STATE OF WISCONSIN | CIRCUIT COURT | DANE COUNTY

In the Matter of the Rehabilitation of:

Segregated Account of Ambac Corporation

Case No. 10 CV 1576

SECOND AFFIDAVIT OF DANIEL KERSTEN

STATE OF MINNESOTA)
) SS.
COUNTY OF HENNEPIN)

Daniel Kersten, being first duly sworn on oath, deposes and states as follows:

1. I am a director of CarVal Investors, LLC ("CarVal"), which is located at 9320 Excelsior Boulevard, 7th Floor, Hopkins, Minnesota, 55343. I submit this Second Affidavit in further support of the CarVal Holders' Motion for Order to Show Cause ("Motion"). Except where stated, this affidavit is based on my personal knowledge.

2. I refer in this Second Affidavit to my affidavit filed on February 9, 2016 ("First Affidavit").

3. In the First Affidavit, I explained that the Rehabilitator's assessment of the financial strength of the General Account of Ambac Assurance Corporation ("Ambac") demonstrates that at least $3.847 billion is available to increase the Interim Payment Percentage from 45.0% to 83.6%, and make a corresponding catch-up distribution to Holders of accrued claims against the Segregated Account. In this Second Affidavit, I address recent Ambac financial reporting that was released after the First Affidavit was filed.

4. On February 18, 2016, Ambac Financial Group, Inc. ("AFGI," the publicly-held parent corporation of Ambac Assurance Corporation, "AAC"), released its consolidated unaudited Quarterly Operating Supplement for the Fourth Quarter of 2015. A copy is attached as

Exhibit 1. The next day, management conducted an earnings call, a Bloomberg transcript of which is attached as Exhibit 2. I attach as well AFGI's press release issued February 18, 2016 as Exhibit 3. These recent disclosures show that Ambac's overall financial condition has continued to improve significantly. However, despite its strong financial condition and significant excess capital, Ambac avoided policyholder distributions in order to re-commence a disturbing program of purchasing the securities it insures in order to repurchase its insurance claims ("Repurchase Program"). In contravention of the Plan of Rehabilitation ("Plan"), this program primarily benefits AFGI equity holders while further delaying distributions to Segregated Account policyholders. In short, Ambac's Repurchase Program enables Ambac management to use policyholder capital to attempt to create value for equity holders.

Ambac's Financial Performance

5. On February 19, 2016, AFGI conducted a public earnings call regarding its financial results for the fourth quarter of 2015. AFGI's Chief Executive Officer, Nader Tavakoli, said that AFGI's equity value had improved from a negative value of ($7.23) in 2013 to almost $25.00 a share today, and that fourth-quarter operating earnings of $481 million "were the highest they have been for any quarter, since Ambac emerged from its restructuring proceedings in 2013." Ex. 2 at 2. In the fourth quarter of 2015, Ambac reported a $396 million improvement in its net loss reserve position from $3.255 billion to $2.859 billion, an improvement of 12.2%, as well as a $10.7 billion or 9% reduction in total insured exposure. Ambac's insured exposure has now declined $270 billion (or 71%) since it entered Rehabilitation in March 2010. Ex. 3 at 1, 4. Mr. Tavakoli said that the J.P. Morgan settlement in January 2016, at $995 million (which I addressed at paragraph 14 of the First Affidavit), was (as I had projected, *see* First Affidavit ¶¶ 17, 19) "well above our previously recorded remediation

claim related to those claims," Ex. 2. at 3, adding that the settlement "was all in cash and has already been paid directly to Ambac." *Id.* He concluded that "this settlement now positions us extraordinarily well to pursue our remaining RMBS related claims, both in terms of [the] validation of our claims and our approach to the cases." *Id.*

6. In short, Ambac is today in even a stronger financial position than it had earlier reported, and the case for a substantial, immediate distribution is even stronger than appeared from earlier financial statements.

Ambac's Hedge Fund Strategy

7. As to the Segregated Account, however, the recent financial releases disclose a disturbing abandonment of the Plan's core purpose of distributing available funds to long-delayed Segregated Account Holders as promptly as possible, in favor of a "hedge fund" strategy to build shareholder value at their expense.

8. As I set out in the First Affidavit, the basic concept of the Plan was that Ambac would be given breathing space to stabilize its business. Holders of Segregated Account claims would be subordinated to all other claims to permit that to happen. Once stabilization had occurred, however, the stated intent of the Plan was to "effectively *render all of the claims-paying resources of the General Account available to pay liabilities of the Segregated Account.*" First Affidavit Ex. A at 13 (emphasis added). The Holders would receive payment -- not be forced to finance a hedge fund. This was the stated intent of the rehabilitation from March 25, 2010, when the Segregated Account was established. *See* Exhibit 4 (Press Release stating that "Ambac ... has established a segregated account ... in order to facilitate an orderly run-of and/or settlement of [the] specific liabilities [in the segregated account]."). The Rehabilitator's and Ambac's public disclosures show that Ambac's financial condition has, in fact, stabilized.

9. On the February 19, 2016 earnings call, Mr. Tavakoli stated, "given the long duration tail of our liability book, *asset management is and will remain a core focus of Ambac* if we are to meet our obligations to our long duration policy holders[,]" adding that "we're giving substantial thought to deploying our capital strategically in asset management businesses." *Id.* (emphasis added). He also stated that "we're giving serious consideration to the possibility of leveraging our operational platform to manage other similar run-off businesses." *Id.*

10. "Asset Management" is a euphemism for running a hedge fund. "Leveraging our operating platform to manage other similar run-off businesses" suggests that Ambac intends to expand its operations, potentially through acquisition, and is no longer pursuing an orderly run-off, as the Plan intends. It appears that Ambac's intent is to use the Holders' capital in the Segregated Account, which is trapped in Ambac, to engage in new investment strategies for its own benefit.

11. As part of this hedge fund approach, Ambac in 2015 implemented a massive Repurchase Program to acquire wrapped bonds, exchanging an estimated $555 million in cash (that was otherwise immediately available for distribution to Segregated Account Holders) for illiquid securities. This $555 million investment represents 12% of Ambac's year-end insurance capital.

12. In the financial guaranty industry, the phrase "wrapped bond," refers to a bond whose performance is guaranteed by an insurer. When Ambac acquires a bond that it "wraps," it purchases a bond that it guarantees. The holder of the bond has either an existing or contingent claim against Ambac's Segregated Account. Ambac exchanges corporate cash for the bond, thereby eliminating its insurance obligation (on default, it would pay itself). Thereafter it relies

on the performance of the bond itself for any return on the Ambac cash with which it purchased the bond.

13. In 2015 the Rehabilitator permitted AFGI to pursue negotiations with major Holders regarding a profound modification of the Plan, in which Segregated Account claims would be exchanged for restructured subordinated debt securities in Ambac (the "Recapitalization Transaction"). Moving Brief at 7. During these negotiations Ambac management suspended its Repurchasing Program, making no purchases of wrapped bonds in the third quarter. Instead, on Ambac's third quarter earnings call, management reported it increased its asset allocation to cash and short-term securities from 4% to 12% of its portfolio, or approximately $563 million, in part to build liquidity in connection with this proposal. *See* First Aff. Ex. I at 7.

14. Large holders rejected management's proposed Recapitalization Transaction in October 2015. Ambac immediately recommenced and expanded the Repurchasing Program, depleting $235 million (or 42%) of the recently raised cash and short-term securities that were intended to be distributed to policyholders as part of the Recapitalization Transaction. Ex. 3 at 1 ("After a short period of inactivity in the third quarter related to discussions with certain claim holders, we returned to the market in the fourth quarter and purchased $235 million of insured securities, including $200 million of insured RMBS.").

15. In calendar year 2015 Ambac repurchased a total of $635 million in Ambac-wrapped bonds. Ex. 3 at 6. It appears from the financial disclosure that approximately $80 million of the 2015 purchases were acquired using AFGI's cash, implying that $555 million was acquired using insurance capital from AAC. First Aff. Ex. H at 13; Ex. 1 at 13. Instead of

making distributions to Holders of Segregated Account obligations, as the Plan contemplates, Ambac used cash to buy obligations themselves, and in a massive amount.

16. If they do not default, Ambac-wrapped RMBS bonds will pay out over time. Many bonds have maturities extending twenty years or more, with the typical weighted average life being approximately three years. This means that, if it holds these securities, Ambac will not recover its investment in them for, on average, three years. Every dollar that Ambac invests in its own wrapped RMBS bonds is therefore potentially held captive for an average three years, and thereby unavailable to make distributions to Holders of obligations of the Segregated Account.

17. By investing heavily in Ambac-wrapped RMBS Bonds, management puts Holders of Segregated Account obligations at risk. Ambac reports that $1.85 billion, or 39.5% of its insurance capital is invested in Ambac-wrapped Bonds. Ex. 1. These securities are heavily exposed to subprime collateral. For the majority of these bonds, Ambac assigns internal ratings of below Investment Grade. Ex. 1 at 13. While the range of loss on these securities is increasingly predictable, their risk profile is significantly higher than that of cash, or of typical insurance capital investments (which ordinarily include government, municipal, and high grade corporate bond investments).

18. Subjecting its financial condition to RMBS is precisely the strategy that forced Ambac to seek rehabilitation in the first place. First Aff. at ¶ 8. When the Segregated Account was created, the Commissioner insisted that all of Ambac's RMBS policies be placed in the Segregated Account, due in large part to the risk presented by these securities. By repurchasing these bonds, Ambac is essentially doubling down on a strategy that already failed.

19. Because of its purchases of Ambac-wrapped bonds, 52% of Ambac's insurance capital is invested in securities rated BBB or worse, while only 42% is invested in securities rated "A" or better. Ex. 1 at 13. By contrast, according to public disclosures, Assured Guaranty, a leading monoline insurer, has invested 9.3% of its insurance capital in securities rated BBB or lower, and 90.4% in securities rated "A" or higher. According to public disclosures, National, a subsidiary of MBIA and another leading monoline insurer, has invested 12.7% of its insurance capital in securities rated BBB or lower, and 93.0% in securities rated "A" or higher.

20. Assuming that Ambac is repurchasing claims at observable market prices, it likely repurchased claims at 80-90% of their face value during 2015. Since Ambac can recover its cash investment only from the bond itself, a market purchase is an implicit admission that Ambac's worst-case estimate for all-in recoveries on holders of Segregated Account claims is in the range of 80-90%. There is no reason that Ambac could not simply improve the distribution to all holders at that level, rather than effectively picking and choosing Holders in the market.

21. The Rehabilitator's base case projects Segregated Account policyholder recoveries of 100%. First Aff. Ex. F at Ex. B at 25. If the base case is realized, any extra value created through Ambac-wrapped Bond purchases can accrue only to non-policyholders. In other words, Ambac's aggressive purchases of wrapped bonds shows that it has abandoned the Plan's objective of distributing available cash to Holders of the Segregated Account as promptly as possible, in favor of using the Holders' cash as trapped capital for hedge fund activity, whose purpose appears to be to try to generate a risky equity return.

FURTHER AFFIANT SAYETH NOT.

Daniel Kersten

Subscribed and sworn to me
this 25 day of February, 2016.

SULAINE MARIE PEDERSEN
Notary Public
Minnesota
My Comm. Expires
Jan 31, 2020