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AMBAC FINANCIAL GROUP
BEFORE THE

SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE AND
GOVERNMENT SPONSORED ENTERPRISES

OF THE HOUSE COMMITTEE ON FINANCIAL SERVICES

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Let me begin by commending Chairman Kanjorski, Ranking Member Pryce and the members of this Subcommittee for holding this hearing. It is important that the Subcommittee has the complete facts regarding bond insurers so that the issues facing the industry can be properly understood and addressed. I hope that my remarks will contribute constructively to achieving this goal.

I'm Mike Callen. I took the role of Ambac's Chairman and interim CEO last month and have been a member of the Board of Directors since 1991. I grew up in Milwaukee, Wisconsin, joined the Marines after high school and returned to graduate from the University of Wisconsin. After that I started a career in the financial sector, working at Citibank for 27 years. I currently split my time between New York and Washington DC, where I teach in the Masters of Science in Foreign Service program at Georgetown University.

Ambac has written financial guarantee insurance for over 35 years. We founded the industry when we provided the first guarantee of a municipal bond for Juneau, Alaska in 1971. Over the past three and a half decades, Ambac and the industry have successfully survived many economic cycles and challenges including multiple recessions, Hurricane Katrina, 9/11, Orange Country, the Washington Public Power System (a.k.a. Whoops) and others. During that time, no holder of an Ambac insured security has ever missed a single interest or principal payment.

Since going public in 1991, Ambac has insured $1.2 trillion in securities, most of these for state and municipal issuers. Claims paid have totaled $280 million, amounting to 0.024% of the amounts guaranteed and 4.3% of net premiums earned. We expect this loss rate to increase as a result of Ambac's diversification away from pure municipal finance, which began in the early 1990's. At that time, Ambac began guaranteeing bonds which facilitated the flow of funds for consumer financing, including housing, manufactured homes, and autos.

Despite higher expected losses, Ambac has the financial resources to comfortably meet existing obligations even under loss scenarios that are on the pessimistic side of market estimates. Almost no one questions the ability of Ambac to make good on obligations to holders of Ambac guaranteed debt. However, confidence in Ambac's ratings stability, and therefore the business model, is being tested. Ambac is committed to do everything we can to restore and maintain confidence entrusted to us by both issuers and investors so as to continue to provide our product and services in the future.

First, issuers, including states and municipal governments, want Ambac to continue to provide market access and lower borrowing costs. This means that we must not only have the ability to pay existing claims, but also must be able to write new business. New business generation requires investors to have a clear and stable view of Ambac and our ratings.

Second, investors in Ambac guaranteed bonds lose value if Ambac is downgraded below triple-A, even though we remain able to meet obligations. For example, retail funds required to invest in triple-A assets would be forced to sell Ambac guaranteed municipal debt upon a downgrade, and to sell into an illiquid market at reduced prices. Maintaining a triple-A rating is the only way to avoid this.

We therefore see the current issues facing the financial guarantors not as a question of ability to meet obligations, but rather a challenge to maintain the stability of ratings that have supported our business in the past and that will support it going forward.

Bond insurers, also known as monolines, guarantee the timely payment of scheduled interest and principal on bonds. Fifty four percent of Ambac's portfolio consists of US public finance exposures, where we guarantee state and municipal obligations, schools, roads, hospitals, airports, water facilities and provide funds for other essential government functions. For example, Ambac has guaranteed, or "wrapped," bonds for Easton in Columbus, Ohio, allowing the city to attract new development. Also in Ohio, Ambac insurance helped raise money to construct a new hospital in Dublin and a new surgical tower at Grant Hospital in Columbus. Ambac-insured bonds in metropolitan Boston were used to construct headquarters for the public radio station WGBH, the Boston Convention Center, Gillette Stadium for the New England Patriots, and to fund renovations at Dana Farber Cancer Center. In New York City, Ambac-insured bonds have provided financing for the MTA, new courthouses in the Bronx and Brooklyn, and assisted-living residences for citizens with disabilities. In Delaware, Ambac-insured bonds provided funds to renovate Christiana Care Health Services, one of Delaware's leading tertiary care hospital systems.

During times of stress for municipalities, Ambac has been there for our clients. Ambac worked extensively with the city of Wilkes-Barre to help it work through its financial difficulties and to empower the city to issue less-expensive bonds at a time when its market access to capital was severely impaired.

In Jacksonville, Florida, after a cash crisis at the city's sole public safety-net hospital, Ambac took the lead role in arranging the workout that turned around the hospital's operations, stepped in to supply fresh capital, and negotiated for support from the University of Florida and its primary teaching hospital, Shands, bringing new physicians to Jacksonville.

After Hurricane Katrina, Ambac supported restructuring of the municipal debt of Jefferson Parish, Louisiana and Harrison County, Mississippi, in order to grant them short-term cash flow and budgetary relief. Additionally, Ambac provided insurance for $283 million of hurricane recovery program bonds, which were used to jump-start and fund public infrastructure projects for New Orleans, including the city's Sewerage and Water Board.

Ambac evaluates the transactions we underwrite, analyzing credit fundamentals, structure and documentation. We perform a function that an individual investor cannot. Even institutional investors, who buy a small part of a deal, often cannot dedicate the time and resources to the in-depth analysis that monolines perform. Additionally, because Ambac has a staff of over 50 people dedicated to monitoring our exposures, we are able to react quickly to credit deterioration, restructuring or taking other measures that reduce or eliminate losses.

The result is that issuers pay less for financing, ultimately resulting in greater financing flexibility and lower tax rates for municipalities and consumers.

Outside of US municipal financing, 32% of Ambac's book consists of structured finance exposures including US consumer finance transactions, commercial and utilities financing. These exposures have largely performed very well, providing Ambac with diversification and the returns required to attract capital to the business.

The remaining 14% percent of the portfolio is international exposure where Ambac has been successful in exporting capital markets solutions common in the United States to countries such as England, Australia, Germany and Japan.

Although Ambac and the industry enjoy a strong track record of success, in order to write new business, we need investor confidence in the stability of our financial condition and ratings. The current uncertainty surrounding bond insurers' ratings, when combined with illiquid and anxious credit markets, means greatly diminished demand from investors.

Demand from issuers, however, is not diminished. Issuers continue to anxiously await the reopening of the market. For example, one of our clients that builds and sells manufactured homes has reduced production, not because of lack of demand, but due to the lack of financing.

The root of the current market predicament is the deterioration in the US housing market, which has exposed unsavory lending and financing practices. Unlike many of the participants in this market, who had little or no "skin in the game," Ambac's incentives were completely aligned with those of our constituents, including the bondholders. The right incentives, however, do not assure that losses will not be incurred.

In 2007, Ambac took $1.4 billion in reserves against mortgage exposure, the majority of which backs collateralized debt obligations (CDO's). Direct mortgage backed security (MBS) losses were a small portion of the loss estimate, highlighting how the more complex instruments magnified, not minimized risk. Although claims paid to date have been relatively small, the $1.4 billion reserve represents Ambac's best estimate as of December 31, 2007 of what Ambac will be required to pay over the life of the wrapped securities, some of which go out to 30 years.

Ambac's exposure to MBS is just under 10% the total portfolio, of which 17% (or 1.6% of the total portfolio) is subprime. Ambac reduced its participation in the subprime market dramatically from 2002 to 2007. CDO's represent 5% of Ambac's portfolio and a small group of those exposures are the ones driving the majority of Ambac's expected losses.

While Ambac's loss reserves are based on best estimates and are payable over time, Ambac's capital can absorb losses well in excess of very pessimistic scenarios that are not currently expected. Claims paying resources are $14.5 billion with additional capital generated by Ambac's existing investment portfolio. The losses that would be required to render Ambac unable to meet obligations are losses reminiscent of those experienced during the Great Depression.

According to Moody's, both a triple-A rating and a double-A rating require Ambac to be able to demonstrate claims paying resources sufficient to cover any potential claims at a 99.99% confidence level. The only difference is this: to get a triple-A rating, Ambac must not only be able to cover potential claims at a 99.99% confidence level, but also to have a 30% capital cushion left over while double-A requires a 15% cushion. Therefore, the risk of downgrade does not signify a materially higher risk of default.

It appears that the market may be confusing the agencies' extreme stress cases with expected losses. As Fitch notes in a recent release, losses are likely to be closer to those covered at a 50%

confidence level, not the over 99% confidence level everyone seems to be focusing on. If losses even approach the 99% confidence level, the US economy will have a drastically different look.

Ambac's obligations extend over the life of the underlying bonds, up to 40 years. On defaulted bonds, we pay as the obligations come due, providing comfortable predictability of obligations. In an industry where financial failure is generally related to a shortfall in liquidity to meet immediate obligations, the structure of the monoline industry is very advantageous and one of the underpinnings of the high ratings historically enjoyed by the industry.

In addition to its ability to meet obligations to holders of Ambac-wrapped debt, Ambac is in no danger of failing to meet its corporate or holding company obligations. Premiums and investment income from the existing investment portfolio is expected to generate $1.2 billion in revenues in each of 2008 and 2009, less than 20% of which will be required to meet operating expenses. During the same period, the holding company's debt obligations will total less than $90 million per annum—less than 10% of investment income net of operating expenses.

It is undeniable that mistakes have been made by financial industry participants during the benign credit cycle that began in 2003. Ambac has not escaped unscathed. Ambac is a credit risk taking institution. In a perfect storm credit crisis such as the one we are experiencing today, with projected losses on mortgage collateral that have not been experienced since the 1930's, it is to be expected that Ambac will pay claims and experience losses. Although many good decisions were made, we are now paying for the small percentage of impaired transactions on our books.

But financial stress experienced by a small portion of our portfolio does not invalidate an entire business model. Ambac has faced sector problems before such as the stress experienced in 2001 by the California utilities. We managed through that period of uncertainty, selectively increasing exposure to these essential service providers. Ambac continues to be active in guaranteeing the debt of California utilities including Southern California Edison, Pacific Gas & Electric and San Diego Gas & Electric.

Ambac has learned valuable lessons. We have strengthened internal risk controls, tightened credit standards and ratings hurdles, implemented more rigorous capital and returns hurdles for new transactions, and exited some complex asset classes.

Ambac has also learned that the form of the protection we provide matters, even if the substance is identical. Historically Ambac provided coverage in the form of a financial guarantee insurance policy, still the dominant form of protection written. However, Ambac began offering the same coverage with the same financial terms, but in the form of a Credit Default Swap or CDS. There is no economic impact of writing this protection in CDS form versus financial guarantee, but there is an important accounting difference.

Exposure taken in CDS form requires mark-to-market accounting under FASB 133. This means that the CDS written must be revalued quarterly. If the market value of the CDS increases Ambac must take an accounting loss on its exposure. This reflects the loss that Ambac would take if it were to liquidate its position in the CDS. However, Ambac does not trade these positions, so there is no economic impact of marking to market.

Fluctuations in the value of CDS are the result of both illiquidity and perceived credit deterioration. Mark-to-market losses that reflect market conditions reverse themselves over time. This is similar to the fluctuating value of a municipal bond portfolio, which goes down when interest rates go up regardless of the credit quality of the bonds. Assuming no defaults, at maturity investors still get 100% of their principal regardless of fluctuations in market value over time.

Ambac underestimated the magnitude of potential mark-to-markets as well as the market's reaction to them. Ambac took a mark-to-market loss of $6 billion in 2007, of which $1.1 billion is estimated to be credit impairment. We would expect the remaining $4.9 billion to flow back into GAAP income over the life of the CDS.

Ambac and the industry's next critical step is to restore confidence. This requires stable and predictable credit ratings. Investors must both have a clear understanding of what it takes to maintain stable ratings, and understand why Ambac comfortably meets the ratings criteria. Raising capital is a critical feature of this plan. Additionally, Ambac will continue to offer a high level of transparency and will continue listing our credit exposures on the website and ongoing communication with the market through periodic reporting and quarterly conference calls.

Finally, the rebuilding of confidence will take time. The passage of time will not only reduce the range of forecasts for housing market losses, but will also prove the value of the guarantee. We expect that investors in Ambac-wrapped paper will not experience losses while many unwrapped investors will. Like the homeowner who buys hurricane insurance after the storm, investors will return to the tested and reliable insurance product offered by the monolines.

Ambac is a Wisconsin domiciled company, regulated by the State of Wisconsin Office of the Commissioner of Insurance, led by Sean Dilweg. Additionally, under Wisconsin regulation, Ambac must comply with the laws and regulations of other states in which it is licensed if they exceed the Wisconsin requirements. Article 69 of the New York insurance laws sets standards for financial guarantee insurers with solvency requirements in excess of Wisconsin and therefore Ambac must also comply with New York regulations. Both Commissioner Dilweg and New York's Superintendent of Insurance, Eric Dinallo, have been extremely involved in regulating and guiding Ambac. In particular, the communications that have emanated from their offices and the level of thoughtful and constructive involvement with Ambac and the industry since the inception of the credit market deterioration have been instrumental in sending the balanced signals of concern and support to the market.

During times of declining confidence in the capital markets, it is critical for regulators, government agencies and those in the position of power to project confidence. We are here today to give you the information and knowledge required for you to decide whether such confidence is in order.

It is in the interest of the markets and the economy to have a strong and viable financial guarantee industry. Issuers benefit from market access and lower borrowing costs and investors benefit from the diligence, structuring and ongoing surveillance performed by the monolines. The capital markets are strengthened by the presence of a risk-taking party with skin in the game. Taxpayers benefit from lower taxes to support the critical spending needs of their local and state governments. The only parties who do not wish to see a viable monoline industry are those with an economic interest in our failure.