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May 31, 2012

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

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

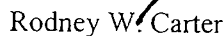
Dear Ms. Baux:

Enclosed for filing please find the Objection of Federal National Mortgage Association to Rehabilitator's Amended Motion to Approve Purchase of Surplus Notes and an Affidavit of Service. We will serve the documents on all interested parties on the service list via email.

Thank you for your attention to this matter.

Very truly yours,

Davis & Kuelthau, s.c.



Rodney W. Carter

RWC:lkr

Enclosures
cc The Honorable William D. Johnston
Counsel of Record (See Enclosed Certificate of Service)

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STATE OF WISCONSIN | CIRCUIT COURT | DANE COUNTY

In the Matter of the Rehabilitation of:

Segregated Account of Ambac Assurance Corporation

Case No. 10 CV 1576

OBJECTION OF FEDERAL NATIONAL MORTGAGE ASSOCIATION TO REHABILITATOR'S AMENDED MOTION TO APPROVE PURCHASE OF SURPLUS NOTES

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Federal National Mortgage Association ("Fannie Mae"), by and through its attorneys, respectfully submits this objection to the Amended Motion To Approve Purchase of Surplus Notes filed by the Commissioner of Insurance of the State of Wisconsin (the "Rehabilitator"), as Rehabilitator of the Segregated Account of Ambac Assurance Corporation ("Ambac").

PRELIMINARY STATEMENT

The Rehabilitator essentially has asked this Court to trust that Ambac's decision to purchase certain surplus notes is in the best interest of Fannie Mae and other segregated account policyholders. That is essentially all the justification the Rehabilitator has given for Ambac's decision to purchase $789 million in deferred surplus notes issued to two financial institutions pursuant to the challenged credit default swap ("CDS") settlement. But it is hardly in the best interest of Fannie Mae for Ambac to pay CDS counterparties *before* Fannie Mae receives any funds despite its status as a priority claimant. However, that is precisely what will happen if the Court permits Ambac to accelerate an otherwise deferred obligation into a present value payment on surplus notes to CDS counterparties who have already received a substantial cash payment on their claims.

More fundamentally, Ambac's proposal violates Wisconsin's priority scheme, which requires payment to holders of permitted policy claims, such as Fannie Mae, ahead of payment to CDS counterparties. Finally, even if Fannie Mae and CDS counterparties are entitled to equal treatment under Wisconsin law, fairness dictates that all policyholders have their surplus notes paid only after the cash portion of their accepted claims are paid in full.

RELEVANT BACKGROUND

Fannie Mae was established as a federal agency in 1938, and was chartered by Congress in 1968, to provide liquidity, stability, and affordability to the U.S. housing and mortgage

markets. Fannie Mae has three lines of business – Single-Family, Multifamily, and Capital Markets – which provide services and products to lenders and a broad range of housing partners. Together these businesses contribute to the company's chartered mission to increase the amount of funds available in order to make homeownership and rental housing more available and affordable. In support of this mission, Fannie Mae securitizes mortgage loans originated by lenders in the primary mortgage market into Fannie-Mae mortgage-backed securities or purchases mortgage loans and mortgage-related securities in the secondary market for its own portfolio. Currently Fannie Mae plays a central role in helping homeowners remain in their homes and this includes homeowners who have relied on mortgage insurance to meet their mortgage commitments.

To increase the supply of money available for mortgage lending and the availability of funding for new home purchases, Fannie Mae actively manages its retained portfolio. Fannie Mae's portfolio investments include residential mortgage-backed securities ("RMBS"). As relevant here, Fannie Mae is the owner of approximately $1.25 billion in RMBS insured by policies issued by Ambac (the "Fannie Mae RMBS Policies") and approximately $2.35 billion in mortgage revenue bonds insured by Ambac policies. The insurance of then AAA-rated Ambac was instrumental to their issuance, and Ambac has received substantial premium payments on the policies.

On March 24, 2010, Ambac, with the approval of the OCI, established a segregated account, and allocated to the account approximately 1,000 insurance policies and other liabilities considered to have material impairments (the "Segregated Account"). Among the liabilities allocated to the Segregated account were: (i) policies insuring RMBS, including the Fannie Mae RMBS Policies; (ii) certain policies insuring CDS contracts; and (iii) Ambac's limited liability

interests in its wholly owned subsidiary, Ambac Credit Products, LLC ("ACP"). (Rehabilitator's Second Annual Report on the Rehabilitation of the Segregated Account of Ambac dated May 24, 2012 ("Rep.") at 1.)

On June 7, 2010, Ambac and ACP entered into a settlement agreement with fourteen financial institutions (the "Bank Group") who were parties to CDS contracts with ACP (the "Bank Group Settlement Agreement"). (*Id.* at 3.) Ambac guaranteed the obligations of ACP under these contracts pursuant to financial guaranty policies. (*Id.*) As part of the Bank Group Settlement Agreement, Ambac paid $2.6 billion in cash and issued $2 billion of surplus notes to the Bank Group (the "Bank Surplus Notes"). (*Id.*) Ambac also negotiated call option agreements with three of the fourteen banks (the "Call Options"), pursuant to which Ambac purportedly has the right to repurchase approximately $939 million of the Bank Surplus Notes at specified prices. (Amended Motion to Approve Purchase of Surplus Notes ("Amended Motion") ¶ 1.).

On October 8, 2010, the Rehabilitator filed a Plan of Rehabilitation (the "Plan"), whereby holders of permitted policy claims, such as Fannie Mae, would receive only 25% of their permitted claims in cash and 75% in surplus notes subordinate to Ambac's other obligations. (Rep. 4-5.) Fannie Mae and other RMBS policyholders timely filed written objections to the Plan. Over those objections, the Court confirmed the Plan by order dated January 24, 2011, finding the Plan is fair and equitable to policyholders. (*Id.* at 4.) Fannie Mae and other parties have appealed the Court's order approving the Plan. As of the date of this filing, the Plan is not effective and the Rehabilitator has not designated an effective date for the Plan. (*Id.*) Among the changes the Rehabilitator is considering to the Plan is the elimination of the issuance of the surplus notes. (*Id.* at 6.)

On May 16, 2012, the Rehabilitator filed a motion seeking approval to commence making interim cash payments on policy claims submitted to the Segregated Account in an amount equal to 25% of the permitted amount of each approved policy claim. (*Id.* at 8.) Also on May 16, 2012, the Rehabilitator filed a motion to approve the purchase of certain Bank Surplus Notes, which motion was subsequently amended on May 23, 2012. In the Amended Motion, the Rehabilitator seeks approval for Ambac to purchase approximately $789 million in par amount of Bank Surplus Notes from John Doe Banks "A" and "C" for a cash payment of $188 million even though holders of permitted policy claims, such as Fannie Mae, have received nothing to date. For the reasons set forth below, the Rehabilitator's Amended Motion should be denied.

ARGUMENT

THE COURT SHOULD DENY THE REHABILITATOR'S AMENDED MOTION TO APPROVE PURCHASE OF SURPLUS NOTES

A. Ambac's Exercise of Its Call Options Requires Court Approval

The Rehabilitator argues that it is not legally required to seek this Court's approval for Ambac to exercise any of the Call Options because the Segregated Account, the Rehabilitator, and the Office of the Commissioner of Insurance ("OCI") are not parties to the Bank Group Settlement Agreement and the Call Option agreements. (Amended Motion ¶ 13.) This is incorrect. The Call Option agreements incorporate by reference the Bank Group Settlement Agreement, which requires the consent of the Segregated Account under the terms of the Cooperation Agreement between the Segregated Account and Ambac whenever Ambac "directly or indirectly enter[s] into any transaction with . . . any third-party . . . involving consideration or other proceeds in excess of $5,000,000 . . . ." (Rep. p. 2.) The only exceptions to this consent requirement are payments of policy claims in "the ordinary course of business" and investments made "in accordance with Ambac's Investment Policy." Given that Ambac's exercise of its Call

Option with John Doe Banks "A" and "C" requires a cash payment of $188 million to those banks and is neither an ordinary course payment of policy claims nor an investment made in accordance with Ambac's Investment Policy, the Segregated Account's consent is required.

Moreover, contrary to the Rehabilitator's arguments, the decision whether to seek the Court's approval is not a matter of discretion but rather is mandatory. (Amended Motion ¶ 13.) Wisconsin's rehabilitation statute expressly provides that OCI's power to rehabilitate an insurer is "[s]ubject to court approval." Wis. Stat. § 645.33(2). Although not every action taken by the OCI requires court approval, Wisconsin Statute section 645.33(2) requires the Rehabilitator to obtain "court approval" for any "action he or she deems necessary or expedient to reform and revitalize the insurer." *Id.* Ambac's purchase of the Bank Surplus Notes from John Doe Banks "A" and "C" increases the likelihood that the General Account's statutory surplus will fall below $100 million, and will "cause the Segregated Account to report negative statutory surplus." (Amended Motion ¶ 20) (emphasis added.) Ambac is not required to make payments from the General Account to the Segregated Account if the General Account's statutory surplus amount falls below $100 million and the Segregated Account's significant negative statutory surplus may potentially result in a breach of regulatory capital requirements and jeopardize Ambac's prospects for a successful rehabilitation. Under these circumstances, Court approval is required pursuant to Wisconsin Statue section 645.33(2).

B. Ambac's Proposed Purchase of Bank Surplus Notes Violates Wisconsin's Statutory Priority Scheme

Approval of Ambac's proposed purchase of Surplus Notes from John Doe Banks "A" and "C" before Fannie Mae and other policyholders in the Segregated Account have their claims satisfied in full would continue the more favorable treatment of CDS counterparties in violation of the priority scheme set forth in Wisconsin Statute section 645.68. Under section 645.68, costs

of administering the estate come first, policyholders such as Fannie Mae come second, and all other creditors follow. *Id.* John Doe Banks "A" and "C" may not be entitled to policyholder priority under Wisconsin Statute section 645.68(3), but rather treatment as no more than general unsecured creditors under Wisconsin Statute section 645.68(5).

First, Ambac guaranteed the performance of its non-insurance, wholly owned subsidiary, ACP, which entered into the CDS contracts with John Doe Banks "A" and "C." Such financial guarantees do not constitute policies of insurance under Wisconsin law, and unless and until the Wisconsin appellate court so holds, the CDS counterparties should not get more favorable treatment than policyholders.

Second, John Doe Banks "A" and "C" do not have an insurable interest because most CDS counterparties do not own the underlying securities against which the CDS contracts were written. To become a policyholder under Wisconsin law, one must have an insurable interest in the property insured. *See* Wis. Stat. § 631.07(1) ("No insurer may knowingly issue a policy to a person without an insurable interest in the subject of insurance."). Absent such interest, Bank Group claims are not entitled to policyholder priority.

Third, Wisconsin Statute section 645.68(3) limits policyholder priority to "claims under policies for losses incurred." *Id.* To the extent John Doe Banks "A" and "C" did not own the underlying securities against which the CDS contracts were written, they did not incur an actual loss entitling them to policyholder priority under Wisconsin's priority scheme.

For all of these reasons, John Doe Banks "A" and "C's" claims should be treated as subordinate to those of policyholders under Wisconsin Statute section 645.68. But even if John Doe Banks "A" and "C" are policyholders, as the Rehabilitator contends, their claims are not entitled to *superior* treatment to the claims of Fannie Mae and other policyholders in the

Segregated Account. And yet that is precisely what will happen if the Court approves Ambac's proposed purchase of Surplus Notes from John Doe Banks "A" and "C" – which have already received a substantial cash payment pursuant to the Bank Settlement Agreement – *before* Fannie Mae and other policyholders in the Segregated Account have the cash portion of their claims paid in full.

As discussed above, the Plan provides for Fannie Mae and other policyholders in the Segregated Account to receive 25% of their permitted claims in cash and 75% in surplus notes, although the Rehabilitator is considering eliminating the issuance of the surplus notes. (Rep. at 6.) The Bank Surplus Notes are a "type of *deferred* payment obligation," according to the Rehabilitator's motion. (Amended Motion ¶ 15) (emphasis added.) As a deferred payment obligation, payment on the Bank Surplus Notes should not be made *ahead* of payments to Fannie Mae and other policyholders in the Segregated Account. Otherwise, John Doe Banks "A" and "C" will receive their cash and surplus notes payments *before* Ambac makes a cash payment and issues surplus notes to Fannie Mae and other policyholders in the Segregated Account. Such an inequitable result should not be permitted.

Perhaps recognizing the patent inequity of Ambac's proposal, the Rehabilitator argues that "[e]xercising the Call Options with Banks A and C is in the best interest of Segregated Account policyholders because it should significantly increase the claims-paying resources available to the Segregated Account and result in larger total cash payments to the policyholders over the course of the Rehabilitation." (Amended Motion ¶ 14.) This argument misses the point. Whatever speculative savings Ambac might achieve by purchasing Bank Surplus Notes from John Doe Banks "A" and "C" is not a justification for abandoning Wisconsin's priority scheme. Under that scheme, even if John Doe Banks "A" and "C" are entitled to policyholder priority,

payment on their Bank Surplus Notes should not come ahead of the cash and surplus note payments due to Fannie Mae and other policyholders in the Segregated Account under the Plan.

Moreover, the Amended Motion fails to establish that the proposed purchase of Bank Surplus Notes from John Doe Banks "A" and "C" is in the best interests of Segregated Account policyholders. As the Rehabilitator acknowledges, the purchase of the Surplus Notes would reduce the statutory surplus of Ambac's General Account and, along with an increase in reserves on both the Segregated and General Accounts, would cause the General Account to report a statutory surplus of exactly $100 million and cause the Segregated Account to report negative statutory surplus. (Amended Motion ¶ 20). This substantially increases the likelihood that the General Account's statutory surplus can fall below $100 million, thereby jeopardizing the value of the reinsurance agreement in favor of the Segregated Account. (Rep. at 2.) The purchase also strips Ambac of $188 million in claims-paying resources at a time when Ambac revised downward its estimate for such resources from $6.8 billion to $6.3 billion. (Rep. at 16.) Additionally, if the surplus notes turn out to be worthless, Fannie Mae and other policyholders in the Segregated Account will have perhaps received 25% of the value of their claims when they come due, while John Doe Banks "A" and "B" will have received a third or more of their claims within two years of the establishment of the Segregated Account. Clearly, this would be an inequitable result for Fannie Mae and other policyholders.

CONCLUSION

For the foregoing reasons, Fannie Mae respectfully requests that this Court deny the Rehabilitator's Amended Motion to Approve Purchase of Surplus Notes, and grant such other and further relief as is just and proper.

Dated: May 31, 2012

Respectfully submitted,

DAVIS KUELTHAU, s.c.

By:

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STATE OF WISCONSIN CIRCUIT COURT DANE COUNTY

In the Matter of the Rehabilitation of:

Segregated Account of Ambac Assurance Corporation

Case No. 10-CV-1576

AFFIDAVIT OF SERVICE

STATE OF WISCONSIN)
) ss.
COUNTY OF WAUKESHA)

Lori K. Rogahn states that on the 31st day of May, 2012, she emailed the Objection of Federal National Mortgage Association to Rehabilitator's Amended Motion to Approve Purchase of Surplus Notes to all parties listed on the attached service list.

Lori K. Rogahn

Subscribed and sworn to before me
this 31st day of May, 2012.

Diane K. Parker
Notary Public, State of Wisconsin
My Commission: 3/10/2013

NOTARY PUBLIC DIANE K. PARKER STATE OF WISCONSIN

Rogahn, Lori K.

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