

ATTORNEYS AT LAW

VEREX PLAZA
150 EAST GILMAN STREET
MADISON, WI 53703-1481
POST OFFICE BOX 1497
MADISON, WI 53701-1497
608.257.5035 TEL
608.258.4258 FAX
foley.com

May 24, 2012

HAND DELIVERED

WRITER'S DIRECT LINE
608.258.4206
mvansicklen@foley.com EMAIL

Jody Baux
Ambac Clerk, Dane County Circuit Court
Dane County Courthouse
215 South Hamilton Street
Madison, Wisconsin 53703

Re: *In the Matter of the Rehabilitation of Segregated Account of Ambac Assurance Corporation*; Dane County Circuit Court Case No. 10 CV 1576

Dear Ms. Baux:

Enclosed for filing is the Rehabilitator's second Annual Report on the Rehabilitation of the Segregated Account of Ambac Assurance Corporation. All parties-in-interest on the service list are in the process of being served today with the report by email, and the report will promptly be posted on the Court-approved website. Please note that this filing is informational and does not require court approval or the scheduling of a hearing.

Thank you for your attention to this matter.

Very truly yours,

FOLEY & LARDNER LLP


Michael B. Van Sicklen

Enclosure

cc: Honorable William D. Johnston (with enclosure, via first-class mail)
All Counsel of Record (with enclosure, via email)

In the Matter of the Rehabilitation of:

Case No. 10 CV 1576

Segregated Account of Ambac Assurance Corporation

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

On March 24, 2010, the Circuit Court for Dane County, State of Wisconsin, the Honorable William D. Johnston presiding, entered an order placing the Segregated Account of Ambac Assurance Corporation into rehabilitation pursuant to the provisions of the Wisconsin Insurers Rehabilitation and Liquidation Act. The Rehabilitator hereby submits the enclosed "Annual Report on the Rehabilitation of the Segregated Account of Ambac Assurance Corporation" on this 24th day of May, 2012, in order to advise the Court and all interested parties on certain developments in the rehabilitation proceeding since the filing of the previous Report on the Rehabilitation of the Segregated Account of Ambac Assurance Corporation on the first day of June, 2011.

FOLEY & LARDNER LLP

By: 

Michael B. Van Sicklen, SBN 1017827
Jeffrey A. Simmons, SBN 1031984

150 East Gilman Street
Post Office Box 1497
Madison, Wisconsin 53701
Telephone: (608) 257-5035
Facsimile: (608) 258-4258

Counsel for the Rehabilitator

Kevin G. Fitzgerald, SBN 1004777
Andrew A. Oberdeck, SBN 1052308
FOLEY & LARDNER LLP
777 East Wisconsin Avenue
Milwaukee, Wisconsin 53202
Telephone: (414) 271-2400
Facsimile: (414) 297-4900

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

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

May 24, 2012

DISCLAIMER

This Annual Report on the Rehabilitation of the Segregated Account of Ambac Assurance Corporation (this “Report”), prepared by the court-appointed Rehabilitator of the Segregated Account, summarizes and describes developments in the Rehabilitation Proceeding since the 2011 Report was submitted to the Rehabilitation Court. It does not contain an exhaustive discussion of the Rehabilitation Proceeding, which is discussed in further detail in the relevant papers and pleadings filed with the rehabilitation court, which are available for review on the Website, 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 Ambac Financial Group, Inc.

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

Except as specifically and expressly stated herein, this 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 or incorporated herein by reference was not prepared with a view toward compliance with published guidelines of the SEC, the American Institute of Certified Public Accountants, Accounting Principles Generally Accepted in the United States of America (“GAAP”) or in accordance with U.S. statutory accounting principles prescribed or permitted by the State of Wisconsin Office of the Commissioner of Insurance.

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

None of Ambac Assurance Corporation, the 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 transactions in conjunction with the Rehabilitation Proceeding. Although the Rehabilitator believes that any such forward-looking statements are reasonable, no assurance can be given that such expectations will prove to have been correct. Any such forward-looking statements involve known and unknown risks, uncertainties, and other factors that may cause the actual results, performance or achievements of the Segregated Account to be different from any future results, performance and achievements expressed or implied by these statements.

TABLE OF CONTENTS

DISCLAIMER	i
TABLE OF CONTENTS.....	iii
I. Introduction.....	1
A. Ambac Assurance Corporation.....	1
B. Establishment of the Segregated Account and Petition for Rehabilitation.....	1
C. Bank Settlement Agreement	3
D. Allocation to the Segregated Account of Liabilities to AFGI and the IRS	4
E. The Commissioner and Special Deputy Commissioner	4
II. Status of Rehabilitation Proceeding.....	4
A. Plan of Rehabilitation	4
1. Confirmation of the Plan of Rehabilitation.....	4
2. Guidelines Issued Pursuant to Plan of Rehabilitation.....	5
3. Development of Claims Processing System	6
4. Potential Amendments to or Modifications of the Plan of Rehabilitation.....	6
B. Order Confirming Procedures for Resolving Claims Through Alternative Resolutions Including Synthetic Commutations.....	6
C. Motion for Approval to Commence Making Interim Cash Payments on Permitted Policy Claims	7
D. Motion to Approve IRS Settlement Offer.....	7
E. Motion to Approve Purchase of Surplus Notes	8
III. Significant Commutations and Settlements	8
A. AFGI Settlement	8
B. Las Vegas Monorail Corporation Bondholders	10
C. The Aardvark IV Policy	11
D. Synthetic Commutations of Policies Insuring Bonds Backed by Student Loan Trusts	12
E. The Aardvark XS Policy	12
F. Access to Loans for Learning Student Loan Corporation	12
G. Other Commutations and Settlements	13
IV. Summary of Litigation Related to the Rehabilitation Proceeding.....	13
A. Consolidated Issues on Appeal	13
B. Litigation Stemming from the Allocation to the Segregated Account of Liabilities to the United States.....	14
C. Litigation Related to the AFGI Settlement	14
D. Litigation with Assured Guaranty Corp. and Assured Guaranty Re Ltd.....	15

V.	Financial Review	15
A.	General Account Assets Available to Pay Segregated Account (and other)	
	Liabilities	16
1.	Investment Portfolio Holdings.....	16
2.	Installment Premiums	18
3.	Intercompany Loans.....	19
4.	Investment in Subsidiaries	20
5.	Miscellaneous	20
B.	Policy Liabilities of the General Account and the Segregated Account.....	21
1.	Summary of Liabilities	21
2.	General Account Exposures.....	21
3.	Segregated Account Exposures.....	23

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 residential mortgage backed securities (“RMBS”); (iii) certain student loan policies, some of which were allocated to the Segregated Account on March 24, 2010 (or shortly thereafter), and some of which were allocated on October 8, 2010, after undergoing an assessment process; (iv) certain other policies insuring obligations with substantial projected impairments or relating to transactions which have contractual “triggers” based upon AAC’s financial condition or the commencement of a rehabilitation proceeding, which triggers, if exercised, could have materially and adversely affected AAC’s financial condition; (v) remediation claims, defenses, offsets, and/or credits (except with respect to recoveries arising from remediation efforts or reimbursement or collection rights), if any, in respect of policies allocated to the Segregated Account; (vi) AAC’s disputed, contingent liability, if any, under the long-term lease with One State Street, LLC, and its contingent liability, if any, under the Ambac Assurance UK Limited (“Ambac UK”) lease with British Land; (vii) AAC’s limited liability interests in Ambac Credit Products, LLC (“ACP”), Ambac Conduit Funding, LLC, Aleutian Investments, LLC, and Juneau Investments, LLC (together, the “Allocated Subsidiaries”); (viii) all of AAC’s liabilities as reinsurer under reinsurance agreements (except for reinsurance assumed from Everspan Financial Guarantee Corp.); and (ix) effective November 7, 2010, any liability to AFGI relating to tax refunds and any liability to the Internal Revenue Service (“IRS”) relating to taxes (as discussed in Section I.D below). A current list of the insurance policy liabilities allocated to the Segregated Account is available on the court-approved website, ambacpolicyholders.com (“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 Wisconsin Office of the Insurance Commissioner ("OCI") permits pursuant to a prescribed accounting practice (the "Minimum Surplus Amount"). As long as the surplus as regards to policyholders is not less than the Minimum Surplus Amount, payments by the General Account to the Segregated Account under the Reinsurance Agreement are not capped.

During the Rehabilitation Proceeding of the Segregated Account (as described below), the 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 consideration or other proceeds of 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 Proceeding"). The Rehabilitation Court appointed the Commissioner as Rehabilitator of the Segregated Account, with full powers and authority granted pursuant to Wis. Stat. §§ 645.33 to 645.35 and all other applicable laws as are reasonable and necessary to fulfill his duties and responsibilities.

On 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, without limitation, the assertion of damages or acceleration of losses based on early termination and the exercise of control rights in transactions that, but for the occurrence of the Rehabilitation Proceedings or the financial condition of AAC, the General Account, the Allocated Subsidiaries or the Segregated Account, would have been exercised by AAC, the Allocated Subsidiaries or the Segregated Account (the "Injunction Order").

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

C. Bank Settlement Agreement

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

On June 7, 2010, AAC, AFGI, ACP and the Bank Group entered into a settlement agreement which effected the commutation of all of ACP's outstanding credit default swaps in respect of ABS CDOs with respect to the Bank Group, and all of AAC's related financial guaranty exposure (the "Bank Group Settlement"). In exchange for AAC and ACP commuting \$16.5 billion of net par exposure, AAC transferred to the Bank Group, in the aggregate, \$2.6 billion in cash and \$2 billion of surplus notes newly issued by AAC (the "Bank Settlement Notes"). AAC also paid \$96.5 million to the Bank Group to commute certain other obligations, including certain non-ABS CDO obligations, with par amounting to \$1.4 billion, in full satisfaction, but partial payment, of such obligations. In addition, subject to certain conditions, AAC is pursuing the commutation of certain other non-ABS CDO exposures with par amounting to a maximum of \$702 million 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.

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

On November 3, 2010, the Rehabilitator learned that AFGI had received an “Information Document Request” from the IRS asking AFGI to describe its legal basis for claiming approximately \$700 million of income tax refunds that were subsequently paid to AAC pursuant to a Tax Sharing Agreement between AFGI and AAC (the “Tax Refund Payments”). Out of concern that the IRS 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 Rehabilitation Court; (ii) any remedies available for such liabilities would be implemented in accordance with the Plan (as described below); and (iii) the federal government’s claims receive the appropriate priority under Wisconsin insurance laws. The Rehabilitation Court granted the Rehabilitator’s motion by order dated November 8, 2010 (the “Supplemental Injunction”).

E. The Commissioner and Special Deputy Commissioner

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

II. STATUS OF REHABILITATION PROCEEDING

A. Plan of Rehabilitation

1. Confirmation of the Plan of Rehabilitation

On October 8, 2010, the Rehabilitator filed the Plan of Rehabilitation (the “Plan”), together with a Disclosure Statement Accompanying Plan of Rehabilitation (the “Disclosure Statement”), and a Motion for Confirmation of the Plan in the Rehabilitation Court. The Plan sets forth the terms and conditions for the settlement and payment of claims against the Segregated Account. The Plan provides that holders of permitted policy claims will receive 25% of their permitted claims

in cash and 75% in surplus notes issued by the Segregated Account, and that delivery of such cash and surplus notes will constitute satisfaction in full of the Segregated Account's obligations in respect of each claim.

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

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

As of the date of this 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.

2. 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 Rehabilitation Court on February 18, 2011 in order to promote the prompt evaluation and payment of policy claims following the effective date of the Plan. In developing 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 the Rehabilitation Court on March 18, 2011 in order to preserve the value of reinsurance in respect of certain policies allocated to the Segregated Account and in recognition of certain requirements imposed by reinsurance contracts to which AAC is a party as a ceding company. These guidelines were developed over several months with input from the reinsurers under such contracts.

Each of these sets of guidelines will be updated in the event that the Rehabilitator obtains the approval of the Rehabilitation Court to commence making interim payments on policy claims submitted to the Segregated Account, as described in Section II.C below. The revised guidelines will generally track the provisions of the existing guidelines, but will be separately stated so

there is no unnecessary confusion about the interim payments proposed to be made pursuant to the approval of the motion described in Section II.C below rather than pursuant to the Plan.

3. Development of Claims Processing System

In anticipation of the effective date of the Plan, the Rehabilitator and AAC, in its capacity as management services provider to the Segregated Account, communicated with trustees for beneficial holders of the underlying financial instruments insured by many policies that were allocated to the Segregated Account, as well as the Depository Trust and Clearing Corporation, 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 Rehabilitation 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.

4. 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 Website.

B. Order Confirming Procedures for Resolving Claims Through Alternative Resolutions Including Synthetic Commutations

On August 31, 2011, the Rehabilitation Court entered, upon the motion of the Rehabilitator, the Order Confirming Procedures for Resolving Claims Through Alternative Resolutions Including Synthetic Commutations, which confirmed the Rehabilitator's power and authority to resolve claims against the Segregated Account through Alternative Resolutions (as defined in such order), provided that (i) such Alternative Resolutions do not violate the law and are equitable to the interests of policyholders, as the Rehabilitator may determine in his sole and absolute discretion, and (ii) the Rehabilitator shall obtain the approval of the Rehabilitation Court prior to effectuating any Alternative Resolution that involves the payment of cash by the Segregated

Account in excess of \$10 million. In addition, such order confirmed that policy obligations of AAC and the Segregated Account which are the subject of an effective and consummated “synthetic commutation” (as described in such order) are fully and completely terminated and released.

C. Motion for Approval to Commence Making Interim Cash Payments on Permitted Policy Claims

On May 16, 2012, the Rehabilitator filed a Notice of Motion and Motion for Approval to Commence Making Interim Cash Payments on Permitted Policy Claims with the Rehabilitation Court. In the motion, the Rehabilitator is seeking approval to commence making interim payments on policy claims submitted to the Segregated Account in an amount, in cash, equal to 25% of the permitted amount of each policy claim, as approved for payment by the Rehabilitator. As set forth in further detail in the motion and supporting affidavit, the Rehabilitator believes that making interim payments on permitted policy claims is in the best interest of policyholders because it delivers partial payment to policyholders in a manner consistent with the approved Plan and partially alleviates the adverse effects of the moratorium during the interim period in which the Plan is not yet effective. A hearing on the motion has been scheduled for June 4, 2012.

D. Motion to Approve IRS Settlement Offer

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 (the “IRS Dispute”). AFGI also sought declaratory relief as to the amount of its tax liability, if any. The IRS’s challenge to the Tax Refund Payments is directed at issues related to AAC’s tax accounting methods with respect to credit default swap contracts. Specifically, the IRS disputes 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 such deductions were disallowed, 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 dispute among the Rehabilitator, OCI, the Segregated Account, AFGI, AAC, the Creditors Committee (as defined below) and the IRS regarding the tax treatment of credit default swap contracts was the subject of a court-directed mediation which began in early July 2011. After several months of negotiations, the Rehabilitator, OCI, AFGI, AAC, the Segregated Account and the Creditor’s Committee made a settlement offer to the IRS relating to the dispute (the “IRS Settlement Offer”). The terms of the IRS Settlement Offer include: (i) a payment by AAC and/or the Segregated Account of \$100 million; (ii) a payment by AFGI of \$1.9 million; (iii) AFGI’s consolidated tax group (including AAC and the Segregated Account) will relinquish their claims to all loss carry-forwards resulting from losses on credit default swap contracts arising on or before December 31, 2010 to the extent that such carry-forwards exceed \$3.4 billion; and (iv) AFGI will pay the IRS (a) 12.5% of any payment made to AFGI by AAC

associated with NOL Usage Tier C (as described in Section III.A below) and (b) 17.5% of any payment made to AFGI by AAC associated with NOL Usage Tier D (as described in Section III.A below). The IRS has not yet accepted the IRS Settlement Offer and there are no assurances that the IRS Settlement Offer will be accepted, that the final terms of any settlement will not change or that a settlement can be finalized within a certain period of time. Finality of the settlement requires the satisfaction of certain conditions and the receipt of certain approvals, including approvals by the Bankruptcy Court and the Rehabilitation Court.

A motion to approve the proposed settlement was filed with Rehabilitation Court on May 16, 2012, and a hearing on the motion has been scheduled for June 13, 2012. In the Plan Confirmation Order (as described in Section III.A below), the Bankruptcy Court noted that AFGI is waiting for the consent of the United States before seeking the Bankruptcy Court's approval of the proposed settlement.

E. Motion to Approve Purchase of Surplus Notes

On May 16, 2012, the Rehabilitator filed with the Rehabilitation Court a Notice of Motion and Motion to Approve Purchase of Surplus Notes, which was subsequently amended by motion filed on May 23, 2012. In the amended motion, the Rehabilitator is seeking approval to permit AAC to purchase approximately \$789 million in principal amount of Bank Settlement Notes (the "Call Option Surplus Notes") for an aggregate cash payment of approximately \$188 million. AAC proposes to purchase the Call Option Surplus Notes pursuant to irrevocable options that AAC negotiated and secured with two of the institutions in the Bank Group (the "Call Options"). As set forth in further detail in the motion and supporting affidavits, the Rehabilitator believes that the purchase of the Call Option Surplus Notes is in the best interest of policyholders because it resolves AAC's liability under the Call Option Surplus Notes for substantially less than AAC would ultimately pay if it did not purchase the Call Option Surplus Notes. As a result, the purchase will make additional funds available to pay the claims of Segregated Account policyholders, and increase the projected recovery to Segregated Account policyholders. A hearing on the amended motion has been scheduled for June 4, 2012, commencing at 2:00 pm.

III. SIGNIFICANT COMMUTATIONS AND SETTLEMENTS

The Rehabilitator has engaged in the following commutations and settlements since the filing of the previous Report on the Rehabilitation of the Segregated Account of Ambac Assurance Corporation on the first day of June, 2011 (the "2011 Report").

A. AFGI Settlement

On September 21, 2011, OCI and the Rehabilitator reached an agreement with AAC, AFGI and The Official Committee of Unsecured Creditors of Ambac Financial Group, Inc. (the "Creditors Committee"), which, subject to the satisfaction of certain conditions, resolves all outstanding tax and expense-related issues between AFGI and AAC, and provides an unconditional, full and complete release of all claims that AFGI and the members of the Creditors Committee may have against OCI, the Rehabilitator, AAC and the Segregated Account (the "AFGI Settlement"). On March 14, 2012, the Bankruptcy Court entered an order approving AFGI's Fifth Amended and Restated Plan of Reorganization (the "Plan Confirmation Order"), which approved *inter alia* the

AFGI Settlement. The Rehabilitation Court approved the AFGI Settlement by order dated November 10, 2011. The AFGI Settlement remains conditioned upon resolution of the IRS Dispute, either by consummation of the settlement contemplated by the IRS Settlement Offer or by a final court judgment that does not require AAC and/or the Segregated Account to pay the IRS more than \$100 million or reduce the NOLs available to AAC and the Segregated Account by more than 10%.

The specific terms of the AFGI Settlement are numerous and relatively complex. The most significant of those terms are set forth below:

- Allows AAC and the Segregated Account to use, at no cost, all NOLs they generate after September 30, 2011.
- Releases AFGI's claims against AAC with respect to the Tax Refund Payments, including the \$38,485,850 that was not subject to the protection of the Supplemental Injunction Order.
- Protects for use by AAC and the Segregated Account up to \$3.65 billion of NOLs generated on or before September 30, 2011.
- Requires AAC and the Segregated Account to pay for NOLs generated by the AFGI consolidated tax group prior to September 30, 2011 only if they use them, according to the "Tolling Schedule" set forth below:

NOL Usage Tier	Allocated NOLs	Applicable Percentage
A	The first \$0.479 billion	15%
B	The next \$1.057 billion after Tier A	40%
C	The next \$1.057 billion after Tier B	10%
D	The next \$1.057 billion after Tier C	15%

Under the above Tolling Schedule, payments to AFGI for use of NOLs are determined by multiplying the Applicable Percentage by the aggregate amount of federal income tax liability that they otherwise would have paid if the NOLs in the respective tier were not available for use.

- After the first five years, any remaining pre-September 30, 2011 NOLs in excess of \$3.65 billion will, with AFGI's consent, become available for use by AAC and the Segregated Account for a payment equal to 25% of tax savings, calculated in the same manner described above.
- Contains provisions for allocating NOLs to AAC and the Segregated Account in the event that AAC and its subsidiaries become deconsolidated from AFGI for federal tax purposes.
- Contains provisions allowing the Rehabilitator to review and approve certain AFGI tax filings to ensure the preservation of NOLs for AAC's use in the event of deconsolidation.

- Permits the Rehabilitator to review and express any concerns regarding AFGI's future tax positions as they affect AAC and provides for arbitration in the event that AFGI and the Rehabilitator cannot agree on an appropriate tax position.
- Requires AFGI and the Creditors Committee to provide an unconditional, full and complete release of OCI, the Rehabilitator, AAC, and the Segregated Account from any and all claims and causes of action they may have by reason of anything occurring before the closing date of the agreement.
- Requires AAC to pay up to \$5 million of AFGI's reasonable operating expenses for each of the next five years and, only upon approval by the Rehabilitator, up to \$4 million for each year thereafter.
- Requires AAC to pay 85% of the litigation fees and expenses incurred by AFGI in the IRS Dispute (subject to a \$2 million credit for amounts already paid), but provides AAC and the Rehabilitator the right to control litigation costs going forward and to engage directly with the IRS to attempt to settle the IRS Dispute and obtain other rulings from the IRS that might benefit the Segregated Account.
- Requires AAC to pay \$30 million into an escrow account for the benefit of AFGI, to be released to AFGI upon satisfaction of certain conditions; up to \$15 million of that amount to be credited against the "tolls" AAC must pay for the use of NOLs.
- Requires the Segregated Account to issue \$350 million of junior surplus notes to AFGI under terms no less favorable than any other recipient of junior surplus notes.
- Requires the Rehabilitator to seek an order from the Rehabilitation Court providing that certain of AAC's obligations to AFGI under the Mediation Agreement will be treated as administrative expenses in the event that AAC is placed in full rehabilitation or any of those obligations otherwise become subject to the Rehabilitation Court's jurisdiction.
- Grants the Rehabilitation Court continuing jurisdiction over any actions for a material breach of the AFGI Settlement.

B. Las Vegas Monorail Corporation Bondholders

On December 29, 2011, AAC purchased approximately 82% of the Las Vegas Monorail Project Revenue Bonds, 1st Tier Series 2000 having an aggregate original principal amount of \$451,448,217.30 (the "LVM Insured Bonds"), thereby commuting the majority of the Segregated Account's exposure under a financial guaranty insurance policy that insures payment of principal and interest on the LVM Insured Bonds. 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 commutation was accomplished pursuant to the terms of an Amended and Restated Settlement Agreement (the "Amended Agreement") between the Segregated Account, AAC, and

the Special Deputy Commissioner and 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 LVM Bondholders”), as holders of approximately 73% of outstanding LVM Insured Bonds. The Amended Agreement was approved by order of the Rehabilitation Court dated December 19, 2011. Pursuant to the Amended Agreement, AAC commenced an offer to purchase outstanding LVM Insured Bonds from all interested bondholders (not just the Settling LVM Bondholders) on November 21, 2011, for a specified amount of cash and no surplus notes. Upon the closing of the offer to purchase on December 29, 2011, AAC acquired approximately 82% of the outstanding LVM Insured Bonds for an aggregate purchase price of \$110,928,514 (inclusive of certain legal fees and expenses paid on behalf of Settling LVM Bondholders and the trustee on the transaction), which represented approximately 26.4% of the Rehabilitator’s total projected claims (using an average of the Rehabilitator’s base and stress case loss projections) with respect to the acquired LVM Insured Bonds.

On January 11, 2012, the Settling LVM Bondholders dismissed their appeals before the Wisconsin Court of Appeals with prejudice.

C. The Aardvark IV Policy

On October 14, 2011, the Segregated Account commuted its exposure under a financial guaranty insurance policy insuring a multiple-asset security program consisting of twenty-eight different securities, including RMBS, commercial asset-backed securities and student loan-backed securities (the “Aardvark IV Policy”). The acquisition of the securities was generally funded through the issuance of asset-backed commercial paper by conduits sponsored by HSBC, National Australia Bank and the Bank of Nova Scotia (the “Counterparty Banks”). The Aardvark IV Policy guaranteed shortfalls of interest when due and ultimate principal on all of the securities. As of August 31, 2011, the total gross par outstanding for all of the securities was \$601,120,058.

Under the terms of the commutation, AAC and the Segregated Account were fully released from their obligations under and in connection with the Aardvark IV Policy in exchange for a cash payment of \$13.7 million from the Segregated Account to the Counterparty Banks. The commutation price represented 28.5% of the estimate of the total projected claims under the Aardvark IV Policy (using an average of base case and stress case loss estimates, discounted to present value). The Rehabilitation Court approved the settlement by order dated October 13, 2011.

D. Synthetic Commutations of Policies Insuring Bonds Backed by Student Loan Trusts

On November 21, 2011, the Segregated Account commuted part of its exposure under several financial guaranty insurance policies guaranteeing the payment of principal and interest on bonds backed by student loans held by the following securitization trusts: The National Collegiate Student Loan Trust 2007-3, The National Collegiate Student Loan Trust 2007-4, and The National Collegiate Master Student Loan Trust I. The bonds subject to the synthetic commutation were held by Goldman, Sachs & Co. ("Goldman") and certain parties with whom Goldman contracted, and Fortress Investment Group, LLC ("Fortress"). The aggregate principal outstanding amount of all bonds issued by such trusts and guaranteed by the Segregated Account was \$2,765,525,000, as of November 21, 2011.

Under the terms of the commutations, the Segregated Account commuted 27.62% of its exposure under all of the financial guaranty insurance policies guaranteeing the subject bonds through the use of a synthetic commutation trust. The Rehabilitator did not publicly disclose the prices paid to Goldman or Fortress in connection with the synthetic commutations; however, the Rehabilitator did disclose that both commutations involved only payments of cash, rather than cash and surplus notes, and that in both commutations, the amount of cash paid to each of Goldman (for itself and for certain parties with whom it contracted) and Fortress was a smaller percentage of the Rehabilitator's projected losses than was the case for the Aardvark IV Policy, as described above in Section III.C above. The Rehabilitation Court approved the synthetic commutations by order dated November 17, 2011.

E. The Aardvark XS Policy

On December 14, 2011, the Segregated Account commuted its exposure under a financial guaranty insurance policy insuring a multiple-asset security program consisting of four different securities: two RMBS, one commercial asset-backed security and one student loan-backed security (the "Aardvark XS Policy"). At the time of the commutation, the securities were held by Royal Park Investments ("Royal Park"). The Aardvark XS Policy guaranteed shortfalls of interest when due and ultimate principal for all of the securities. As of October 31, 2011, the total gross par outstanding for all of the securities was \$225,578,961.

Under the terms of the commutation, AAC and the Segregated Account were fully released from their obligations under and in connection with the Aardvark XS Policy in exchange for a cash payment of \$12.75 million from the Segregated Account to Royal Park. The commutation price represented 22.1% of the estimate of the total projected claims under the Aardvark XS Policy (using an average of base case and stress case loss estimates, discounted to present value). The Rehabilitation Court approved the settlement by order dated December 12, 2011.

F. Access to Loans for Learning Student Loan Corporation

On March 29, 2012, the Segregated Account commuted its exposure under two financial guaranty insurance policies that insured payment of principal and interest on certain bonds issued by Access to Loans for Learning Student Loan Corporation ("ALL"), and one surety bond issued for the benefit of Lloyds TSB Bank plc, New York Branch ("Lloyds") in its capacity as liquidity

provider under the terms of the trust indenture pursuant to which the bonds were issued (collectively, the “ALL Policies”). At the time of the commutation, the outstanding aggregate principal amount of the bonds was approximately \$341,000,000. The bonds were held by Depfa Bank plc, New York Branch, on behalf of itself and its affiliates (collectively “Depfa”), and Lloyds.

Under the terms of the commutation, AAC and the Segregated Account were fully released from their obligations under and in connection with the ALL Policies in exchange for a cash payment of \$17,475,000 from the Segregated Account to BNY Mellon as trustee, who will use the settlement proceeds to redeem a portion of the Depfa bonds and the Lloyds bonds. The commutation price represented 27.8% of the Rehabilitator’s estimate of the gross claim liability under the ALL Policies (using an average of the Rehabilitator’s base and stress case loss scenarios, discounted to present value). The Rehabilitation Court approved the settlement by order dated March 7, 2012.

On March 29, 2012, Depfa dismissed its appeals before the Wisconsin Court of Appeals with prejudice, and on March 30, 2012, ALL and Lloyd’s dismissed their appeals with prejudice.

G. Other Commutations and Settlements

In addition to the foregoing settlements and commutations, since the filing of the 2011 Report, the Segregated Account has settled or otherwise resolved its liabilities under portions of twelve policies aggregating \$1.386 billion of net par outstanding, for aggregate consideration, before reinsurance recoveries of \$8.5 million in cash. 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 filing of the 2011 Report, the Segregated Account has commuted its exposure under three policies, aggregating approximately \$136.4 million of par outstanding, net of reinsurance, without any payments by AAC or the Segregated Account.

Since the filing of the 2011 Report, the Segregated Account has commuted one surety bond which insured an interest rate swap with a notional principal amount of \$94,285,000, without any payments by AAC or the Segregated Account.

IV. SUMMARY OF LITIGATION RELATED TO THE REHABILITATION PROCEEDING

A. Consolidated Issues on Appeal

By order dated March 16, 2011, the Wisconsin Court of Appeals ordered that it would consider at one time all of the appeals relating to the Rehabilitation Proceeding pending before the Wisconsin Court of Appeals at that time, except for the United States’ appeal of the Confirmation Order, which is addressed in Section IV.B below. The issues raised in the consolidated 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 Rehabilitation Court; (iv) challenges to the Rehabilitation 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 Rehabilitation Court's competency or jurisdiction to issue certain rulings; and (viii) challenges to the Plan. Briefing on the appeals was completed on September 8, 2011.

As noted above, in conjunction with various commutations, the Settling LVM Bondholders, ALL, Depfa and Lloyds have voluntarily dismissed their appeals with prejudice.

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

On December 8, 2010, after the confirmation hearings but before entry of the Confirmation Order, the United States removed the Rehabilitation Proceeding to the United States District Court for the Western District of Wisconsin (the "District Court"), with the stated intent of challenging the Supplemental Injunction. The United States subsequently sought to dissolve the Supplemental Injunction, and OCI sought to remand the rehabilitation proceeding. By order dated January 14, 2011, the District Court remanded the rehabilitation proceeding to the Rehabilitation Court, concluding that the removal was preempted by the McCarran-Ferguson Act, and that the District Court therefore lacked subject matter jurisdiction over the proceeding. The United States appealed that decision to the United States Court of Appeals for the Seventh Circuit. On February 9, 2011, the United States filed a complaint and a motion for a preliminary injunction in the District Court seeking, inter alia, to enjoin enforcement of the Supplemental Injunction and the Confirmation Order against the United States in a case captioned United States of America v. Wisconsin State Circuit Court for Dane County, Case No. 11-cv-099. The District Court dismissed that suit for lack of subject matter jurisdiction on February 18, 2011, and the United States filed a notice of appeal on February 22, 2011. The appeals at the Seventh Circuit are pending as Appeal Nos. 11-1158 and 11-1419.

If the IRS Settlement Offer (as described in Section II.D) is accepted by the United States and thereafter consummated, it would result in, among other things, the dismissal of the appeals. While the IRS Settlement Offer remains pending, the United States, the Rehabilitator, OCI, AAC and the Segregated Account have requested that the Seventh Circuit continue to hold the appeals in abeyance through not rescheduling oral argument, with the parties filing further status reports at intervals directed by the Seventh Circuit.

On March 9, 2011, the United States appealed the Order of Confirmation entered by the Rehabilitation Court on January 24, 2011. That appeal, No. 2011-AP-987, was dismissed by the Wisconsin Court of Appeals. The Wisconsin Supreme Court subsequently granted the United States' Petition for Review, and affirmed the decision of the Wisconsin Court of Appeals to dismiss the United States' appeal on March 8, 2012.

C. Litigation Related to the AFGI Settlement

On October 21, 2011, the Rehabilitator filed the Motion To Authorize the Rehabilitator and the Segregated Account to Proceed With Specified Agreements With Ambac Assurance Corporation and Ambac Financial Group, Inc. and Its Official Committee of Unsecured Creditors, by which

the Rehabilitator sought Rehabilitation Court approval of the AFGI Settlement, as described in Section III.A above. On November 7, 2011, eight different parties or groups of parties filed objections to the motion. By order dated November 10, 2011, the Rehabilitation Court granted the Rehabilitator's motion to approve the AFGI Settlement. Seven different parties or groups of parties appealed such order to the Wisconsin Court of Appeals. In accordance with an order of the Wisconsin Court of Appeals dated December 28, 2011, the appellants filed a memorandum with the Wisconsin Court of Appeals dated January 11, 2012 addressing whether appellate jurisdiction exists. The Rehabilitator filed a response memorandum on January 25, 2012. The Wisconsin Court of Appeals has not yet ruled on whether appealed-from order of the Rehabilitation Court entered on November 10, 2011 is final, and accordingly, whether appellate jurisdiction exists.

D. Litigation with Assured Guaranty Corp. and Assured Guaranty Re Ltd.

On March 14, 2011, the Rehabilitator reached a settlement with the holder and beneficiaries of a Segregated Account policy whereby the Segregated Account's exposure on the policy was commuted in exchange for, among other consideration, \$3 million in surplus notes issued by the Segregated Account. The subject policy was reinsured by Assured Guaranty Corp., which took the position that it did not consider the issuance of surplus notes to give rise to a reinsured "Loss" within the meaning of applicable reinsurance contracts. Accordingly, Assured Guaranty Corp. declined to reimburse its share of the settlement proceeds that was satisfied by the Segregated Account through the issuance of surplus notes unless and until the Segregated Account actually made cash payments on those surplus notes.

On April 7, 2011, Assured Guaranty Corp. and its affiliate, Assured Guaranty Re Ltd. (collectively, "Assured") demanded that AAC arbitrate this dispute pursuant to the arbitration clauses of the applicable reinsurance contracts, and on April 8, they filed a petition to compel arbitration in a New York court. On April 18, the Rehabilitator moved the Rehabilitation Court for an order requiring Assured to refrain from arbitrating disputes with AAC, to withdraw their petition to compel arbitration, and to pay in cash their shares of the surplus notes' principal amounts. On June 14, 2011, the Rehabilitation Court held that Assured's actions violated the Injunction Order and the applicable provisions of the reinsurance contracts, and ordered Assured to comply with the Injunction Order.

Assured appeal the Rehabilitation Court's order to the Wisconsin Court of Appeals. Briefing on the appeals was completed on October 31, 2011.

AAC, Assured, the Segregated Account and the Rehabilitator subsequently entered into a Stipulated Agreement, which delineated how the parties would proceed with respect to a number of disputed issues under the reinsurance agreements during and after the pending appeal is decided. On December 12, 2011, the Rehabilitation Court granted the Rehabilitator's motion to approve the Stipulated Agreement.

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 are estimated at approximately \$6.3 billion as of December 31, 2011, a decrease from estimated claims-paying resources of \$6.8 billion as of March 31, 2011. Primary components of claims-paying resources include (i) \$5.1 billion of investment portfolio assets at statutory carrying value, (ii) \$0.6 billion in net present value of future installment premiums, (iii) \$0.4 billion of intercompany loans, and (iv) \$0.2 billion of investments in subsidiaries and miscellaneous assets. The foregoing estimate of claims-paying resources includes certain assumptions and judgments regarding future events that are described more fully below.

1. Investment Portfolio Holdings

As of December 31, 2011, AAC held fixed income investment securities with fair value of approximately \$5.5 billion, statutory carrying value of \$5.1 billion and par value of \$6.5 billion. Certain information regarding AAC's portfolio holdings are summarized below.

AAC Investment Portfolio by Asset Class as of December 31, 2011

Dollars in Millions	Fair Value	Carrying Value	Par Value	YTM	WAL
Municipal Obligations.....	\$1,947	\$1,817	\$1,962	5.00%	9.8
RMBS.....	960	730	1,819	28.62%	4.9
Corporate Obligations.....	795	758	742	4.83%	5.8
Short-Term.....	688	688	688	0.14%	0.0
Military Housing.....	377	331	357	7.60%	18.0
U.S. Government, Agency, and GSE Obligations.....	448	434	431	2.28%	1.9
ABS, CDO, and Structured Insurance.....	303	357	478	2.49%	10.4
Total	\$5,518	\$5,113	\$6,478	7.71%	6.9

Dollars in Millions	Fair Value	Carrying Value	Par Value
Municipal Obligations.....	35%	36%	30%
RMBS.....	17%	14%	28%
Corporate Obligations.....	14%	15%	11%
Short-Term.....	12%	13%	11%
Military Housing.....	7%	6%	6%
U.S. Government, Agency, and GSE Obligations.....	8%	8%	7%
ABS, CDO, and Structured Insurance.....	5%	7%	7%
Total	100%	100%	100%

Relative to March 31, 2011 levels, aggregate portfolio fair value increased by \$111 million, or 2%, while statutory carrying value declined by \$91 million, or 2%. Factors affecting the increase in the aggregate fair value of investment portfolio holdings include (i) improved market pricing and (ii) the reinvestment of cash generated by AAC activities during this time frame, offset by (i)

increased inter-company borrowings and (ii) commutation payments. Portfolio fair value as a percentage of aggregate par value increased from 81.5% to 85.2%.

AAC has allocated a significant portion of available funds to the purchase of AAC-insured instruments as part of loss mitigation efforts. As of December 31, 2011, AAC-insured instruments held in the investment portfolio through such loss mitigation efforts accounted for 12% of portfolio fair value, 10% of portfolio carrying value, and 17% of portfolio par value, compared with 9%, 9%, and 15%, respectively, as of March 31, 2011.¹ The fair value of AAC-insured holdings acquired through such loss mitigation efforts as a percentage of par value was 59% as of December 31, 2011, compared with 49% as of March 31, 2011.

In the fourth quarter of 2011, AAC entered into a set of transactions that accelerated the receipt of approximately \$35 million in cash related to certain RMBS that were owned and insured by AAC. In these transactions, AAC contributed RMBS to a trust in exchange for \$35 million in cash and equity ownership of a limited liability corporation that has interests in two trusts. The statutory carrying value of the equity interest is approximately \$142 million while statutory carrying value of the borrowed funds relating to the trusts is approximately \$174 million resulting in a net liability of \$32 million. The contributed RMBS remain reported in AAC's investment portfolio. Please see the notes to AAC's 2011 annual statutory financial statement for further information on this set of transactions.

As of December 31, 2011, investment portfolio holdings representing approximately 76% of aggregate portfolio carrying value possess an investment grade rating or may otherwise be considered investment-grade, versus 78% 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 December 31, 2011 is summarized below.

¹ March 31, 2011 information has been restated to exclude holdings of AUK-insured instruments.

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

	Fair Value	Carrying Value	Par Value	Fair Value	Carrying Value	Par Value
	(In millions)			(Percentage of Total)		
Highly Liquid	\$1,988	\$1,918	\$1,907	36%	38%	29%
Medium	1,938	1,828	1,983	35%	36%	31%
Low	311	222	679	6%	4%	10%
Illiquid	1,280	1,145	1,909	23%	22%	29%
Total	\$5,518	\$5,113	\$6,478	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.

Securities classified as highly liquid or medium liquid presently represent 74% of total portfolio carrying value, versus 73% as of March 31, 2011. Securities classified as low liquid or illiquid represent 26% of aggregate carrying value, compared with 27% as of March 31, 2011. The weighted-average book yield for securities classified as either highly liquid or medium liquid was 3.7% as of December 31, 2011. In comparison, the weighted-average book yield for securities classified as either low liquid or illiquid was 18.3% as of December 31, 2011.

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 \$0.6 billion as of December 31, 2011 using a 5.1% discount rate, compared with \$0.7 billion as of March 31, 2011.

3. Intercompany Loans

As of December 31, 2011, AAC had \$1.240 billion in loans to affiliates, representing a \$215 million increase from the \$1.025 billion of intercompany loans outstanding as of March 31, 2011. Loans to affiliates were comprised of (i) \$226 million in secured loans and \$275 million in unsecured loans extended to Ambac Capital Funding Inc. ("ACFI"), and (ii) \$271 million in unsecured securities loans and \$468 million in unsecured cash loans extended to Ambac Financial Services, LLC ("AFS"). All of the increase in the aggregate intercompany loan balance from March 2011 to December 2011 is attributable to higher borrowings by AFS.

A portion of the AFS obligation is comprised of \$271 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.A.1 above and, therefore, such \$271 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) \$582 million of impairments will be experienced with respect to the unsecured intercompany loans, resulting in aggregate statutory carrying value of \$387 million.²

a) ACFI Intercompany Loans

The guaranteed investment contract ("GIC") business, operated through ACFI, had approximately \$547 million in GICs outstanding as of December 31, 2011, compared with \$717 million as of March 31, 2011.

AAC currently expects to experience a \$114 million impairment of the \$275 million unsecured loan to ACFI, implying a 59% 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 December 31, 2011, AFS maintained swap positions with gross notional exposure of approximately \$5.5 billion, compared with \$5.9 billion as of March 31, 2011. These swap

² A security with par and carrying values of \$84 million is included in the investment portfolio component of this analysis but is classified as an intercompany loan on AAC's statutory statements.

obligations are primarily floating-for-fixed interest rate swaps with municipalities and financial institutions.

AAC currently expects to experience a \$468 million impairment of the \$468 million unsecured loan to AFS, implying no principal recovery. 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 December 31, 2011, AAC's investment in subsidiaries comprised \$197 million in Everspan Financial Guarantee Corp. ("Everspan"), compared with \$178 million as of March 31, 2011. Everspan's insured book totals approximately \$254 million in net par outstanding and primarily consists of healthcare, leasing, and higher education exposures. As of December 31, 2011, three exposures representing approximately 19% 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.

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 December 31, 2011, AAC had \$41 million in accrued and unpaid interest and \$1 million in cash, neither of which is incorporated in the investment portfolio totals summarized above.

b) Certain Tax Attributes

As of December 31, 2011, the consolidated return group of which AAC is a part (the "Ambac Group") had NOLs of approximately \$7.2 billion. 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 the IRS Dispute, (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 IRS 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. As described in Section III.A of this Report, the AFGI Settlement resolves all outstanding tax and expense-related issues between AFGI and AAC, but it remains subject to the satisfaction of certain conditions, including resolution of the IRS Dispute.

In the event that (i) substantial amounts of CODI are recognized by AAC and/or 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 annual report on Form 10-K for the period ended December 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. 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 December 31, 2011.

2. General Account Exposures

a) Overview

As of December 31, 2011, approximately 11,000 policies representing \$213 billion in net par outstanding remain in the General Account, compared with approximately 12,000 policies aggregating \$241 billion in net par outstanding as of March 31, 2011.³ The 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 refinancing or commutation transactions).

U.S. public finance exposures represent \$176 billion, or 83%, 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.

³ All General Account policy, net par outstanding and other General Account information includes Everspan totals.

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

Dollars in Millions	Policies		Net Par Outstanding	
	Amount	Percentage	Amount (In millions)	Percentage
Direct				
U.S. Public Finance.....	10,298	95%	\$175,796	83%
Other Structured Finance	395	4%	16,927	8%
CLOs and other CDOs	51	0%	10,586	5%
International.....	57	1%	9,289	4%
Total.....	10,801	100%	\$212,597	100%

b) Credit Profile

The total amount of adversely classified General Account net par outstanding has increased by \$1.3 billion, or 19%, since March 31, 2011. Approximately \$8.2 billion, or 4%, of General Account net par outstanding is adversely classified, compared with \$6.9 billion, or 3%, of General Account net par outstanding as of April 30, 2011. Approximately \$1.4 billion of all adversely classified General Account exposures are currently classified in the more severe III and IV classifications, compared with \$1.2 billion as of March 31, 2011. A summary of adversely classified General Account net par outstanding is shown below.

Net Par Outstanding Associated with Adversely Classified General Account Policies

Dollars in Millions	Adversely Classified NPO	Credit Classification			
		I-A	II	III	IV
(In millions)					
U.S. Public Finance.....	\$4,542	\$1,620	\$2,145	\$230	\$548
Other Structured Finance.....	\$2,874	1,636	660	578	0
CLOs and Other CDOs.....	\$190	129	61	0	0
International.....	\$552	437	115	0	0
Total.....	\$8,158	\$3,822	\$2,980	\$808	\$548

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 December 31, 2011, total statutory reserves associated with General Account policies were approximately \$(103) 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 \$292 million as of December 31, 2011, versus approximately \$275 million as of March 31, 2011. 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 March 31, 2011 and since the Petition Date⁴

AAC paid \$18 million in claims resulting from General Account policies between March 31, 2011 and December 31, 2011. AAC has made \$46 million in aggregate General Account payments from the Petition Date through December 31, 2011.

3. Segregated Account Exposures

a) Overview

Aggregate Segregated Account net par outstanding declined by \$7.3 billion, or 17%, from \$42 billion as of March 31, 2011 to \$35 billion as of December 31, 2011. RMBS and student loan exposures account for 88% of aggregate Segregated Account net par outstanding and 66% of all Segregated Account policies. See below for a summary of Segregated Account policies and net par outstanding.

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

Dollars in Millions	Policies		Net Par Outstanding	
	Amount	Percentage	Amount (In millions)	Percentage
Direct				
RMBS.....	290	48%	\$23,164	67%
U.S. Public Finance.....	155	26%	985	3%
Structured Finance.....	26	4%	485	1%
Student Loans.....	111	18%	7,494	22%
International.....	15	2%	565	2%
ACP.....	9	1%	1,868	5%
Subtotal.....	606	100%	\$34,561	99%
Assumed.....	0	N/A	258	1%
Total.....	606	100%	\$34,818	100%

b) Credit Profile

Approximately \$29 billion, or 84%, of aggregate Segregated Account net par outstanding is adversely classified, compared with \$35 billion, or 84%, as of March 31, 2011. Approximately \$27 billion, or 79% of aggregate Segregated Account net par outstanding, was designated with the more severe III and IV risk classifications, compared with \$32 billion, or 75%, as of March 31, 2011. A summary of adversely classified Segregated Account net par outstanding is presented below.

⁴ All claim payment data is presented gross of realized recoveries.

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.....	\$21,059	\$138	\$33	\$9,482	\$11,406
U.S. Public Finance.....	168	0	58	0	109
Structured Finance.....	55	0	55	0	0
Student Loans.....	7,494	0	1,331	6,163	0
International.....	218	13	205	0	0
CDS.....	290	0	96	194	0
Subtotal.....	\$29,284	\$151	\$1,779	\$15,839	\$11,515
Assumed.....	137	0	0	137	0
Total.....	\$29,421	\$151	\$1,779	\$15,976	\$11,515

c) Loss Reserves

As of December 31, 2011, total statutory loss reserves associated with defaulted Segregated Account policies were approximately \$3.3 billion, compared with \$2.8 billion as of March 31, 2011. Statutory loss reserves as of December 31, 2011, are net of approximately \$2.5 billion of projected recoveries associated with alleged representation and warranty breaches (“R&W Recoveries”) related to certain RMBS transactions.⁵ If such R&W Recoveries are excluded, aggregate statutory reserves associated with Segregated Account policies would be \$5.8 billion as of December 31, 2011, compared with \$5.0 billion as of March 31, 2011.⁶

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.

⁵ 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.

⁶ R&W Recoveries associated with defaulted RMBS policies was \$2.5 billion and \$2.2 billion as of December 31, 2011 and March 31, 2011, respectively.

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

Dollars in Millions	<u>Statutory Reserves</u>	<u>Statutory Reserves Excluding R&W Remediation Recoveries</u>
RMBS.....	\$3,149	\$5,658
US Public Finance.....	55	55
Student Loans.....	-	-
Loss Adjustment Expense (1).....	126	126
Total	<u>3,329</u>	<u>5,839</u>

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

As noted above, statutory reserves reflect prospective losses for defaulted policies. As part of GAAP accounting requirements, AAC develops estimates of gross claim liability for all policies, whether defaulted or not. The aggregate gross claim liability associated with Segregated Account policies was approximately \$6.3 billion as of December 31, 2011, compared with \$5.5 billion as of March 31, 2011. Such estimates include R&W Recoveries of \$2.7 billion as of December 2011 and \$2.5 billion as of March 2011, respectively. If such R&W Recoveries are excluded, aggregate gross claim liabilities associated with Segregated Account policies would be \$9.0 billion as of December 31, 2011, compared with \$8.0 billion as of March 31, 2011. As the calculation of gross claim liabilities, including R&W Recoveries, under GAAP is different than that of statutory loss reserves in many respects, readers should consult AFGI's annual reports on Form 10-K and quarterly reports on Form 10-Q for further descriptions of GAAP loss calculations.

d) Claim Presentments since March 31, 2011 and since the Petition Date

Approximately \$1.0 billion in claims resulting from Segregated Account policies were presented between March 31, 2011 and December 31, 2011. Second lien claims presented during this time frame were approximately \$243 million. In contrast, first lien claims presented were \$758 million.

From the Petition Date through December 3, 2011, approximately \$2.8 billion in claims have been presented on Segregated Account policies, representing an average of \$132 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 to June 30, 2010	July 1, 2010 to March 31, 2011	March 31, 2011 to December 31, 2011	Total
1st Lien RMBS	\$251	\$581	\$758	\$1,590
2nd Lien RMBS	405	521	243	1,169
Other SA Exposures	-	10	(2)	8
Total	\$656	\$1,112	\$1,000	\$2,767