
In the Matter of the Rehabilitation of:

Segregated Account of Ambac Assurance Corporation

Case No. 10-CV-1576
10-CV-1576-B
10-CV-1576-C
10-CV-1576-D
10-CV-1576-G
10-CV-1576-I
10-CV-1576-J
10-CV-1576-K

SECOND AFFIDAVIT OF CATHLEEN J. MATANLE

STATE OF NEW YORK)
) ss.
COUNTY OF NEW YORK)

Cathleen J. Matanle, being duly sworn, deposes and states as follows:

Introduction

1. My background and employment history at Ambac Assurance Corporation ("Ambac") are set forth in my first affidavit submitted in this proceeding, which was dated May 20, 2010. My current position has changed. I am now the head of credit and portfolio risk management.

Control Rights

2. Several trustee banks seek modification of the Injunction Order such that Ambac would sacrifice its "control rights" in hundreds of transactions. These banks state that they are trustees with respect to residential mortgage-backed securities ("RMBS"), asset-backed securities, and other bonds insured by Ambac.



3. Although there are differences from transaction to transaction, I am familiar with the general types of contractual rights that Ambac typically holds (either directly or acting through insured noteholders) in relation to RMBS, asset-backed securities and other types of bonds. Ambac's contractual rights include rights to approve amendments, waivers and consents, rights to access records, rights to receive information, rights to remove certain transaction parties with ongoing administrative responsibilities, rights to declare events of default, trigger events and early amortization events and rights to direct enforcement actions and the exercise of remedies, including the disposition of collateral. These rights, individually and collectively, are referred to herein as "control rights." I believe that Ambac possesses varying degrees of control rights with respect to most of the transactions involving policies allocated to the Segregated Account.

4. If Ambac were no longer entitled to exercise its control rights, some of these rights would be exercisable by the bond trustee or the bondholders, but some may be lost and not be exercisable by the bond trustee, the bondholders or any other party in the transaction.

5. In some transactions, Ambac enjoys certain control rights under the transaction documents that enable Ambac to exercise a greater level of control and access to information than any other party on the creditor side of the deal, including the holders of Ambac-insured bonds. Ambac negotiated for these rights because it is skilled and experienced in utilizing such rights to mitigate losses, which benefits both Ambac and the bondholders. For example, in certain RMBS transactions, Ambac may be the only party with the rights to obtain information such as loan files and to perform diligence visits on

the servicer. The ability to obtain loan files is critical in identifying breaches of representations and warranties triggering the repurchase remedy or providing the evidentiary basis for an enforcement action. If Ambac were to lose these rights, or any control-right that belongs exclusively to Ambac, then no other party on the creditor side of the transaction would be entitled to exercise them and the performance of the transaction could materially suffer as a result. This would be counter to the interests of both Ambac and bondholders. Even in transactions where other parties have the same or similar rights, Ambac may be the party most capable and motivated to exercise such rights.

6. Except for control rights belonging only to Ambac, if Ambac were to lose its control rights then such rights would likely belong to either the bond trustee or the bondholders. In my experience, where bond trustees have not been able to rely upon Ambac's control, they have typically been unable or unwilling to take action without the direction of a requisite number of bondholders representing a material amount of the principal outstanding under the notes (hereafter, the "Requisite Bondholders") and indemnification from such bondholders.

7. If the control rights lost by Ambac were left to the Requisite Bondholders or to the trustee (acting upon the directions of the Requisite Bondholders), such bondholders may be unable to organize or to reach a consensus to take action in a timely way, particularly in cases where the consent of a majority, supermajority or 100% of the bondholders is required. Thus, the loss of Ambac's control rights would likely stall, and possibly prevent, remediation efforts with respect to a transaction (e.g., changing servicers, negotiating loan repurchases, and conducting litigation). Inaction or delays in

action may increase the risks of loss inherent in transactions. This would be counter to the interests of both Ambac and bondholders.

8. For example, in certain RMBS transactions, Ambac has negotiated for the ability to terminate a poorly performing servicer due to the triggering of certain pool delinquency or default triggers. If Ambac were to lose this right, it would become exercisable by the bondholders, but their ability to collectively effect the termination and transition to a new servicer would be uncertain. The transfer of servicing requires not only the expenditure of funds, but expertise and consensus in selection of an effective servicer, amendments to the transaction documents required by the new servicer, and negotiation with the rating agencies to obtain their approval. Failure to terminate a poorly performing servicer due to the bondholders' inability to take decisive action in an expedient fashion would be counter to both the interests of Ambac and the bondholders.

9. In addition, if Ambac were to lose its control rights, then in some transactions issuers of insured obligations would also be deprived of one of the benefits that they received by involving Ambac in such transactions, namely, having a single, experienced and willing counterparty empowered to make decisions in respect of its requests for amendments, waivers and consents. Issuers would have to seek such deal modifications from bondholders, and may suffer from defaults or onerous covenants due to inaction or delays in action by bondholder groups authorized to exercise control rights that had belonged to Ambac.

10. Bondholders might exercise control rights differently than Ambac would, as their interests may not always be aligned with Ambac's interests. For example, some bondholders that purchased bonds at low prices may be inclined to dispose of collateral at

depressed prices, which would increase deficits in cash flow available for debt service. Under these circumstances, such differences in incentives and approach could expose Ambac to the risk of increased liability under its policies and hurt other bondholders. Given that Ambac bears the ultimate risk of loss, Ambac believes it should control any disposition of collateral and should similarly retain its other important control rights.

Indemnification

11. I am informed that certain trustee banks have objected to obtaining indemnification in the form of an administrative claim against the Segregated Account. Such administrative claims are addressed by Sections 9.B.2(iv) and 9.C.2(ii) of the Injunction Order.

12. Recently, one of the banks that has filed objections in this proceeding, Bank of New York Mellon ("BNY"), received payment of a claim against the Segregated Account for costs and expenses. BNY had administrative claims for its costs and expenses relating to a commutation transaction with The Weinstein Portfolio Funding Company LLC that was approved by this Court on June 23, 2010. Dkt. 261. The claim was paid in full.

ALL Student Loans

13. Ambac insures certain bonds issued by Access to Loans for Learning Student Loan Corporation ("ALL"). The policies insuring these bonds are numbered 24368BE and 25599BE (the "ALL Policies") and were allocated to the Segregated Account. This affidavit refers to the bonds issued by ALL that are insured by the ALL Policies as the "ALL Bonds."

14. The ALL Bonds are payable by a trust (the "ALL Trust") that holds a portfolio of student loans as collateral. The bondholders' recourse is limited to the ALL Trust, with Ambac insuring the trust's bond repayment obligations. Thus, Ambac is liable to pay principal and interest on the ALL Bonds to the extent the ALL Trust fails to do so. The student loans comprising the assets of the ALL Trust are insured by governmental authorities, but the principal and interest obligations of the ALL Trust with respect to the ALL Bonds are not so insured. Therefore, since Ambac insured the payment of principal and interest on the ALL Bonds when due, Ambac is at risk of loss if the assets of the ALL Trust are not sufficient to pay the liabilities of the ALL Trust in respect of the ALL Bonds.

15. ALL filed a brief objecting to the allocation of the ALL Policies to the Segregated Account. Dkt. 234. ALL was joined in this brief by Lloyds TSB Bank plc ("Lloyds Bank"), which is the liquidity provider for a series of ALL Bonds that was issued in 2006 and insured by Ambac policy no. 25599BE. My understanding, based upon communications between representatives of Ambac and Lloyds Bank, is that Lloyds Bank now owns the entire series of ALL Bonds issued in 2006.

16. Depfa Bank plc ("Depfa") also filed a brief addressing the ALL Bonds Dkt. 218. Depfa is the liquidity provider for a series of ALL Bonds issued in 2005 and insured by Ambac policy no. 24368BE. Based upon communications between representatives of Ambac and Depfa, my understanding is that Depfa owns the entire series of ALL Bonds issued in 2005.

17. Lloyds Bank and Depfa became bondholders when, pursuant to the terms of the liquidity facilities provided by such banks, the banks purchased the bonds

supported by such liquidity facilities when the former bondholders exercised their right to sell the bonds at par to the liquidity providers pursuant to the terms of their liquidity facility agreements.

18. While owned by the liquidity providers, the bonds (sometimes called "bank bonds" after their purchase by the liquidity providers) bear interest at much higher rates (sometimes known as "bank bond rates") than the interest rates that were in effect prior to their acquisition by the banks. In addition, upon the occurrence of certain defaults under the liquidity facility agreements, the banks are entitled to charge default rates of interest on bank bonds that are even higher than the bank bond rates. Both Depfa and Lloyds Bank would have had the contractual right to increase the bank bond rates payable on the ALL Bonds for which they are the respective liquidity providers to such higher default rates. This additional increase would materially deplete the assets in the ALL Trust, in the absence of the Injunction Order issued by the Court. Such further increases in interest rates would result in the assets of the ALL Trust being used more quickly to pay debt service on the ALL Bonds. Thus, allocating the ALL Policies to the Segregated Account prevented further deterioration of the ALL Trust.

19. The bank bonds are subject to accelerated principal payments. Lloyds Bank has the right to have its bonds redeemed in full in 2013 and Depfa has the right to have its bonds redeemed in full in 2018. Before they were bank bonds, principal on the bonds issued in 2006 was not scheduled to be paid until the legal final maturity date of July 1, 2041, and principal on the bonds issued in 2005 was not scheduled to be paid until the legal final maturity date of July 1, 2040. Had the ALL Bonds not become bank

bonds, only interest would have been contractually due periodically before such maturity dates.

20. The changes in interest rates from variable market-based interest rates to bank bond rates and the acceleration of the principal payment schedule have placed, and will continue to place, a great amount of stress upon the ALL transaction. The consequence of the present condition of the ALL Trust is that it must use principal payments received on the underlying student loans to pay current interest on the bank bonds, a phenomenon that will cause the gap between the assets and liabilities of the ALL Trust to grow wider over time, ultimately resulting in a shortfall in the amount of funds available to pay principal on the ALL Bonds when due. Indeed, the principal amount of the student loan assets in the ALL Trust is now lower than the principal amount of the outstanding ALL Bonds. This shortfall in assets available to satisfy liabilities is already identifiable, and essentially ensures that Ambac will suffer a loss on the ALL Policies. An increase in interest rates to the applicable default rates would only have exacerbated the shortfall. This is not a question of the quality of the collateral, since the pool of student loans is insured by governmental authorities. The problem results from the finite quantity of student loan assets and the income they generate in relation to the elevated interest rates and accelerated payment obligations on the ALL Bonds, which must be met by the ALL Trust in the first instance and by Ambac if the ALL Trust fails to meet these obligation.

21. In summary, as a result of the shortfall in assets available to satisfy the liabilities of the ALL Trust and Depfa's and Lloyds Bank's ability to increase the interest rate to the applicable default rate (absent the Injunction Order), which would have led to

further deterioration of the already stressed ALL Trust, it was decided to allocate the ALL Policies to the Segregated Account.

22. While other Ambac-insured student loan backed securities may have had problems similar to those affecting the ALL Bonds, no consensus was reached as to whether the related policies should be allocated to the Segregated Account because more time was required to assess loss probabilities associated with such transactions. For this reason, it was believed that a decision about whether those policies should be allocated to the Segregated Account would best be made after further review during the assessment period. With respect to the ALL Policies, however, it was not believed that the assessment process would result in any change to the analysis.

The Treasurer of the State of Ohio and KnowledgeWorks

23. There are three Ambac policies pertaining to student loan-backed bonds issued by the Treasurer of the State of Ohio (the "Ohio Bonds"). These policies are numbered 23838BE, 26053BE and SW0240BE (the "Ohio Policies"). The full title of the final policy, SW0240BE, is Surety Bond for Swap Agreement (the "Swap Policy"). The Swap Policy was allocated to the Segregated Account. The other two Ohio Policies remain obligations of the General Account, but are subject to an assessment process described below and in the Plan of Operation for the Segregated Account.

24. The Swap Policy differs from the other two Ohio Policies in that it insures payments due from the Treasurer of the State of Ohio (the issuer of the Ohio Bonds) under a swap agreement, as opposed to the payment of principal of, and interest on, the Ohio Bonds themselves. A copy of the Swap Policy is attached as Exhibit 3 to the

Affidavit of Donald J. Kohne, sworn to on June 21, 2010, which was filed with KnowledgeWorks' Brief. Dkt. 238.

25. The purpose of this swap agreement is to provide a hedge against a mismatch between the interest that must be paid on the Ohio Bonds and the interest generated by the student loans held by the trust that must repay the bonds.

26. The underlying swap insured by the Swap Policy is governed by an ISDA Master Agreement that contains provisions that entitle the swap counterparty to terminate the swap based on the occurrence of certain bankruptcy or insolvency events involving Ambac or based on the financial condition of Ambac because Ambac is designated "Credit Support Provider" of the issuer of the Ohio Bonds. (A copy of this ISDA Master Agreement is attached as Exhibit 8 to the Kohne Affidavit.) In connection with any such termination, the issuer might be required to pay a settlement amount to the swap counterparty. Should the issuer default on such obligation, the swap counterparty could demand payment from Ambac under the Swap Policy.

27. In the absence of the Injunction Order, which prevents the exercise of termination rights by the swap counterparty, the issuer and Ambac would be exposed to the risk that the swap counterparty would attempt to terminate the swap agreement based on either the occurrence of certain bankruptcy or insolvency events involving Ambac or based on the financial condition of Ambac.

28. If the Swap Policy were removed from the Segregated Account, thus allowing the swap counterparty to assert the right to terminate the swap, there would be the potential for the issuer to owe a termination payment. Ambac would be liable for this termination payment should the issuer be found to be liable to, and fail to, make this

payment. Additionally, the issuer would be left without an effective hedge for its interest rate exposure on the bonds, which are insured by Ambac.

29. These triggers based upon certain bankruptcy or insolvency events involving Ambac or based upon Ambac's financial condition are standard components of swap documentation in many Ambac-insured transactions. Because of these triggers, approximately 150 swap surety policies issued by Ambac were allocated to the Segregated Account. The Swap Policy related to the Ohio Bonds is being treated in the same manner as these other swap surety policies.

30. The other two Ohio Policies, No. 23838BE and No. 26053BE, remain obligations of the General Account. These two policies, along with numerous other student loan policies, are subject to an assessment process discussed below.

Assessment Process

31. The Plan of Operation for the Segregated Account of Ambac Assurance Corporation provides for an assessment process to be used in connection with those Ambac policies that presently remain obligations of the General Account and that insure student loan-backed securities.

32. While it was determined that the ALL Policies and swap surety policies should be allocated to the Segregated Account for the reasons described above, it was determined that further study was warranted in order to decide whether other student loan-backed policies should be allocated to the Segregated Account. Accordingly, an assessment process was determined to be appropriate for these policies.

33. This assessment process is ongoing and there are, as yet, no definitive results. In the meantime, however, until the assessment process is complete, the vast majority of student loan policies remain obligations of the General Account.

34. It is intended that at the conclusion of the assessment process, student loan policies that are to be allocated to the Segregated Account will be identified.


Additional Subjects

35. Since the start of this rehabilitation proceeding, ordinary course claims paid on policies allocated to the General Account, gross of both reinsurance and other subrogation recoveries, have amounted to approximately \$13 million through July.

36. Since the start of this rehabilitation proceeding, Deutsche Bank National Trust Company and other companies affiliated with it, acting as trustees for certain securities insured by Ambac, have withheld payment of approximately \$1.1 million in premiums as of August 4, 2010.


Cathleen J. Matanle

Subscribed and sworn to before me
this 17th day of August, 2010


Notary Public, State of New York
My commission expires _____

ANNE G. KELLY
Notary Public, State of New York
No. 02G15044534
Qualified in New York County
Commission Expires October 12, 2011