Operator

Greetings and welcome to the Ambac Financial Group Incorporated fourth quarter 2018 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

Thank you. Good morning and thank you all for joining today's conference call to discuss Ambac Financial Group's fourth quarter 2018 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 annual report 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 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. For the year ended December 31, 2018 Ambac reported net income of $267 million and net income to common shareholders of $186 million or $3.99 per diluted share. Adjusted Earnings were $301 million or $6.47 per diluted share.

These results were driven by a very successful 2018 during which we meaningfully progressed our strategic priorities.

We started the year with the exit from rehabilitation of AAC's Segregated Account through a holistic transformational restructuring transaction. This transaction created a book value increase of approximately $7.00 per share, or a 25% increase to our fourth quarter 2017 book value per share. As a result of the execution of this transaction we streamlined our capital structure, reduced our regulatory oversight, lowered our operating expenses and unified our governance structure.

Another major accomplishment in 2018 that further streamlined our capital structure was the execution of an exchange offer for the AAC Preferred Shares, or AMPS, which closed in August of 2018.

This exchange transaction resulted in a discount capture of approximately $250 million, or 45%, on $557 million of AMPS exchanged. It also further delevered our capital structure, reduced certain financial and other risks and further improved the quality of the Book Value and Adjusted Book Value of Ambac Financial Group.

We also took additional steps to further streamline our capital and liability structure including the full redemption of an RMBS secured debt obligation and pay down of a portion of the Ambac Senior Note.

Moving on now to our key business priority, the active de-risking of our insured portfolio**.** 2018 was our Risk Management Group's first full year operating under an enhanced risk management approach and operating structure. The Risk Group's mandate is the active pursuit of various targeted de-risking activities focused on remediation and loss mitigation of our Adversely Classified and Watch List Credits. This expanded approach and protocol was developed to reduce the volatility of AAC's insured portfolio and thereby directly improve the overall quality of our book value. The success of this enhanced approach and our active de-risking activities are evident in our overall results.

During 2018 the insured portfolio was reduced by 25%, from $62.7 billion net par outstanding to $46.9 billion. Adversely Classified Credits were reduced by 23% or $3.2 billion to $10.9 billion, and Watch List Credits were reduced by 19% or $2.1 billion to $9.0 billion.

I've highlighted some of the more significant de-risking transactions over the year but would like to emphasize two material transactions that closed during the fourth quarter which were:

One - A 100% quota share reinsurance transaction on certain public finance exposures, totaling $1.5 billion of performing par exposure with principal and interest of $3.4 billion, mostly comprised of capital appreciation bonds and including $232 million of Adversely Classified and Watch List Credits and;

Two - The refinancing, as a result of our de-risking efforts, of a key watch list Public Finance sector exposure that was also one of our largest single risk exposures, reducing outstanding par by approximately $850 million.

In addition to the significant transactions executed in 2018, exactly one year after AAC's Segregated Account exit from rehabilitation, another key Ambac objective was achieved when the COFINA Plan of Adjustment went effective on February 12, 2019.

Ambac was actively involved in crafting the terms of the consensual agreement which became the basis of the COFINA Plan of Adjustment. In connection with the Plan of Adjustment 75% of Ambac's insured COFINA bondholders elected to commute Ambac's insurance policies in exchange for cash and the new COFINA bonds.

We believe the COFINA Plan of Adjustment along with the associated commutations and collateralized trust structure is a tremendous achievement for Ambac in managing its overall portfolio risk exposure.

Through the execution of the COFINA Plan of Adjustment, Ambac fully addressed and significantly reduced its largest single risk exposure, which represented approximately 78% of Ambac's total Puerto Rico exposure. After months of intense negotiations, Ambac and other senior COFINA creditors received a 93% notional recovery, important protections clarifying that the share of the sales and use tax earmarked for COFINA are not available resources for the Commonwealth and dismissals of challenges to the COFINA structure.

As a as a result, Ambac's insured COFINA exposure and our overall insured Puerto Rico debt service exposure decreased by $5.5 billion. The 25% holders who elected not to commute their policies received units issued by a trust. This trust holds a ratable distribution of cash and new COFINA bonds which will significantly offset Ambac's remaining COFINA insurance liability.

David will elaborate on the financial impact of this transaction in a few minutes.

As a result of the successful COFINA transaction, the Government of Puerto Rico will receive, per an AAFAF press release, access to $425 million annually for the next 40 years. Ambac believes that socially responsive and fiscally responsible government spending of this new source of unencumbered funds, as well as cooperation between the Oversight Board and the local government are all necessary conditions to the long-term financial success of Puerto Rico.

To that end, Ambac was recently surprised and disappointed that almost immediately after the First Circuit Court of Appeals issue of its ruling on the appointment of the Oversight Board members, Governor Rossello asked the Commonwealth CFO Raul Maldonado, and AAFAF Executive Director Christian Sobrino, to start authorizing budget reapportionments without Oversight Board approval, in direct contravention to PROMESA.

For this reason, Ambac believes President Trump and the U.S. Senate need to act quickly to nominate and confirm members of the Oversight Board in accordance with applicable law. Swift federal government action will be critical to ensuring proper oversight of the Commonwealth's fiscal framework.

Furthermore, Ambac is fully supportive of Resident Commissioner González's efforts to advance the concept of a federal recovery czar for Puerto Rico which we believe will help ensure a long-term high level of transparency, accountability and efficacy with regards to local government spending of federal disaster aid, among other things.

In light of the progress made to date, Ambac also hopes the momentum from the COFINA debt restructuring will help accelerate consensual, favorable outcomes for Ambac's remaining insured Puerto

Rico exposures. The COFINA debt restructuring demonstrates that negotiated solutions can be found and disagreements between disparate stakeholders can be resolved.

Turning now to our loss recovery efforts tied to our active litigation management**.** Our RMBS litigations continued to progress through 2018 and in the primary Countrywide case, we began 2019 with a positive development. The trial court issued decisions on all of the pre-trial motions that were briefed and argued last year and ruled in Ambac's favor on each one.

While we are pleased with the decision, we were not able to proceed to trial as previously scheduled for February 25th given that Bank of America/Countrywide filed an appeal on all of these decisions and the trial has been put off pending resolution of these appeals. Our legal team remains focused on progressing this case to trial as soon as possible.

Moving on to our ongoing review of the effectiveness and efficiency of our operating platform. During the year we took further steps to streamline our operating platform including additional headcount reductions of approximately 9%, which when combined with the 19% headcount reduction we made in the second half of 2017, results in a material reduction in baseline compensation costs. We also benefitted from lower regulatory costs following the Segregated Account exit from rehabilitation and other decreases in expenses.

We will continue to evaluate areas of realignment within the company in 2019 as we progress our run-off and consider new business strategies.

Finally, we ramped up our efforts in evaluating potential opportunities in certain business sectors that meet criteria that we believe will generate long-term shareholder value with attractive risk-adjusted returns. Our activities have intensified in the past few months and we have made significant progress in identifying some target opportunities.

As noted on prior calls, we have been evaluating opportunities in insurance, credit, asset management and other financial service businesses for select business transactions that are complementary to Ambac and where we can leverage our core competencies. As we have stated previously, we are following a disciplined approach, evaluating various types of strategic transactions of different magnitudes as we pursue potential opportunities to deploy our capital with the goal of creating sustainable long-term shareholder value.

Now I would 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 everyone.

During the fourth quarter of 2018, Ambac incurred a net loss attributable to common stockholders of \$20.5 million or \$0.45 per diluted share, compared to a net loss attributable to common stockholders of \$104 million, with \$2.27 per diluted share in the third quarter. Third quarter results included an \$82 million charge related to the AMPS transaction. Fourth quarter Adjusted Earnings were $11 million, or $0.24 per diluted share, compared to an Adjusted Loss of $76 million, or $1.66 per diluted share in the third quarter. Relative to the third quarter, our fourth quarter results reflect favorable loss development, lower operating expenses and higher net premiums earned, offset by macro hedge mark-to-market losses and lower investment income.

More specifically, premiums earned were $29 million during the fourth quarter versus $26 million during the third quarter. Normal earned premiums decreased by about $2 million to $17 million or 13% due to the continued run-off of the portfolio and the reinsurance of $1.5 billion of net par exposure.

Accelerated premium increased by $5 million, or 82%, to $12 million. This increase was due to de-risking activity in the public finance sector.

The performance of the investment portfolio in the fourth quarter reflected the volatility we observed in the capital markets and which we expect from time to time for a portfolio managed with a long-term outlook. Volatility in the equity and credit markets impacted our trading portfolio, causing a $19 million swing in investment income. This negative variance was almost entirely allocable to Ambac UK's portfolio.

In total, investment income for the fourth quarter of 2018 was $37 million, a $21 million dollar reduction from $58 million for the third quarter. Other than trading book volatility, a reduction in the size of the portfolio and in the allocation to higher-yielding Ambac insured RMBS resulted in a modest reduction in investment income. However, the volatility also provided us some opportunity to reallocate some cash and short-term investments to higher spread assets, including additional AAC-insured PRIFA bonds. This reallocation effort will continue in the future as we have the opportunity to selectively monetize our investment in $946 million in face value of newly issued COFINA bonds. At December 31, 2018 we owned 58% of our insured COFINA bonds and 37% of our insured PRIFA bonds.

Net realized gains for the fourth quarter totaled $29 million as compared to $30 million in the third quarter. The principal source of the fourth quarter gains was a $27 million dollar recovery from a financial crisis era, class action RMBS litigation related to securities we previously held in our investment portfolio.

With regards to loss and loss expense reserves, we produced a benefit of $42 million for the fourth quarter, compared to an expense of $34 million for the third quarter. The fourth quarter benefit was mostly driven by positive development in the RMBS portfolio resulting from the impact of lower interest rates on excess spread and continued credit improvements.

We also produced an incurred benefit in the Public Finance portfolio driven by the COFINA restructuring.

While the Plan of Adjustment closed on February 12, 2019, the COFINA transaction, which Claude described, produced a $42 million dollar incurred loss and loss expense benefit during the fourth quarter. This benefit was mostly offset by a strengthening of reserves on other transactions and the impact of a lower discount rate used for reserving, resulting in a net $5 million dollar incurred benefit for the quarter. Including the benefit recognized in the third quarter, as part of our probability weighted reserving method, the COFINA restructuring produced a total incurred loss and loss expense benefit of $120 million over the last two quarters.

In terms of the remainder of the insured portfolio, it produced a benefit in Student Loans, driven by lower interest rates and marginally improved credit, and incurred additional losses at Ambac UK and elsewhere of approximately $16 million, mostly due to foreign exchange movements and a lower discount rate.

Net losses on derivative contracts were $45 million, including a $4 million dollar counterparty credit adjustment, for the fourth quarter compared to net gains on derivative contracts of $18 million for the third quarter, resulting from significant forward interest rate declines during the fourth quarter compared to rising interest rates during the third quarter.

Fourth quarter operating expenses were $21 million, a decrease of $7 million or 25% from the third quarter.

The decrease was due to lower compensation costs, driven by headcount reductions, lower performance-based compensation, and lower severance charges. Non-compensation expenses declined $4.5 million mostly due to the absence of $5.9 million of professional fees related to the third quarter AMPS exchange transaction, partially offset by various additional professional fees and some costs related to the consolidation and upcoming move of our New York headquarters.

We should note that as a result of this move, we will begin to experience higher rent expense in the second and third quarters of 2019 despite materially lower economic or actual rent payments. This is partially a function of a short-term overlap of new and existing leases, but primarily as a result of the fact that since 2016 our New York rent expense has been mostly offset by reductions to a junior surplus note issued to our landlord in connection with our bankruptcy settlement.

We remain focused on reducing all of our core operating expenses, but similar to the third and fourth quarters of 2018, which reflected costs associated with various strategic initiatives, we expect to experience volatility quarter-to-quarter associated with normal course operations and various other initiatives.

Interest expense for the fourth quarter was unchanged from the third quarter of 2018 at $66 million. Higher interest expense from the issuance of surplus notes related to the AMPS exchange transaction in the third quarter was offset by lower interest expense due to principal paydowns of the Ambac Note. Since issuance, $214 million, or approximately 10% of the principal of the Ambac Note has been paid down.

Interest on debt backed by representation and warranty litigation accounted for $42.5 million or 64% of fourth quarter interest expense.

Turning to the balance sheet, shareholder's equity declined $3.65 to $35.12 per share at December 31, 2018, due mostly to unrealized investment portfolio losses of $129 million related to credit spread widening on the available for sale investment portfolio.

Adjusted Book Value declined $0.92 per share to $27.58 per share at December 31, 2018 due to the impact of the previously announced reinsurance of $1.5 billion of exposure and the depreciation of the British pro pound, partially offset by Adjusted Earnings for the three months ended December 31, 2018.

On a stand-alone basis, as of the end of 2018, AFG held cash, investments and receivables of approximately $455 million or $10.03 per share.

That concludes my formal remarks. I will now turn the call back to Claude for some brief closing remarks.

Claude LeBlanc, Chief Executive Officer

Thank you, David.

We are pleased with our achievements this year and the momentum we have developed going into 2019. I would like to thank my colleagues and our board of directors for their dedication and hard work throughout the year in helping us meet, and in many cases exceed our goals.

I would also like to thank our shareholders for your continued support. We appreciate your feedback during the year and we look forward to continuing to progress our strategic priorities to further create material long term value for our shareholders. This concludes our prepared remarks.
Operator, please open the call for questions. Thank you.

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, and 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 that are using speaker equipment, it may be necessary to pick up your handset before pressing the * keys. One moment please while we hold for questions.

Thank you.

First question comes from the line of Andrew Gadlin with Odeon. Please proceed with your question.

Andrew Gadlin, Odeon Capital Group
Hi good morning. Claude you walked through some cost reduction initiatives that I believe are starting again this year. Can you talk about how that affects the run rate on SG&A again going forward as well as what the impact from the move to the new office space will be?

Claude LeBlanc, Chief Executive Officer
Good morning Andrew. I'll maybe pass that over to David.

David Trick, Chief Financial Officer
Sure, thanks Claude. So Andrew just touching on the real estate for a moment from, as I mentioned in the prepared remarks, from an economic standpoint, what we're doing is basically collapsing four floors here at our current headquarters into one at our new location and we're cutting our square footage that represents our footprint by more than half.

And as a result of that we're going to reduce our annual spend as we look at it from a sort of cash out the door standpoint by just more than half. So were spending over about $6 million dollars a year currently in rent for our current office space and we'll be spending just over $3 million when we move to the new location. So in terms of just general expenses you know, we continue to look at every opportunity to manage expenses. As Claude had mentioned, we've made some significant headcount reductions in the last two years that's had an impact on our baseline compensation cost and in addition to that, from a non-compensation standpoint in addition to the real estate move, we continually look at different opportunities internally ranging from changes to certain systems and operating platforms, one of which is going to be occurring the first quarter that will save us about a million dollars a year in run rate.

So we're taking a hard look at every expense and continue to do so, so we hope and expect that trend in expenses to continue to move downward, and that being said, and again as I note every quarter in my comments there are things that happen quarter to quarter, whether related to strategic initiatives or just the nature of how the business operates that will cause and does cause quarter-to-quarter movements up and down in our expenses including frankly just timing of how certain expenses are recorded. So we're you know, trending towards something that is more inline, and hopefully below what you know the fourth quarter looked like this year on a run-rate basis.

Andrew Gadlin, Odeon Capital Group
So, I can just sort of use that as sort of a trend through 2019?

David Trick, Chief Financial Officer
That's a reasonable basis, yes.

Andrew Gadlin, Odeon Capital Group
Alright, ok thanks. And then just strategically, as you think about Puerto Rico and the delay, or the potential delay, to the process because of turnover at the Oversight Board, how do you think about that in terms of managing liquidity and thinking about the processes you're running for HTA and PRIFA which are your next two largest exposures?

Claude LeBlanc, Chief Executive Officer
So I think at this stage we're obviously evaluating the situation and the decision by the First Circuit on the appointments clause. We heard yesterday that there was an appeal made to the supreme court which could result in a further stay beyond the 90-day period yet to be determined. You know, I think from our perspective, I think this is a good opportunity to revisit in a fresh way the directors on the board. And we hope that the President and the Senate act quickly to appoint someone in near term, as I mentioned.

And in the meantime, you know we do believe and have seen with empirical evidence that the Commonwealth continues to improve economically quarter after quarter. So we do believe that in the passage of time that there is a momentum that's building in Puerto Rico with the economic reform that's taking place and recovery, in addition to an increase in fund balances, I think they have over $12 billion dollar of funds in bank accounts in Puerto Rico that certainly support a meaningful repayment of creditors, if not a full repayment of creditors to the Commonwealth. So I think time is probably not a good thing if it extends into years, but I think a reposition, a refocusing, and the proper appointment of a new Oversight Board, we think will be likely something that will be favorable to the outcome of PROMESA.

Andrew Gadlin, Odeon Capital Group
Thank you very much.

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

Charles Post, Sterling Grace Municipal Securities
Good morning guys. My question is on the COFINA transaction. We saw a benefit in reserves in the third quarter and fourth quarter, the transaction closed to first quarter of 2019. Will there be any more benefit in the first quarter or are we done there?

David Trick, Chief Financial Officer
From the insurance side, Charles, of the balance sheet, no, there will be no additional benefits in the first quarter on a net basis, due to how we reserve for our transactions on a probability-weighted basis.

We recognize the benefit from the liability side of the balance sheet during the third and fourth quarters, which totals about $120 million. And in the first quarter we'll see a little other movements around in the income statement but on a net basis we won't see any material change on an adjusted earning basis in the first quarter.

What we will see is the result of the fact that we owned 58% of the COFINA bonds on our balance sheet, so there will be some impact to be determined on the basis that those bonds converted on February 12th, and there will be some realized gains or losses in the first quarter depending on where the pricing of those bonds fall out.

Claude LeBlanc, Chief Executive Officer
There could be some additional changes to reserving in the event that we were to engage in further transactions with the trust certificate holders in the trust, but those would be sperate transactions post the planned exit.

Charles Post, Sterling Grace Municipal Securities
Ok. David, I'm glad you mentioned that because I was going to follow up about the holdings of the COFINA bonds that you guys have. I'm assuming that we're going to see a benefit given looking back to when you guys were buying those bonds versus, you know, we own COFINA ourselves, so we're up so I believe you guys are up nicely too, so I see a nice benefit in the first quarter from that hopefully. Get the book value going the right way.

David Trick, Chief Financial Officer
Right. What we've been saying about is that we're being cautious about, and not giving any guidance as to what we anticipate there. You know the bonds obviously settled on February 12th, and we did have a big position which of course been accreting up and subject to estimates of fair value and ultimately what we do in terms of selectively selling the bonds will generally determine the ultimate outcome in terms of any results there in the first quarter.

Charles Post, Sterling Grace Municipal Securities
Ok. The case says that the Citi settlement could pay out in the first quarter. Is there any update on timing on that?

David Trick, Chief Financial Officer
We don't have any official update. I think that the guidance we had gotten, and we published in our last Q and K was that we anticipated that a filing would be made by the distribution agent in the first quarter and payout would be made in the first quarter, which is what the distribution agent reported. We've yet to see any filing with the court and given that it's now March 1st, I would anticipate that there may be some delay and it would be hopefully more of a second quarter event. But we don't have any official guidance on that as of now.

Charles Post, Sterling Grace Municipal Securities
Ok. And my last question is on domestic public finance reserves. You know we've had some really good stuff this quarter in terms of burn off and getting rid of some bad credits. And they're down a little bit but it's not down that much and on a percentage basis compared to your peers, your reserves are way above those guys. So it seems like that line item is sort of sticky, and I'm just trying to get a better sense for it. It's a material number in terms of your reserve level compared to everybody else's, so that would be a huge benefit to book value too. So if you could give me more color there I would appreciate it.

David Trick, Chief Financial Officer
Yeah, you know I think there's a couple, a couple of things going on. One is you know, we certainly reevaluate reserves every quarter and do so in a very detailed and thoughtful way. And as I think we've commented on before, we have, well we certainly have at least some reserves as we just noted on the COFINA transaction but we have strengthened reserves in other areas including other areas of Puerto Rico. And we've also in more recent quarters, and in the fourth quarter in particular, we've seen a significant decline in discount rates in terms of how we account for our reserves. So there was approximately a $38 million increase in reserves on the public finance book this past quarter just because of the lower discount rate. And as you know, many of our public finance reserves and exposures are much longer-dated. So lower discount rates have a disproportional impact on public finance reserves as they do on other parts of the book.

Charles Post, Sterling Grace Municipal Securities
Ok, thanks guys.

Operator
Thank you. Your next question comes from the line of Jonathan Hughes with Raymond James. Please proceed with your question.

John McHugh, Raymond James
Yeah, there's been a delay with the lawsuit between Bank of America and Ambac and is there any way you guys can say or bring down the deadline on that? When is the next court date?

Claude LeBlanc, Chief Executive Officer
Thanks John. So yes, I think you know coming into the year we were obviously very pleased with the decisions that came down by the Supreme Court which all ruled in favor of Ambac.

But understandably and expectedly, BofA filed appeals on all of those decisions which we expected they would and the new Judge, Justice Sherwood, elected to you know, defer the trial date pending resolution of these appeals. What I would say is I think we were very pleased with Justice Sherwood's approach to the process. I think as a new judge to our case, this case, I think he understands that we've been at this litigation for eight and a half years, and I think his messaging during the scheduling hearings was that he wanted to ensure that there was a prompt filings of the appeals, perfected appeals, suggesting that he wants this to be moved along and not delayed any further in order to get to a trial. So again I think we're generally very pleased with the process but we believe it's something that will likely, as a result of the appeal process, mean that the earliest that we envision, although it's reasonable to expect, that we could be in front of a trial would be sometime later in the year.

John McHugh, Raymond James
Well, are you guys negotiating outside of court? I mean, from what I understand, one percent of all lawsuits go to trial. And are you guys in negotiations to settle outside?

Claude LeBlanc, Chief Executive Officer
Yeah, we don't comment on the nature and existence of settlement discussions as you can appreciate. But obviously we're are a commercial enterprise, as well as Bank of America, and we exercise prudent judgement on evaluations of outcomes on an ongoing basis. So I think we'll just leave it at that.

We do understand there is a heavy debt burden also associated with the litigation recoveries, but at the same time, there is also a statute of default interest rate of nine percent that accretes on our claims that we don't report quarter to quarter on our financial statements that increases our recoveries every quarter.

So we're mindful of the timing, and we, I can tell you as well, are very frustrated with the delay its taken to get to this point in time on this case, but we are optimistic that we will be in front of a judge or a jury later this year.

Operator
Thank you. At this time this will conclude today's teleconference. We thank you for participating. You may disconnect your lines at this time. Thank you for your participation.