STATE OF WISCONSIN CIRCUIT COURT DANE COUNTY

In the Matter of the Rehabilitation of:

Segregated Account of Ambac Assurance Corporation

Case No. 10 CV 1576

AFFIDAVIT OF JAMES W. SCHACHT IN SUPPORT OF RMBS POLICYHOLDERS' OBJECTIONS TO THE CONFIRMATION OF THE PROPOSED PLAN OF REHABILITATION

County of Cook)
) SS
State of Illinois)

I, James W. Schacht, being first duly sworn do hereby depose and state as follows:

1. I am not a party to this action. I was retained by the RMBS Policyholders in the above-captioned case. I make this affidavit in support of RMBS Policyholders' Objections to the Confirmation of the Proposed Plan of Rehabilitation.

2. I have been retained by the RMBS Policyholders regarding issues pertaining to the Rehabilitator's proposed Plan of Rehabilitation for the Segregated Account of Ambac Assurance Corporation. I am being paid my customary rate of $500 per hour for my work on this matter. I have no financial interest in the outcome of this matter.

3. I am presently the President of The Schacht Group which provides consulting and advisory services to a variety of clients with regard to insurance, reinsurance and regulation. Part of my practice involves providing expert consulting and testimony. My complete resume, including expert appearances and a list of publications, is attached. (*See* Exhibit A.) Also attached is a list of documents that I have reviewed in connection with this engagement. (*See* Exhibit B.)

4. I have been qualified as an expert on a variety of matters dealing with insurance, reinsurance, insolvency and insurance regulation in state, federal and tax court. Most recently, I testified in The Commonwealth Court of Pennsylvania in the matter of *Joel S. Ario, Insurance Commissioner of the Commonwealth of Pennsylvania, Plaintiff v. Reliance Insurance Company, Defendant, In Re Objections of Mizuho Corporate Bank Limited to Notice of Determination for Proof of Claim,* January, 2010, (Docket No. 269 MD 2001). The court cited my testimony in its opinion on issues relating to a very substantial claim filed by a policyholder of Reliance Insurance Company now in liquidation. Several other courts have cited and relied upon my testimony in their opinions, including: 1) *Internal Revenue Service v. Utah Medical Insurance Association,* U.S. Tax Court, 2) *Trustmark Insurance Company v. General Cologne Life Re of America,* U.S. District Court, Northern District of Illinois, Case No. 00C 1926, and 3) *Harry W. Low, Insurance Commissioner of the State of California and as Conservator, Liquidator and Rehabilitator of Executive Life Insurance v. Altus Finance S.A., Credit Lyonnais, S.A., Artemis S.A., et al*., U.S. District Court for the Central District of California.

5. From 1964 through 1995, I was employed at the Illinois Department of Insurance ("Illinois DOI"), and the Illinois Office of the Special Deputy Receiver ("OSD"), and during that time, I held a number of positions including Chief Deputy Director, Special Deputy Receiver, and Acting Director of Insurance. On three occasions I was appointed, by two Illinois Governors, as head of the Illinois Department of Insurance, a cabinet level position.

6. From 1964 through 1976, I held various positions in the Financial Examination Division of the Illinois DOI and was Chief Examiner in that Division toward the end of that time period. From 1976 through 1979, I was the Deputy Director of the Financial-Corporate

Division of the Illinois DOI. In 1973, I was involved in handling the failure of Equity Funding Life Insurance Company, the largest life insurance company failure up to that point in time.

7. In 1979, I was promoted to the position of Chief Deputy Director of the Illinois DOI, and I remained in that position until I left the Illinois DOI in 1995. As Chief Deputy Director, I reported directly to the Director of the Department of Insurance, who was the agency head appointed by the Governor of Illinois. I managed and oversaw the day-to-day operations of the Department as that agency regulated the insurance industry in Illinois. One of the matters I confronted as Chief Deputy Director was the failure of Reserve Insurance Company in 1979. This was the largest property and liability insurance failure at the time and presented complex and unique issues, as the company wrote a variety of personal and commercial insurance business nationwide. Prior to this time, most insolvencies were smaller local or regional automobile insurance writers.

8. In addition to my duties as Chief Deputy Director, I was appointed in 1983 to the position of Special Assistant for Insurance Receiverships, and in 1986 to the position of Special Deputy Receiver by the Illinois Insurance Director. I held the positions of Chief Deputy Director and Special Deputy Receiver until I left the Department in 1995. As Special Assistant for Insurance Receiverships, I oversaw the Office of the Special Deputy for the Insurance Director. As Special Deputy Receiver, I was given the Director's power of attorney to directly administer all insurers subject to conservation, rehabilitation and liquidation proceedings. In that capacity, I was responsible for the administration of over fifty insurance company receiverships. These receiverships included large and complex professional reinsurers and writers of sophisticated commercial insurance products. The receivership staff exceeded 200

employees and consisted of claims personnel, accountants and auditors, attorneys and other insurance professionals.

9. In addition to my positions as Chief Deputy Director and Special Deputy Receiver, I also served as Director of the Illinois DOI at the request of the Governor for the State of Illinois. I served as Director, in addition to my other positions at the DOI and OSD, from 1982 to 1983, 1991 to 1992, and 1994 to 1995. While I was Director, I was responsible for administering the insurance laws in Illinois, regulating the insurance industry, and overseeing all aspects of the Illinois DOI, including policy and legislative issues. In this capacity, I was also the Statutory Receiver of all other companies subject to conservation, rehabilitation and liquidation proceedings in Illinois. Since the Illinois DOI was a pioneer in developing regulatory laws and tools to identify insurers trending to a hazardous financial condition, we had a large number of insurers entering delinquency proceedings, perhaps more than any other state.

10. In 1995, I joined Coopers and Lybrand LLP, an international professional service firm, to form a national insurance regulatory practice. All major firms soon after followed our lead and developed similar practices. In 1998, Coopers and Lybrand LLP and Price Waterhouse LLP merged to form PricewaterhouseCoopers LLP. During my tenure at both Coopers and Lybrand and then PricewaterhouseCoopers, I counseled many clients on insurance, reinsurance, regulatory, and receivership issues until I resigned in August 2005. One of my specialties has been the ability to develop creative and innovative solutions for troubled insurers. In 2003, Kemper Insurance Company became the largest solvent property casualty run-off in the world with assets in excess of $12 billion. In my work with both the board of directors and senior management, I was able to formulate a detailed overarching strategy and implementation plan

for commercial run-off. In addition, I was able to effectively manage regulatory relationships and convince Illinois and others that the run-off plan was appropriate. I continue to serve as a strategic advisor to Kemper as its solvent run-off continues today, demonstrating that I have been able to quickly evaluate and execute strategic options that preserve and improve policyholder values.

11. In September 2005, I joined Navigant Consulting, Inc. as Managing Director of the Regulatory, Restructuring and Run-off practice and continued in that role until resigning in 2008 to form The Schacht Group. While at Navigant, I was engaged to assist the senior management team and the board of Triad Guaranty Insurance Corporation in developing the run-off plan that guided the company in maintaining statutory solvency. Triad Guaranty was a multi-billion dollar mono-line mortgage guaranty insurer. As conditions in the housing market became more adverse, the original run-off plan had to be modified to ensure that all policyholders were treated similarly and fairly. The plan incorporated a cash payment and a deferred payment for all policyholders.

12. I applied for and was granted a designation of Certified Insurance Receiver – multi-line by the International Association of Insurance Receivers (IAIR). This designation means that this professional organization has determined that I am fit to administer all types of insurers that encounter financial difficulty. I was one of the early recipients of this professional designation.

13. Besides my extensive involvement with receiverships in Illinois, including such property & casualty, commercial, direct writers and reinsurers as Pine Top Insurance Company, Centaur Insurance Company, American Mutual Reinsurance Company and many others, I served as Chairman of the National Association of Insurance Commissioners task force on

insurance receiverships for the years 1982-83, 1991-92, and 1994-95. The National Association of Insurance Commissioners is an association whose members are the chief insurance regulator for each of the jurisdictions in the United States. The group I chaired had responsibility for oversight of insolvencies in the United States and revisions of the model laws for administering insurance company insolvencies in the United States. The following are among the initiatives I oversaw:

- Revisions to the Model Insurers Rehabilitation and Liquidation Model Act (NAIC Proc-1992) (NAIC Proc-1994)
- Re-established closed regulator sessions to discuss pending and ongoing receiverships
- Review and revisions to the "Receiver's Handbook for Insurance Company Insolvencies" as well as adoption by this task force
- Minimum Standards for Receiverships (NAIC Proc-94)
- Revisions to the Receivership Model Act
- Uniform Data Standards for Property/Casualty Insolvencies
- National Receivership Database

14. During my 25 years of active participation in the NAIC, I was instrumental in the development of model laws and regulations on numerous subjects including reinsurance, insurance guaranty funds, insurance holding companies, receiverships, loss reserve opinions, insurance department examinations and independent audit reports. I was actively involved in the development of changes to the various annual statement blanks promulgated by the NAIC. I served on numerous technical committees dealing with reinsurance, insurance and other regulatory issues, including the following:

- Accounting Practices and Procedures Task Force (Chairman – 1983)
- Reinsurance and Anti-Fraud Task Force (Member – 1983)

- Reinsurance Practices and Procedures Working Group (Chairman – 1984 – the group was formed at my suggestion).
- Reinsurance Task Force (Chairman – 1991)
- Special Committee on Alien Reinsurance (Chairman – 1991)

15. I was principally responsible for creating several important NAIC manuals and programs including the following:

- "Early Warning" Ratios for Property and Casualty Companies (a series of financial ratios designed to aid state insurance departments in the detection of troubled insurers.)
- Examiner Team Program (This NAIC program was designed to assist state insurance departments prioritize insurance companies requiring regulatory action.)
- Statutory Accounting Manuals for Property and Liability and Life and Health Insurance Companies (These were the first NAIC accounting manuals to be adopted as authoritative guidance by every state.)
- Troubled Company Manual (In 1985, I presented a preliminary outline for this new manual and ultimately chaired the drafting group. Today, this manual serves as guidance to state regulators in handling troubled insurance companies.)
- Financial Regulation Standards and Accreditation Program (This program established standards and requirements for state insurance departments to be accredited by the NAIC.)

16. I was often requested by the NAIC to oversee and provide advice to the NAIC and non-domiciliary states on insurers that were troubled or subject to delinquency proceedings. For example, I chaired the group that oversaw the regulatory responses to both Baldwin United Insurance Company and Executive Life Insurance Company.

17. In 1991, I was privileged to serve on a focus group of those experienced with insurance receiverships, which identified certain problems and inefficiencies with the current system. In 1993, at the request of the Insurance Commissioners of the Midwest Zone of the

NAIC, I chaired the group that developed an Interstate Compact for Insurance Receiverships. After enactment of the compact in several states, I participated on the Receivership Law Advisory Committee, which created the Uniform Receivership Law, applicable to the compacting states. I saw the opportunity to use the interstate compact as a vehicle to address the problems of the existing receivership system, but also to address other areas of insurance regulation. Later, this concept was embraced by the NAIC.

18. In 1983, I initiated the development of the International Association of Insurance Supervisors in collaboration with insurance regulators from Bermuda, the Cayman Islands and the United Kingdom. I continue today as an official observer of the International Association of Insurance Supervisors.

19. In 2006, at the request of the Bermuda Monetary Authority and the Bermuda Insurance Department, I was engaged to assess Bermuda's current regulatory framework, regulatory process and procedures, and to prepare appropriate recommendations for enhancement with a particular focus on financial surveillance.

20. I have been commissioned to prepare numerous ground-breaking public policy studies for The National Conference of Insurance Legislators (NCOIL) and other industry trade associations, all of which are identified in Exhibit A. The most recent of these studies entitled, "A Study on State Authority: Making a Case for Proper Insurance Oversight" was prepared for NCOIL in 2007.

21. I have given deposition and court testimony on numerous occasions in civil, criminal and tax litigation involving insurance, reinsurance and insurance regulation. I have also given testimony before state legislative committees and congressional committees on

insurance and its regulation. I have given testimony in arbitration proceedings on reinsurance disputes as well. A complete list of my expert appearances is contained in Exhibit A.

22. I have authored numerous articles on insurance regulation and have served as a reviewer of insurance textbooks. A complete list of my publications is included in Exhibit A.

23. In 1990, I was honored with the National Association of Insurance Commissioner's distinguished Robert E. Dineen Award in recognition of outstanding contributions to insurance regulation. In 1996, I received the National Association of Mutual Insurance Companies' Award in recognition of my contribution and service in regulation and to the industry.

24. Through my thirty years of regulatory experience, well over fifteen years of direct receivership experience, my leadership at the NAIC involving insurance receiverships, written work and related research and related professional experience, I have become familiar with the custom and practice employed by regulators to handle a troubled insurer and the conflicting and competing demands it presents, particularly a large complex insurer.

25. I have included throughout my affidavit references to Spencer L. Kimball. In 1967, Wisconsin substantially revised its insurance rehabilitation and liquidation provisions and appointed Professor Kimball as the executive director of the Wisconsin Insurance Code Revision Project. Professor Kimball, Seymour Logan Professor of Law at the University of Chicago Law School at the time, prepared the extensive annotations to the Wisconsin law upon enactment to explain the history, content and operation of these provisions. The Wisconsin statute served as a basis for the insurer rehabilitation and liquidation provisions incorporated into the NAIC Model Act, as well as state laws throughout the United States.

26. Spencer L. Kimball was a world renowned scholar on insurance law and regulation. Much of his work in insurance law remains a model for insurance codes today. He served as dean of the University of Utah Law School and as a professor at the University of Michigan Law School early in his career. In 1972, he was appointed dean of the University of Wisconsin Law School and ultimately served as the Seymour Logan Professor of Law at the University of Chicago until his retirement in 1988. He also served as executive director of the American Bar Association Foundation in Chicago.

27. The overall Plan of Rehabilitation developed by the OCI and Ambac violates the basic principles in the Wisconsin rehabilitation and liquidation statutes as set forth by Kimball and as discerned from his commentary and other writings. While his work on the Wisconsin Statute was carried out more than four decades ago, it continues to represent the custom and practice of insurance regulation today.

28. The Wisconsin Statute and the laws of the various states concerning the administration of insurer rehabilitations and liquidations embody the following underlying principles:

- Fair allocation of the assets of the estate according to the established priorities.
- Vigorous marshalling of assets to meet the obligations of the estate.
- Prompt resolution of the business of the estate and distribution of marshalled assets.
- Minimizing administrative costs of the receivership in order to maximize assets available for claimants.

29. Rehabilitation, according to Kimball, "is not appropriate at a point where a company has been allowed to approach insolvency, unless substantial additional resources are

poured into the enterprise immediately by contributors of capital funds."[1] To do otherwise creates risk for policyholders in that the liquidation value may be lessened.

30. I begin with a brief overview of regulation of the insurance industry in the United States, since the basic concepts and principles underlying that regulation continue when a company encounters financial difficulty. This is followed by a brief discussion of the principles that must be followed when addressing the troubles of a distressed insurer.

31. Next, I address a few of the specific issues and problems of the Plan of Rehabilitation for the Segregated Account, as well as the conceptual flaws of the Plan fashioned by OCI and Ambac when considered in its entirety.

32. Financial guaranty insurance is a very specialized coverage and highly sensitive to economic conditions. It is not unexpected that in periods of economic stress, as recently experienced in the United States and globally, that a financial guaranty insurer would experience financial trouble such as occurred with Ambac. While regulators do not have a great deal of experience in addressing troubled financial guarantee insurers, they should not abandon basic principles, nor create a precedent that will not serve the industry and its policyholders in the long run. It is my opinion that the solution created by OCI and Ambac violates both of these conditions. Addressing the problems of a troubled insurer, particularly a large and complex one is not only challenging but filled with conflicts and competing demands. Naturally, the insurer seeks to survive. Government officials want to retain a major corporation as operational and offering employment to its citizens. But these are distractions that must not influence regulatory decisions. The focus must be doing what is in the best interests of the insurer's policyholders.

[1] Wisconsin Laws of 1967, Chapter 89, August, 1967, Introductory Comment by Spencer L. Kimball. American Bar Association Reference Handbook on Insurance Company Insolvency, 1986, p 199. (Attached as Exhibit C.)

The public policy question that government officials need to answer is whether the future of the financial guaranty business is well served by this Plan.

33. The custom and practice employed by regulators to handle troubled insurers includes the fundamental principle that policyholders be treated equally and fairly. The role, power, authority and responsibility of the insurance commissioner generally with respect to financial regulation, and specifically with respect to troubled companies is broad but constrained by doctrines of equal treatment of policyholder obligations.

34. As in most other developed countries, insurance in the United States is subject to a high degree of regulation. The term “regulation” narrowly refers to government restriction of private actions to achieve particular public goals. In addition to its general duty to protect the public interest, the State of Wisconsin, through the Department of Insurance and its Commissioner, has a specific duty, and has specifically assumed a duty, to protect insurance company policyholders. This specific duty derives, among other places, from the Wisconsin Statutes (the "Insurance Code"), its comprehensive nature, its repeated references to the protection and best interests of the policyholders and the insurer's creditors, and the comprehensive and specific powers and duties delineated by it to the Commissioner to execute his statutory duty to examine, regulate, and supervise the affairs of insurance companies. The Wisconsin Statutes set forth specific duties assumed by the State of Wisconsin for the protection of policyholders.

35. Insurance regulatory responsibilities are divided into two primary categories 1) solvency or financial regulation; and 2) market regulation. Financial regulation seeks to protect policyholders against the risk that insurers will not be able to meet their financial obligations. Market regulation attempts to ensure fair and reasonable insurance prices, products

and trade practices. Financial and market regulation are inextricably related and must be coordinated to achieve their specific objectives. Regulation of rates and market prices will affect insurers' financial performance and financial regulation constrains the prices and products that insurers can reasonably offer.

36. Most importantly, regulators must act within the framework of insurance laws enacted by the legislature, all designed to protect all policyholders. This objective does not change when a company becomes financially troubled.

37. The nature of the appropriate regulatory action for a troubled insurer varies depending on the circumstances, but the essential purpose is to prevent or minimize losses and to protect policyholders. There are two levels of regulatory actions with respect to troubled companies: 1) actions to prevent a financially troubled insurer from becoming insolvent; and 2) delinquency proceedings against an insurer for the purpose of rehabilitating or liquidating the insurer. (NAIC, Troubled Companies Handbook, 1992.)

38. If an insurance department detects that an insurer is financially troubled, the regulator's actions within the first category is to determine whether corrective action can restore the insurer to financial health and to implement such corrective action. Often the domiciliary state is assisted by regulators from other states in which such an insurer does business and by the NAIC's financial staff and their resources. Customarily, regulators will assert greater control over the insurer during this period. For example, regulators have the power and authority to require the insurer to prepare and submit a corrective action plan, to restrict transactions the insurer can undertake without the regulator's prior approval, to remove management, to require the disposition of non-qualifying assets, to reduce premium writings and other actions. The NAIC has provided guidance to regulators regarding the handling of a

troubled insurer through the Troubled Company Handbook. This is a manual of steps and procedures customarily employed in such situations. Some of these actions may be conducted informally, others require formal measures.

39. The insurance regulatory scheme in the United States results in foreign states relying on the domiciliary state to be the primary financial regulators. These states presume that the domestic regulator will diligently enforce insurance laws and closely monitor a company's financial condition. If a company should become troubled, the domestic regulator will institute appropriate corrective action. If the trouble cannot be remedied, then the domestic regulator will limit or cease the writing of insurance business or take more drastic action.

40. The role and responsibility of the insurance commissioner when faced with a troubled insurer are proprietary in nature. Once an insurer has ceased writing business, the regulator's concern is no longer with the protection of the general public, but with minimizing losses and protecting all policyholders on an equal basis. The primary focus should be protecting all policyholders, not just those that will not create "collateral damage." The insurer's assets should be preserved for all policyholders.

41. A key consumer protection in the existing state delinquency proceedings are the priority distribution statutes that require payment of policyholder claims before the payment of any other claimants, including those of other insurers, the government, general creditors, and shareholders. These priority distribution statutes also require members of the same class or group of creditors to be treated similarly. These statutes ensure that the needs of consumers/policyholders are placed ahead of non-policyholder level claimants and that everyone with the same level or type of claim is treated equally. The laws seek to preserve, to

the greatest extent possible, the insurance protection that the policyholders believed they were getting when they purchased the policy.

42. Today, a growing number of troubled insurers are seeking to engage in mechanisms of run-off or restructuring as an alternative to a traditional receivership proceeding, as in the case of Ambac. While there is little formal documentation available to regulators on how to deal with the winding down of troubled companies through the use of alternative mechanisms, the NAIC adopted a white paper on this subject in March 2010, which includes best practices for state insurance departments to consider if utilizing these alternative mechanisms in the United States. As state insurance regulators consider whether an alternative mechanism is appropriate for a particular insurer, care must be taken to ensure this approach stays within the context of the overall policy objective behind each alternative. The current regulatory system, which utilizes liquidation and guaranty fund protection, reflects a legislative policy that places the rights of policyholders and claimants over the interests of the investors and general creditors of the insurer. A plan that provides for a perceived quicker and less costly resolution to a troubled insurer of course must be balanced with maintaining the policy protections the policyholder expected when the policy was purchased from the insurer.

43. The white paper is intended to provide guidance to state insurance regulators and to be an advisory resource. Most importantly, it underscores that there are certain core principles that regulators should strive to maintain with any alternative mechanism for troubled insurers, as in the case of Ambac.[2] These core principles include the following:

> "1) *Honor contractual obligations to policyholders.* Alternative mechanisms should not be a way for the company to sidestep its contractual obligations to policyholders.

[2] Alternative Mechanisms for Troubled Companies, A NAIC White Paper, February 2010, p 1. (Attached as Exhibit D.)

2) *Meaningful notice and information sharing.* This contemplates accurate, consistent and meaningful information at inception and on an established schedule thereafter.

3) *Adherence to priority scheme.* Alternative mechanism should require adherence to statutory liquidation priority schemes. They should not provide a mechanism for circumventing the distribution priority to benefit the company, its shareholders, employees, other stakeholders, or specific groups of policyholders at the expense of other classes of policyholders.

4) *Coherent, comprehensive financial planning.* Any alternative mechanism should be based on a fully developed and comprehensive financial plan that includes complete and meaningful financial data and projections based on reasonable and realistic financial assumptions….There should be no ring-fencing or piecemeal disposition of assets and liabilities that may result in unequal treatment of policyholder claims, and give rise to preference and priority concerns. Moreover, the fairness and reasonableness of any mechanism cannot be reasonably assessed on a transaction-by-transaction basis without consideration of the overall impact on other policyholders and creditors.

5) *Procedural safeguards.* Any alternative mechanism should provide substantive procedural safeguards, including clear standards for disclosure, reporting, and external review; appropriate and timely notice; access to information and the opportunity for informed for all stakeholders; court and/ or regulatory approval for all significant actions to be taken; and meaningful compliance monitoring and reporting."[3]

44. The OCI should worry about this Plan, where it might lead and the public policy issues it raises. During the course of my tenure in regulation, I have seen a number of unusual and bold steps suggested, and in some cases carried out, to solve the problems of a failed or failing company. I have never seen anything like this. The notion that the claims and rights of policyholders can be separated into those which we like and will support, and those which we don't like and find more risky, is unheard of and foreign to the insurance mechanism and the regulatory scheme earlier described. That gives reason enough to thoroughly consider the full implications of this Plan. The public trust in the insurance industry has been built on the

[3] Alternative Mechanisms for Troubled Companies, A NAIC White Paper, February 2010, p 20-21.

principle that payment of premium creates a promise that sufficient assets will be available to pay claims in the future. That public trust is lost when a plan is proposed and allowed that does not give all policyholders access to all of the insurer's assets that remain. Moreover, the Segregated Account and the uncertainty of the value of assets supporting the policies in this account will give the Rehabilitator inappropriate leverage to achieve commutations and settlements with these policyholders. For a receiver and/or regulator to create such a situation is contrary to the duties and responsibilities of these offices. Other companies are watching this Plan and the proceedings around it to see if it will pass regulatory muster. This matter will have implications in years to come, perhaps dangerously setting a framework for other such proposals.

45. The proposed Plan violates well-established basic regulatory principles and accepted regulatory custom and practice, including:

a) The proposed Plan is not a true plan of rehabilitation, but instead a *de facto* liquidation. Stripping away the complexities and industry jargon, the overall plan developed by the OCI and Ambac to address Ambac's problems and deteriorating financial condition is an attempt to preserve a portion of Ambac's operation at the expense of certain policyholders. This is not part of the bargain these policyholders struck with Ambac. They expected performance on their contracts, and if that could not be achieved, they expected that they would share in the assets of Ambac on a pro rata and equal basis with all other policyholders. It is simply wrong to finance a rescue plan with selected policyholder funds.

b) The "surgical" approach taken by OCI and Ambac to place certain volatile risks in a Segregated Account in hopes of preserving what remains in the General Account is contrary to the principles of proper conduct by a regulator. Clearly, the regulatory system earlier described was not intended to be conducted in favor of one group of policyholders over another. To do so when there may be insufficient assets to meet insurance obligations is simply wrong. In all my years of experience, I have never seen such a blatant plan to prefer one segment of policyholders over another group of policyholders.

c) The Plan of Rehabilitation for the Segregated Account of Ambac Assurance Corporation departs from the accepted and customary practice of insurance receivers and regulators and the usual provisions of plans of rehabilitation, including**:**

1. Article 4 of the Plan covers the procedures for the submission of claims by policyholders' insurance coverage transferred to the Segregated Account. I have identified several deficiencies in these provisions. For example, rather than the Rehabilitator being in complete control of the claim administration process, the function is under the control of Ambac, through the Management Services Agreement, subject to whatever, if any, guidelines or specific direction of the Rehabilitator. This is a subtle, yet important difference and contrary to how rehabilitations are conducted. The rehabilitator must be in complete control since by law he replaces the authority previously exercised by the board and management of the insurer. Surprisingly, this section does not require the administration of claims to follow the insurance contract provisions

for those insurance policies transferred to the Segregated Account. Given that there may be insufficient assets available to meet policyholder obligations, the claim approval or denial process should be public, transparent and under the oversight of the Court.

2. It is highly unusual for a plan of rehabilitation to be executed by the statutory rehabilitator and a "management services provider." The statutory rehabilitator should have full power and authority under the Plan as the statute contemplates.

3. The Rehabilitator has not made any provision in the Plan for an advisory creditor's committee composed primarily of policyholders. The Wisconsin Statutes indicate that the Rehabilitator may consult with and obtain formal or informal advice from insurance experts.[4] Given the enormity of the task proposed and the reliance on prior management and staff, it is a plan feature that is missing. Such a committee not only would help the OCI and creditors of Ambac, but also assist the Court in performing its oversight function.

4. The reporting to policyholders, creditors, the court and the public set forth in Article 7 provides for an annual report five months after the end of each calendar year. This reporting should be more frequent, allowing all parties to monitor implementation of the Plan and to track its progress. It is noted that the Reliance Insurance Company in Liquidation provides similar reports on a quarterly basis. The Plan should set forth greater specificity and detail as to the

[4] Wisconsin Statute 645.33(3).

contents of the report so as to provide useful information to policyholders and creditors.

5. It is noted that the Plan does not indicate whether the Rehabilitator will continue to prepare statutory financial statements. I have found that continuing this requirement improves accounting and reporting discipline and controls that otherwise might deteriorate.

6. Whether there will be an annual audit of the Segregated Account is another question unanswered by the Plan. In my opinion this should be required.

46. The proposed Plan of Rehabilitation offered by the OCI for the Segregated Account Policyholders and the Plan for Ambac Assurance Corporation fail to provide an adequate basis for evaluating the Plans proposed:

a) Most importantly, the Plan and supporting material do not contain any disclosure or information with respect to liquidation value or that the OCI even performed such a calculation. Liquidation value is that value or range of values that all policyholders would expect to receive if an entity was placed in liquidation and ultimately dissolved. It is a critical calculation that must be performed since all alternative plans, including rehabilitation plans, must be measured against it. The reason for this is simple. It is the principle established by the U.S. Supreme Court in 1938.[5] When an insuring entity becomes troubled and the ability of the entity to deliver on its contractual promises is in question, policyholders cannot be exposed to the risk that an alternative plan might diminish what value remains in the entity.

[5] *Neblett, et al. v. Carpenter, Insurance Commissioner, et al*, 305 U.S. 297, 59 S. Ct. 170 (1938).

Policyholders transfer risk through the purchase of insurance. It is wrong to require them to participate in a plan that will not deliver such value to them and expose this value to loss. This calculation must be done for the whole company and not just the Segregated Account or what remains in the General Account.[6]

b) There are any number of ways to demonstrate that an insurer's Plan would likely improve (or worsen) an insurer's ability to meet policyholder obligations. New York, for example, requires a filing that contains a balance sheet that reflects the insurer's impairment or insolvency as determined by the regulator, a pro forma balance sheet reflecting the financial condition of the insurer subsequent to the effective date of the Plan, and a reconciliation between both balance sheets.[7]

c) A calculation of liquidation value provides a baseline in developing a rehabilitation or liquidation plan.

d) In addition to the failure to consider and provide liquidation value, the OCI has not provided sufficient information regarding the Segregated Account's likely (or unlikely) ability to pay claims of policyholders in the Segregated Account. While lengthy, the Disclosure Statement for the Plan of Rehabilitation lacks certain basic and necessary information. For example, Exhibits D-G to the Disclosure Statement are the Rehabilitator's financial

[6] As the drafter of the Wisconsin Rehabilitation and Liquidation laws, Spencer Kimball pointed out in his commentary on these provisions, rehabilitation is to be used when there is a chance of saving an insurer without unduly endangering the interest of the creditors and others and when there is a prospect for success. Wisconsin Laws of 1967, Chapter 89, Senate bill 303, August 4, 1967.

[7] Insurance Department of the State of New York, Regulation 141 (11NYCRR128) "Commutation of Reinsurance Agreements." (Attached as Exhibit E.)

projections for the combined results of the General Account and Segregated Account. Yet, the concern of a policyholder placed in the Segregated Account proposal is how that account is projected to perform and its associated risks. This information is not provided. Exhibit C to the Disclosure Statement begins to provide some information needed to understand the various scenarios; however it does not provide sufficient information to explain the meaning or methodology of the scenarios and associated risks. Coupled with the complete lack of liquidation value, the information provided does not permit any policyholder, or for that matter the Rehabilitator, to determine if the Rehabilitation Plan is the best course of action that will not create undue risk for policyholders.

e) The fact that the Rehabilitator's projections under various scenarios is done on a combined basis is further recognition that the Segregated Account does not possess an adequate amount of capital and surplus and funding of liabilities that the Segregated Account statute requires.[8]

f) It appears the entire cost of administration of the Plan of Rehabilitation will be borne entirely by the policyholders in the Segregated Account.

g) Further, it is disturbing that OCI has decided that some policyholders can retain their "durable coverage" in the General Account while other policyholders are relegated to the Segregated Account. This separation is

[8] Wisconsin State 611.24 (3) (a).

solely made on the basis of perceived risk or other factors. Determining who should be most adversely impacted amongst policyholders of a distressed insurer is a dangerous precedent to establish and contrary to law.

47. The OCI indicates in the Disclosure Statement Accompanying the Plan of Rehabilitation that complete liquidation of Ambac was considered but rejected "as not being a viable alternative."[9] As noted by Spencer Kimball, rehabilitation is appropriate when an insurer's difficulty is the result of bad practices of varying kinds—not when the difficulty is closely related to insolvency. When the cause of some type of delinquency proceeding is insolvency, which includes an insurer's inability to pay debts as they come due, the Commissioner should proceed directly to liquidation since rehabilitation is no longer appropriate.[10]

48. Given the size and nature of the Ambac Assurance Corporation's troubles, I would have expected OCI to have had communications with other state insurance departments with respect to OCI's objectives for dealing with Ambac's problems and OCI's specific plans for achieving these objectives. I did not see mention in OCI's filings that such communications had occurred. It is very customary, as mentioned earlier, for a domiciliary regulator to advise other regulators of the plans to deal with a troubled insurer, as well as to obtain advice and counsel on what should be done. Statutory provisions have been enacted in the states to allow for such communications to occur in a confidential and protected manner.

[9] Disclosure Statement Accompanying the Plan of Rehabilitation, page 5 (c).

[10] Spencer L. Kimball, Professor of Law, University of Michigan, "Regulation of Insurance" address to the College of Insurance, July 17, 1967, page 16 and following. (Attached as Exhibit F.)

49. When the Plan for Ambac Assurance Corporation is considered in its entirety, I note several instances where the Plan is conceptually flawed and contrary to accepted and customary practices of insurance regulators and receivers:

a) Improperly, the business and associated liabilities of Ambac Assurance Corporation is divided between the General Account and the Segregated Account. The General Account retains the policies with little or no projected claim payments, largely the municipal bond business. The Segregated Account receives the troubled segments of business, including the RMBS policies, Las Vegas Monorail policy, and credit default swaps, but no hard assets. This structure violates principles of fairness and equal treatment underlying the receivership system in the United States.

b) The Plan discriminates between policyholders and does not provide policyholders the right to opt out of the Plan and be paid their liquidation value. It is well established that policyholders cannot be transferred from one insuring entity to another without their approval. Particularly, in the case of a troubled insurer like Ambac, those policyholders rejecting transfer are entitled to opt out and receive what they otherwise would receive if the insurer was liquidated.

c) The OCI appears to have exceeded the authority in Wisconsin's Segregated Account statute by allowing the Segregated Account to be established for existing in force business and without adequate funding. The Segregated Account statute appears to require funding of liabilities assumed, as well as additional funding for capital in excess of liabilities.

d) Should the General Account become insolvent it is not clear what priority level the claim of the Rehabilitator of the Segregated Account would have against the General Account. Since the Rehabilitator would be presenting a claim under the Reinsurance Agreement and/or the Secured Note, it would appear a claim under either instrument would be a claim below the policyholder level.

e) One of the books of business that was transferred to the Segregated Account was credit default swap obligations issued by a subsidiary of Ambac Assurance Corporation and guaranteed by Ambac. This transfer presents at least a few issues. First, it places in the Segregated Account non-insurance business. Next, it improperly elevates the claims from that of a general creditor to a policyholder level claim to the detriment of all policyholder claims that exist at the effective date of the Segregated Account or claims that will arise in the future.

f) Having created many such plans and having read numerous plans created by others, there appears to be an unusual bias toward and favor of continuing Ambac in some form, and in fact, having it return to business at some point in the future. It seems to have the attributes of a prepackaged plan common in bankruptcy proceedings but not in insurance receivership proceedings. It is not consistent with the fundamental principles of insurance receivership discussed above.

50. Supervising courts have an important role in dealing with distressed insurers. They must ensure that what the regulator or receiver is proposing is in the best interests of the policyholders. It is my opinion that the Plan is not in the best interests of the policyholders in the Segregated Account, and that it directly contradicts the fundamental principles and accepted customs and practices of insurance regulation and receivership.

FURTHER AFFIANT SAYETH NOT.

Signed: _____
James W. Schacht

Subscribed and sworn to before me
this 11th day of November, 2010.

_____
Notary Public, State of Illinois
My commission expires on July 15, 2013

NOTARY PUBLIC OFFICIAL SEAL STATE OF ILLINOIS
LINDA MATTHES
MY COMMISSION EXPIRES
JULY 15, 2013