Operator

Greetings, and welcome to the Ambac Financial Group, Inc. Third Quarter 2019 Earnings Call.

At this time all participants are in a listen-only mode. A brief question and answer section 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 host, 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

Thank you. Good morning and thank you all for joining today's conference call to discuss Ambac Financial Group's third quarter 2019 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 reports under Management's Discussion and Analysis of Financial Condition and Results of Operation 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 that presentations have been posted to the Events and Presentations section of our IR website which support our comments today.

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.

Yesterday Ambac reported net income of $66.1 million or $1.41 per diluted share and an increase in Book Value per share of $1.66 to $34.44 as at September 30. Adjusted Earnings were $76.8 million or $1.63 per diluted share for the third quarter, resulting in an increase in Adjusted Book Value per share of $0.74 to $30.31 as at September 30.

This quarter's favorable results include the realization and recognition of a $142 million cash settlement in connection with the SEC action against Citigroup, which drove our third quarter net income. All proceeds received from this settlement will be used to pay down the secured notes issued in connection with our holistic restructuring transaction. The payment, which will be applied on the next scheduled payment date, will allow us to further de-lever our balance sheet and reduce future interest costs.

David Trick will speak to the financial results in greater detail in a moment.

During the quarter, we continued to make significant progress in the de-risking of our insured portfolio. Our insured net par was reduced by approximately $3.2 billion to $39.0 billion, with $1.5 billion of that decline representing Adversely Classified and Watch List Credits. Active de-risking has been the primary driver of the accelerated decline of our insured portfolio, which stands at 17% year-to-date on the overall portfolio and approximately 21% year-to-date on Adversely Classified and Watch List Credits.

One of our key de-risking and portfolio-shaping transactions completed during the quarter included a significant reinsurance transaction for a portfolio of public finance credits, ceding $1.2 billion of performing par exposure, or almost 3% of our total insured net par at June 30th.

This transaction also included approximately $509 million of Adversely Classified and Watch List Credits. Our reduction of Adversely Classified and Watch List Credits, in particular, further optimizes our insurance platform and facilitates our goals to significantly reduce our insured risk exposure, improve the quality of our book value, and increase our optionality with respect to our remaining insured portfolio.

Turning now to Puerto Rico.

On September 27th, the Oversight Board filed the Commonwealth Plan of Adjustment in court. Rather than negotiating a consensual agreement with a majority of the creditors before filing, the Board chose to proceed with a deeply flawed Plan of Adjustment, which Ambac believes is a step backwards that risks embroiling Puerto Rico in many more years of protracted litigation.

Ambac cannot support this Plan because it disregards revenue bondholder rights and liens entirely, inappropriately allocating all pledged revenues for payment of Commonwealth expenses.

Ambac also opposes the Commonwealth Plan of Adjustment as it simply shows a lack of willingness to pay, given it is premised on demonstrably incorrect Commonwealth Fiscal Plan projections and estimates of debt capacity that severely underestimate the Commonwealth's ability to pay. If the Oversight Board were to reconcile cash balances and correct patently incorrect fiscal plan assumptions, the Commonwealth's true debt service capacity would become evident, opening the door for a reasonable holistic debt restructuring. Evidence of the Oversight Board's blatant errors and unsupportable assumptions were shared with the market on October 17th as part of an information release agreement with creditors.

We urge the Oversight Board to revise the Commonwealth Fiscal Plan and Plan of Adjustment to reflect the actual economic performance and realistic financial expectations. Doing so would be a start to facilitate the process to arrive at acceptable and consensual debt restructuring deals.

Ambac will continue to aggressively litigate to defend its rights in Puerto Rico so long as creditor rights and economic realities continue to be ignored. The Oversight Board's current path will only prolong the increasingly destructive effects of a long-term bankruptcy on the people of Puerto Rico.

Switching now to our RMBS loss recovery efforts.

In September, the Appellate Division of the First Department decided the appeals that were argued in May in our main case against Countrywide and Bank of America. The decision was very favorable to Ambac in affirming that we may proceed to trial on our contract claim with respect to all breaching loans and that our fraud claim remains viable. The First Department also issued decisions in three other RMBS cases in September and October that were favorable to the plaintiffs in those cases and helpful to our own case.

Consistent with past practice, Bank of America continues its efforts to put off a trial and filed with the First Department, a motion for re-argument and/or leave to appeal to the NY Court of Appeals, the highest court in the State.

It is not clear whether the First Department will grant this motion. Nevertheless, we do not believe this latest legal maneuver by Bank of America warrants additional delay in moving the case forward and plan to ask Justice Sherwood to set a trial date at our upcoming conference scheduled for November 12th.

As it relates to new business, we continue to see and evaluate attractive new business opportunities in various sectors and will provide an update when it is appropriate.

In closing, we had another strong quarter with measurable success in reducing our insured portfolio, achieving a significant recovery on the SEC-Citi settlement and favorable decisions on our main case against Bank of America/Countrywide. As our results demonstrate, we remain keenly focused on pursuing and executing on our strategic priorities which we will continue to progress during the remainder of 2019.

I would now like to turn the call over to David Trick to discuss our financial results in greater detail. David.

David Trick, Chief Financial Officer

Thank you, Claude, and good morning to everyone.

During the third quarter of 2019, Ambac reported net income of $66 million or $1.41 per diluted share, compared to a net loss of $(128) million or $(2.79) per diluted share in the second quarter of 2019.

As Claude noted, the main driver of net income for the third quarter was the recognition of a $142 million gain from the SEC-Citigroup settlement, proceeds from which were received in September. Second quarter results, in comparison, were adversely impacted by the Ballantyne commutation, which while economically beneficial, contributed an $83 million GAAP loss.

The entire $142 million of settlement proceeds will be used to pay down AAC's secured notes at the end of the year, reducing annualized gross and net interest expense by approximately $14 million and $10 million, respectively, based on current 3-month LIBOR rates.

Adjusted Earnings for the third quarter were $77 million, or $1.63 per diluted share compared to an Adjusted Earnings of $86 million, or $1.88 per diluted share in the second quarter. The main driver to the difference between GAAP and Adjusted earnings for both quarters was the amortization expense associated with our insurance intangible asset.

Now for some more perspective on the third quarter.

Premiums earned were $10 million versus $8 million during the second quarter. The increase resulted from $6 million of negative accelerated premiums experienced in the second quarter resulting from the Ballantyne commutation, offset by insured portfolio runoff and a $5 million increase in uncollectible premium during the third quarter.

Investment income for the third quarter was $45 million, a $41 million decrease from $86 million for the second quarter of 2019.

The decrease in net investment income was mostly due to the inclusion, in the second quarter, of accelerated accretion on owned Ballantyne notes associated with the Ballantyne commutation.
Net realized investment gains were $18 million for the third quarter, which included gains from the sales of uninsured COFINA bonds at AAC and foreign exchange gains at Ambac UK.

Proceeds from the sale of COFINA bonds and cash on hand are being redeployed into an expanded range of investments which are designed to create greater diversity in the portfolio and generate more attractive risk-adjusted returns to defease our insurance and other obligations.

Loss and loss expenses incurred were $37 million in the third quarter, compared to a benefit of $133 million in the second quarter. The expense in the third quarter was due to an increase in Public Finance reserves partially offset by favorable RMBS and Student Loan development.

Public Finance losses in the third quarter of $77 million were due to an increase in non-COFINA Puerto Rico reserves driven mostly by lower discount rates, assumption changes and higher loss expenses related to our ongoing aggressive efforts to mitigate our remaining risk.

The benefit in RMBS of $25 million was primarily driven by the impact of lower interest rates on excess spread whereas the benefit from Student Loans of $16 million was primarily due to improved credit experience, particularly with regards to recoveries.

Net losses on derivative contracts were $(10) million for the third quarter compared to $(35) million for the second quarter. Losses in both periods were due to declines in forward interest rates and a reduction in hedge sensitivity in the third quarter.

Interest rate derivative losses in the third quarter were more than offset by $65 million of gains recognized in the carrying values of the insured and investment portfolios driven by forward interest rate movements.

Operating expenses for the third quarter decreased $3.5 million from the second quarter to $26 million. The decline was driven mostly by lower compensation expenses.

Compensation costs were lower by $3.2 million mostly due to the inclusion of incentive-based compensation in the second quarter of 2019 related to the Ballantyne restructuring. The absence of these costs in the third quarter was partially offset by approximately $1.7 million of severance expense in connection with our continuous right-sizing initiatives.

Non-compensation expenses were down modestly at $11.5 million for the third quarter compared to the second quarter. Lower legal and consulting costs were offset by the final redemption of certain junior surplus notes, the quarterly redemption of which had offset our corporate headquarters rent expense from 2012 until June 2019.

Rent expense in the third and second quarters, also included the short-term overlap of our new and old headquarters lease, which ends in November 2019. Beginning in the first quarter of 2020 we will experience approximately $1 million per quarter reduction in rent expense relative to our third quarter cost as a result of our space consolidation.

Our focus on reducing core operating expenses, as noted previously, will be met with volatility as our cost-cutting actions often result in short term overlapping and/or upfront costs. Nonetheless, we are disciplined on our approach and such short-term expenses are only incurred if the payback is a sustainable and absolute reduction to longer-term operating expenses.

Turning to the balance sheet.

Shareholder's equity increased $1.66 per share from June 30th, 2019 to $34.44 per share at September 30th, 2019, primarily due to the net income for the quarter.

Adjusted Book Value increased to $1.38 billion at September 30th, 2019 from $1.35 billion at June 30th, 2019 primarily driven by third quarter adjusted earnings partially offset by premiums ceded under the reinsurance transaction executed this quarter. Adjusted Book Value on a per share basis increased $0.74 to $30.31 per share at September 30th, 2019.

On a stand-alone basis, as of September 30th, 2019, AFG held cash, investments and receivables of approximately $473 million or $10.39 per share.

I will now turn the call back to Claude for some brief closing remarks.

Claude LeBlanc, Chief Executive Officer

Thank you, David.

Our accomplishments year-to-date reflect our commitment to our shareholders to take measurable steps to strengthen our platform and position Ambac for the future.

Thank you for joining us on today's call. Operator – please open the call for questions.

Operator
Thank you. We will now be conducting a question and answer session. If you would like to ask a question, please press *1 on your telephone keypad. A confirmation tone will indicate your line is in the question queue. You may press *2 if you would like to remove your question from the queue. For participants using speaker equipment, it may be necessary to pick up your handset before pressing the * key. One moment please while we poll for your questions.

Our first question comes from the line of Giuliano Bologna with BTIG. Please proceed with your question.

Giuliano Bologna, BTIG, LLC
Congratulations on another good quarter of execution.

Claude LeBlanc, Chief Executive Officer
Thank you.

Giuliano Bologna, BTIG, LLC
Thinking about on the rep and warranty side of the world. Obviously, the timing is based on the courts, but it'd be interesting to get your take on some of the recent rulings that have come out in other related cases and if there have been any developments on the legal front related to rep and warranty claims.

Claude LeBlanc, Chief Executive Officer
Thanks, Giuliano. Yes, there have been a number of other decisions in the first department relating to the notice matter that the first department ruled on our case that were similar and those rulings were ruled favorably in favor of the plaintiffs. So, we view those cases as also highlighting a uniform view that a number of the judges on the panels in the first department have agreed with our perspective alongside these other cases. So again, I think it's supportive, not deterministic of our case, but there

seems to be a very consistent pattern with all the decisions that were related to our case, ruling in favor of the plaintiffs.

Giuliano Bologna, BTIG, LLC
That sounds good. And then thinking about what you guys are doing on the de-risking side. Are there any other large opportunities for other reinsurance transactions or working with servicers to clean up some of the legacy structured deals?

Claude LeBlanc, Chief Executive Officer
Yes, we've got a pretty deep pipeline of opportunities that we are pursuing aggressively and looking to implement. The timing of these opportunities vary in terms of their availability and pricing. We do have a very rigorous process in terms of evaluating individual transactions, but we do see the opportunity in particular with the low interest rate environment and some of the issues relating to the timing of where we are in the credit cycle that will introduce opportunities to de-risk.

On the reinsurance side, we continue to evaluate opportunities that could be significant to sculpting and shaping the portfolio. And we believe on the derisking, whether it's reinsurance, alternative risk transfer or other form of de-risking that the number and types of opportunities continue to expand as the market evaluates different options that we've been able to develop over the last number of years. So, we are excited to believe there will be a number of other opportunities that will help us sculpt the portfolio and continue to improve the overall credit profile of the run-off business.

Giuliano Bologna, BTIG, LLC
That sounds good. And then you guys mentioned that you plan on taking out a portion of the secured notes with the Citi CDO proceeds. Are there any other opportunities to pay down those notes sooner? And the only reason why I ask that is, obviously, they have a more expensive cost than a lot of the investment securities in the investment portfolio. So, there would be some accretion by paying off some of those notes earlier. Do you think there are any other opportunities in the near-term to do that? Or is it more so focused on de-risking?

David Trick, Chief Financial Officer
That's something we evaluate regularly, Giuliano. When we talk about allocating capital, obviously, there's capital needs with regards to the de-risking activity, quite frankly, quite frequently, sorry, and so we weigh those all the time. We also have a number of investments that when you kind of break down the portfolio and allocate against the various different liabilities as we do, that are generating positive carry relative to the debt. So at the end of the day, as you note, the average yield on the portfolio is below the average yield on the debt, particularly the secured notes, but of course, we don't recognize significant asset that we have on the balance sheet with regards to rep and warranty, which ultimately causes that negative carry from an interest accretion standpoint. So ultimately, the short answer is that, yes, there are opportunities, but we're thoughtful in terms of how we spend liquidity and allocate capital but since we've had that new outstanding, we've paid down around $200 million of the note with this $142 million that would significantly increase that amount. And we'll continue to selectively pay down of the note when the opportunities arise.

Giuliano Bologna, BTIG, LLC
That sounds good. Thank you very much for answering my questions.

Claude LeBlanc, Chief Executive Officer
Thank you.

Operator
Thank you. Once again if you would like to ask a question please press *1 on your telephone keypad. For participants using speaker equipment, it may be necessary to pick up your handset before pressing the * keys. One moment please while we poll for more questions.

Thank you. We have reached the end of our question and answer session and the conclusion of today's teleconference. We thank you for your participation. You may disconnect your lines at this time and have a wonderful day.