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Honorable Barbara B. Crabb
U.S. District Court, Western District of Wisconsin
120 North Henry Street
Madison, WI 53703-2559

Honorable William D. Johnston
Lafayette County Circuit Court
626 Main Street
Darlington, WI 53530-0040

Re: *In the Matter of the Rehabilitation of the Segregated Account of Ambac Assurance Corporation*, Case No. 13-cv-325 (Western District of Wisconsin) (Removed from Dane County Circuit Court Case No. 10-CV-1576)

In the Matter of the Rehabilitation of Segregated Account of Ambac Assurance Corporation, Case No. 10 CV 1576 (Dane County Circuit Court)

Dear Judge Crabb and Judge Johnston:

Enclosed for filing in each of your respective courts is a corrected copy of the Annual Report we filed yesterday which inadvertently did not include several corrections to the text which had been made earlier in the day. We apologize for any inconvenience caused by our error.

Very truly yours,

FOLEY & LARDNER LLP

/s/ Michael B. Van Sicklen

Michael B. Van Sicklen

Enclosure

cc: All counsel of record in both cases
Theodore Nickel, Wisconsin Commissioner of Insurance
Roger Peterson, the Special Deputy Commissioner

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UNITED STATES DISTRICT COURT
FOR THE WESTERN DISTRICT OF WISCONSIN

IN THE MATTER OF THE REHABILITATION
OF THE SEGREGATED ACCOUNT OF
AMBAC ASSURANCE CORPORATION

Case No. 13-cv-325

(Removed From Dane Court Circuit
Court – No. 10 CV 1576)

**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. As part of the Decision and Final Order Confirming the Rehabilitator's Plan of Rehabilitation (entered January 24, 2011) (at page 60, ¶ 8), the Court directed the Rehabilitator to file a report each June "advising on the status of the rehabilitation."

The Rehabilitator hereby submits the enclosed "Annual Report on the Rehabilitation of the Segregated Account of Ambac Assurance Corporation" in order to advise the Court and all interested parties about 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 24th day of May, 2012.

Dated June 3, 2013.

FOLEY & LARDNER LLP

/s/ Michael B. Van Sicklen

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**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**

June 1, 2013

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 2012 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. Those papers and pleadings are available for review on the website (the “Website”), <http://www.ambacpolicyholders.com>.

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

The Rehabilitator's Loss Projections (found in Section VI herein) are based upon estimates and assumptions developed in good faith by the Rehabilitator based upon certain materials provided by Ambac Assurance Corporation and other information that was determined to be relevant. THE REHABILITATOR'S LOSS PROJECTIONS AND UNDERLYING ASSUMPTIONS DO NOT REFLECT THE VIEWS OF AMBAC ASSURANCE CORPORATION OR AMBAC FINANCIAL GROUP, INC. OR ITS MANAGEMENT. The estimates and assumptions incorporated in the Rehabilitator's Loss Projections may not be realized and are inherently subject to significant business, economic and competitive uncertainties and contingencies, many of which are beyond the Rehabilitator's control. No representations can be or are made as to whether the actual results will be within the range set forth in the Rehabilitator's Loss Projections. Some assumptions will not materialize and events and circumstances occurring subsequent to the date on which the Rehabilitator's Loss Projections were prepared may be different from those assumed or may be unanticipated, and therefore may affect financial results in a material and possibly adverse manner. Accordingly, due to the inherently unpredictable nature of such projections, no representation can be or is being made with respect to the accuracy of the Rehabilitator's Loss Projections, and the Rehabilitator's Loss Projections, therefore, may not be relied upon as a guarantee or other assurance of the actual results that will occur.

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I. INTRODUCTION

A. Ambac Assurance Corporation

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

B. Establishment of the Segregated Account and Petition for Rehabilitation

On March 24, 2010, AAC established the Segregated Account of Ambac Assurance Corporation (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 of Insurance for the State of Wisconsin (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. A current list of the insurance policy liabilities allocated to the Segregated Account is available on the Website.

The Segregated Account is operated in accordance with the Plan of Operation for the Segregated Account (the “Plan of Operation”). Pursuant to the Plan of Operation, the liabilities of the Segregated Account are supported by the Secured Note and the Aggregate Excess of Loss Reinsurance Agreement (the “Reinsurance Agreement”). AAC issued the Secured Note to the Segregated Account in the initial principal amount of \$2 billion, 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 surplus notes and 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 million, 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 Commissioner controls the management of the Segregated Account. AAC provides certain management and administrative services to the Segregated Account and the Commissioner as Rehabilitator of the Segregated Account (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 million (or such higher amount as is agreed with the Rehabilitator) without the Segregated Account's prior consent (other than policy claim payments made in the ordinary course of business and investments in accordance with 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 the Petition Date, 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 Proceeding 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.

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. 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 surplus 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 might have attempted 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").

Note that certain disputes with the IRS have been settled. See Section III.A for further details.

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. 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. References in this Report to the Special Deputy Commissioner are to Mr. Peterson or Ms. Shaul, as appropriate. 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. See Section II.A.4 below for details regarding potential amendments to the Plan currently being contemplated by the Rehabilitator.

2. Guidelines Issued Pursuant to the 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 provisions and purposes 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.

The Guidelines described above are issued pursuant to the Plan; as the Plan is not yet effective, the Segregated Account has not acted in accordance with them. At present, the Rehabilitator is making partial cash payments pursuant to the motion described in Section II.B below (the “Interim Claim Payments”). As part of the commencement of the Interim Claim Payments, the Rehabilitator promulgated rules for claims processing and ceded reinsurance (described in Section II.B below).

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 and the Interim Rules discussed in Section II.B below.

4. Potential Amendments to 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. Under the potential amendments currently under consideration, the Segregated Account would not issue surplus notes with respect to the unpaid balance of permitted policy claims, but would instead record such balance as an outstanding policy obligation which would accrete at a rate of 5.1%, compounded annually. The Rehabilitator intends to make a request to the IRS for a private letter ruling ("PLR") regarding certain tax issues associated with the potential amendments in early June.

The Rehabilitator currently has no specific timeline or deadline for determining whether to seek amendments to or modifications of the Plan, and will only proceed with the potential amendments, as currently contemplated, if the IRS issues a favorable PLR. When decisions relating to potential amendments to the Plan are finalized, the Rehabilitator will promptly advise the Rehabilitation Court and parties-in-interest.

B. Commencement of Interim Cash Payments on Permitted Policy Claims

On June 4, 2012, the Rehabilitation Court approved the Rehabilitator's Motion for Approval to Commence Making Interim Cash Payments on Permitted Policy Claims. On September 20, 2012, pursuant to that motion, the Rehabilitator commenced payment of interim cash payments equal to 25% of the permitted amount of each policy claim, as approved for payment by the Rehabilitator ("Interim Claim Payments"). The Interim Claim Payments have been made in accordance with: (i) the Rules Governing the Submission, Processing and Partial Payment of Policy Claims in Accordance with June 4, 2012 Interim Cash Payment Order promulgated by the Rehabilitator on August 1, 2012, and (ii) the Rules Governing the Submission, Processing and Partial Payment of Claims under Financial Guaranty Policy No. 17548BE in Accordance with

June 4, 2012 Interim Cash Payment Order (collectively the “Interim Rules”). In connection with the commencement of Interim Claim Payments, the Rehabilitator also issued: (i) Rules Governing Ceded Insurance Contracts Following June 4, 2012 Interim Cash Payment Order on August 28, 2012, and (ii) a statement on September 6, 2012, clarifying that policyholders may not submit claims under the Interim Rules subject to a reservation of rights.

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. Financial information including the amount paid to policyholders as Interim Claim Payments is provided in Section V.

C. Order Confirming Process for Settling RMBS Remediation Claims

On October 5, 2012, the Rehabilitation Court entered, upon the motion of the Rehabilitator, the Order Granting Rehabilitator’s Motion for Approval of the Process for Settling RMBS Remediation Claims (the “RMBS Settlement Order”), which confirmed the Rehabilitator’s power and authority to resolve lawsuits involving Segregated Account insurance policies issued in connection with RMBS (“RMBS Remediation Claims”) on terms that the Rehabilitator finds advantageous, in his sole and absolute discretion, so long as: (i) the settlements advance the best interests of the Segregated Account rehabilitation and are fair to policyholders, and (ii) the Rehabilitator provides periodic notices to the Rehabilitation Court stating the fact of any material settlements, any information the counterparties will themselves need to disclose publicly, and any other information the counterparties agree to disclose. Under the terms of the order, the Rehabilitator is not required to: (i) submit RMBS Remediation Claim settlements to the Rehabilitation Court for approval; (ii) disclose the dollar amounts or other key terms of settlement agreements; or (iii) identify settlement counterparties. The Rehabilitator believes that these conditions will allow the Segregated Account to maximize settlement proceeds for the benefit of the Rehabilitation and all policyholders.

Certain small settlements of RMBS Remediation Claims have been negotiated and closed in the last year. Those settlements are not material for purposes of AAC’s financial statements. Nevertheless, the Rehabilitator is pleased that some progress has been made consistent with the Rehabilitation Court’s RMBS Settlement Order in resolving certain of the RMBS Remediation Claims on terms favorable to the Segregated Account.

D. Motion for Supplemental Payments

On May 23, 2013, the Rehabilitator posted to the Website a draft Motion for Approval to Make Supplemental Cash Payments as to Certain Policy Claims for the Purpose of Maximizing Reimbursements for the Benefit of All Policyholders (the “Supplemental Payments Motion”). If he files the motion, the Rehabilitator will be seeking authority to make payments in excess of the current 25% permitted cash payment percentage (“Supplemental Payments”) for certain permitted policy claims for the purpose of maximizing reimbursements payable to AAC. In certain RMBS transactions, AAC is contractually entitled to be reimbursed from various cash flows in the transaction (“Reimbursements”) to the extent that AAC has satisfied claims under the policies issued by it in connection with such transactions. This means that amounts in excess

of the Segregated Account's current 25% cash payments to policyholders may not be reimbursed unless a Supplemental Payment is made in respect of the permitted policy claims on such transactions.

The Rehabilitator has currently identified 14 RMBS transaction policies (the "Supplemental Payment Policies") for which he believes Supplemental Payments are appropriate. If the Supplemental Payments Motion is not approved, the Rehabilitator believes that approximately \$310 million of Reimbursements (on a present value basis) which would have been available to Ambac had it satisfied the necessary permitted policy claims will instead be distributed to uninsured security holders and Ambac will not be able to recover those amounts in the future. If the Supplemental Payments Motion is approved, the Supplemental Payments will effectively pay for themselves out of Reimbursements and, as a result, reduce the outstanding unpaid permitted policy claims owed on the Supplemental Payment Policies while also increasing the claims-paying resources available in the future for other Segregated Account policy claimants.

The Supplemental Payments Motion has not yet been submitted to the Rehabilitation Court and as a result, no Supplemental Payments have yet been made.

E. Improving Mortgage Loan Servicing

Throughout the pendency of the Rehabilitation, the Rehabilitator and the Management Services Provider have pursued various efforts and strategies directed at maximizing claims-paying resources and mitigating the amount of insured claims expected to be presented for payment to the Segregated Account. Those efforts are consistent with the Rehabilitator's overall effort to improve outcomes for insured policyholders through prompt, efficacious management and administrative strategies. Those efforts have included improvement of the quality of the servicing being performed by third parties for mortgage loans in the various RMBS transactions related to Segregated Account policies. In certain instances, the Rehabilitator and AAC have replaced mortgage loans servicers, either through voluntary agreements or through the exercise of control rights provided in the transactional documents governing the insured securities.

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 24th day of May, 2012 (the "2012 Report").

A. IRS Settlement

On April 30, 2013, the Rehabilitator, OCI, the Segregated Account, AFGI, AAC, The Official Committee of Unsecured Creditors of Ambac Financial Group, Inc. (the "Creditors Committee") and the IRS settled the lawsuit brought by AFGI against the IRS seeking: (i) to enjoin the IRS from attempting to levy AFGI's assets in connection with the Tax Refund Payments, and (ii) to determine the amount, if any, of AFGI's tax liability (the "IRS Dispute"). The terms of this settlement (the "IRS Settlement") include: (i) a payment by 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 (the "Ambac Group"), relinquishing its claims to 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) certain payments by AAC for the use of net operating losses (“NOLs”) generated by the AFGI consolidated tax group prior to September 30, 2011. The Rehabilitation Court approved the IRS Settlement by order dated June 13, 2012, and the Bankruptcy Court by order dated April 29, 2013. On April 30, 2013, AFGI and the IRS executed a closing agreement for the IRS Settlement. As a result, the IRS Settlement has been consummated and the IRS Dispute is resolved.

B. Purchase of Surplus Notes

In June 2012, AAC purchased 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 purchased the Call Option Surplus Notes pursuant to irrevocable call option agreements (the “Call Options”) that AAC secured with two of the institutions in the Bank Group at the time of the Bank Group Settlement.

The exercise of the Call Options reduced AAC’s liability to third parties for principal and accrued interest on the Bank Settlement Notes by approximately \$819 million, representing an effective exercise price of \$0.23. The exercise of the Call Options is expected to increase the claims-paying resources available to the Segregated Account and to result in larger total cash payments to policyholders over the course of the Rehabilitation. The exercise of the Call Options was approved by order of the Rehabilitation Court dated June 4, 2012.

C. Synthetic Commutation of Policies Insuring Bonds Backed by Student Loan Trusts

In October 2012, 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 (collectively, the “Student Loan Bonds”). The bonds subject to the synthetic commutation were held by Morgan Stanley Atlas, Inc. (“Morgan Stanley”). The aggregate outstanding principal amount of all Student Loan Bonds guaranteed by the Segregated Account was approximately \$1.9 billion, as of September 30, 2012, after taking into account commutations (including synthetic commutations).

Under the terms of the commutation, the Segregated Account commuted approximately 18% of its outstanding principal 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 price paid to Morgan Stanley in connection with the synthetic commutation. However, the Rehabilitator did disclose that the commutation involved only payments of cash, rather than cash and surplus notes, and that the amount of cash paid to Morgan Stanley was less than 28.5% of the Rehabilitator’s estimate of the total projected policy claims relating to the Student Loan Bonds. The Rehabilitation Court approved the synthetic commutations by order dated October 5, 2012.

In May 2013, the Segregated Account commuted approximately 20.8% of its remaining outstanding principal exposure under the financial guaranty insurance policies guaranteeing the payment of principal and interest on the bonds issued by the National Collegiate Master Student Loan Trust I (the "Master Trust Bonds"). The consideration paid by AAC relative to the Rehabilitator's estimate of projected losses associated with this exposure was commensurate with prior commutations of Student Loan Bonds and involved only payments of cash, rather than cash and surplus notes. This commutation did not require approval by the Rehabilitation Court as the consideration to be paid by the Segregated Account was below the level that requires Rehabilitation Court approval.

The Segregated Account has now extinguished approximately 80% of the Rehabilitator's estimate of the total projected claims under the policy guaranteeing the Master Trust Bonds through synthetic commutations. In addition, between the two commutations closed in 2012 and 2013 and two previous commutations of portions of the Student Loan Bonds, the Rehabilitator has successfully commuted a total of approximately 43.4% of the outstanding principal amount of the Student Loan Bonds.

D. Other Commutations and Settlements

Since the filing of the 2012 Report, the Segregated Account has participated in the refinancing of part of its student loan exposure. These refinancings have reduced the Segregated Account's exposure by approximately \$1.48 billion of par outstanding, net of reinsurance, 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. The Court of Appeals has not yet issued its decision.

In conjunction with various commutations, Nuveen Asset Management, Restoration Capital Management LLC, Stone Lion Capital Partners L.P., One State Street LLC, Access to Loans for

Learning Student Loan Corporation, Depfa Bank, plc, and Lloyds TSB Bank plc 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 (the "Appeals").

As a result of the closing of the IRS Settlement (as described in Section III.A), on May 9, 2013 the United States filed an Unopposed Motion to Dismiss the Appeals. The Seventh Circuit ruled on that motion on May 15, 2013 and ordered the United States to request that the district court indicate whether it is inclined to vacate the orders underlying the Appeals prior to filing a status report with the Seventh Circuit.

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 the 2012 Report. 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 that 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 the 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 the 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 appealed the Rehabilitation Court's order to the Wisconsin Court of Appeals. Briefing on the appeals was completed on October 31, 2011. The Court of Appeals has not yet ruled on that appeal.

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.

E. OneWest's Disputed Effort to Remove Certain Aspects of the Rehabilitation to Federal Court

Consistent with the efforts noted above in Section II.E, the Rehabilitator moved the Rehabilitation Court on April 5, 2013 for an order confirming his authority to direct Deutsche Bank National Trust Company ("Deutsche"), in its capacity as a trustee for certain RMBS transactions, to change the servicer for certain trusts. OneWest Bank, F.S.B. ("OneWest"), the servicer for the Deutsche trusts identified in the motion, filed a removal petition with the United States District Court for the Western District of Wisconsin on May 9, 2013 purporting to remove from the Rehabilitation Court to the District Court specified aspects of the Rehabilitation Proceeding. The Rehabilitator believes that the OneWest removal is improper. On May 21, 2013, the Rehabilitator filed a motion with the United States District Court for the Western District of Wisconsin to remand the proceedings back to the Rehabilitation Court. Briefing on the remand motion has not yet been completed and the remand motion has not yet been decided by the District Court.

V. FINANCIAL REVIEW

With the assistance of his financial advisors, the Rehabilitator provides the following update on the financial condition of the General Account and Segregated Account.

A. General Account Assets

Total claims-paying resources are estimated at approximately \$5.3 billion as of December 31, 2012, a \$1 billion decrease from estimated claims-paying resources of \$6.3 billion as of December 31, 2011. The primary components of claims-paying resources are (i) \$4.7 billion of investment portfolio assets at statutory carrying value, (ii) \$0.4 billion in net present value of future installment premiums and (iii) \$0.2 billion of statutory value comprising (a) investments in, and loss on guarantees of, subsidiaries, (b) intercompany loans, and (c) 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, 2012, AAC held fixed income investment securities with fair value of approximately \$5.3 billion, statutory carrying value of approximately \$4.7 billion and par value of approximately \$5.8 billion. Certain information regarding AAC's portfolio holdings are summarized below:

AAC Investment Portfolio by Asset Class as of December 31, 2012^{1,2,3}

Dollars in Millions	Fair Value	Carrying Value	Par Value	YTM	WAL
Municipal Obligations.....	\$1,746	\$1,575	\$1,695	4.99%	8.5
RMBS.....	1,294	962	1,849	16.97%	NA
Corporate Obligations.....	817	743	727	4.74%	5.2
Short-Term.....	446	446	446	0.02%	0.0
U.S. Government, Agency, and GSE Obligations....	440	431	430	1.85%	1.4
Military Housing.....	380	327	352	7.59%	17.0
ABS, CDO, and Structured Insurance.....	159	192	319	3.57%	10.0
Total	\$5,281	\$4,676	\$5,819	7.04%	6.8

Dollars in Millions	Fair Value	Carrying Value	Par Value
Municipal Obligations.....	33%	34%	29%
RMBS.....	24%	21%	32%
Corporate Obligations.....	15%	16%	12%
Short-Term.....	8%	10%	8%
U.S. Government, Agency, and GSE Obligations....	8%	9%	7%
Military Housing.....	7%	7%	6%
ABS, CDO, and Structured Insurance.....	3%	4%	5%
Total	100%	100%	100%

Relative to December 31, 2011 levels, aggregate portfolio fair value decreased by \$237 million, or 4%, while statutory carrying value declined by \$437 million, or 9%. AAC's holdings of municipals, short-term instruments, and ABS, CDO, and structured insurance declined from prior-year levels. In contrast, the fair value, carrying value, and par value of RMBS holdings

¹ On December 16, 2011, AAC entered into a secured loan transaction in which it contributed certain RMBS insured by the Segregated Account and held by AAC to a trust as collateral and to fund repayment in exchange for \$35 million in cash and 100% equity ownership of Orient Bay, LLC, a single-member limited liability company that has interests in two REMIC trusts (the "Secured Borrowing"). As of December 31, 2012, the statutory carrying value of the equity interest was \$188 million while statutory carrying value of the borrowed funds relating to the trusts was approximately \$143 million, including \$36 million in accrued interest, resulting in a net asset of \$45 million as of December 31, 2012. The contributed RMBS remain reported in AAC's investment portfolio. Approximately \$17 million of proceeds from the contributed RMBS were used to pay Secured Borrowing principal during 2012. See Notes 10 and 11 to AAC's 2011 and 2012 annual statutory financial statements for further information on this transaction.

² Approximately two-thirds of AAC's non-agency RMBS holdings, as measured by statutory carrying value, are AAC-insured instruments acquired for loss mitigation purposes. Accordingly, the YTM associated with AAC's non-agency RMBS holdings are necessarily linked to AAC's assumptions (which may not come to pass) regarding the amount and timing of payments such holdings will receive under the Rehabilitation Plan.

³ Weighted-average life is not provided for AAC's non-agency RMBS holdings. Accordingly, the portfolio weighted-average life estimate provided herein is presented exclusive of non-agency RMBS holdings.

increased materially, due to (i) increased open market purchases of AAC-insured RMBS for loss mitigation purposes and (ii) an intercompany transaction consummated in December 2012 (described below) that transferred a significant amount of non-agency RMBS from certain AAC affiliates to AAC.

The primary factors leading to the decrease in investment portfolio holdings were the initiation of interim cash payments under the Plan of Rehabilitation in September 2012, purchases of the Call Option Surplus Notes, and payments made in respect of negotiated commutations. Together, these items totaled \$1.3 billion in 2012.

Such factors were partially offset by (i) investment portfolio appreciation and (ii) partial repayment of intercompany loans. Portfolio fair value as a percentage of aggregate par value increased from 85.2% in December 2011 to 91.0% as of December 2012. The Company's RMBS holdings accounted for nearly all of the increase in aggregate portfolio fair value. The fair value as a percentage of par for AAC's RMBS holdings increased from 52.8% of par in December 2011 to 70.0% in December 2012. The Company also received \$320 million in net repayments of intercompany loans.

The fair value of non-agency RMBS holdings increased by \$333 million, while statutory carrying value of such holdings increased by \$232 million. On a percentage basis, non-agency RMBS holdings accounted for 24% of portfolio fair value, 21% of portfolio carrying value, and 32% of portfolio par value, compared with 17%, 14%, and 28%, respectively, as of December 31, 2011. Approximately two-thirds of the Company's RMBS holdings consist of AAC-insured securities purchased for loss mitigation; one-third consists of other non-agency RMBS purchased by one of AAC's affiliates and later transferred to AAC.

As of December 31, 2012, AAC-insured RMBS instruments acquired for loss mitigation accounted for 16% of portfolio fair value, 14% of portfolio carrying value, and 20% of portfolio par value, compared with 12%, 10%, and 17%, respectively, as of December 31, 2011. The fair value of AAC-insured holdings acquired through such loss mitigation efforts as a percentage of par value was 75% as of December 31, 2012, compared with 59% as of December 31, 2011. The yield of these holdings was 19% as of December 31, 2012, compared to 30% as of December 31, 2011. In 2012, AAC effectively reduced its interim claim payments by \$135 million as a result of its holdings of AAC-insured RMBS.

As of December 31, 2012, other non-agency RMBS held in AAC's investment portfolio accounted for 8% of portfolio fair value, 7% of portfolio carrying value, and 12% of portfolio par value, compared with 6%, 4%, and 11%, respectively, as of December 31, 2011. Substantially all of the increases in this category result from a related-party transaction consummated in the fourth quarter of 2012, in which AAC purchased certain RMBS from Ambac Investments, Inc. ("AII") for \$136.8 million. Such securities supported a portion of the inter-company loans between Ambac Capital Funding Inc. ("ACFI"), as borrower, and AAC, as lender. The proceeds of this transaction were used to repay all secured borrowings by ACFI from AAC, as well as a portion of unsecured borrowings between these entities.

The fair value of such non-agency RMBS holdings as a percentage of par value was 61% as of December 31, 2012, compared with 43% as of December 31, 2011. The yield associated with such holdings was 12% as of December 31, 2012, compared with 24% twelve months prior.

As of December 31, 2012, investment portfolio holdings representing approximately 78% of aggregate portfolio carrying value had an investment grade rating or may otherwise be considered investment-grade, versus 76% twelve months earlier. AAC-insured instruments purchased as part of loss mitigation efforts account for approximately two-thirds of all non-investment grade holdings.

The market liquidity profile of AAC's investment portfolio as of December 31, 2012 is summarized as follows:

AAC Investment Portfolio by Market Liquidity Classification as of December 31, 2012

	Fair Value	Carrying Value	Par Value	Fair Value	Carrying Value	Par Value
	(In millions)			(Percentage of Total)		
Highly Liquid	\$1,604	\$1,533	\$1,525	30%	33%	26%
Medium	1,918	1,736	1,872	36%	37%	32%
Low	321	207	560	6%	4%	10%
Illiquid	1,438	1,200	1,862	27%	26%	32%
Total	\$5,281	\$4,676	\$5,819	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 represent 70% of total portfolio carrying value, versus 74% as of December 31, 2011. Securities classified as low liquid or illiquid represent 30% of aggregate carrying value, compared with 26% as of December 31, 2011. The weighted-average book yield for securities classified as either highly liquid or medium liquid was 3.78% as of December 31, 2012. In comparison, the weighted-average book yield for securities classified as either low liquid or illiquid was 14.02% as of December 31, 2012. Approximately one-half of all securities classified as either low liquid or illiquid are AAC-insured instruments purchased for loss mitigation.

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 for 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. Events such as early contract termination, commutation,⁴ faster than expected runoff or prepayment of underlying obligations, and payment default may lead to lower than projected installment premium receipts. In light of these factors, the Rehabilitator has reduced his estimate of future installment premium receipts.

After giving effect to such adjustments, the Rehabilitator's estimate of the present value of future installment premiums (net of reinsurance and consummated and pending commutations) is \$0.4 billion as of December 31, 2012 using a 5.1% discount rate, compared with \$0.6 billion as of December 31, 2011.

3. Intercompany Loans

As of December 31, 2012, AAC had \$908 million in loans to affiliates, representing a \$332 million decrease from the \$1.24 billion of intercompany loans outstanding as of December 31, 2011. Loans to affiliates comprised (i) \$234 million in unsecured loans to ACFI and (ii) \$258 million in unsecured loans of securities and \$415 million in unsecured cash loans to Ambac Financial Services, LLC ("AFS"). The decrease in the aggregate balance of inter-company loans receivable between December 2011 and December 2012 is attributable to (i) repayments by ACFI due to the continued run off of the guaranteed investment contract business and the intercompany sale of RMBS to AAC (described above), and (ii) recovery of collateral and receipt of cash proceeds resulting from swap terminations.

A portion of the AFS obligation is comprised of \$258 million of loans in the form of marketable securities. In accordance with Statutory Accounting Practices ("SAP"), the statutory carrying value of the loaned securities is included in the investment portfolio totals summarized in Section V.A.1 above; accordingly, \$258 million is excluded from the intercompany loan component of claims-paying resources, and the net inter-company loan receivable, before impairments, is \$649 million.

a) ACFI Intercompany Loans

The guaranteed investment contract ("GIC") business operated through ACFI had approximately \$363 million in GICs outstanding as of December 31, 2012, compared with \$547 million as of December 31, 2011.

⁴ AAC has retained its right to receive installment premiums in respect of certain commuted exposures.

AAC currently expects a \$168 million impairment of the \$234 million unsecured loan to ACFI, implying a 28% recovery of principal and a \$66 million statutory value for the ACFI intercompany loan. This 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 eventual impairment in respect of this obligation may be materially different from the current estimate.

b) AFS Intercompany Loans

As of December 31, 2012, AFS maintained swap positions with gross notional exposure of approximately \$2.6 billion, compared with \$5.5 billion as of December 31, 2011. These swap obligations are primarily floating-for-fixed interest rate swaps with municipalities and financial institutions as counter-parties.

AAC currently expects a \$415 million impairment of the \$415 million unsecured loan to AFS. Accordingly, no value is attributed to the AFS unsecured loan; furthermore, AAC has established a liability reflecting its projected loss on its guarantee of AFS' obligations (described below). The rise in impairments was largely the result of adverse interest rate movements and narrower AAC credit spreads employed in valuing swap liabilities, offset somewhat by application of a higher discount rate to calculate the impairment. In addition to the foregoing factors, 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, and Guarantee of, Subsidiaries

As of December 31, 2012, AAC's investment in subsidiaries comprised \$205 million in Everspan Financial Guarantee Corp. ("Everspan"), compared with \$197 million as of December 31, 2011. Everspan's insured book totals approximately \$40 million in net par outstanding (a substantial reduction from the \$254 million in net par outstanding as of December 31, 2011) and consists of certain healthcare and university exposures. As of December 31, 2012, two exposures representing approximately 69% of aggregate net par outstanding were adversely classified, although no case-basis statutory reserves have been established. The Rehabilitator believes that AAC's investment in Everspan will ultimately be available to fund Segregated Account and General Account obligations in accordance with the Plan.

As noted above, AAC guarantees the liabilities of AFS. As of December 31, 2012, AAC recognized a \$144 million loss on its guarantee of AFS' liabilities, indicating that the Company's expects to use claims-paying resources to satisfy the obligations of AFS. Accordingly, this \$144 million loss on AAC's guarantee of AFS obligations is incorporated as a reduction of claims-paying resources for purposes of this analysis.

5. Miscellaneous

Other claims-paying resources include accrued, unpaid interest and cash. As of December 31, 2012, AAC had \$36 million in accrued, unpaid interest and \$32 million in cash, neither of which is incorporated in the investment portfolio totals summarized above.

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. 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. Further information on this subject is contained in AFGI's annual reports on Form 10-K and quarterly reports on Form 10-Q.

2. General Account Exposures

As of December 31, 2012, the general account has approximately 9,000 policies in force, representing \$172 billion in net par outstanding, compared with approximately 11,000 policies, representing \$213 billion in net par outstanding as of December 31, 2011.⁵ The year-over-year decline of 19%, or \$41 billion, in net par outstanding is a function of both scheduled terminations (such as maturity of a specific obligation) and unscheduled terminations (such as refinancing transactions).

U.S. public finance exposures represent \$142 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.

General Account Policies and Net Par Outstanding as of December 31, 2012

Dollars in Millions	Policies		Net Par Outstanding	
	Amount	Percentage	Amount (In millions)	Percentage
U.S. Public Finance.....	8,538	95%	\$142,107	83%
Other Structured Finance.....	330	4%	13,055	8%
CLOs and other CDOs.....	40	0%	7,973	5%
International.....	52	1%	8,446	5%
Total.....	8,960	100%	\$171,581	100%

a) Credit Profile

Approximately \$7.3 billion, or 4.2%, of General Account exposure is adversely classified, compared with \$8.2 billion, or 3.8%, of then-outstanding General Account net par outstanding as

⁵ All General Account policy, net par outstanding and other General Account information includes Everspan totals.

of December 31, 2011. Approximately \$1.8 billion of all adversely classified General Account exposures are currently classified in the more severe III and IV classifications, compared with \$1.4 billion as of December 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.....	\$5,061	\$1,793	\$2,089	\$1,035	\$144	
Other Structured Finance.....	\$1,579	\$390	636	554	0	
CLOs and Other CDOs.....	\$74	\$74	0	0	0	
International.....	\$565	\$436	13	115	0	
Total.....	\$7,279	\$2,694	\$2,738	\$1,704	\$144	

b) Loss Reserves

Statutory loss reserves, net of reinsurance, 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, 2012, total statutory reserves (including loss adjustment expenses) associated with General Account policies were \$35 million, compared with \$(103) million in the prior-year period.

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, gross of reinsurance, associated with all General Account policies was \$795 million as of December 31, 2012, versus \$292 million as of December 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.

c) Claim Payments since December 31, 2011 and since the Petition Date⁶

AAC paid \$58 million in claims resulting from General Account policies between December 31, 2011 and December 31, 2012, and received \$62 million in recoveries. AAC has made \$104 million in aggregate General Account payments from the Petition Date through December 31, 2012, and received \$70 million in recoveries.

⁶ All claim payment data is presented gross of realized recoveries.

3. Segregated Account Exposures

a) Overview

Aggregate Segregated Account net par outstanding declined by \$7.7 billion, or 22%, from \$35 billion as of December 31, 2011 to \$27 billion as of December 31, 2012. RMBS and student loan exposures accounted for 89% of aggregate Segregated Account net par outstanding and 71% 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, 2012

Dollars in Millions	Policies		Net Par Outstanding	
	Amount	Percentage	Amount (In millions)	Percentage
<u>Direct</u>				
RMBS.....	269	55%	\$19,117	70%
U.S. Public Finance.....	116	24%	866	3%
Structured Finance.....	10	2%	124	0%
Student Loans.....	78	16%	5,128	19%
International.....	10	2%	438	2%
ACP.....	7	1%	1,254	5%
Subtotal.....	490	100%	\$26,927	99%
Assumed.....	0	NA	235	1%
Total.....	490	100%	\$27,163	100%

b) Credit Profile

Approximately \$23 billion, or 85%, of aggregate Segregated Account net par outstanding is adversely classified, compared with \$29 billion, or 84%, as of December 31, 2011. Approximately \$22.2 billion or 82% of aggregate Segregated Account net par outstanding was allocated to the more severe III and IV risk classifications, compared with \$27 billion, or 79%, as of December 31, 2011. A summary of adversely classified Segregated Account net par outstanding is presented below.

Net Par Outstanding Associated with Adversely Classified Segregated Account Policies

Dollars in Millions	Adversely Classified NPO	Credit Classification			
		I-A	II (In millions)	III	IV
<u>Direct</u>					
RMBS.....	\$17,413	\$27	\$0	\$5,701	\$11,685
U.S. Public Finance.....	86	0	0	0	86
Structured Finance.....	0	0	0	0	0
Student Loans.....	5,122	0	795	4,327	0
International.....	201	0	201	0	0
CDS.....	292	0	0	292	0
Subtotal.....	\$23,114	\$27	\$996	\$10,319	\$11,772
Assumed.....	137	0	0	137	0
Total.....	\$23,251	\$27	\$996	\$10,456	\$11,772

c) Loss Reserves

As of December 31, 2012, total statutory loss reserves, net of reinsurance, associated with defaulted Segregated Account policies amounted to approximately \$2.9 billion, compared with \$3.3 billion as of December 31, 2011. Statutory loss reserves as of December 31, 2012, include \$3.4 billion of unpaid permitted policy claims and are net of approximately \$2.7 billion of projected remediation recoveries associated with alleged representation and warranty breaches (“R&W Recoveries”) related to certain RMBS transactions.⁷ Excluding R&W Recoveries, aggregate statutory reserves associated with Segregated Account policies are \$5.6 billion as of December 31, 2012, compared with \$5.8 billion as of December 31, 2011.⁸

Statutory loss reserves associated with Segregated Account policies are maintained in the General Account for reporting purposes, in accordance with accounting principles prescribed or permitted by OCI 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.

⁷ 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.

⁸ R&W Recoveries associated with defaulted RMBS policies and discounted at the statutory discount rate were \$2.7 billion and \$2.5 billion as of December 31, 2012 and December 31, 2011, respectively.

Statutory Reserves Associated with Segregated Account Policies as of December 31, 2012

Dollars in Millions	Statutory Reserves	
	<u>Statutory Reserves</u>	<u>Excluding R&W Remediation Recoveries</u>
RMBS.....	\$2,725	\$5,402
US Public Finance.....	\$57	\$57
Student Loans.....	\$0	\$0
Loss Adjustment Expense (1).....	130	130
Total	<u>\$2,911</u>	<u>\$5,588</u>

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, gross of reinsurance, associated with Segregated Account policies was approximately \$5.0 billion as of December 31, 2012, compared with \$6.3 billion as of December 31, 2011. Such estimates include (i) unpaid policy claims of \$3.4 billion as of December 2012 and \$2.8 billion as of December 2011, respectively, and (ii) R&W Recoveries (as estimated in accordance with GAAP) of \$2.5 billion as of December 2012 and \$2.7 billion as of December 2011, respectively. If such R&W Recoveries are excluded, aggregate gross claim liabilities associated with Segregated Account policies would be \$7.5 billion as of December 31, 2012, compared with \$9.0 billion as of December 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 December 31, 2011 and since the
Petition Date

Aggregate claims of approximately \$1.7 billion against Segregated Account policies were presented between December 31, 2011 and December 31, 2012. Second-lien mortgage-backed claims during this timeframe amounted to approximately \$349 million; first-lien claims amounted to \$1.3 billion.

From the Petition Date to December 31, 2012, approximately \$4.4 billion in claims were presented against Segregated Account policies, representing an average of \$131 million per month. Such claims are summarized by category as follows:

Segregated Account Claims Presented Since Petition Date

Dollars in Millions	March 25, 2010 to December 31, 2011	January 1, 2012 to December 31, 2012	Total
1st Lien RMBS	\$1,590	\$1,326	\$2,916
2nd Lien RMBS	1,169	349	1,518
Other SA Exposures	8	6	14
Total	\$2,767	\$1,681	\$4,448

e) Claims Paid Since December 31, 2011**Segregated Account Claims Presented, 2012 Claims Paid, and Claims Outstanding**

Dollars in Millions	Total Claims Presented Gross of Recoveries	2012 Claims Paid	Claims Outstanding as of December 31, 2012
1st Lien RMBS	\$2,916	\$679	\$2,237
2nd Lien RMBS	1,518	378	1,140
Other SA Exposures	14	3	11
Total	\$4,448	\$1,062	\$3,388

VI. THE REHABILITATOR'S LOSS PROJECTIONS

The Rehabilitator and his financial advisors have developed certain loss estimates for both the General Account and Segregated Account, using financial information provided by AAC, including information that may be prepared for Statutory or GAAP financial statements, or at the request of the Rehabilitator. Such loss estimates do not reflect the views of AAC or its management.

Two distinct loss estimates, a “base case” and a “stress case”, have been developed. These loss estimates are based on financial data for the year ending December 31, 2012 and employ a 5.1% discount rate in all present value calculations. The ultimate losses resulting from General Account and/or Segregated Account policies may exceed these base case and stress case loss estimates, perhaps materially, and such estimates do not represent a cap on prospective losses.

The base case losses for the General Account and the Segregated Account, before any R&W Recoveries, as of December 31, 2012 are estimated to be, respectively, \$0.7 billion and \$7.1 billion. The Segregated Account loss estimate includes (i) \$3.4 billion in accrued but unpaid claims, (ii) \$2.8 billion in projected RMBS losses, (iii) \$0.8 billion in projected student loan losses, and (iv) \$0.1 billion in losses associated with other Segregated Account exposures. Total

accrued but unpaid claims represented 48% of aggregate Segregated Account base case losses as of December 31, 2012.

The stress case losses for the General Account and the Segregated Account, before any R&W Recoveries, as of December 31, 2012 are estimated to be, respectively, \$1.0 billion and \$8.2 billion. The Segregated Account loss estimate includes (i) \$3.4 billion in accrued but unpaid claims, (ii) \$3.7 billion in projected RMBS losses, (iii) \$1.0 billion in projected student loan losses, and (iv) \$0.1 billion in losses associated with other Segregated Account exposures. Total accrued but unpaid claims represented 41% of aggregate Segregated Account stress case losses as of December 31, 2012.

The RMBS component of the Rehabilitator's Loss Projections includes estimates for potential incremental losses that could result from Plan amendments currently under consideration by the Rehabilitator. Such potential incremental losses result from (i) incremental interest costs associated with non-reducing RMBS exposures and (ii) reduced reimbursement receipts. The Rehabilitator is considering various measures to mitigate such potential incremental policy losses, including the Supplemental Payments Motion.⁹

AAC has approximately \$1.4 billion of surplus notes outstanding (including accrued and unpaid interest) through December 31, 2012.¹⁰ While the surplus notes are not included in the base case and stress case losses detailed above, OCI has determined that it will treat the surplus notes as *pari passu* with the non-cash consideration to be provided to the Segregated Account policyholders in the Rehabilitation Proceeding.¹¹ Accordingly, AAC's surplus note obligations (including accrued but unpaid interest) could affect the financial condition of the Segregated Account and prospective recoveries for Segregated Account policy beneficiaries.

The total amount of Segregated Account policy-level obligations (including the outstanding surplus notes with accrued but unpaid interest) is estimated to be \$8.5 billion in the base case scenario and \$9.6 billion in the stress case scenario. Based on the foregoing, approximately 56% of total Segregated Account policy-level obligations have crystallized in the base case, and 49% in the stress case as of December 31, 2012.¹²

Further, the base case and stress case loss estimates detailed above do not incorporate prospective tax liabilities of AAC (whether payable to AFGI under the Tax Sharing Agreement or to federal, state, and local tax authorities), or AAC operating expenses. Both categories of

⁹ Further, such Plan amendments, if implemented, may result in improved tax efficiency and higher recoveries for Segregated Account policy beneficiaries.

¹⁰ Excludes junior surplus notes.

¹¹ See the Affidavit of Regina Frank in Support of the Rehabilitator's Motion to Approve Purchase of Surplus Notes, dated May 16, 2012.

¹² Defined as the sum of (i) accrued but unpaid claims and (ii) surplus notes outstanding (including accrued but unpaid interest, divided by the sum of (i) the total base or stress case loss estimate (as the case may be) and (ii) surplus notes outstanding (including accrued but unpaid interest).

cash outflows effectively represent a higher-priority claim on AAC's claims-paying resources than that of payments in respect of non-cash consideration to Segregated Account policy beneficiaries. As a result, the use of claims-paying resources to fund tax payments and operating expenses could have an adverse effect on the prospective recoveries of Segregated Account policy beneficiaries.

VII. RECOVERY CONSIDERATIONS

The summary of claims-paying resources found in Section V and the base case and stress case loss estimates summarized in Section VI represent point estimates of AAC's financial condition as of December 31, 2012. However, the foregoing information incorporates point estimates for prospective financial resources and policy losses that are inherently uncertain in many respects, and subject to significant variance.

Accordingly, the ultimate recovery achieved by Segregated Account policy beneficiaries in respect of their claims is subject to many factors, including but not limited to the following:

- R&W Recoveries: Ambac's total potential R&W Recoveries may exceed or fall short of the \$2.7 billion estimate incorporated in AAC's statutory financial statements. The \$2.7 billion estimate takes into account, among other things, the risks and uncertainties inherent in litigation. The \$2.7 billion estimate could be considered as one point in a very broad relevant range of potential outcomes for R&W Recoveries; accordingly, an outcome near either the low or high end of this relevant range could represent a significant change in the financial condition of the Segregated Account (and Segregated Account recoveries), as compared to an outcome in line with the \$2.7 billion estimate.
- Unanticipated loss development: Although the loss estimates described above reasonably reflect information currently available to the Rehabilitator and his financial advisors, and make some allowance for the potential of future adverse developments, unanticipated credit developments may occur during the course of the Rehabilitation. In the absence of mitigating circumstances, such credit developments could have an adverse effect on the Segregated Account's financial condition and the prospective recoveries of Segregated Account policy beneficiaries.
- The Company's ability to effectuate loss mitigation transactions: The Company has consummated a series of loss mitigation transactions since the Petition Date. Such transactions have been important elements of the Company's risk reduction efforts and accretive to Segregated Account policy beneficiaries. Although the base case and stress case loss estimates do not make assumptions regarding commutations that have yet to be negotiated, additional commutation activity could provide further gains for Segregated Account policy beneficiaries.
- Investment portfolio performance: Certain upside considerations include the \$0.6 billion excess of fair value over statutory carrying value as of December 31, 2012 and the current book yield of 7% - greater than the interest rate on the surplus notes.

Downside concerns include reinvestment risk, which is particularly relevant given prevailing financial market conditions.

- AAC's tax liability to AFGI under the Mediation Agreement and to federal, state, and local tax authorities: The ultimate structure of the Rehabilitation Plan and the tax treatment thereof, represent a significant source of uncertainty and, potentially, a significant use of AAC's claims-paying resources in the event that AAC is subject to adverse tax consequences.
- AAC's ability to utilize NOLs: Pro forma for the IRS Settlement and certain adjustments related to AFGI's emergence from bankruptcy, the Ambac Group has NOLs of approximately \$5.4 billion as of December 31, 2012. The Ambac Group may be able to 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 group member (including AAC). The eventual benefits to be realized by the members of the Ambac Group are subject to many uncertainties, including (i) the ability of the Ambac Group or its members to generate taxable income that would allow for meaningful utilization of the NOLs, and (ii) the potential of annual limitations on usage due to an "ownership change" as defined in Section 382 of the Internal Revenue Code (as a result of trading in the common stock of a reorganized AFGI).

The foregoing discussion is meant to highlight uncertainties in respect of prospective Segregated Account recoveries, and is not meant to be exhaustive. Further information on this subject is contained in AFGI's annual reports on Form 10-K and quarterly reports on Form 10-Q.