	-	-	(2,065,386)	2,065,386
Admitted deferred tax assets	\$ 33,809	\$ -	\$ 33,809	\$ 8,870	\$ 24,939
Deferred tax liabilities:					
Other	\$(33,809)	\$ -	\$(33,809)	\$(8,870)	\$ (24,939)
Total deferred tax liabilities	\$(33,809)	\$ -	\$(33,809)	\$(8,870)	\$ (24,939)
Net admitted deferred tax asset (liability)	\$ -	\$ -	\$ -	\$ -	\$ -

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The admitted deferred tax assets provisions of paragraph 10.e. do not apply to the Company because it is a Financial Guarantee Monoline insurer and is not required to prepare a Risk Based Capital calculation. The Company has no net admitted adjusted gross deferred tax assets under SSAP 10R, or as a result of the application of paragraph 10.e., because the Company does not believe that it is more likely than not it will generate sufficient taxable income and realized future tax benefits in order to recover the gross deferred assets and accordingly a full valuation allowance was established.

The change in deferred income taxes reported in surplus before consideration of nonadmitted assets is of the following components:

	<u>12/31/2009</u>	<u>12/31/2008</u>	<u>Change</u>
Net adjusted deferred tax asset	\$ -	\$ 2,065,386	\$ (2,065,386)
Tax-effect of unrealized gains and losses	-	-	-
Net tax effect without unrealized gains and losses	<u>\$ -</u>	<u>\$ 2,065,386</u>	<u>\$ (2,065,386)</u>
Change in deferred income tax			<u>\$ 2,065,386</u>

Current income taxes incurred consist of the following major components:

	<u>12/31/2009</u>	<u>12/31/2008</u>
Current year tax expense (benefit)	\$ (483,521)	\$ (862,271)
Investment tax credits	-	-
Prior year adjustments	-	-
Current income taxes incurred	<u>\$ (483,521)</u>	<u>\$ (863,271)</u>

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The Company's income tax incurred and change in deferred income tax differs from the amount obtained by applying the federal statutory rate of 35% to income before taxes as follows:

	12/31/2009	12/31/2008
Current income tax incurred	\$(483,521)	\$(862,271)
Change in deferred income tax (without tax on unrealized gains & losses)	2,065,386	(1,649,319)
Total income tax reported	<u>\$1,581,865</u>	<u>\$(2,511,590)</u>
Income before taxes	\$(3,062,817)	\$(4,952,593)
	35%	35%
Expected income tax expense at 35% statutory rate	<u>\$(1,071,986)</u>	<u>\$(1,733,408)</u>
Increase (decrease) in actual tax reported resulting from:		
Nondeductible expenses for meals, penalties & lobbying	140	175
Tax-exempt income	(46,670)	(94,301)
Change in deferred taxes on nonadmitted assets	-	(636,606)
Change in valuation allowance	2,212,276	-
Other	488,105	(47,450)
Total income tax reported	<u><u>\$1,581,865</u></u>	<u><u>\$(2,511,590)</u></u>

At December 31, 2009, the Company had \$4,635,076 of unused operating loss carryforwards available to offset against future taxable income that will begin expiring in 2028 and fully expire in 2029. At December 31, 2009, there are no amounts available for recoupment in the event of future net losses. The Company has no deposits admitted under Section 6603 of the Internal Revenue Code.

A reconciliation of the beginning and ending amount of unrecognized tax benefits for 2009 and 2008 is as follows:

	2009	2008
Balance at January 1,	\$ 77,700	\$ 84,100
Increases related to prior year tax provisions	6,023	4,100
Decreases related to prior year tax provisions	(60,873)	(10,500)
Balance at December 31,	<u><u>\$ 22,850</u></u>	<u><u>\$ 77,700</u></u>

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Certain reclassifications have been made to prior years' amounts to conform to current year's presentation.

Included in these balances at December 31, 2009 and 2008 are \$22,850 and \$25,900 respectively, of unrecognized tax benefits that, if recognized, would affect the effective tax rate. During the years ended December 31, 2009 and 2008, federal tax reserves related to unrecognized tax benefits decreased by \$60,873 and \$10,500, respectively. The December 31, 2008 release relates to issues that no longer warrant a tax reserve after a U.S. tax settlement for the years 2001 through 2004. The December 31, 2009 release relates to the availability of net operating loss carryback to offset any IRS assessment for potential tax issues related to tax years 2003 through 2007. Ambac Assurance accrues interest and penalties related to unrecognized tax benefits in the provision for income taxes. During 2009 and 2008, Ambac Assurance recognized interest of approximately \$6,023 and \$4,100, respectively. Ambac Assurance had approximately \$15,020 and \$9,000 for the payment of interest accrued at December 31, 2009 and 2008, respectively.

Aside from an additional accrual for interest and penalties, it is not likely that the uncertain tax position will change in the next 12 months.

(12) Employee Benefits

Employees of the Company are eligible to participate in a defined contribution plan sponsored by Ambac. Ambac makes an employer matching contribution subject to limits set by the Internal Revenue Code, of 100% of the employees' contribution up to 6%. Effective January 1, 2010, matching contributions will now equal 100% of the employees' contributions, up to 3% of such participants' base, plus 50% of contributions up to an additional 2% of base compensations. Ambac made a basic profit sharing contribution of 3% of base compensation and a supplemental profit sharing contribution of an additional 3% of base compensation to eligible employees in 2009. The expense is allocated to the subsidiaries based upon salary expense. The total cost to the Company was \$4,238 and \$4,156 in 2009 and 2008, respectively. No Basic Profit-Sharing contributions or Supplemental Profit-Sharing contributions will be made to the Plan in 2010.

In addition, Ambac provides various postretirement benefits, principally health and life benefits, covering substantially all employees of the Company who meet certain age and service requirements. Effective August 1, 2005, new employees were not eligible for postretirement benefits. All plans are contributory. None of the plans are currently funded. The Company recorded \$556 and \$1,047 of postretirement benefits expense during 2009 and 2008, respectively. The postretirement benefit expense is allocated to the subsidiaries based upon salary expense.

Employees of the Company participate in Ambac's 1997 Equity Plan which provides for the granting of stock options, stock appreciation rights, restricted stock units ("RSUs"), performance units and other awards that are valued or determined by reference to Common Stock. During 2009, neither options nor RSUs were granted to Ambac's employees. Stock options and RSU expenses are allocated to each of Ambac's subsidiaries based on the actual number of stock options and restricted stock units granted to each subsidiary's employees. In accordance with SSAP No. 13, "Stock Options and Stock Purchase Plan", stock

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options, purchase and award programs of the principal stockholder shall be treated as contributed surplus by the principal stockholder. As the consideration received for the options is equal to the quoted market price at the measurement date, no expense is reflected in the financial statements. Paid in surplus in the amount of \$10,116 was recognized in 2009 relating to the expensing of RSUs granted to employees of Ambac and its subsidiaries. Of that amount, \$9,664 relates to Ambac Assurance's employees and has been expensed in the Statement of Operations. The remaining amounts were contributed to Ambac Assurance's subsidiaries and accounted for as capital contribution of \$432 to Ambac UK and \$19 to AFS.

A summary of AFGI's RSU, and other stock activity for 2009 is as follows:

	Shares	Weighted average grant date fair value
Outstanding at beginning of year	3,048,529	\$ 18.70
Granted	398,513	1.04
Delivered	(471,775)	33.37
Forfeited	(537,643)	17.05
Outstanding at end of year	<u>2,437,624</u>	<u>\$ 14.19</u>

The Company has no legal obligations for benefits under the defined benefit pension plan, the defined contribution plan, the equity plan, or for other postretirement benefit plans.

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(13) Guarantees in Force

The gross par amount of bonds guaranteed, for nonaffiliates, was \$422,377,000 and \$497,960,000 at December 31, 2009 and 2008, respectively. As of December 31, 2009 and 2008, the guarantee portfolio, net of reinsurance, was diversified by type of insured bond as shown in the following table:

	Net par amount outstanding	
	2009	2008
	(Dollars in millions)	
Public finance:		
Lease and tax-backed revenue	\$ 73.081	\$ 77.060
General obligation	53.342	58.296
Utility revenue	30.835	32.166
Transportation revenue	22.501	22.306
Higher education	16.577	17.959
Health care revenue	11.987	15.115
Housing revenue	9.966	10.862
Other	<u>3.892</u>	<u>4.457</u>
Total public finance	<u>222,181</u>	<u>238,221</u>
Structured finance:		
Mortgage-backed and home equity	32.407	36.995
Other CDOs	18.313	19.988
CDO of ABS > 25% MBS	16.718	23.190
Asset-backed and conduits	16.455	25.443
Student loan	14.518	16.644
Investor-owned utilities	13.066	14.650
Other	<u>2.651</u>	<u>3.499</u>
Total structured finance	<u>114,128</u>	<u>140,409</u>
International finance:		
Asset-backed and conduits	13.663	16.383
Investor-owned and public utilities	9.331	8.449
Other CDOs	9.083	12.784
Transportation revenue	7.584	6.870
Sovereign/sub-sovereign	6.859	5.980
Mortgage-backed and home equity	3.386	3.669
Other	<u>1.408</u>	<u>1.502</u>
Total international finance	<u>51,314</u>	<u>55,637</u>
Total net par outstanding	<u>\$ 387,623</u>	<u>\$ 434,267</u>

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As of December 31, 2009 and 2008, the international guaranteed portfolio is shown in the following table by location of risk:

	Net par amount outstanding	
	2009	2008
	(Dollars in millions)	
United Kingdom	\$ 22,260	\$ 20,108
Australia	5,529	4,952
Germany	3,821	2,843
Italy	1,842	905
Japan	1,149	1,913
Internationally diversified	9,914	14,937
Other international	6,799	9,979
Total international finance	\$ 51,314	\$ 55,637

Internationally diversified obligations represent pools of geographically diversified exposures which include significant components of domestic exposure.

Gross financial guarantees in force (principal and interest) were \$677,553,000 and \$811,178,000 at December 31, 2009 and 2008, respectively. Net financial guarantees in force (after giving effect to reinsurance) were \$614,718,000 and \$695,954,000 as of December 31, 2009 and 2008, respectively.

In the United States, California and New York were the states with the highest aggregate net par amounts in force, accounting for 11.0% and 5.9%, respectively, of the total at December 31, 2009. No other state accounted for more than five percent. The highest single insured risk represented 0.6% of aggregate net par amount guaranteed.

In connection with its financial guarantee business, Ambac Assurance has outstanding commitments to provide guarantees of \$8,455,000 at December 31, 2009. These commitments relate to potential future debt issuances or increases in funding levels for existing insurance or credit derivative transactions. Commitments generally have fixed termination dates and are contingent on the satisfaction of all conditions set forth in the contract. These commitments may expire unused or be reduced or canceled at the counterparty's request. Additionally, approximately 78% of the total commitment amount represents commitments that contain one or more of the following provisions: (i) the commitment may be terminated at the Company's election upon a material adverse change, (ii) in order for the funding levels to be increased, certain asset eligibility requirements must be met, or (iii) for commitments to provide protection in credit derivative form, the commitment may not be exercised upon an event of default or after the reinvestment period. Accordingly, the \$8,455,000 of commitments outstanding at December 31, 2009 does not necessarily reflect actual future amounts. Additionally, due to Ambac Assurance's current financial

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strength rating and investor concern with respect to our financial position, certain commitments are unlikely to be exercised.

(14) Reconciliation of Statutory Net Income and Capital and Surplus to U.S. GAAP

The following reconciles statutory net income and capital and surplus as determined in accordance with accounting practices prescribed or permitted by the Wisconsin Insurance Commissioner under the Wisconsin Administrative Code to such amounts determined in conformity with U.S. GAAP:

	Year ended December 31	
	2009	2008
Ambac statutory net loss, as reported herein	\$ (2,579,296)	\$ (4,034,665)
Net change in affiliated investments	5,227,670	489,152
Income taxes	(1,163,297)	(994,491)
Losses incurred	(1,305,929)	(613,928)
Premiums earned	(3,682)	(32,441)
Stock option expenses	(3,031)	1,753
Deferred acquisition costs	73,087	(41,755)
Other	(141,429)	(24,324)
Ambac U.S. GAAP net income (loss)	\$ 104,093	\$ (5,250,699)

	Year ended December 31	
	2009	2008
Ambac statutory capital and surplus, as reported herein	\$ 710,645	\$ 1,554,448
Unrealized losses on affiliates	718,797	(5,133,506)
Mandatory contingency reserve	336,056	1,914,597
Income taxes	—	268,938
Loss reserves	(3,667,420)	(968,906)
Unearned premium reserve	1,339,721	629,114
Deferred acquisition costs	339,534	213,709
Nonadmitted assets	19,409	1,494,098
Unrealized gains (losses) on fixed income investments	8,563	(1,747,986)
Other	12,584	47,165
Ambac U.S. GAAP stockholder's equity	\$ (182,111)	\$ (1,728,329)

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(15) Fair Values of Financial Instruments

The following methods and assumptions were used to estimate the fair value of each class of financial instrument for which it is practicable to estimate that value:

Bonds and Other Unaffiliated Invested Assets

The estimated fair values represent fair values as determined by the NAIC SVO. In the event the SVO has not determined the fair value of a security, fair value amounts are determined by using independent market sources, when available, and appropriate valuation methodologies when market quotes are not available. In cases where specific market quotes are unavailable, interpreting market data and estimating market values require considerable judgment by management. Accordingly, the estimates presented are not necessarily indicative of the amount Ambac could realize in the market.

Short-Term Investments, Cash and Cash Equivalents and Intercompany Loans with Affiliates

The fair values of short-term investments, cash and cash equivalents are approximately their amortized cost. Intercompany loans with affiliates are reflected net of impairments.

Investment Income Due and Accrued

The fair value of investment income due and accrued approximates carrying value.

Liability for Net Financial Guarantees Written

The fair value of the liability for financial guarantees written is based on the estimated cost to reinsure those exposures at current market rates, which amount consists of the current net unearned premium reserve based on U.S. GAAP plus the present value of estimated future installment premiums, less an estimated ceding commission, plus case basis credit loss reserves thereon. The estimate of the amounts and timing of the future installment premiums is based on contractual premium rates, debt service schedules and expected run-off scenarios. The fair value of the liability for net financial guarantees written also includes the estimated impairment loss on a credit derivative subsidiary.

The key variables are par amounts outstanding (including future periods for the calculation of future installment premiums), expected term, discount rate, and expected net loss and loss expense payments. Net par outstanding is monitored by Ambac Assurance's surveillance group. Estimates of future installment premiums received and ceded are based on contractual premium rates and estimates of the expected terms of these contracts. With respect to the discount rate, the nonperformance risk of a financial liability is included in the estimation of fair value. This nonperformance risk would include considering Ambac Assurance's own credit risk in the fair value of financial guarantees we have issued, thus the estimated fair value for direct contracts written was discounted at LIBOR plus Ambac Assurance's current credit spread. The credit spread used to estimate the nonperformance risk component of the fair value of financial

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guarantees as of December 31, 2009 was 4,905 basis points. The estimated fair value of ceded reinsurance contracts factors in any adjustments related to the counterparty credit risk we have with reinsurers.

There are a number of factors that limit our ability to accurately estimate the fair value of our financial guarantees. The first limitation is the lack of observable pricing data points as a result of the current disruption in the credit markets and recent rating agency actions, both of which have significantly limited the amount of new financial guarantee business written by Ambac Assurance. Additionally, fair value concepts, as they relate to valuing liabilities, requires a company to consider the cost to completely transfer its obligation to another party of comparable credit worthiness. However, our primary insurance obligation is irrevocable and thus there is no established active market for transferring such obligations. Finally, as a result of the breadth, volume and geographic diversification of our financial guarantee exposures, we may need to enhance our model to more accurately incorporate other key variables that may influence the fair value estimate. Variables which are not incorporated in our current fair value estimate of financial guarantees include the credit spreads of the underlying insured obligations, the underlying ratings of those insured obligations and assumptions about current financial guarantee premium levels relative to the underlying insured obligations' credit spreads.

The carrying amount and estimated fair value of these financial instruments are presented below:

	2009		2008	
	Carrying amount	Estimated fair value	Carrying amount	Estimated fair value
Financial assets:				
Bonds	\$ 6,104,258	\$ 6,149,398	\$ 7,792,665	\$ 6,094,277
Short-term investments	619,101	619,101	1,163,645	1,163,645
Cash and cash equivalents	6,255	6,255	15,186	15,186
Other unaffiliated invested assets	8,688	10,286	—	—
Intercompany loans with affiliates	835,918	835,918	1,173,000	1,173,000
Investment income due and accrued	58,539	58,539	71,157	71,157
Financial liabilities:				
Liability for net financial guarantees written	\$ 7,647,300	\$ 2,029,577	\$ 9,104,000	\$ 4,482,337

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The Company's financial assets carried at fair value have been classified, for disclosure purposes, based on a hierarchy defined by SFAS No. 157, *Fair Value Measurements*. The Company has no financial liabilities carried at fair value. SFAS 157 specifies a fair value hierarchy based on whether the inputs to valuation techniques used to measure fair value are observable or unobservable. Observable inputs reflect market data obtained from independent sources, while unobservable inputs reflect Company-based market assumptions. In accordance with SFAS 157, the fair value hierarchy prioritizes model inputs into three broad levels as follows:

- Level 1 – Quoted prices for identical instruments in active markets. Assets classified as Level 1 include US treasury securities, money market funds and mutual funds.
- Level 2 – Quoted prices for *similar* instruments in active markets; quoted prices for identical or similar instruments in markets that are not active; and model-derived valuations in which all significant inputs and significant value drivers are observable in active markets. Assets classified as Level 2 generally include fixed income securities representing municipal, asset-backed and corporate obligations.
- Level 3 – Model derived valuations in which one or more significant inputs or significant value drivers are unobservable. This hierarchy requires the use of observable market data when available. Assets and liabilities classified as Level 3 include certain fixed income securities for which quoted prices are not available and valuation models require significant Company based assumptions.

When available, the Company generally uses quoted market prices to determine fair value, and classifies such items within Level 1. Because many fixed income securities do not trade on a daily basis, pricing sources apply available information through processes such as matrix pricing to calculate fair value. In those cases the items are classified within Level 2. If quoted market prices are not available, fair value is based upon models that use, where possible, current market-based or independently-sourced market parameters. Items valued using valuation models are classified according to the lowest level input or value driver that is significant to the valuation. Thus, an item may be classified in Level 3 even though there may be significant inputs that are readily observable.

The determination of fair value for financial instruments categorized in Level 2 or 3 involves significant judgment due to the complexity of factors contributing to the valuation. The current market disruptions make valuation even more difficult and subjective. Third-party sources from which we obtain independent market quotes also use assumptions, judgments and estimates in determining financial instrument values

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and different third parties may use different methodologies or provide different prices for securities. We believe the potential for differences in third-party pricing levels is particularly significant with respect to residential mortgage backed and certain other asset-backed securities held in our investment portfolio due to the very low levels of recent trading activity for such securities. As a result of these factors, in the current market environment, the actual trade value of a financial instrument in the market may be significantly different from its reported fair value.

Financial assets and liabilities measured at fair value on a recurring basis

As of December 31, 2009, none of Ambac Assurance's financial assets and liabilities were measured at fair value on a recurring basis.

Assets measured at fair value on a non-recurring basis

Certain financial assets are measured at fair value on a non-recurring basis, and are recorded at fair value on the balance sheet at December 31, 2009. The following table summarizes the changes in assets measured at fair value on a non-recurring basis as of December 31, 2009:

Description	Fair value as of December 31, 2009	Fair Value Measurements Using			Total Gains (Losses) in 2009
		Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	
Bonds	278,934	—	278,934	—	158,925

Bonds carried at fair value include certain bonds that have an NAIC designation of 3 to 6, which are valued at the lower of cost or fair value and investments that are impaired due to an intent to sell. Fair values for these securities at December 31, 2009 were determined using independent market sources, consistent with prior periods.

(16) Credit Lines

As of August 6, 2008, AFGI was in violation of certain net asset covenants contained in the Credit Agreement dated as of July 30, 2007, as amended (the "Credit Agreement"), among AFGI, Ambac Assurance, Citibank, N.A., as Administrative Agent, (the "Administrative Agent"), The Bank of New York and KeyBank, National Association, as co-syndication agents, HSBC Bank USA, N.A. and Wachovia Bank, National Association, as co-documentation agents (collectively the "Lenders") and Citigroup Global Markets Inc., as the sole lead arranger and sole book runner, and certain other financial institutions. Management determined that the terms required to amend the Credit Agreement were uneconomical and not in the best interests of AFGI and its shareholders. As a result, the Commitments (as defined in the

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Credit Agreement) under the Credit Agreement and, accordingly, the Credit Agreement were terminated, effective September 4, 2008, pursuant to the notice given by AFGI and Ambac Assurance to the Administrative Agent on September 2, 2008. The Credit Agreement provided Ambac Assurance and AFGI with a \$400 million five-year unsecured, committed revolving credit facility that was due to expire on July 30, 2012. The Credit Agreement enabled AFGI and Ambac Assurance to borrow for general corporate purposes, including the payment of claims. Because neither AFGI nor Ambac Assurance has drawn any amounts under the Credit Agreement, there was no early termination penalties incurred.

(17) Subsequent Events

Pursuant to SSAP 9, *Subsequent Events*, the date through which subsequent events have been evaluated was May 28, 2010 for the year ended December 31, 2009, the same date on which Ambac Assurance's financial statements are issued.

As further described in Note 1, on March 24, 2010 Ambac Assurance Corporation established a segregated account to segregate certain segments of Ambac Assurance's liabilities. Further the OCI commenced rehabilitation proceedings with respect to the Segregated Account in order to permit the OCI to facilitate an orderly run-off and/or settlement of such liabilities. Until the Segregated Account Rehabilitation Plan is approved, which OCI has indicated will be in approximately six months, it is anticipated that no claims will be paid on Segregated Account Policies. Accordingly, estimated cash flows on such securities have been adversely impacted. As further described in Note 2, this resulted in other-than-temporary impairment credit losses recorded in the Statement of Operations of \$99,684 which includes a reclassification of unrealized capital loss from unassigned surplus of \$8,460 for Ambac Assurance's investment portfolio relating to holdings in such securities.

(18) Financial Guaranty Contracts

For financial guarantee insurance contracts where premiums are received as installment payments over the period of the contract rather than at inception, if the installment premiums had all been recorded at inception in accordance with ASC Topic 944 and amortized in proportion to the amount and period of coverage, the unearned premium revenue (net of reinsurance) would have been \$3,412,685 at December 31, 2009.

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The table below summarizes the expected future premiums at December 31, 2009:

		<u>Future premiums expected to be collected</u>
<u>Three months ended:</u>		
March 31, 2010	\$	81,729
June 30, 2010		86,829
September 30, 2010		78,519
December 31, 2010		86,423
<u>Twelve months ended:</u>		
December 31, 2011		316,546
December 31, 2012		293,814
December 31, 2013		273,322
December 31, 2014		262,999
<u>Five years ended:</u>		
December 31, 2019		1,084,414
December 31, 2024		894,027
December 31, 2029		721,031
December 31, 2034		449,537
December 31, 2039		165,009
December 31, 2044		46,290
December 31, 2049		11,153
December 31, 2054		1,175
December 31, 2059		5
Total	\$	<u>4,852,822</u>

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Below are the expected future premiums roll-forward for the period ended December 31, 2009:

Expected future premiums at January 1, 2009	\$	5,912,956
Premium payments received		(410,734)
Adjustments to expected future premium payments*		<u>(649,400)</u>
Expected future premiums at December 31, 2009	\$	<u>4,852,822</u>

*Adjustments to expected future premium payments represent policies that have terminated early as a result of rate step-ups or other retirement provision incentives for the issuer as well as principal repayments on contractual policies that were not legally mandated and as a result not factored into the original expected future premium payments.

Total accelerated revenue recognition for non-installment contracts during 2009 was \$274,539. Accelerations of upfront paying transactions resulting from the legal defeasance of Ambac Assurance insured obligations during 2009 were \$4,677. Accelerations during 2009 due to Ambac Assurance insured obligations being either called or terminated were \$269,861.

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The table below summarizes the expected future expected premiums earned, net of reinsurance on non-installment contracts at December 31, 2009:

	Future expected premiums earned, net of reinsurance
<u>Three months ended:</u>	
March 31, 2010	\$ 28,899
June 30, 2010	26,224
September 30, 2010	34,833
December 31, 2010	30,060
<u>Twelve months ended:</u>	
December 31, 2011	123,211
December 31, 2012	124,996
December 31, 2013	123,167
December 31, 2014	117,897
<u>Five years ended:</u>	
December 31, 2019	522,472
December 31, 2024	424,041
December 31, 2029	340,590
December 31, 2034	226,160
December 31, 2039	118,129
December 31, 2044	36,023
December 31, 2049	22,245
December 31, 2054	26,798
Total	\$ <u>2,325,745</u>

In addition, net unearned premium reserves at December 31, 2009 includes \$38,774 of future expected premiums earned on installment paying contracts.

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Below is the losses and loss adjustment expense roll-forward, net of subrogation recoverable and reinsurance for the period ended December 31, 2009:

(\$ in Thousands)	Year Ended December 31, 2009
Losses and Loss Adjustment Expenses at December 31, 2008, net of subrogation recoverable and net of reinsurance ⁽¹⁾	\$ 1,160.3
Change in loss reserves due to:	
Credits added ⁽¹⁾	1,926.9
Credits removed ⁽¹⁾	(0.4)
Change in existing credits ⁽¹⁾	710.2
Change in subrogation recoveries ⁽¹⁾	(1,073.6)
Change in discount rate	(54.5)
Claim payments, net of subrogation received and reinsurance	<u>(1,532.0)</u>
Net change in loss reserve	<u>(23.4)</u>
Loss and Loss Adjustment Expenses at December 31, 2009 ⁽²⁾	<u>\$ 1,136.9</u>
(1) Discounted @ 4.5%	
(2) Discounted @ 5.1%	

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(Dollar amounts in thousands, except share and per share data)

	IV	V	Total
Number of Policies	84	1	85
Remaining weighted-average contract period (in years)	6	8	6
Gross insured contractual payments outstanding:			
Principal	\$ 11,398,611	\$ 747	\$ 11,399,358
Interest	2,739,666	164	2,739,830
Total	<u>\$ 14,138,277</u>	<u>\$ 911</u>	<u>\$ 14,139,188</u>
Gross claim liability	\$ 5,488,321	\$ 911	\$ 5,489,232
Less:			
Gross potential recoveries	(3,471,831)	-	(3,471,831)
Discount	(896,838)	(61)	(896,899)
Claim liability reported in the balance sheet (excluding reinsurance)	<u>\$ 1,119,652</u>	<u>\$ 850</u>	<u>\$ 1,120,502</u>
Gross unearned premium revenue	\$ 33,917	\$ -	\$ 33,917
Reinsurance recoverables reported in the balance sheet	\$ (15,961)	\$ -	\$ (15,961)

* Excludes \$32,839 gross of reinsurance and \$32,441 net of reinsurance, of loss adjustment expense reserves

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Supplemental Schedule of Reinsurance Interrogatories

December 31, 2009

(Dollar amounts in thousands)

1. There are no quota share reinsurance contracts containing provisions for limiting the reinsurer's losses below the stated quota share percentage.
2. The Company has reinsured risks with another entity and agreed to release that entity from liability, in whole or in part, from any loss that may occur on the risk, or portion thereof.

During 2009, Ambac Assurance terminated all reinsurance agreements with Financial Guarantee Insurance Company ("FGIC"), RAM Reinsurance Company Ltd. ("Ram Re"), Swiss Reinsurance Company ("Swiss Re"), Assured Guaranty Municipal Corp. (formerly Financial Security Assurance Inc., "AGMC"), and all but one reinsurance contracts with Radian Asset Assurance Inc ("Radian") and MBIA Insurance Corporation ("MBIA"). The terminations reflect a net recapture of approximately \$22.3 billion of par outstanding. The economic result was net settlement payments to Ambac Assurance of \$541 million. In connection with the terminations Ambac Assurance recorded pre-tax income of approximately \$316.7 million in the Statement of Operations during the year ended December 31, 2009.

3. The Company has not ceded any risk under any reinsurance contract (or under multiple contracts with the same reinsurer or its affiliates) for which during the period covered by the statutory financial statements:
(i) the Company recorded a positive or negative underwriting result greater than 5% of prior year-end surplus as regards policyholders, or it reported calendar year written premium ceded or year-end loss and loss expense reserves ceded greater than 5% of prior year-end surplus as regards policyholders; (ii) the Company accounted for the contract as reinsurance and not as a deposit; and (iii) the contract contained one or more of the following features or other features that would have similar results:
 - a) A contract term longer than two years and the contract is noncancelable by the reporting entity during the contract term;
 - b) A limited or conditional cancellation provision under which cancellation triggers an obligation by the reporting entity, or an affiliate of the reporting entity, to enter into a new reinsurance contract with the reinsurer, or affiliate of the reinsurer;
 - c) Aggregate stop loss reinsurance coverage;
 - d) An unconditional or unilateral right by either party to commute the reinsurance contract, except for such provisions which are only triggered by a decline in the credit status of the other party;
 - e) A provision permitting reporting of losses, or payment of losses, less frequently than on a quarterly basis (unless there is no activity during the period); or
 - f) Payment schedule, accumulating retention from multiple years or any features inherently designed to delay timing of the reimbursement to the ceding entity.

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Supplemental Schedule of Reinsurance Interrogatories

December 31, 2009

(Dollar amounts in thousands)

4. The Company has not, during the period covered by the statutory financial statements, ceded any risk under any reinsurance contract (or under multiple contracts with the same reinsurer or its affiliates), where the Company recorded a positive or negative underwriting result greater than 5% of prior year-end surplus as regards policyholders or it reported calendar year written premium ceded or year-end loss and loss expense reserves ceded greater than 5% of prior year-end surplus as regards policyholders; excluding cessions to approved pooling arrangements or to captive insurance companies that are directly or indirectly controlling, controlled by, or under common control with (i) one or more unaffiliated policyholders of the reporting entity, or (ii) an association of which one or more unaffiliated policyholders of the reporting entity is a member, where:
 - a) The written premium ceded to the reinsurer by the reporting entity or its affiliates represents fifty percent (50%) or more of the entire direct and assumed premium written by the reinsurer based on its most recently available financial statements; or
 - b) Twenty-five percent (25%) or more of the written premium ceded to the reinsurer has been retroceded back to the reporting entity of the affiliates.
5. Except for the transactions meeting the requirements of the paragraph 31 of SSAP No. 62, *Property and Casualty Reinsurance*, the Company has not ceded any risk under any reinsurance contract (or multiple contracts with the same reinsurer or its affiliates) during the period covered by the statutory financial statements, and either:
 - a) Accounted for that contract as reinsurance (either prospective or retroactive) under NAIC SAP and as a deposit under U.S. GAAP; or
 - b) Accounted for that contract as reinsurance under U.S. GAAP and as a deposit under NAIC SAP.

See accompanying independent auditors' report.

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Supplemental Schedule of Investment Risk Interrogatories

December 31, 2009

(Dollar amounts in thousands)

The Company's total admitted assets as reported in the Statement of Admitted Assets, Liabilities and Surplus were \$8,442,287 at December 31, 2009.

1. The 10 largest exposures to a single issuer/borrower/investment at December 31, 2009 are as follows:

Issuer	Amount	Percentage of total admitted assets
Prudential Financial	\$ 177,841	2.107%
The State of New Jersey EDA Pension Fund	156,907	1.859
BlackRock Liquidity TempFund	142,680	1.690
Federated Taxable	116,156	1.375
Goldman Sachs Prime Obligation	112,496	1.333
J.P. Morgan Taxable	107,000	1.267
GMAC Fort Meade Military Housing	91,314	1.082
Pershing Road Development Corp	90,482	1.072
The State of California University Sytem	89,798	1.063
GMAC Fort Lewis Military Housing	72,450	0.858

2. The amounts and percentages of the Company's total admitted assets held in bonds and preferred stocks by NAIC rating are as follows:

Bonds			Preferred Stock		
NAIC-1	\$ 5,951,502	70.496%	P/RP-1	\$ —	—%
NAIC-2	690,560	8.180	P/RP-2	—	—
NAIC-3	48,505	0.575	P/RP-3	—	—
NAIC-4	—	—	P/RP-4	—	—
NAIC-5	4,275	0.051	P/RP-5	—	—
NAIC-6	28,516	0.338	P/RP-6	—	—

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Supplemental Schedule of Investment Risk Interrogatories

December 31, 2009

(Dollar amounts in thousands)

3. The amount of the Company's total admitted assets held in foreign investments are greater than 2.5% of total admitted assets, including (i) total admitted assets held in foreign investments of \$373,437, (ii) foreign-currency-denominated investments of \$82,574, and (iii) insurance liabilities denominated in that same foreign currency of \$204,785 at December 31, 2009.

The amounts below are the aggregate foreign investment exposure categorized by the NAIC sovereign rating:

Countries rated NAIC-1	\$ 373,437	4.423%
Countries rated NAIC-2	—	—
Countries rated NAIC-3 or below	—	—

The largest foreign investment exposures by country, categorized by the country's NAIC sovereign rating are detailed below:

Countries rated NAIC-1

Bermuda	\$ 84,000	0.995%
United Kingdom	68,617	0.813%

France is the lone country that has unhedged foreign currency exposure. The exposure is rated NAIC-1 and totals 486.

The ten largest non-sovereign (i.e. non-governmental) foreign issues are below:

Issuer	NAIC Rating	Amount	Percentage of total admitted assets
Slalom Re Ltd.	1	\$ 84,000	0.995%
Ballantyne Re Pic 20061A	6	52,565	0.623
DBS Bank	1	25,000	0.296
Citi Institutional	1	23,850	0.283
Autopista Maipo	2	20,431	0.242
Coast Investment Grade 20021A1	1	15,463	0.183
Augusta Fndg VII	2	8,257	0.098
Tyco International Ltd	2	8,003	0.095
Swedish Export Credit	1	7,993	0.095
Telecom Italia Capital	2	7,527	0.089

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Supplemental Schedule of Investment Risk Interrogatories

December 31, 2009

(Dollar amounts in thousands)

4. The Company's total admitted assets held in Canadian investments and unhedged Canadian currency exposure is less than 0.0% of the Company's total admitted assets at December 31, 2009, including Canadian-currency denominated investments of \$0 supporting Canadian-denominated insurance liabilities of \$0.
5. The aggregate amount of the reporting entity's total admitted assets held in investments with contractual sales restrictions (defined as investments having restrictions that prevent investments from being sold within 90 days) at December 31, 2009 is \$0.
6. The Company's total assets held in equity interests is less than 2.5% of the Company's total admitted assets at December 31, 2009.
7. The amount of admitted assets held in nonaffiliated privately placed equities at December 31, 2009 is \$0.
8. The amount of the reporting entity's total admitted assets held in general partnership interests at December 31, 2009 is \$0.
9. The amount of the reporting entity's total admitted assets held in mortgage loans at December 31, 2009 is \$0.
10. The amount of the reporting entity's total admitted assets held in each of the five largest investments of real estate at December 31, 2009 is \$0.
11. The amount of the reporting entity's total admitted assets held in mezzanine real estate loans at December 31, 2009 is \$0.
12. The amounts and percentages of the reporting entity's total admitted assets subject to the following types of agreements are as follows:

	<u>At Year End</u>		<u>At End of Each Quarter</u>		
	<u>Amount</u>	<u>Percentage of total admitted assets</u>	<u>First Quarter Amount</u>	<u>Second Quarter Amount</u>	<u>Third Quarter Amount</u>
Securities lending (do not include assets held as collateral for such transactions)	\$ 194,890	2.284%	\$ 273,830	\$ 186,591	\$ 253,270
Repurchase agreements	—	—	—	—	—
Reverse repurchase agreements	—	—	—	—	—
Dollar repurchase agreements	—	—	—	—	—
Dollar reverse repurchase agreements	—	—	—	—	—

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Supplemental Schedule of Investment Risk Interrogatories

December 31, 2009

(Dollar amounts in thousands)

13. The amounts and percentages of warrants not attached to other financial instruments, options, caps, and floors at December 31, 2009 are as follows:

	Owned		Written	
	Amount	Percentage of total admitted assets	Amount	Percentage of total admitted assets
Hedging	\$ —	—%	\$ —	—%
Income generation	—	—	—	—
Other	—	—	—	—

14. The amounts and percentages of potential exposure for collars, swaps, and forwards at December 31, 2009 are as follows:

	At year-end		At end of each quarter		
	Amount	Percentage of total admitted assets	First quarter amount	Second quarter amount	Third quarter amount
Hedging	\$ —	—%	\$ —	\$ —	\$ —
Income generation	—	—	—	—	—
Replications	—	—	—	—	—
Other	—	—	—	—	—

15. The amounts and percentages of potential exposure for futures contracts at December 31, 2009 are as follows:

	At year-end		At end of each quarter		
	Amount	Percentage of total admitted assets	First quarter amount	Second quarter amount	Third quarter amount
Hedging	\$ —	—%	\$ —	\$ —	\$ —
Income generation	—	—	—	—	—
Replications	—	—	—	—	—
Other	—	—	—	—	—

See accompanying independent auditors' report.

AMBAC ASSURANCE CORPORATION
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Summary of Investments Schedule
December 31, 2009
(Dollar amounts in thousands)

<u>Investment Categories</u>	<u>Gross investment holdings</u>	<u>Percentage</u>	<u>Admitted assets as reported in the annual statement</u>	<u>Percentage</u>
Bonds:				
U.S. treasury securities	\$ 155,704	2.0%	\$ 155,704	2.0%
U.S. government agency obligations (excluding mortgage-backed securities):				
Issued by U.S. government sponsored agencies	75,560	1.0	75,560	1.0
Non-U.S. government (including Canada, excluding mortgage-backed securities)	51,653	0.7	51,653	0.7
Securities issued by states, territories and possessions and political subdivisions in the U.S.:				
States, territories and possessions general obligations	217,322	2.7	217,322	2.7
Political subdivisions of states, territories and possessions and political subdivisions general obligations	746,893	9.4	746,893	9.4
Revenue and assessment obligations	1,995,060	25.2	1,995,060	25.2
Mortgage-backed securities (includes residential and commercial MBS):				
Pass-through securities:				
Issued or guaranteed by GNMA	4,927	0.1	4,927	0.1
Issued or guaranteed by FNMA and FHLMC	146,280	1.8	146,280	1.8
CMOs and REMICs:				
Issued or guaranteed by GNMA, FNMA, FHLMC or VA	3,810	—	3,810	—
All other	841,382	10.6	841,382	10.6
Other debt and other fixed income securities (excluding short-term):				
Unaffiliated domestic securities (includes credit tenant loans and hybrid securities)	1,565,168	19.8	1,565,168	19.8
Unaffiliated non-U.S. securities (including Canada)	300,499	3.8	300,499	3.8
Equity interests:				
Investments in mutual funds	—	—	—	—
Other equity interests including tangible personal property under lease:				
Affiliated	341,475	4.3	341,318	4.3
Receivables for securities	2,251	—	2,251	—
Cash, cash equivalents and short-term investments	625,356	7.9	625,356	7.9
Other invested assets	846,970	10.7	844,849	10.7
Total invested assets	<u>\$ 7,920,310</u>	<u>100.0%</u>	<u>\$ 7,918,032</u>	<u>100.0%</u>

* Gross Investment Holdings are valued in compliance with NAIC Accounting Practices and Procedures Manual.

See accompanying independent auditors' report.