Ambac

Fourth Quarter 2017 Earnings Transcript

Operator
Greetings and welcome to the Ambac Financial Inc. fourth quarter 2017 earnings call. At this time, all participants are in a listen-only mode. A brief question and answer session will follow the formal presentation.

If anyone should require operator assistance during the conference, please press *0 on your telephone keypad.

As a reminder, this conference is being recorded. It is now my pleasure to introduce your hosts, Ms. Lisa Kampf, Head of Investor Relations; Claude LeBlanc, Chief Executive Officer; and David Trick, Chief Financial Officer.

I will now turn the call over to Lisa.

Lisa Kampf, Managing Director, Head of Investor Relations

Good morning, and thank you, all, for joining today's conference call to discuss Ambac Financial Group's fourth quarter financial results. We'd like to remind you that today's presentation may contain forward-looking statements which are based on management's current expectations and are subject to uncertainty and changes in circumstances. Any forward-looking statements are not guarantees of future performance of events.

Actual performance and events may differ, possibly materially, from such forward-looking statements. Factors that could cause this include the factors described in our most recent SEC filed quarterly or annual report under management's discussion and analysis of financial condition and results of operations and under risk factors.

Ambac is not under any obligation and expressly disclaims any obligation to update any forward-looking statement whether as a result of new information, future events, or otherwise. Today's presentation contains non-GAAP financial measures. The reconciliations of such measures to the most comparable GAAP figures are included in our earnings press release which is available on our website at ambac.com. Please note we have posted slides on our website to accompany this call.

I would now like to turn the call over to Mr. Claude LeBlanc.

Claude LeBlanc, Chief Executive Officer

Thank you, Lisa, and welcome to everyone joining today's call. 2017 was a transformational year for Ambac with the successful achievement of many key strategic priorities, and material advancement of others, we believe Ambac is well-positioned entering into 2018 for the creation of long-term shareholder value.

Our accomplishments include: first, the February 12th exit from rehabilitation of AAC Segregated Account, a transformational strategic priority that will create an estimated pro forma book value increase of $7.56 per share, or a 25% increase on our Q4 book value per share, once reflected in our first quarter 2018 financial results.

Next, the removal of the going concern risk language from Ambac Financial Group's 10-K, which we filed last night. This is the first time since 2008 that AFG's audit opinion did not express concern about such risks, which reflects the material improvement in Ambac's financial strength achieved to-date.

Last night, we also announced the appointment of Ms. Joan Lamm-Tennant as a new director at both the AFG and AAC boards. Joan brings with her a wealth of experience and industry knowledge and is a welcome addition to our board. Joan's appointment will expand the board skills and bring new perspective as we move forward post-exit from rehabilitation. With the addition of Ms. Lamm-Tennant to our boards, we now have seven-member interlocking boards in the U.S.

We also implemented significant changes to the risk management group in 2017 to improve its effectiveness at reducing risk exposures and accelerating the stabilization of our insurance platforms. Notably, during the past year, we reduced the insured portfolio by 21% from $79.3 billion net par outstanding to $62.7 billion as of December 31, 2017.

Over the same period, we also reduced adversely classified credits by 17%, or $3 billion, to $14 billion from $17 billion at year-end 2016. Major commutations and settlements during the year included: first, the termination of Augusta Funding, a $185 million adversely classified credit resulting in a gain of $43 million; second, the de-risking of Spirit, a £188 million UK pub securitization transaction; third, the settlement of the JPMorgan Ballantyne litigation, the key terms of which are confidential, but which contributed to a $92 million benefit from the reduction of loss and loss expense reserves; fourth, the commutation of $44.6 million of net par exposure of a distressed municipality; fifth, we helped facilitate a settlement with the mortgage insurer and trustee, amongst others, that resulted in a benefit of approximately $49.8 million, with respect to two transactions as reimbursements for claims paid. I will highlight additional material de-risking transactions achieved during the fourth quarter in a few minutes.

During the year, we also continued to pursue all appropriate actions to protect our legal rights in Puerto Rico. Most recently, Ambac joined a group of creditors in challenging the draft fiscal plan for Puerto Rico seeking more oversight and transparency. We also significantly increased our investments in Ambac-wrapped securities during the year, purchasing over $815 million of distressed and Ambac-insured securities, including insured RMBS and Puerto Rico Securities.

At December 31st, we, Ambac, owned 58% of COFINA and 29% of our PRIFA-insured bonds. To remind everyone, these instruments are held in our investment portfolio and we do not factor our bond ownership into our reserves for any such purchases. We also continue to progress our BofA countrywide litigation case, which we are firmly prepared to take through trial on the strength of our claims.

And finally, we took significant steps to reduce operating expenses, reducing headcount by approximately 19% from the beginning of 2017, which will translate into $8.5 million in annual cost savings and reflects an approximate decrease of 20% in our annual compensation costs.

I would now like to spend a few minutes to address some of these accomplishments in more detail. The closing of the transaction that marked the exit from rehabilitation of the Segregated Account announced on February 12th was a culmination of years of hard work. The transaction closed following the successful conclusion of AAC's tender offers and consent solicitation, which received overwhelming support from surplus note holders who participated in the transaction, representing 99.6% of the principal and accrued and unpaid interest outstanding on AAC's general account surplus notes held by parties other than the AAC and AFG. As I mentioned a moment ago, the transaction resulted in an estimated increase in book value of $7.56 per share on a pro forma basis, which will be reflected in our first quarter 2018 results. David will provide greater detail of the financial impact of the transaction momentarily.

As a result of closing this highly complex transaction, significant benefits will accrue to Ambac's stakeholders. In exchange for an effective consideration package of 40% cash, 41% secured notes, and 12.5% general account surplus notes, AAC received the following:

First, satisfaction and discharge of all outstanding DPOs of the Segregated Account, totaling approximately $3.9 billion, including accretion. Second, cancellation of the $809.5 million in principal plus accrued and unpaid interests of AAC's 5.1% general account surplus notes. Third, an effective discount of 6.5% on the accreted value of DPOs and the outstanding amount of principal and accrued and unpaid interest on tender general account surplus notes. And, fourth, $240 million in new capital from the issuance of Tier 2 notes backed by certain RMBS rep and warranty litigation recoveries. In addition, with the merger of the Segregated Account into AAC's General Account following the conclusion of the Segregated Account rehabilitation, claims are now being paid 100% in cash.

Additional benefits from the exit include reduced regulatory oversight, reduced cost and expenses related to the rehabilitation process, improved strategic and financial flexibility, and a unified corporate governance structure. We are extremely pleased with the outcome of this transaction, and I believe that the flexibility that this transaction affords us will position us to further deliver on our commitment to create significant long-term value for our shareholders.

Turning now to our de-risking activities, which is an ongoing key strategic priority. During the fourth quarter, we took significant steps to re-organize the risk management group, sharpen and expand our focus on risk remediation activities, and have now added a group of credits known as watch list credits to our targeted de-risking activities. Watch list credits are those for which there may be heightened potential for future adverse development based on certain quantitative and qualitative factors, and which we will also target in our efforts to improve the overall quality of AAC's insured portfolio.

We believe that these steps will enhance our overall focus on actively de-risking the insured portfolio, reducing its long-term volatility, and improving the quality of adjusted book value.

Turning now to some transaction highlights for the fourth quarter. Active remediations and normal run-off of our book resulted in a 6% decrease in net par exposure and 8% decrease in Adversely Classified Credits since September 30th.

We achieved a number of key successes with respect to Adversely Classified Credits during the fourth quarter, including the negotiated re-financing of $145 million of Adversely Classified bonds related to Chicago public schools. Next, the termination of a number of residential mortgage-backed security transactions which reduced Adversely Classified Credits by $422 million. And third, the re-financing of the only non-investment grade CDS left in our portfolio, further reducing Adversely Classified Credits by $74 million.

Turning now to litigation. Our RMBS litigation continues to progress. In the primary Countrywide case, briefing of our appeal to the highest court in New York was completed during the fourth quarter, and we are awaiting a date for oral arguments to be heard by the court. The judge that has been overseeing this case has advised us that she will not set a trial date until the Court of Appeals issues a decision. Based on what we know of the appellate court schedule, we believe the earliest we could reasonably expect a trial to occur is in the latter half of the year.

Our other case against Countrywide that is pending in New York, as well as our cases against Nomura and First Franklin are progressing, and conclusion of fact discovery is expected by the end of the second quarter.

Turning now to Puerto Rico, Ambac is pleased that the Bipartisan Budget Act of 2018 provides billions in additional federal aid and also requires Governor Rosselló to develop a 12 to 24 month economic and disaster recovery plan, and periodically provide progress reports to Congress.

Such increased transparency and accountability is also foundational to any restructuring process yet continues to be absent in Puerto Rico. Ambac and a broad group of creditors had just days before issued a statement calling for the same transparency in connection with the fiscal plan development and restructuring process.

Ambac and the other creditors identified many deficiencies in the revised fiscal plan and ways in which it fails to comply with the core requirements outlined in PROMESA. Among many other weaknesses, the plan uses healthcare costs and government spending assumptions that contradict the government's own outmigration forecasts.

And the plan fails to fully count for cash held at various accounts that may be available to meet needs outlined in the plan. In short, we do not view the fiscal plan as a realistic starting point for restructuring Puerto Rico's debt and, more importantly, do not believe that it will lead to renewed capital market access which is the ultimate goal of PROMESA.

The Commonwealth and the Oversight Board need to stop engaging in protracted legal battles and start developing and implementing holistic solutions which will use public and private funds to revitalize the local economy. This can only be accomplished in consultation and coordination with creditors and potential investors.

The focus needs to be on stabilizing Puerto Rico's financial profile, capital market access and ability to provide for its residents. Respect for legal rights and upholding the rule of law is essential to accomplish these goals. In this regard, we were pleased to see the Oversight Board in its recent filings recognize that under Puerto Rico law the dedicated sales tax was transferred to COFINA and should not be considered available resources for the Commonwealth.

We vehemently disagree with the suggestion of the oversight board that PROMESA allows these property rights to be ignored and expect that issue to be strenuously litigated. Congress created the Oversight Board so that the Oversight Board can make the tough decisions that politicians are reluctant to make to put Puerto Rico on a path towards economic growth.

The Oversight Board is failing in this basic goal and continues to ignore the basic precepts set forth in PROMESA. Unfortunately, the court's recent ruling on Ambac’s HTA complaint holding that the fiscal plan is not subject to review for its compliance with requirements of PROMESA may further limit the Oversights Board's willingness to cooperate with creditors in development and review of the revised fiscal plan.

While unfortunate, and we believe wrongly decided, this decision is consistent with Judge Swain's recent rulings in related litigations where, in our opinion, she similarly misapplied existing precedent and failed to consider long-term customs and practices of the municipal market, resulting in rulings that deviate significantly from municipal bond market expectations, particularly with respect to continued payment on revenue bonds. These rulings are being appealed.

Continued lack of progress, unnecessary lengthy legal battles, further protracted resolution timelines and persisting uncertainty, will result in the failure of PROMESA law and the stated mission of the Oversight Board, as well as lead to increased cost and burden. Failure to progress matters in an efficient manner will only stand to benefit the Oversight Board, advisers and lawyers at the expense of the people of Puerto Rico. The situation in Puerto Rico continues to reflect significant uncertainty which could result in material losses to creditors including Ambac. We plan to continue to actively pursue dialogue with local and federal officials, and progress all aspects of our strategy and litigation with respect to mitigating losses in Puerto Rico.

Now, I would like to turn the call over to David Trick, to discuss the financial results in greater detail. David?

David Trick, Chief Financial Officer

Thank you, Claude, and good morning. Relative to the third quarter, our fourth quarter results reflect lower loss and loss expenses, higher investment returns, and higher gains from interest rate derivatives all partially offset by lower premiums earned.

For the fourth quarter of 2017, Ambac reported a net loss of $19.5 million, or $0.43 per diluted share, compared to a net loss of $190.9 million, or $4.20 per diluted share, for the third quarter of 2017. Adjusted earnings in the fourth quarter were $5.5 million, or $0.12 per diluted share, compared to an adjusted loss of $149.8 million, or $3.30 per diluted share, in the third quarter.

Turning into some more specifics on our financial results, premiums earned were $31.5 million during the fourth quarter, versus $53 million during the third quarter. Normal earned premium decreased during the quarter to $22.7 million, from $26.8 million, or about 15%, primarily due to the continued runoff of the insured portfolio.

Accelerated premium declined by $17.4 million, to $8.8 million, mainly due to the proactive de-risking of two material and short international transactions during the third quarter, which resulted in the acceleration of about $14 million of premium.

Accelerated premium also declined due to a 10% reduction and public finance net par calls driven by runoff of insured callable exposure.

Net investment income for the fourth quarter and the third quarter of 2017 was $107.1 million, and $87.2 million, respectively. As noted previously, net investment income for the fourth quarter was impacted by accelerated discount accretion on investments in AAC-insured RMBS securities, resulting from updated cash flow projections incorporating the impact of the expected first quarter 2018 Segregated Account exit from rehabilitation.

The increase in investment income was tempered by an increase in cash and short-term investments and, consequently, a reduction in portfolio duration, as we completed the liquidity build-up required to close the Seg Account rehabilitation exit transactions. Shortening duration over the last few quarters provided the added benefit of positioning us well in the face of rising rates.

Mark-to-market gains on invested assets classified as trading were $3.1 million in the fourth quarter of 2017 compared to $4.9 million in the third quarter of 2017. The decline in fourth quarter trading income was reflective of the strong third quarter, particularly with regards to our holdings of Corolla notes. Losses and loss expenses incurred were $102.3 million for the fourth quarter of 2017, down from $209.8 million for the third quarter.

The fourth quarter incurred losses were driven by adverse development in public finance and RMBS portfolios, offset by improved credit performance in the international portfolio.

More specifically, public finance produced incurred losses of $42.2 million, mostly due to adverse development in Puerto Rico, versus $212.5 million in the third quarter. RMBS-produced incurred losses of $18.2 million in the fourth quarter driven by excess spread compression, loss expenses incurred, and a modest reduction to the rep and warranty credit. These items are partially offset by a $21.8 million benefit from the termination of the 20 RMBS transactions during the quarter. The third quarter benefit of $34.4 million included a pooled mortgage insurance policy recovery resulting from a settlement between the trustee and the mortgage insurer, the proceeds from which were received during the fourth quarter.

Ambac UK produced an incurred benefit of $7.3 million in the fourth quarter, down modestly from the third quarter, mainly due to improved credit performance and foreign exchange gains because the pound, Ambac UK's functional currency, strengthened relative to the Dollar and Euro.

Interest rate derivative gains were $23 million in the fourth quarter compared to $4 million in the third quarter. Our interest rate derivative position continues to serve as an effective partial hedge against the impact of rising rates on our insured and investment portfolios. The company is well-positioned for rising rates as the derivatives portfolio maintains a sensitivity of approximately $800,000 for each basis point increase in interest rates.

Fourth quarter operating expenses decreased by $5.1 million from the third quarter to $28.7 million. The decrease was mainly due to a $3.6 million reduction to severance costs related to the third quarter firm-wide corporate reorganization, and a resulting reduction in salary expense, partially offset by an increase in performance-based incentive compensation. Non-compensation expenses also declined during the fourth quarter, led by a near $2 million decrease in restructuring costs to about $5 million and about $1 million of other cost reductions, partially offset by close to $3 million of additional OCI advisory expenses.

As noted previously, we remain focused on reducing our core operating expenses but also anticipate that we will experience the volatility quarter to quarter associated with normal course operations and various other events. That said, restructuring and OCI fees accounted for a total of just over $10.2 million in the quarter compared to approximately $9.2 million in third quarter.

These amounts equate to approximately 62% and 54% of non-compensation expenses during the fourth and third quarters of 2017, respectively. After the successful conclusion of the Segregated Account rehabilitation, and beginning with the second quarter of 2018, we will not incur additional restructuring costs and OCI-related costs will be reduced materially.

Regarding taxes, our fourth quarter provision of $12.6 million reflects an estimated net $1.9 million cost related to the passage of the Tax Cuts and Jobs Act along with $8.7 million of Ambac UK current taxes and $2 million of state taxes. The $1.9 million net impact related to the implementation of the new tax law includes $31 million of deferred taxes associated with foreign subsidiaries, which will reverse over time, partially offset by a $30 million benefit from the repeal of the corporate AMT. We expect the AMT credit, which will benefit AAC, will be refunded in stock in installments through 2021.

For the 2017 tax year, AAC has utilized NOLs in an amount that resulted in the accrual of $30.5 million of tolling payments for AFG. We expect AFG to receive this amount in May 2018.

Our NOLs now total approximately $3.7 billion, including $1.4 billion allocated to AFG, and $2.3 billion allocated to AAC. Our fourth quarter total comprehensive loss of $127.8 million led to a decrease in stockholders' equity at December 31, 2017 to $1.4 billion, or $30.52 per share, from $1.5 billion, or $33.33 per share, as of September 30, 2017.

The total comprehensive loss was due to the net loss for the fourth quarter and unrealized mark-to-market losses on certain Ambac-insured bonds held in the investment portfolio. Adjusted book value was $1.1 billion or $24.34 per share at December 31st, 2017 compared to $1.1 billion, or $24.56 per share, at September 30th.

On a stand-alone basis, as of year-end 2017 and after the restructuring transaction, AFG held cash and investments including net securities receivables of approximately $377 million and $385 million, or

$8.32 and $8.49 per share, respectively. The majority of these assets were invested in AAC-issued and related securities.

The impact of the segregated account rehabilitation exit transaction will be recognized in the first quarter of 2018. A pro forma balance sheet as of December 31, 2017 reflecting the estimated impact of the transaction was included in our public disclosures. Notably, the pro forma estimated book value and adjusted book value pick-up is an increase of $344 million, bringing estimated book value to $38.08 per share and adjusted book value to $31.90 per share, an increase of approximately $7.56 per share.
That concludes my formal remarks. I will now turn the call back to Claude for some additional brief closing remarks.

Claude LeBlanc, Chief Executive Officer

Thanks, David. For 2017, we laid out a number of strategic priorities, including the active run-off of AAC and its subsidiaries, loss recovery to litigation, and the exercise of contractual and legal rights, improved cost effectiveness and efficiency of the operating platforms, rationalization of Ambac's capital and liability structures leading to a simplified corporate governance structure and the successful exit from rehabilitation of the Segregated Account, and the exploration of selective business transactions that would offer attractive risk-adjusted returns and enable utilization of Ambac's Net operating losses. We are pleased to report that we've made significant progress with respect to all of our stated objectives and are continuing to advance against each.

Looking ahead to 2018, we are focused on building upon our momentum from 2017 to improve the quality of our book value and leverage the overall strategic and financial flexibility achieved through the exit from rehabilitation of the Segregated Account.

Having completed the restructuring transaction, a key priority for the board and management in 2018 is capital allocation at the holding company. We will continue to evaluate the best uses of our capital at AFG to deliver value to our shareholders on a tax and risk-adjusted basis, considering liquidity and the strategic needs which may include additional investments in AAC securities, new business opportunities, as well as direct and/or synthetic stock repurchases.

Today, AFG has used its capital strategically to support the creation of material value from its investment in AAC.

Recently, AFG put its capital to work to support and facilitate the restructuring, and presently maintains an investment of about $215 million in AAC surplus notes and secured notes. While still materially invested in AAC securities, AFG is now better positioned to consider and act upon alternatives to put its capital to work to create long-term value for shareholders.

In conclusion, I would like to thank our shareholders for their ongoing support as we navigated a successful close to 2017. As we look forward to 2018, we remain focused on executing our strategic priorities, and delivering long-term shareholder value.

Operator, please open the call for questions. Thank you.

Operator
Thank you. We will now be conducting a question and answer session and our first question comes from the line of Andrew Gadlin with Odeon Capital Group. Please proceed with your question.

Andrew Gadlin, Analyst, Odeon Capital Group
Hi. Good morning. Thank you for the pro forma statements and the breakout and Claude your comments that there's $215 million of notes at the holding company. Could you give us a breakout between litigation notes and the surplus notes?

David Trick, Chief Financial Officer, Ambac
Yeah this is David. The breakout between the secured notes, about $125 million of secured notes, and the remaining surplus notes on a fair value basis is about $88 million.

Andrew Gadlin, Analyst, Odeon Capital Group
So, that's fair value, it was close to $100 million, right?

David Trick, Chief Financial Officer, Ambac
About $100 million of accrued P&I.

Andrew Gadlin, Analyst, Odeon Capital Group
Got it. Okay. And then, what's the pro forma cash balance following the transaction?

David Trick, Chief Financial Officer, Ambac
Cash and short-term investments is just over $100 million.

Andrew Gadlin, Analyst, Odeon Capital Group
Got it.

David Trick, Chief Financial Officer, Ambac
$102 million. So, total assets on a pro forma basis after the transaction on a fair value basis is about $384 million. And if you include the tolling payments we talked about, that will bring it up to about $415 million at the holding company.

Operator
Thank you. Our next question comes from the line of Mark Palmer with BTIG. Please proceed with your question.

Mark Palmer, Analyst, BTIG
Good morning. As you think about the best use of your resources for loss mitigation, how do you put continued or additional purchases of the bonds underlying the COFINA senior insured exposures up against other options?

Claude LeBlanc, Chief Executive Officer, Ambac
Thank you, good morning, Mark. So, I think the way we think of bond purchases is really separate from risk remediation as we talk about our risk mitigation strategies in Puerto Rico. We are looking at our litigation, our active engagement with both federal and state officials, as well as our efforts in working through both mediation and negotiations with various stakeholders. But I think, at this stage in Puerto Rico, we really think of the litigation as being the key driver to most of our activity until the - – we hope - the negotiation process becomes more active.

On the bond purchase side, we have made some significant purchases for Puerto Rico bonds where we see the pricing of those bonds to be attractive. We hold those bonds available for sale and they are not considered – we do not consider them as part of our risk remediation activities, and we also do not consider them with respect to our reserving modeling calculations. So, they are held independently. We do believe that in the case of a plan of adjustment and for voting purposes, that to the extent we still hold the bonds at that time that there will be bonds that we will vote in addition to our rights under the insurance policy at that appropriate time. But I think for the purposes of the remediation, we really view that as distinct from the – our ALM and bond purchase activity.

Mark Palmer, Analyst, BTIG
Thank you.

Operator
Thank you. Our next question comes from the line of Andrew Hain with Stifel. Please proceed with your question.

Andrew Hain, Analyst, Stifel
Yeah. Good morning. Just want to quickly understand your subrogation rights just a little bit more in detail. Just by way of example, if you have a bond that you wrap which matures, Puerto Rico I'm talking about, in light of the filing and the bond were to mature, let's say, tomorrow. My understanding is that the bondholder's rights subrogate to you and that you will pursue claims against Puerto Rico. I want to understand how you are situated or how you view your situation in that example relative to bondholders and is there any risk that you are potentially treated differently?

Claude LeBlanc, Chief Executive Officer, Ambac
I think that we – the way that we would view things obviously as it relates to Puerto Rico you're asking specifically or...

Andrew Hain, Analyst, Stifel
Well, just because it's the most recent example out there, where everybody's focused on, so, yes but...

Claude LeBlanc, Chief Executive Officer, Ambac
Yes. So, again I think the way you've described is correct and I think we have subrogation rights and we have unique rights as an insurer the bondholders do not have. So, I think the way you described it at a high level is correct.

We obviously also own a number of bonds ourselves. So, I think when we look at exit plans and in our rights vis-à-vis other bondholders, you know I think we will be looking at it both as a bondholder given we are now one of the larger holders of Puerto Rico exposures, but also look at it through the lens of our insurance policies and historically, I think these have been on exits and in bankruptcy situations.

Monolines have been significant participants in the negotiation around the exit plans. So, I think there will be obviously an insurance overlay that we believe will dominate as part of our insurer rights as part of that process. But I also think that given the size of our direct bond holdings that we will also have potentially, a broader perspective vis-à-vis exit plans.

Andrew Hain, Analyst, Stifel
Yeah. Okay. Okay. Great. And then just on that same notion, is there precedent that you can provide there with Detroit or anybody – any other situations where you might have been involved where...

Claude LeBlanc, Chief Executive Officer, Ambac
I think it's, again, probably the best example I'd point to you is maybe Jefferson County. I think you've seen – you saw their monolines pick different directions all of which were in their best interest, but leveraging their insurer rights and also ensuring that their subrogration rights were appropriately addressed, and also a situation again where certain of the monolines had, you know, relatively more meaningful holdings in certain bonds and also different litigation rights, and I think that's probably the most relevant example I would point to.

Andrew Hain, Analyst, Stifel
Great. I appreciate the color and congratulations on the exit from rehabilitation.

Claude LeBlanc, Chief Executive Officer, Ambac
Thank you.

Operator
Our next question comes from the line of Ben Clifford with Nomura Securities. Please proceed with your question.

Mr. Clifford, can you check to see if your line is on mute?

Benjamin Clifford, Analyst, Nomura Securities
Oh, sorry. I was on mute. Thanks for taking my questions. I guess my first one is in your 8-K from earlier in the month you talked about on top of the pre-disclosed gain that you gave this morning to adjusted book value, there was $287 million of gains from settlement of unpaid claims and $50 million from settlement of deferred amounts. I was just wondering if you could clarify whether that $7.56 – seven and a half dollar gain to book value includes that amount or not?

David Trick, Chief Financial Officer, Ambac
Yes. If you look at the pro forma we've provided, there's a $344 million gain on a pro forma basis to book value and adjusted book value as of December 31st and the amounts you described effectively are the same amounts that affect that $344 but with, of course, some passage of time.

Benjamin Clifford, Analyst, Nomura Securities
So, we shouldn't expect any incremental gains on top of what you've already disclosed when you report Q1?

David Trick, Chief Financial Officer, Ambac
There'll be a few million dollars extra because of the accretion of interest between December 31st and February 12th when we closed the transaction. So, there will be a few million dollars of extra pickup of discount on that accretion amount.

Benjamin Clifford, Analyst, Nomura Securities
And then, my last question, you disclosed in July that you had an option to purchase more of the Corolla notes. I was wondering if that option is still outstanding and whether you've exercised your ability to purchase those notes.

David Trick, Chief Financial Officer, Ambac
Yeah. We did exercise the option and we purchased that $45 million of original phase I believe in the third quarter.

Benjamin Clifford, Analyst, Nomura Securities
That's all from me. Thank you.

David Trick, Chief Financial Officer, Ambac
Thank you.

Operator
Thank you. Our next question comes from the line of Andrew Hain with Stifel. Please proceed with your question.

Andrew Hain, Analyst, Stifel
Thanks, guys. Just a follow-up. Maybe I missed it, but did you guys comment on your intentions on coupon payments on the surplus notes. And am I right that if you do pay a coupon or if you're allowed to pay a coupon on those notes, the Tier – the new Tier 2 financing also goes cash pay? Is that correct?

David Trick, Chief Financial Officer, Ambac
That's correct but under the surplus notes, first of all, I think you're aware that we did get approval to pay a $13.5 million interest payment, which will be paid on March 1st, which represents six months interest that 5.1% on the accrued – principal and accrued interest outstanding as of the closing of the transaction. But under the surplus notes, we are required within 45 days of their interest payment date to request from the OCI permission to pay interest on those notes.

So, Our ability to pay notes is solely with and this is solely a decision of the OCI. But we are required to make that request every year. And you are correct if we are to make payment on the surplus notes, it does trigger pro-rata payment of interest on the Tier 2 notes.

Andrew Hain, Analyst, Stifel
Great. And then just so I'm clear on that but if you were able to pay or OCI lets the dollars out for the coupon payments, the interest will be payable on the accreted amount and it's not retroactive right? It must be on a go forward basis?

David Trick, Chief Financial Officer, Ambac
Well, they are PIK'd notes. So, we would have to put aside the amounts for the notes, but it would not have to be paid in cash.

Andrew Hain, Analyst, Stifel
Okay. Thank you.

Operator
Thank you. Our next question comes from the line of Charles Post with Sterling Grace Municipal Securities. Please proceed with your question.

Charles Post, Vice President, Sterling Grace Municipal Securities
When you acquired the PRIFA bonds or the COFINA bonds, I assume you're doing that for loss mitigation purposes. Is that correct?

Claude LeBlanc, Chief Executive Officer, Ambac
We do not acquire bonds for loss mitigation. We are acquiring them as part of our ALM strategy when we are able to acquire bonds at attractive prices, we look at those bonds. We focus, we have a broad asset management – asset liability management program, but there is an allocation that we do look at acquiring our own wrap paper and we saw attractive prices to acquire the COFINA bonds.

From the perspective of matching out our liabilities, I think you can equate the duration and risk profile of these securities obviously tie into our liabilities to the extent we were to maintain our holdings in those securities. So, we think it is a good ALM strategy for some of those liabilities.

But these assets are held for sale and we have no commitment to maintain ownership of those securities in the future. So I think it's not a risk management or risk mitigation strategy, but a strategy that is focused on our asset liability management.

Charles Post, Vice President, Sterling Grace Municipal Securities
Okay. But the – perhaps some reserves on COFINA and PRIFA I assume – but we have no – just to be clear, we have no benefit from owning those to reduce the reserves we have on these credits?

Claude LeBlanc, Chief Executive Officer, Ambac
That is correct. So, that's what we said and that is correct. So, the reserves are gross. We do not adjust our reserves because of buying or selling any of our wrapped bonds.

Charles Post, Vice President, Sterling Grace Municipal Securities
Okay. Is that the same thing on the RMBS side, too?

Claude LeBlanc, Chief Executive Officer, Ambac
Yes, it is…

Charles Post, Vice President, Sterling Grace Municipal Securities
Okay. So, we've got gross reserves. We got no benefit in any way to our reserves from the ownership of those underlying securities? So, in theory, our book value could be understated to the extent we own those when these transactions occur and maybe we offset some of the losses with the fact that we own some of those bonds.

David Trick, Chief Financial Officer, Ambac
Yes, Charles. You could, I guess, look at it that way. But the better way of looking at it is we bought these bonds whether they're Puerto Rico, RMBS bonds at discounts to their face and they have attractive yield as a result of that, and so the – if you look at the sort of discount to par at which we purchase them, there is significant value in terms of the yields and discount capture from the face value of those bonds that we've captured.

Charles Post, Vice President, Sterling Grace Municipal Securities
And we're not seeing that value anywhere in the book value is I guess where I'm getting at.

David Trick, Chief Financial Officer, Ambac
You see it over time as those bonds accrete up as we earn the yield over time. And, two, if you're looking at book value versus a book, adjusted book value subject to the mark-to-market on that portfolio.

Charles Post, Vice President, Sterling Grace Municipal Securities
I guess some COFINA is going to take some time because you got until 2054.

David Trick, Chief Financial Officer, Ambac
Yeah. I mean, they're there pretty long.

Charles Post, Vice President, Sterling Grace Municipal Securities
I might be around, I might not be.

David Trick, Chief Financial Officer, Ambac
We hope you are.

Charles Post, Vice President, Sterling Grace Municipal Securities
Then on the Citigroup settlement that continues to be out there, is there any sense for timing on that or dollar amount? I know it says significant so just trying to get a sense of what that could be and when that could be.

David Trick, Chief Financial Officer, Ambac
We have made, what I'll say, is some progress along in the process but it's still too early to say with any level of accuracy that, you know, when those monies will come in. The SEC did appoint a distribution

agent. That's a positive sign, and hopeful that it will be in 2018. But at this point time, I can't give you a specific date.

Charles Post, Vice President, Sterling Grace Municipal Securities
Okay. And on the presentation, we continue to have that language that besides the R&W, we're pursuing other recovery efforts. Are you guys pursuing anything and could it be significant? Can you comment anymore on that?

Claude LeBlanc, Chief Executive Officer, Ambac
This is language with relation to RMBS or...

Charles Post, Vice President, Sterling Grace Municipal Securities
No. It's in the RMBS section where it talks about recoveries and there's also a comment that you're pursuing other opportunities for recoveries.

Claude LeBlanc, Chief Executive Officer, Ambac
Yeah. I mean, we are always engaging in activities for enhancing our recoveries. So, there's a number of things that we may do in relation with servicers and other participants in our securitizations. And we also have a number of other litigations with trustees and other parties that we are pursuing to increase our recoveries.

Charles Post, Vice President, Sterling Grace Municipal Securities
All right. Last thing, at the very end of your presentation, you mentioned direct or synthetic stock repurchases. It's the first time I've heard you say that or probably I missed it before. Is there a timing when you could do that, a sense for it? Is it that you're open to do it like later this year or it could take some time?

Claude LeBlanc, Chief Executive Officer, Ambac
It is something that we have considered in the past and we've been much more active now that we're exiting rehabilitation. AFG still, as we mentioned, fairly committed to AAC between senior notes and surplus notes, but as we look at our capital allocations at the holding company, we are now with increased flexibility looking at other ways to create long-term shareholder value.

We believe that a repurchase program may be something that could be considered more near term than previously. But we will be valuing that along with a host of other options including the deployment of capital in new businesses amongst others.

But I think – for us, I think one of the issues that we've highlighted in the past that's a challenge are the issues surrounding our NOLs and the 382 rules on change of control, which is why we mentioned this potential for a synthetic buyback, which may have a mitigating effect on that particular issue or limit any risk on that issue, which is not one that we have a tolerance for.

So, it is something that we'll continue to consider, and if and when appropriate, we'll report back to the markets once our board decides the timing and that decision is appropriate.

Charles Post, Vice President, Sterling Grace Municipal Securities
Okay. Great. Thank you.

Claude LeBlanc, Chief Executive Officer, Ambac
Thank you.

Operator
Thank you. Our next question is a follow-up from Andrew Gadlin with Odeon Capital Group. Please proceed with your question.

Andrew Gadlin, Analyst, Odeon Capital Group
Thanks. Thank you. Following up on the previous question, is the Ambac-insured muni portfolio held at AAC? I know that the regulator pointed to that as part of the de-risking done that supports the exit from rehab. Now that you're out, I mean, is there any limitations on your ability to sell any of that?

Claude LeBlanc, Chief Executive Officer, Ambac
No. I don't think we have any limitations at all. So, I think we are clearly committed, as I mentioned earlier in my prepared remarks, on a strategy of de-risking as well as maximizing our returns in long-term value creation for shareholders. So, again, I think we will be exploring with increased flexibility a number of options around both de-risking and our ALM activity. And I think that's one of the enhancements of being out of rehab, but we have not committed either way on holding our positions other than we are certainly committed on our continued focus on de-risking.

Andrew Gadlin, Analyst, Odeon Capital Group
Okay. Thank you.

Operator
Thank you. There are no further questions at this time. This does conclude today's teleconference. We thank you for your participation. You may disconnect your lines at this time, and thank you for your participation.