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In the Matter of the Rehabilitation of:

DANE CO. CIRCUIT COURT

Case No. 10 CV 1576

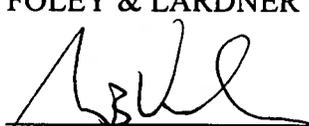
Segregated Account of Ambac Assurance Corporation

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

On March 24, 2010, the Circuit Court for Dane County, State of Wisconsin, the Honorable William D. Johnston presiding, entered an order placing the Segregated Account of Ambac Assurance Corporation into rehabilitation pursuant to the provisions of the Wisconsin Insurers Rehabilitation and Liquidation Act. The Rehabilitator hereby submits the enclosed "Report on the Rehabilitation of the Segregated Account of Ambac Assurance Corporation" on this first day of June, 2011, in order to advise the Court and all interested parties on the current status of the Plan of Rehabilitation, as confirmed by the Court on January 24, 2011, and to summarize and describe certain developments in the rehabilitation proceeding since March 24, 2010.

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

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

**June 1, 2011**

## DISCLAIMER

This Report on the Rehabilitation of the Segregated Account of Ambac Assurance Corporation (this “Report”) summarizes and describes developments in the Rehabilitation Proceeding since the Petition for Rehabilitation was filed on March 24, 2010. It does not contain an exhaustive discussion of the rehabilitation proceeding, which is discussed in further detail in the relevant papers and pleadings filed with the rehabilitation court, which are available for review on the Website, [www.ambacpolicyholders.com](http://www.ambacpolicyholders.com).

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

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

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

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

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

This Report may contain statements that are, or may be deemed to be, forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995.

Such forward-looking statements include those regarding consummation of the transactions contemplated by the Plan. Although the Rehabilitator believes that any such forward-looking statements are reasonable, no assurance can be given that such expectations will prove to have been correct. Any such forward-looking statements involve known and unknown risks, uncertainties, and other factors that may cause the actual results, performance or achievements of the Segregated Account to be different from any future results, performance and achievements expressed or implied by these statements.

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## I. INTRODUCTION

### A. Ambac Assurance Corporation

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

### B. Establishment of the Segregated Account and Petition for Rehabilitation

On March 24, 2010, AAC established the Segregated Account. Under Wisconsin insurance law, the Segregated Account is a separate insurer from AAC for purposes of the Rehabilitation Proceeding (as described below). The Commissioner, then Sean Dilweg, approved the establishment of the Segregated Account by letter dated March 24, 2010. The Segregated Account was established for the primary purpose of conducting an orderly run-off and/or settlement of the liabilities allocated to the Segregated Account.

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

The Segregated Account is operated in accordance with the Plan of Operation for the Segregated Account (the “Plan of Operation”). Pursuant to the Plan of Operation, the liabilities of the Segregated Account are supported by the Secured Note and the Aggregate Excess of Loss Reinsurance Agreement (the “Reinsurance Agreement”). AAC issued the Secured Note to the Segregated Account in the initial principal amount of \$2,000,000,000 due in 2050. Pursuant to the Secured Note, the Segregated Account has the ability to demand payment from AAC from time to time to pay claims and other liabilities. Once the Secured Note has been exhausted, the Segregated Account has the ability to demand payment from time to time under

the Reinsurance Agreement to pay claims and other liabilities. The Secured Note together with the Reinsurance Agreement effectively render all of the claims-paying resources of AAC's General Account (the "General Account") available to pay liabilities of the Segregated Account (including any payments with respect to the surplus notes and the junior surplus notes), with the exception that AAC is not obligated to make payments on the Secured Note or under the Reinsurance Agreement if its surplus as regards to policyholders is (or would be) less than \$100,000,000, 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 to policyholders is not less than the Minimum Surplus Amount, payments by the General Account to the Segregated Account under the Reinsurance Agreement are not capped.

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

AAC and the Segregated Account have also entered into a Cooperation Agreement, pursuant to which the parties have agreed to certain matters related to decision-making, information sharing, tax compliance and allocation of expenses (including an agreement by AAC to reimburse the Segregated Account for specified expenses to the extent not reimbursed under the Secured Note, subject to the Minimum Surplus Amount). AAC has made certain covenants to the Segregated Account, including an agreement to not enter into any transaction involving more than \$5,000,000 (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 AAC's investment policy), and providing the Segregated Account with an annual operating expense budget for AAC and its subsidiaries, as well as quarterly analyses of variances.

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

On March 24, 2010, the Rehabilitation Court also issued an injunction effective until further order of the Rehabilitation Court enjoining certain actions by Segregated Account

policyholders and other counterparties, including the assertion of damages or acceleration of losses based on early termination and the loss of control rights in insured transactions (the “Injunction Order”).

Policy obligations not allocated to the Segregated Account are not subject to and, therefore, will not be directly impacted by, the Rehabilitation Proceedings. Neither AAC nor its General Account is in rehabilitation proceedings.

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

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

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

D. The Commissioner and Special Deputy Commissioner

On January 3, 2011, Theodore K. Nickel replaced Sean Dilweg as Commissioner. Thereafter, Mr. Nickel assumed all roles and duties as Rehabilitator of the Segregated Account. References in this Report to the Commissioner or the Rehabilitator are to Mr. Dilweg or Mr. Nickel, as appropriate. Further on January 13, 2011, the Rehabilitator appointed Roger A. Peterson, Deputy Administrator, Division of Regulation and Enforcement for OCI, as Special Deputy Commissioner for the Segregated Account. Mr. Peterson replaced former Special Deputy Commissioner Kimberly A. Shaul, and assumed all authority of the Special Deputy Commissioner as set forth in the Rehabilitation Order and the Plan.

## II. STATUS OF PLAN OF REHABILITATION

A. Confirmation of the Plan of Rehabilitation

On October 8, 2010, the Rehabilitator filed the Plan of Rehabilitation (the “Plan”), together with a Disclosure Statement Accompanying Plan of Rehabilitation (the

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

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

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

As of the date of this Report, the Plan is not effective. The Rehabilitator is not satisfied that all of the conditions precedent to effectiveness of the Plan set forth in Section 5.01 of the Plan have been satisfied, and accordingly, the Rehabilitator has not designated an effective date for the Plan.

#### B. Summary of Litigation related to the Plan of Rehabilitation

On December 8, 2010, after the confirmation hearings but before entry of the Confirmation Order, the IRS removed the Rehabilitation Proceedings to the United States District Court for the Western District of Wisconsin (the “District Court”), with the stated intent of challenging the Supplemental Injunction. The IRS subsequently sought to dissolve the Supplemental Injunction, and OCI sought to remand the rehabilitation proceeding.

By order dated January 14, 2011, the District Court remanded the rehabilitation proceeding to the Court, concluding that the IRS removal was preempted by the McCarran-Ferguson Act, and that the District Court therefore lacked subject matter jurisdiction over the proceeding. The IRS appealed to the United States Court of Appeals for the Seventh Circuit on January 18, prompting the Court of Appeals to issue an order to show cause why the appeal should not be dismissed for lack of subject matter jurisdiction. As of the date of this Report, the appeal is pending as Case No. 11-1158 (7th Cir.).

On February 9, 2011, the IRS filed with the District Court a complaint for injunctive relief against the Court, the Rehabilitator and AAC seeking to enjoin them from enforcing or implementing the Plan. The IRS also filed a motion for preliminary injunction, claiming that exigent circumstances warranted emergency relief in the matter. On February 18,

2011, the District Court issued an opinion and order in which it concluded that it lacked subject matter jurisdiction over the lawsuit for the same reasons that it lacked jurisdiction over the IRS' attempted removal. The District Court dismissed the lawsuit, prompting the IRS to file a second appeal to the Seventh Circuit. This second appeal is pending before the Court of Appeals as Case No. 11-1419 (7th Cir.).

Apart from the IRS appeals in federal court, fifteen different parties or groups of parties have appealed from the Confirmation Order, bringing the total number of state court appeals to nineteen. The issues raised in the state court appeals include: (i) challenges to the establishment of the Segregated Account; (ii) challenges to the allocation of specific parts of AAC's business to the Segregated Account; (iii) challenges to the scope and substance of injunction orders issued by the Court; (iv) challenges to the Court's refusal to enjoin the Bank Settlement; (v) challenges relating to the denial of parties' requests to formally intervene as parties to the rehabilitation proceeding; (vi) challenges relating to the adequacy of Plan disclosures, denial of discovery requests, scheduling of hearings, evidentiary rulings, and other case-management rulings; (vii) challenges to the Court's competency or jurisdiction to issue certain rulings; and (viii) challenges to the Plan. The Rehabilitator has sought to consolidate these appeals for the sake of convenience and efficiency.

#### C. Guidelines Issued Pursuant to Plan of Rehabilitation

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

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

The Guidelines under Plan of Rehabilitation (Ceded Reinsurance) were filed with this Court on March 18, 2011 in order to preserve the value of reinsurance in respect of certain policies allocated to the Segregated Account and in recognition of certain requirements imposed by reinsurance contracts to which AAC is a party as a ceding company. These guidelines were developed over several months with input from the reinsurers under such contracts.

#### D. Development of Claims Processing System

In anticipation of the effective date of the Plan, OCI and AAC, in its capacity as management services provider to the Segregated Account, communicated with trustees for beneficial holders of the underlying financial instruments insured by many policies that were allocated to the Segregated Account, as well as the Depository Trust and Clearing Corporation, in an effort to facilitate the processing of policy claims beginning on the effective date. Such communications began in August 2010 (before the Plan was filed with the Court). Such

communications facilitated and informed the development of the provisions of the Plan governing the payment of policy claims, as well as the subsequent Guidelines under Plan of Rehabilitation (Claims Processing) as discussed above.

E. Potential Amendments to or Modifications of the Plan of Rehabilitation

The issuance of surplus notes by AAC and the issuance of surplus notes by the Segregated Account as contemplated by the Plan, together with continued deterioration of AAC's financial strength, could subject AAC to the risk of deconsolidation from the AFGI consolidated tax group for U.S. federal income tax purposes, which may require AAC to recognize significant cancellation of indebtedness income ("CODI") and limit AAC's ability to deduct surplus note interest. The recognition of substantial CODI and limitation of the surplus note interest deduction may have a material adverse effect on the financial condition of AAC and the Segregated Account, and reduce recoveries to Segregated Account policyholders. The Rehabilitator is continuing to evaluate these tax considerations and whether amendments to the Plan and/or the initiation of rehabilitation proceedings with respect to AAC would eliminate or mitigate such adverse potential tax consequences for the benefit of policyholders. Such amendments to the Plan could include the elimination of the issuance of surplus notes by the Segregated Account and/or the imposition of transfer restrictions on any surplus notes issued by the Segregated Account.

The Rehabilitator currently has no specific timeline or deadline for determining whether to seek amendments to or modifications of the Plan. When such decisions are finalized, the Rehabilitator will promptly advise parties-in-interest on the court-approved website, [ambacpolicyholders.com](http://ambacpolicyholders.com).

### III. AFGI BANKRUPTCY

On November 8, 2010, AFGI filed with the United States Bankruptcy Court for the Southern District of New York (the "Bankruptcy Court") a voluntary petition for relief under chapter 11 of the United States Bankruptcy Code (the "Bankruptcy Case"). Upon filing for bankruptcy protection, AFGI immediately commenced a lawsuit against the IRS, seeking to enjoin the IRS from attempting to levy its assets in connection with the Tax Refund Payments. AFGI also sought declaratory relief as to the amount of its tax liability, if any. The IRS's challenge to the tax refunds is directed at issues related to AAC's tax accounting methods with respect to credit default swap contracts. Specifically, the IRS is seeking to disallow AAC's deductions of credit default swap losses as ordinary losses, effectively taking the position that they were more properly characterized as capital losses. If the IRS were to successfully assert the proposed disallowance, AFGI and the various members of its consolidated tax group, including AAC, would be subject to both a substantial reduction in net operating losses ("NOLs") and would suffer a material assessment for federal income taxes, including with respect to the Tax Refund Payments. The Bankruptcy Case is pending in the Bankruptcy Court as Case No. 10-15973, and the lawsuit against the IRS is the subject of court-directed mediation scheduled to take place in early July 2011.

For nearly one year, and in particular since the commencement of AFGI's bankruptcy case in November, 2010, AAC and the Rehabilitator have negotiated with a group of

bondholder creditors of AFGI regarding the terms of a consensual plan of reorganization for AFGI. The parties have exchanged multiple versions of term sheets for a chapter 11 plan since November 2010, but have not yet reached an agreement on several critical components of such a plan, including the treatment of NOLs. AFGI's exclusive period to file a chapter 11 plan expires on July 6, 2011. The parties' failure to consummate a consensual plan would increase the likelihood that AAC and the Segregated Account would not retain access to the existing NOLs.

#### **IV. SIGNIFICANT POST-PETITION COMMUTATIONS AND SETTLEMENTS**

##### **A. The Bank Group Settlement – June 7, 2010**

In the fall of 2009, AAC became aware that several large financial institutions that were parties to credit default swaps with ACP in respect of collateralized debt obligations backed primarily by RMBS ("ABS CDOs") and collateralized loan obligations ("CLOs") and other CDOs were forming a group to negotiate with AAC regarding a global commutation of those exposures (the "Bank Group"). These policies represented the greatest concentration of projected losses to AAC as well as the largest potential source of collateral damage through the possibility of "mark-to-market" damages. The Bank Group eventually consisted of 14 financial institutions that, together with their direct affiliates, are among the largest financial institutions in the world.

On June 7, 2010, AAC, AFGI, ACP and the Bank Group entered into a settlement agreement which effected the commutation of all of ACP's outstanding credit default swaps in respect of ABS CDOs with respect to the Bank Group, and all of AAC's related financial guaranty exposure (the "Bank Group Settlement"). In exchange for AAC and ACP commuting \$16.5 billion of net par exposure, with an appraised present value ranging from \$8.7 to \$12.9 billion of projected losses (\$7.7 to \$12.9 billion using a 5.1% discount rate), AAC transferred to the Bank Group, in the aggregate, \$2.6 billion in cash and \$2 billion of surplus notes newly issued by AAC (the "Bank Settlement Notes"). AAC also paid \$96.5 million to the Bank Group to commute certain other obligations, including certain non-ABS CDO obligations, with par amounting to \$1.4 billion, in full satisfaction, but partial payment, of such obligations. In addition, subject to certain conditions, certain other non-ABS CDO exposures with par amounting to a maximum of \$702 million are expected to be commuted within the next six months for an amount up to approximately \$45 million.

Averaging the valuations of AAC's independent appraiser, the Bank Group Settlement ultimately paid the Bank Group 43.3% of the present value of expected losses, with 24.5% in cash and 18.8% in notes.

##### **B. The Weinstein Settlement – July 29, 2010**

On July 29, 2010, AAC commuted the Segregated Account's exposure under a financial guaranty insurance policy relating to a December 23, 2005, film securitization facility between The Weinstein Company LLC, HSBC Bank USA, National Association, as agent for the lender, The Weinstein Portfolio Funding Company LLC ("WPFC"), a special purpose subsidiary of TWC, and AAC. The facility provided \$500 million of funding for WPFC, and had an

outstanding principal balance of approximately \$450 million; AAC guaranteed the payment of interest and principal on the loan.

Under the terms of the settlement, AAC was fully released from the Weinstein policy in exchange for a cash payment of \$65 million from the Segregated Account and delivery of \$50 million in principal amount of surplus notes from the Segregated Account. Projected losses ranged from \$264 to \$300 million. The Court approved the settlement by order dated June 23, 2010.

C. Ambac UK Commutation – September 28, 2010

Pursuant to an Amended and Restated 1997 Reinsurance Agreement between Ambac UK and AAC (the “AUK Reinsurance Agreement”), AAC reinsured substantially all of the liabilities under policies issued by Ambac UK. On September 28, 2010, AAC entered into a Commutation and Release Agreement with Ambac UK and the Special Deputy Commissioner, pursuant to which the AUK Reinsurance Agreement was commuted and other capital support arrangements between AAC and Ambac UK were terminated. AAC paid a nominal termination amount to Ambac UK in connection with the commutation. The Ambac UK lease with British Land was terminated in 2010 without any payment by AAC.

D. Settlement with One State Street – May 19, 2011

One State Street, LLC (“OSS”) and AFGI were parties to a 1992 lease with respect to premises occupied by AAC and AFGI personnel at One State Street Plaza in New York. OSS asserted, and AAC and the Segregated Account denied, that AAC was a primary obligor under the lease. Nevertheless, AAC allocated to the Segregated Account any liability to OSS with respect to the lease. OSS challenged that allocation, the effectiveness of injunctions issued by the Court, the jurisdiction of the Court, and confirmation of the Plan. AAC and the Rehabilitator opposed the challenges and objections by OSS.

Pursuant to a Settlement, Discontinuance and Release Agreement entered into March 1, 2011, and made effective May 19, 2011, AAC, AFGI, the Segregated Account and OSS terminated AFGI’s existing headquarters office lease with OSS (the “Existing Lease”) and settled all claims among the parties relating to the Existing Lease. Pursuant to the Settlement Agreement, on May 19, 2011, AAC and OSS commenced a new lease (the “New AAC Lease”) extending through December 31, 2015. The New AAC Lease provides for a reduced amount of space at AAC’s current location, One State Street Plaza, at a current market price. In addition, OSS was permitted an allowed general unsecured claim in the Bankruptcy Case in the amount of approximately \$14 million, which amount is equal to the amount that AFGI would owe OSS under the Bankruptcy Code upon rejection of the Existing Lease (the “AFGI Payment”). The Segregated Account also issued two junior surplus notes to OSS in the aggregate amount of approximately \$36 million, which amount is equal to (i) the net present value (using a 7% discount rate) of certain amounts owed under the Existing Lease *minus* (ii) the net present value (using a 7% discount rate) of amounts owed under the New AAC Lease. One of the junior surplus notes is subject to reduction in amounts equal to (x) 83.33% of the value of any distribution received by OSS from AFGI’s bankruptcy estate and (y) the net present value (using a 7% discount rate) of rents paid during any extension term of the New AAC Lease.

The Settlement Agreement was approved by the Court on March 21, 2011, and by the Bankruptcy Court on March 24, 2011.

E. Las Vegas Monorail Corporation Bondholders – Pending

On December 27, 2010, the Segregated Account and AAC entered into a Settlement Agreement (the “LVM Settlement Agreement”) with Nuveen Asset Management, Restoration Capital Management LLC and Stone Lion Capital Partners L.P., on behalf of themselves and/or funds and accounts managed or controlled by them (collectively, the “Settling Bondholders”), as holders of Las Vegas Monorail Project Revenue Bonds, 1st Tier Series 2000, consisting of current interest bonds and capital appreciation bonds (the “LVM Insured Bonds”) insured by AAC pursuant to a financial guaranty insurance policy and surety bond (the “LVM Policies”). The LVM Insured Bonds were issued to fund the acquisition of, and upgrades and additions to, a monorail system in Las Vegas, Nevada, which is owned, managed and operated by the Las Vegas Monorail Company. The Las Vegas Monorail Company has been the subject of a chapter 11 bankruptcy proceeding since January 2010.

The LVM Settlement Agreement provides two alternative methods for resolving claims of the holders of LVM Insured Bonds (collectively, the “LVM Bondholders”) against the Segregated Account. The primary method (referred to as the “commutation”) provides that the LVM Policies will be commuted and the Segregated Account will be released from all liabilities and obligations thereunder. In consideration for such commutation and release, the LVM Bondholders will receive their pro rata share of a cash payment equal to \$111 million and \$90 million in principal amount of surplus notes issued by the Segregated Account to Wells Fargo Bank, N.A., as trustee (the “Trustee”), on behalf of holders of LVM Insured Bonds.

In the event that the commutation is not consummated by August 31, 2011 or is abandoned at the election of the Settling Bondholders or the Segregated Account in accordance with the terms of the LVM Settlement Agreement, the Segregated Account will commence an offer to purchase (the “offer to purchase”) from all LVM Bondholders their rights under the LVM Policies. The offer to purchase will be conducted through a “synthetic commutation” in which obligations of the Segregated Account under the LVM Policies will be fully and completely terminated and released as to all LVM Bondholders that accept the offer to purchase, but the rights of such LVM Bondholders against the Las Vegas Monorail Company in respect of the LVM Insured Bonds will be preserved. Those LVM Bondholders that do not accept the offer to purchase will retain their rights against the Segregated Account in respect of the LVM Policies. The Settling Bondholders have agreed to accept the offer to purchase, subject to certain terms and conditions specified in the LVM Settlement Agreement. In consideration for the termination and release of the obligations of the Segregated Account under the LVM Policies to each LVM Bondholder that accepts the offer to purchase, each such LVM Bondholder will receive its pro rata share of a cash payment equal to \$111 million and \$81 million in principal amount of surplus notes issued by the Segregated Account (which amounts assume that all LVM Bondholders accept the offer to purchase, i.e., if fewer than all LVM Bondholders accept the offer to purchase, then the aggregate cash payment and aggregate principal amount of surplus notes would be reduced proportionately).

Whether effected through the commutation or the offer to purchase, the surplus notes to be issued to the LVM Bondholders will be consistent with the terms and conditions of the form of surplus note annexed to the Plan.

The Court approved the Settlement Agreement by order dated April 21, 2011, since the settlement involves the payment of cash by the Segregated Account in excess of \$50 million.

F. Other Commutations and Settlements

Pursuant to certain surety bonds for swap agreements, AAC guaranteed certain payments required to be made by obligors under certain interest rate swap transactions to certain financial institutions, as beneficiaries under the policies (the “Swap Sureties”). On March 24, 2010, AAC’s obligations under the Swap Sureties were allocated to the Segregated Account. Since the Petition Date, AAC has entered into two separate agreements with certain financial institutions, as beneficiaries under the Swap Sureties, pursuant to which the financial institutions have agreed to release AAC and the Segregated Account from any obligations and liabilities under, or related to, the Swap Sureties, in exchange for the consent of the Rehabilitator to the exercise by the financial institutions of certain rights and remedies in connection with the interest rate swap transactions that would otherwise be enjoined by the Injunction, subject in each case to the terms and conditions of the respective agreements.

In addition to the foregoing settlements and commutations, since the Petition Date, the Segregated Account has settled or otherwise resolved its liabilities under four policies aggregating \$730 million of net par outstanding, for aggregate consideration, before reinsurance recoveries of \$18 million in cash and \$4 million in surplus notes. Each such settlement was concluded with the consent of the Rehabilitator or Special Deputy Commissioner, as authorized by Wis. Stat. § 645.33(2), the Order for Rehabilitation, and the Injunction.

In addition, since the Petition Date, the Segregated Account has commuted 32 policies, aggregating approximately \$2.5 billion of net par outstanding, without any payments by AAC or the Segregated Account.

**V. FINANCIAL REVIEW**

With the assistance of his financial advisors, the Rehabilitator has set forth below a detailed update on the assets and liabilities of the General Account and Segregated Account.

A. General Account Assets Available to Pay Segregated Account (and other) Liabilities

Total claims-paying resources were approximately \$6.8 billion as of March 31, 2011, unchanged from estimated claims-paying resources as of June 30, 2010. Primary components of claims-paying resources include (i) \$5.2 billion of investment portfolio assets at statutory carrying value, (ii) \$0.7 billion in net present value of future installment premiums, (iii) \$0.7 billion of intercompany loans, and (iv) \$0.2 billion of investments in subsidiaries. The foregoing estimate of claims-paying resources includes certain assumptions and judgments regarding future events that are described more fully below.



Available funds not used to purchase short-term instruments and corporate and taxable municipal bonds have generally been deployed to purchase AAC-insured instruments as part of loss mitigation efforts. During the nine-month period ended March 2011, AAC paid approximately \$189 million to purchase approximately \$295 million in then-outstanding par value of AAC-insured instruments. As of March 31, 2011, AAC-insured instruments held in the investment portfolio through such loss mitigation efforts account for 10% of portfolio fair value, 10% of portfolio carrying value, and 17% of portfolio par value, compared with 6%, 6%, and 16%, respectively, as of June 30, 2010. The fair value of AAC-insured holdings acquired through such loss mitigation efforts as a percentage of par value was 46% as of March 31, 2011, compared with 36% as of June 2010.

As of March 31, 2011, investment portfolio holdings representing approximately 78% of aggregate portfolio carrying value possess an investment grade rating or may otherwise be considered investment-grade, versus 83% nine months earlier. This reduction in investment grade holdings is primarily due to the purchase of AAC-insured instruments as part of loss mitigation efforts. Similarly, this loss mitigation strategy has led to an increase in holdings of defaulted securities, which now represent approximately 6% of total portfolio carrying value as of March 31, 2011 compared with 3% nine months earlier.

AAC categorizes investment portfolio holdings by market liquidity, or salability. This categorization process is intended to assess the relative ease with which a particular security can be sold. Accordingly, each security is classified as either (i) highly liquid, (ii) medium liquid, (iii) low liquid or (iv) illiquid. The market liquidity profile of AAC's investment portfolio as of March 31, 2011 is summarized below:

#### AAC Investment Portfolio by Market Liquidity Classification as of March 31, 2011

	Fair Value	Carrying Value	Par Value	Fair Value	Carrying Value	Par Value
	(In millions)			(Percentage of Total)		
Highly Liquid	\$2,009	\$1,977	\$1,963	37%	38%	30%
Medium	1,879	1,822	2,023	35%	35%	30%
Low	396	278	841	7%	5%	13%
Illiquid	1,123	1,127	1,807	21%	22%	27%
Total	\$5,407	\$5,204	\$6,634	100%	100%	100%

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

Over the past nine months, securities classified as highly liquid or illiquid have increased as a percentage of overall holdings, while the percentage of securities classified as either medium liquid or low liquid have declined – an outcome consistent with the investment and loss mitigation strategies described above. Consequently, securities classified as highly liquid presently represent 38% of total portfolio carrying value, versus 35% as of June 30, 2010 and securities classified as illiquid represent 22% of aggregate carrying value, compared with 20% as of June 30, 2010.

## 2. Installment Premiums

Many insurance policies provide for premiums to be paid to AAC over the life of the exposure. Under the terms of the Plan of Operation, the General Account retains the right to receive installment premiums from all policies, although the right to receive installment premiums related to Segregated Account policies constitutes part of the security for its obligations under the Secured Note and the Reinsurance Agreement.

The value attributable to future installment premium receipts is subject to significant uncertainty. In the ordinary course of business, factors such as early contract termination or commutation, accelerated prepayments of underlying obligations, or insufficiency of cash flows (by the premium paying entity) may lead to lower-than-projected installment premium receipts. Based on his consideration of these factors, the Rehabilitator believes that AAC is unlikely to receive all currently anticipated future installment premium receipts, and therefore reduced his estimate of future installment premium receipts to reflect such belief.

After giving effect to such adjustments, the present value of such future installment premiums (net of reinsurance and reflecting consummated and pending commutations) are estimated at \$0.7 billion as of March 31, 2011 using a 5.1% discount rate, compared with \$1.0 billion as of June 30, 2010.

## 3. Intercompany Loans

As of March 31, 2011, AAC had \$1.025 billion in loans to affiliates, representing an \$88 million decline from the \$1.113 billion of intercompany loans outstanding as of June 30, 2010. Loans to affiliates were comprised of (i) \$257 million in secured loans and \$285 million in unsecured loans extended to Ambac Capital Funding Inc. (“ACFI”), and (ii) \$143 million in unsecured securities loans and \$340 million in unsecured cash loans extended to Ambac Financial Services, LLC (“AFS”). Most of the reduction in the aggregate intercompany loan balance from June 2010 to March 2011 is attributable to lower borrowings by AFS.

A portion of the AFS obligation is comprised of \$143 million of loans provided in the form of marketable securities. In accordance with Statutory Accounting Practices (“SAP”), the statutory carrying value of the loaned securities are included in the investment portfolio totals summarized in Section V.1 above and, therefore, such \$143 million is excluded from this calculation of the intercompany loan component of claims-paying resources.

AAC anticipates that (i) no impairments will be experienced with respect to the ACFI secured loan and (ii) \$217 million of impairments will be experienced with respect to the

unsecured intercompany loans, resulting in aggregate statutory carrying value of \$665 million (as reported in AAC's March 31, 2011 statutory financial balance sheet).

a) ACFI Intercompany Loans

The guaranteed investment contract ("GIC") business, operated through ACFI, had approximately \$717 million in GICs outstanding as of March 31, 2011, compared with \$943 million as of June 30, 2010.

AAC currently expects to experience a \$65 million impairment of the \$285 million unsecured loan to ACFI, implying a 77% recovery of principal. This impairment estimate is based upon various assumptions, including, but not limited to, assumptions regarding interest rates, portfolio performance, early contract terminations, and litigation recoveries. Accordingly, the ultimate impairment realized in respect of this obligation may change, perhaps materially, to the extent future performance differs from such assumptions.

b) AFS Intercompany Loans

As of March 31, 2011, AFS maintained positions with gross notional exposure of approximately \$5.9 billion, compared with \$6.4 billion as of June 30, 2010. These swap obligations are primarily floating-for-fixed interest rate swaps with municipalities and financial institutions.

AAC currently expects to experience a \$152 million impairment of the \$340 million unsecured loan to AFS, implying a 55% recovery of principal. This impairment estimate is based upon various assumptions, including, but not limited to, forward interest rates, the ability of counterparties to pay when due, early contract terminations and litigation recoveries. Accordingly, the ultimate impairment realized in respect of this obligation may change, perhaps materially, to the extent future performance differs from such assumptions.

4. Investment in Subsidiaries

As of March 31, 2011, AAC's investment in subsidiaries comprised \$178 million in Everspan Financial Guarantee Corp. ("Everspan"), compared with \$173 million as of June 30, 2010. Everspan's insured book totals approximately \$286 million in net par outstanding and primarily consists of healthcare, leasing, and higher education exposures. As of March 31, 2011, three exposures representing approximately 17% of aggregate net par outstanding were adversely classified, although no case-basis statutory reserves had been established in respect of these exposures. The Rehabilitator believes that AAC's investment in Everspan will ultimately be available to fund Segregated Account and General Account obligations in accordance with the Plan.

5. Miscellaneous

Other prospective claims-paying resources include (i) accrued but unpaid interest and cash and (ii) certain tax attributes.

a) Accrued Interest and Cash

As of March 31, 2011, AAC had \$37 million in accrued and unpaid interest and \$3 million in cash, neither of which is incorporated in the investment portfolio totals summarized above.

b) Certain Tax Attributes

As of December 31, 2010, the consolidated return group of which AAC is a part (the “Ambac Group”) had NOLs of approximately \$7 billion (including approximately \$300 million attributable to Ambac UK). The Ambac Group can utilize these tax attributes in certain circumstances to offset future U.S. taxable income and reduce the U.S. federal income tax liability of a member of the Ambac Group (including AAC). The ultimate benefits that may be realized by the members of the Ambac Group are subject to many uncertainties, including (i) the outcome of ongoing litigation with the Internal Revenue Service, (ii) the ability of the Ambac Group, or members thereof, to generate taxable income that would allow for meaningful utilization of the NOLs, (iii) the potential of annual limitations on usage due to an “ownership change” as defined under Section 382 of the Internal Revenue Code (whether as the result of the AFGI reorganization, subsequent trading in the common stock of a reorganized AFGI, a ruling by the Internal Revenue Service that the surplus notes represent an equity interest for federal income tax purposes, or otherwise), and (iv) the potential that existing tax attributes may be extinguished if AFGI is unable to reorganize successfully.

Furthermore, the ultimate benefits that may be specifically realized by AAC and its direct and indirect subsidiaries, rather than the broader Ambac Group, are subject to further uncertainties related to the allocation of such NOLs among members of the Ambac Group. Such allocation has been the subject of discussions with AFGI and a group of bondholder creditors of AFGI as a component of a consensual plan of reorganization for AFGI; however, the parties have not yet reached an agreement on such allocation. In the event that (i) substantial amounts of CODI are recognized by AAC and the surplus note interest deduction is limited and (ii) the existing NOLs are rendered unavailable to AAC and its direct and indirect subsidiaries, the loss of such NOLs may have a material adverse effect on the financial condition of AAC and the Segregated Account, and reduce recoveries to Segregated Account policyholders. Readers should consult AFGI’s quarterly report on Form 10-Q for the period ended March 31, 2011 for further information.

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

1. Summary of Liabilities

The Segregated Account is primarily exposed to RMBS and student loan-related risk, although some public finance and non-RMBS structured finance policies have also been allocated to the Segregated Account as well. While the General Account is primarily exposed to the U.S. public finance sector on a direct basis, it retains exposure to Segregated Account policies under the terms of the Secured Note and the Reinsurance Agreement.

The following information about General Account and Segregated Account exposures is presented as of March 31, 2011, with the exception of information related to

adversely classified credits, which is presented as of April 2011. Comparisons to June 30, 2010 data are presented pro forma for the results of the student loan assessment process and the termination of the AUK Reinsurance Agreement, consistent with the presentation of June 2010 data in the Disclosure Statement.

## 2. General Account Exposures

### a) Overview

As of March 31, 2011, approximately 12,000 policies representing \$241 billion in net par outstanding remain in the General Account, compared with approximately 13,000 policies aggregating \$267 billion in net par outstanding as of June 30, 2010.<sup>1</sup> The significant reduction in General Account policies and net par outstanding experienced over the past nine months is a function of both scheduled terminations (such as maturity of a specific obligation) and unscheduled terminations (such as a refinancing transaction).

U.S. public finance exposures represent \$193 billion, or 80%, of aggregate net par outstanding in the General Account, as well as 95% of total General Account policies. See below for a summary of policies and net par outstanding by exposure category.

### General Account Policies and Net Par Outstanding as of March 31, 2011

Dollars in Millions	Policies		Net Par Outstanding	
	Amount	Percentage	Amount	Percentage
			(In millions)	
U.S. Public Finance.....	11,297	95%	\$193,344	80%
Other Structured Finance.....	459	4%	22,272	9%
CLOs and other CDOs.....	60	1%	14,782	6%
International.....	61	1%	10,549	4%
<b>Total.....</b>	<b>11,877</b>	<b>100%</b>	<b>\$240,947</b>	<b>100%</b>

### b) Credit Profile

The total amount of adversely classified General Account net par outstanding has increased by \$1.7 billion, or 32%, since June 30, 2010. Approximately \$6.9 billion, or 3%, of General Account net par outstanding is adversely classified, compared with \$5.2 billion, or 2%, of then-outstanding General Account net par outstanding as of June 30, 2010. Approximately \$1.2 billion of all adversely classified General Account exposures are currently classified in the more severe III and IV classifications, compared with \$0.7 billion as of June 30, 2010. A summary of adversely classified General Account net par outstanding is shown below.

<sup>1</sup> All General Account policy and net par outstanding information includes Everspan totals.

## Net Par Outstanding Associated with Adversely Classified General Account Policies

Dollars in Millions	Adversely Classified	Credit Classification			
		I-A	II	III	IV
		(In millions)			
U.S. Public Finance.....	\$3,518	\$843	\$2,044	\$46	\$584
Other Structured Finance.....	2,935	2,302	92	541	0
CLOs and Other CDOs.....	299	214	85	0	0
International.....	121	0	121	0	0
<b>Total.....</b>	<b>\$6,873</b>	<b>\$3,359</b>	<b>\$2,342</b>	<b>\$587</b>	<b>\$584</b>

### c) Loss Reserves

Statutory loss reserves reflect AAC management's best estimate of the present value of future loss payments (net of projected subrogation recoveries) for policies that have already defaulted, discounted at the applicable statutory rate (currently 5.1%). As of March 31, 2011, total statutory reserves associated with General Account policies were approximately \$(32) million.

As part of GAAP accounting requirements, AAC develops estimates of gross claim liability for all policies, whether defaulted or not. The aggregate gross claim liability associated with all General Account policies was approximately \$275 million as of March 31, 2011, versus approximately \$120 million as of June 30, 2010.<sup>2</sup> As the calculation of gross claim liabilities under GAAP is different than that of statutory loss reserves in many respects, readers should consult AFGI's annual reports on Form 10-K and quarterly reports on Form 10-Q for further descriptions of GAAP loss calculations.

### d) Claim Payments since June 30, 2010 and since the Petition Date<sup>3</sup>

AAC paid \$18 million in claims resulting from General Account policies between July 1, 2010 and March 31, 2011, compared with \$26 million in projected claim payments contemplated for this period in the General Account Base Case Loss Estimates, as set forth in the Disclosure Statement. Since the Petition Date, AAC has made \$28 million in aggregate General Account payments.

## 3. Segregated Account Exposures

### a) Overview

Aggregate Segregated Account net par outstanding declined by \$5 billion, or 11%, from \$47 billion as of June 30, 2010 to \$42 billion as of March 31, 2011. RMBS and student loan exposures account for 87% of aggregate Segregated Account net par outstanding

<sup>2</sup> General Account gross claim liability data is presented gross of projected recoveries associated with certain structured finance policies.

<sup>3</sup> All claim payment data is presented gross of realized recoveries.

and 65% of all Segregated Account policies. See below for a summary of Segregated Account policies and net par outstanding.

### Segregated Account Policies and Net Par Outstanding as of March 31, 2011

Dollars in Millions	Policies		Net Par Outstanding	
	Amount	Percentage	Amount (In millions)	Percentage
<u>Direct</u>				
RMBS.....	296	46%	\$26,419	63%
U.S. Public Finance.....	167	26%	1,390	3%
Structured Finance.....	29	5%	594	1%
Student Loans.....	120	19%	10,288	24%
International.....	18	3%	868	2%
ACP.....	12	2%	2,141	5%
Subtotal.....	643	100%	\$41,700	99%
Assumed.....	0	N/A	442	1%
<b>Total.....</b>	<b>643</b>	<b>100%</b>	<b>\$42,142</b>	<b>100%</b>

#### b) Credit Profile

Approximately \$35 billion, or 84%, of aggregate Segregated Account net par outstanding is adversely classified, compared with \$38 billion, or 81%, as of June 30, 2010. Approximately \$32 billion, or 75% of aggregate Segregated Account net par outstanding, was designated with the more severe III and IV risk classifications, compared with \$35 billion, or 74%, as of June 30, 2010. A summary of adversely classified Segregated Account net par outstanding is presented below.

### Net Par Outstanding Associated with Adversely Classified Segregated Account Policies

Dollars in Millions	Adversely Classified NPO	Credit Classification			
		I-A	II	III	IV
(In millions)					
<u>Direct</u>					
RMBS.....	\$23,743	\$1,512	\$372	\$8,757	\$13,102
U.S. Public Finance.....	582	0	58	0	523
Structured Finance.....	55	0	55	0	0
Student Loans.....	10,183	0	1,468	8,715	0
International.....	366	67	208	91	0
CDS.....	291	0	97	194	0
Subtotal.....	\$35,220	\$1,579	\$2,259	\$17,757	\$13,626
Assumed.....	247	0	110	137	0
<b>Total.....</b>	<b>\$35,467</b>	<b>\$1,579</b>	<b>\$2,369</b>	<b>\$17,894</b>	<b>\$13,626</b>

#### c) Loss Reserves

As of March 31, 2011, total statutory loss reserves associated with defaulted Segregated Account policies were approximately \$2.8 billion, compared with \$1.8 billion as of June 30, 2010. Statutory loss reserves as of March 2011 are net of approximately \$2.2 billion of

projected recoveries associated with alleged representation and warranty breaches (“R&W Recoveries”) related to certain RMBS transactions.<sup>4</sup> If such R&W Recoveries are excluded, aggregate statutory reserves associated with Segregated Account policies would be \$5.0 billion as of March 31, 2011, compared with \$3.8 billion as of June 30, 2010.<sup>5</sup>

Statutory loss reserves associated with Segregated Account policies are maintained in the General Account in accordance with accounting principles prescribed or permitted by OCI for reporting purposes and exclude the effect of the allocation of the policies to the Segregated Account. The allocation of the liabilities to the Segregated Account is reflected on the balance sheet of the General Account, prepared in accordance with SAP as “Liabilities Allocated to the Ambac Assurance Segregated Account.” See below for a summary of statutory reserves associated with Segregated Account policies by category.

### Statutory Reserves Associated with Segregated Account Policies as of March 31, 2011

Dollars in Millions	Statutory Reserves	
	Statutory Reserves	Excluding R&W Remediation Recoveries
RMBS.....	\$2,407	\$4,646
US Public Finance.....	220	220
Student Loans.....	14	14
Loss Adjustment Expense <sup>(1)</sup> .....	129	129
<b>Total .....</b>	<b>\$2,771</b>	<b>\$5,010</b>

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

As noted above, statutory reserves reflect prospective losses for defaulted policies. As part of GAAP accounting requirements, AAC develops estimates of gross claim liability for all policies, whether defaulted or not. The aggregate gross claim liability associated with Segregated Account policies was approximately \$5.5 billion as of March 31, 2011, compared with \$4.3 billion as of June 30, 2010. Such estimates include R&W Recoveries of \$2.5 billion as of March 2011 and \$2.3 billion as of June 2010, respectively. If such R&W Recoveries are excluded, aggregate gross claim liabilities associated with Segregated Account policies would be \$8.0 billion as of March 31, 2011, compared with \$6.6 billion as of June 30, 2010. As the calculation of gross claim liabilities under GAAP is different than that of statutory loss reserves in many respects, readers should consult AFGI’s annual reports on Form 10-K and quarterly reports on Form 10-Q for further descriptions of GAAP loss calculations.

<sup>4</sup> Readers should consult AFGI’s annual reports on Form 10-K and quarterly reports on Form 10-Q for additional disclosure regarding R&W Recoveries.

<sup>5</sup> R&W Recoveries associated with defaulted RMBS policies was \$2.1 billion as of June 30, 2010.

d) Claim Presentments since June 30, 2010 and since the Petition Date

Approximately \$1.1 billion in claims resulting from Segregated Account policies were presented between June 30, 2010 to March 31, 2011, compared with \$1.8 billion in projected claim development contemplated for this period in the Segregated Account Base Case Loss Estimates, as set forth in the Disclosure Statement. Second lien claims presented during this time frame exceeded the levels contemplated in the Segregated Account Base Case Loss Estimates by \$34 million, or 7%. In contrast, first lien claims presented were \$677 million, or 54% below the levels contemplated in the Segregated Account Base Case Loss Estimates, largely due to delays in liquidation of delinquent collateral in insured first lien securitizations. See below for a comparison of actual versus projected Segregated Account claims presented from June 30, 2010 to March 31, 2011.

**Actual versus Projected Segregated Account Claim Development from June 30, 2010 to March 31, 2011**

Dollars in Millions	Actual	Projected	Above (Below) Projections	
			Dollars	Percentage
1st Lien RMBS	\$581	\$1,258	(\$677)	-54%
2nd Lien RMBS	521	487	34	7%
Other SA Exposures	10	32	(22)	-70%
Total	\$1,112	\$1,777	(\$666)	-37%

Since the Petition Date, approximately \$1.8 billion in claims have been presented on Segregated Account policies, representing an average of \$136 million per month. Total Segregated Account claims presented by category since the Petition Date are summarized below:

**Segregated Account Claims Presented Since Petition Date**

Dollars in Millions	March 25, 2010	July 1, 2010	Total
	to June 30, 2010	to March 31, 2011	
1st Lien RMBS	\$251	\$581	\$832
2nd Lien RMBS	405	521	926
Other SA Exposures	-	10	10
Total	\$656	\$1,112	\$1,768