

February 12, 2008

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Department of Insurance
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The Honorable Sean Dilweg
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Ambac

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Re: Bond Insurer Transparency; Open Source Research

Ladies and Gentlemen:

We write to you with regard to Pershing Square Capital Management's January 30, 2008 letter promoting its "Open Source Research."¹ Unlike Pershing Square, Ambac welcomes any serious efforts to assist market participants and others in understanding its business and the quality of its portfolio. This is evidenced by the extensive disclosure on our website (www.ambac.com.)

In contrast, the so-called analysis promoted by William Ackman of Pershing Square is not of this nature. Pershing Square's analysis is flawed and relies on misleading

¹ We have subsequently learned that Credit Suisse is the unnamed "Global Bank". We have been informed by Credit Suisse that while they sold/licensed the Open Source model to Pershing Square, they did not provide Pershing Square with any proprietary Ambac data and Credit Suisse does not endorse Pershing Square's conclusions or results.

assertions. Their conclusions are based on selective use of Ambac's disclosures and many arbitrary assumptions involving little fundamental analysis. With regard to Ambac's CDO exposures, an entirely different picture – one that is more consistent with Ambac's loss estimates than with Ackman's wildly exaggerated figures – results from use of more accurate assumptions or, even better, a detailed drill down approach that takes into account waterfall mechanics and other key aspects of the underlying CDOs. For Ambac's RMBS exposures, loss numbers are simply inputs. There is no evidence of the "fundamental, data-driven approach" Ackman touts. Neither does Ackman ever offer any explanation or research explaining why Pershing Square's methodology is preferable, or why it should be applied or believed.



Pershing Square's Short Position

Before addressing the myriad of specific weaknesses in Pershing Square's modeling, it is important to note that Pershing Square makes no secret of the fact that it is trying to reap profits from its net short position in Ambac. Given the gross errors in the analysis and Pershing Square's use of its analysis to promote its short positions and realize windfall profits, regulators and others have every right to question Pershing Square's true motives in disseminating their so-called analysis. Indeed, Pershing Square stands to benefit most if it can convince regulators to restrict dividends from Ambac Assurance to Ambac Holdings (a relatively small amount for Ambac - \$54 million per quarter as compared to contractual net premium earnings of over \$700 plus investment income over \$400 million expected in 2008). While Ackman professes a concern for the interests of policy holders, nowhere in Pershing's analysis does Ackman note Ambac's \$14.5 billion in claims paying resources, well in excess of his projected losses.

Specific Weaknesses of Open Source Model's Conclusions

The quality of a model's output is a function of the quality of the inputs. While purporting to be a "fundamental, data-driven approach," most of the inputs in Pershing Square's running of the Open Source Model are based on completely generalized market assumptions that are patently incorrect. Specifically, the model significantly ignores:

- The timing of losses,
- Specific structural protections,
- The benefit of Ambac's control rights in many transactions, and
- Ambac's successful track record in remediating deals in order to minimize losses.

Our primary criticism of the Open Source model as applied by Pershing Square is that it uses a set of simplified and, in many cases, wildly unrealistic assumptions: a single table to generate losses in Ambac's ABS CDOs, and a series of hard coded loss rates and write downs to derive losses for Ambac's direct mortgage book. The value of this so-

called model's architecture is limited. It lacks the analysis and research to justify the underlying assumptions and the hard coded inputs that drive the conclusions.

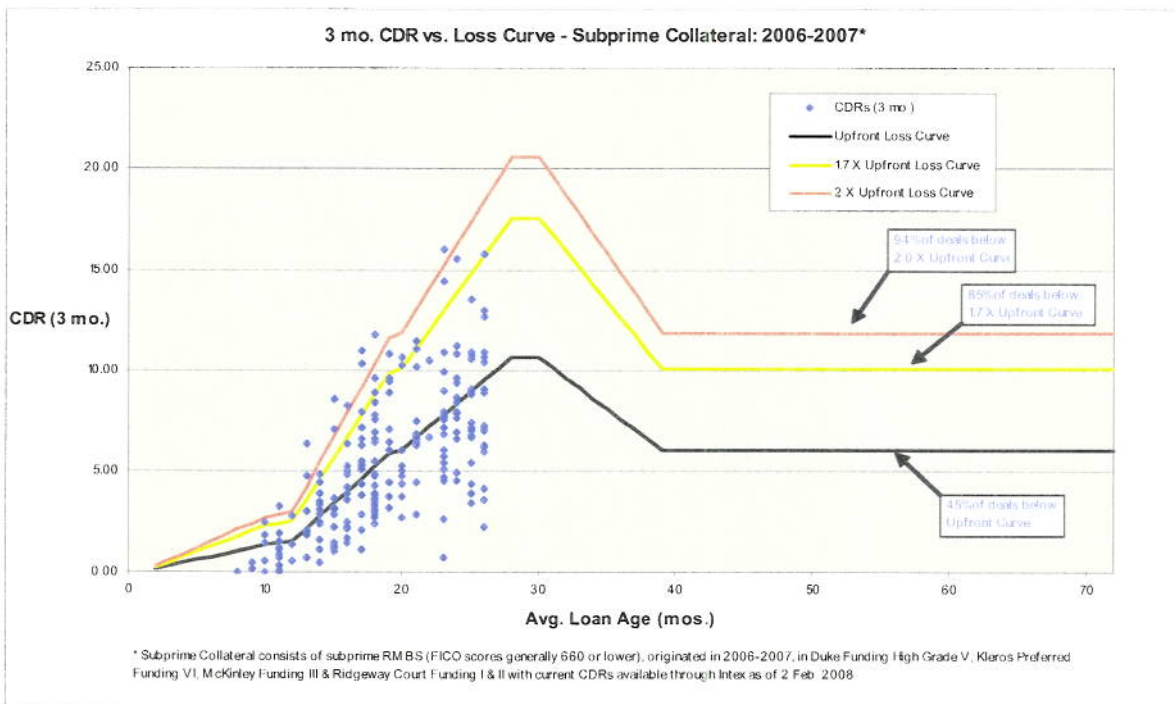
ABS CDOs:

- The model uses a table arranged by ratings within vintage years: '05, '06, and '07 and by asset class, Alt A, HELOCs, etc. Each cell in the table is plugged with a crude, unsupported assumption for cumulative losses which is then used to compute losses on our deemed ABS CDO portfolio. The cumulative loss assumptions up and down the ratings spectrum are weighted in many cases at or near 100%, except for prime, CLO, CMBS and other ABS collateral that are assumed at 0% losses.



Ackman's high level approximations to derive Pershing Square's broad based assumptions for losses are unsound – *no research nor explanation nor analysis nor forecasts nor estimates are presented.* Instead we are left with a group of loss numbers in isolation which are established at the discretion of Ackman to generate a total loss for Ambac ABS CDOs. One has every right to question how this can be considered as credible or useful analysis.

Below is a chart showing the actual conditional default rates (CDRs) of the 2006-2007 vintage RMBS underlying five CDOs of ABS that Ackman has identified as generating large losses for Ambac. Each diamond on the chart represents the CDR for a single RMBS available through Intex as of February 2, 2008. While Ackman assumes CDRs of 20% at the low end and as high as 35%, the chart suggests that this is unlikely to be the case. Fully 94% of the deals are below the 20% default rate curve and 85% of the deals are below the curve peaking around 17.5%. This highlights the arbitrary nature of Ackman's assumptions and the absence of analytical underpinning.





- Pershing Square's use of crude assumptions to evaluate collateral losses on our ABS CDOs is too primitive to accurately estimate losses on Ambac's book and yields exaggerated inaccurate results. A proper examination requires a detailed 360 degree view of each insured security likely using a variety of techniques, for example a CDO rating based simulation modeling analysis, selective drill down to the underlying cashflows of the constituent securities or possibly a more legal / structure based approach that captures the idiosyncratic structural elements of each insured exposure and how they may react to changing rating agency collateral views
- Ambac's fourth quarter loss estimate, primarily developed using the last approach identified above, is \$1.1 billion, compared to an estimate of \$6.95 billion from the crude approach used by Ackman. No explanation or research is provided explaining why Pershing Square's methodology is preferable, or why it should be applied or believed.

Additional CDO² Commitment:

- The analysis appears to take none of the collateral criteria/characteristics into account. Instead, Pershing Square simply inputs assumed loss rates without any explanation, analysis or support and generates an expected loss of \$498.34 million. We currently project no claims on this transaction, a conclusion well supported by the detailed disclosure on Ambac's website.

Closed End Second Liens, HELOCs, Direct Subprime, and Direct Alt/A:

- Ambac's direct mortgage exposures are fully detailed on our website, making it possible for any serious analyst to assess the performance of each one and risk of loss using other publicly available data.
- Pershing Square apparently has not availed itself of this opportunity. Rather, its loss number for each deal is a plugged number with no supporting computations. Without computational support it should be clear that the Pershing Square calculation is woefully inadequate.
- Ambac updates its analysis of all direct MBS exposures monthly, based on the most recent delinquency, foreclosure and loss data. Based on this we have set aside over \$303 million in reserves. We see no way to reconcile Pershing Square's \$4.15 billion projection with our detailed analysis.
- We also observed certain inconsistencies in the model. For example, the Direct Alt A spreadsheet shows a write down of \$48.8 million for IMSA 2007-3 while the deal is currently performing and the outstanding amount is only \$40 million. We continue to uncover other errors as we analyze the Open Source model.

History of “Talking his book”

We would finally note that, while Pershing Square tries to trumpet that it is seeking to provide transparency, the very opposite is the case. Consider:

- Pershing Square is not willing to disclose its short positions in Ambac nor does it disclose when it changes these positions as it plays the market.
- Ackman has a track record of “talking his book”, as detailed in Gretchen Morgenson’s and Geraldine Fabrikant’s January 19, 2003 article in *The New York Times* titled, “A Rescue Ploy Now Haunts a Hedge Fund That Had It All.” The article details the winding down of Gotham Partners, Mr. Ackman’s previous fund. In the article, the reporters state:

“That decision [by Gotham Partners] to publicly promote two of their biggest holdings -- known in Wall Street parlance as talking one's book -- is highly unusual among secretive hedge funds.... Even worse, Gotham's publication of upbeat research about one company, even as the fund was quietly selling its shares, looked very much like a classic pump-and-dump scheme.”²

We believe that our disclosures, and our extremely rigorous, multi-faceted analysis and conservative assumptions, facilitate clarity and are useful for those evaluating Ambac and its insured exposures. This is in sharp contrast to the flawed analysis and misperceptions now being promoted by Pershing Square as part of its campaign to promote its self interests. We are available to answer any questions you may have and would welcome the opportunity to present to you some of our own detailed analysis. We suggest you hold Pershing Square to the same standard.

Sincerely,



Douglas Renfield-Miller
Executive Vice President

² See <http://query.nytimes.com/gst/fullpage.html?res=9400E0D81630F93AA25752C0A9659C8B63> for full article