Operator
Greetings and welcome to the Ambac Financial Group Inc. first quarter 2020 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 first quarter 2020 financial results. We hope everyone is doing well.

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 or 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 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. Due to shelter-in-place restrictions, management is participating in this call from remote locations. If technical difficulties occur and we have to terminate the call, you will be able to read the transcript of our prepared remarks, which will be posted to the Investor Relations section of our website. In addition, management will be available to address any questions that remain unanswered. Please feel free to contact me via the contact information in our press release to schedule a call.

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

Claude LeBlanc, Chief Executive Officer
Thank you, Lisa. For those of you joining us on today's call, we hope that you and your families are managing through this unprecedented crisis and keeping safe. We would first like to express our gratitude to all the first responders who have been risking their lives on the front lines, fighting the COVID-19 pandemic. Our thoughts are with those directly impacted by this crisis.

With regards to Ambac, we are currently working remotely to protect the health and wellbeing of all our employees and colleagues. Thanks to the efforts of all our employees, our business continues to operate without interruption. The fast-moving and evolving nature of COVID-19 has created significant economic uncertainty with global and U.S. GDP forecast showing sharp declines. In the U.S., monetary and fiscal policies, particularly the CARES Act, have helped to moderate some of the negative economic impact. However, credit remains a big concern, given the uncertainty as to the severity and duration of COVID-19-related disruptions.

Financial markets and economic volatility resulting from the COVID pandemic have impacted our insured and investment portfolios as reflected in our financial results released yesterday. We reported a net loss of $280 million or $6.07 per diluted share for the first quarter of 2020 and an adjusted loss of $265 million or $5.75 per diluted share. At March 31, 2020, our book value and adjusted book value were $21.88 and $22.11 per share, respectively.

This quarter's results were primarily driven by the steep decline in the forward rate curve, impacting the discount rate on our GAAP reserves, mark-to-market losses on our investment and derivative portfolios as well as losses on our macro hedge. While we increased economic losses in our insured portfolio during the quarter, primarily tied to our municipal finance exposures, this was more than offset by higher expected excess spread recoveries in our MBS portfolios. David will provide a more detailed review of our quarterly results in a few minutes.

While the ultimate economic outcome of the COVID-19 pandemic remains uncertain, we believe that the results to date of our de-risking strategy provide us with a stronger platform to navigate through this challenging period.

Turning now to our insured portfolio. Our risk and surveillance teams have been performing in-depth reviews on credits most exposed to the COVID disruption and the ensuing economic recession. To date, we have not had any COVID-19-related claims and many issuers have funds on hand or alternative means to meet their near-term obligations. As we assess our portfolio and the effects of the pandemic, we're closely monitoring our exposures, and we have moved certain credits to the adverse and classified category and increased economic reserves for others based on our risk assessment. These changes primarily relate to certain U.S. public finance and certain securitizations, including mortgage-backed securities and student loans.

In our public finance portfolio, we consider exposures most immediately impacted by the decrease in economic activity to include certain hotel occupancy tax-backed deals and sitting financings, which are dependent upon narrow revenue or tax streams that have declined precipitously since stay-in-place orders have enacted.

Other sectors we are closely monitoring include transportation, hospitals and private higher education. While it is still too early to assess the full impact of the global pandemic and associated recession, there exists significant protection in the majority of our impacted transactions, which we believe will mitigate ultimate losses even if claims are paid to cover liquidity shortfalls in the near term. We have also been assessing the impact of the significant monetary and fiscal stimulus by the federal government, which has initiated numerous measures, including those beneficial to states and municipalities. While we believe these programs will help soften the impact of liquidity and credit risk to the municipal market, we also believe significant additional actions will be required. In support of municipalities and states, we have been sharing our views with decision-makers in the federal government about ways to alleviate fiscal pressures for municipal entities as Congress, treasury and others in Washington develop and implement programs to aid the public sector in dealing with the consequences of the pandemic.

Turning now to structured finance. A weaker U.S. consumer highlighted by the 33.5 million new jobless claims over the past 7 weeks will likely result in higher delinquencies and potentially incremental losses to our MBS and private student loan exposures. However, lower interest rates have sharply increased the expected excess spread recoverable in our first lien MBS portfolio, offsetting much of the expected impact of the deterioration associated with the COVID-19 pandemic for our consumer asset portfolio. I would like to remind everyone that our MBS and private student loan portfolios are very seasoned and have been reduced by more than 90% since the Great Recession. Moreover, remaining borrowers are in a better position to face this crisis with overall improved equity in their homes and better household balance sheets. Nonetheless, near-term challenges in these sectors are expected, and we are in active dialogue with servicers of these consumer assets, in particular, evaluating the potential impact of recently enacted forbearance and payment monitoring measures.

With regards to our de-risking efforts, activity slowed during the first quarter as a result of the significant market disruption. However, we were still able to execute a number of transactions, including the commutation of the last of our remaining Chicago GO exposures of $170 million.

During the quarter, our total net par outstanding declined from $38 billion to $36 billion. As market conditions improve, we will aim to take advantage of additional opportunities to further de-risk our watch list and adversely classified credits.

Turning now to Puerto Rico. Our thoughts are also with Puerto Rico as it deals with the crisis caused by COVID-19. Having shown great resilience in the face of harsh conditions in the past, we believe that Puerto Rico will do so again. We expect COVID-19 will be sufficiently addressed in due course, and over the medium to longer term, Puerto Rico may be better positioned versus other U.S. economies to take advantage of certain post-pandemic opportunities. This includes a potential for expansion of its domestic pharmaceutical and medical device manufacturing base and the revitalization of its recently redeveloped and expanded tourism industry. We believe the longer-term fundamentals of the island remains strong and will improve over time.

In the meantime, we hope the Oversight Board will choose to stop spending hundreds of millions in taxpayer money on unnecessary legal battles, including challenging the lawful priority and liens of revenue bonds. The effects of certain court decisions during the Puerto Rico bankruptcy have upended municipal markets and created meaningful challenges and uncertainty for municipalities and state issuers.

The Oversight Board is currently advancing legal arguments that, if successful, could have a severe and permanent impact on municipalities and states throughout the country, leading to widespread destruction of value and increased taxes for U.S. taxpayers. Given the significant challenges facing the U.S. municipal market stemming from COVID-19, the Oversight Board and their advisers should immediately refocus their efforts on consensual resolution of the crisis of Puerto Rico, as was expected when the federal government enacted PROMESA.

Ambac remains committed to working with the Oversight Board and the Commonwealth to achieve holistic consensual and durable resolutions for Puerto Rico. Negotiating consensually in good faith with a broad set of Commonwealth creditors is the only way to help Puerto Rico successfully navigate the challenges and opportunities in the months and years ahead and restore access to capital markets. Regarding our loss recovery efforts, given the challenges impacting courts throughout our nation, the timeline of our RMBS litigation has also been extended.

As the New York state courts look to manage through this pandemic, not unlike many other currently scheduled trials, the previously scheduled July 13, 2020, trial date in our case against Countrywide and Bank of America has been vacated. We will seek to reschedule the trial once greater clarity develops about when it can be conducted. In the meantime, we're still waiting for the First Department to determine whether its decision on Countrywide's pretrial motion should be reviewed by the New York Court of Appeals as countrywide requested.

Countrywide has also asked that our judge wait for the Court of Appeals to decide on pending appeals in 2 non-Ambac RMBS-related cases before proceeding with our trial. We have also opposed this request. We continue to believe in the merits and strength of our case and look forward to its resolution at the earliest possible opportunity.

On the new business front, we remain very active in assessing opportunities to deploy capital on new business initiatives in the insurance and credit space, and we believe the market dislocation and global recession may present more opportunities to acquire businesses and make investments at attractive valuations. However, we also recognize that we may face additional challenges in executing new business transactions, given the uncertainty and volatility in the market.

I will now turn the call over to David Trick to discuss our financial results in more detail. David?

David Trick, Chief Financial Officer
Thank you, Claude, and good morning, everyone. As Claude commented, the main contributor to our results for the first quarter of 2020 was the impact of the COVID-19 pandemic on the economy and financial markets. Lower interest rates, higher market risk premiums and the expected financial impact on certain insured transactions were the primary drivers to the first quarter net loss on derivatives, investments in our insured portfolio.

During the first quarter of 2020, Ambac reported a net loss of $280 million or $6.07 per diluted share compared to a net loss of $110 million or $2.40 per diluted share in the fourth quarter of 2019. Adjusted loss for the first quarter was $265 million or $5.75 per diluted share compared to adjusted loss of $88 million or $1.91 per diluted share in the fourth quarter. The principal variance between adjusted and net loss for the first quarter was $13 million of insurance intangible amortization.

Touching on some specifics. Premiums earned were $10 million in the first quarter versus $20 million during the fourth quarter. In addition to continued runoff of the portfolio, the decrease was mainly due to an improvement in the allowance for premium receivable credit losses in the fourth quarter versus an increase in the allowance in the first quarter. Investments, excluding realized gains, produced a net loss for the first quarter of $21 million, down from net income of $42 million in the fourth quarter of 2019. Mark-to-market losses on limited partnership and other pooled investments of $52 million accounted for the first quarter net investment loss.

Despite some de-risking of exposure to these asset classes towards the end of February, significant declines in asset values due to the drastically higher risk premiums associated with the market dislocation that occurred in March related to the COVID-19 pandemic, accounted for the adverse performance in our global portfolio of equity, high-yield credit and asset-backed investments. Subject to future trading decisions we may make, our current view is that the significant majority of these mark-to-market losses are temporary in nature. And to that point, we have already begun to observe a reversal of these losses during April, with a couple of funds experiencing high single-digit returns for the month.

The market dislocation that led to these negative results also provided us the opportunity to deploy some capital in Ambac-insured securities and select other assets at relatively favorable levels late in the first quarter and early second quarter. Income from available-for-sale securities was $31 million in the first quarter versus $34 million in the fourth quarter. The decline being mostly attributable to redemptions of owned LSNI notes and claims and other payments.

Loss and loss expenses incurred were $117 million in the first quarter compared to $97 million in the fourth quarter of 2019. Lower discount rates in the first quarter caused noneconomic incurred losses of approximately $190 million as we present valued our expected loss cash flows using a discount rate on average of 115 basis points lower than the prior quarter. Lower discount rates had the most profound impact on the public finance insured portfolio due to the long-term nature of claims in that sector and relative size of reserves. As a result, incurred public finance losses were $178 million in the first quarter compared to $54 million in the fourth quarter. Incurred public finance losses, excluding the impact of interest rates related to assumption changes on previously reserved transactions and the establishment of new reserves for insured exposures exposed to COVID-19, amounted to $67 million in the first quarter.

The RMBS benefit of $83 million in the first quarter compared to a loss of $40 million in the fourth quarter was due to an increase in expected excess spread recoveries of $130 million, resulting from lower interest rates and higher estimated representation and warranty subrogation recoveries of $36 million resulting from lower discount rates, partially offset by an $83 million negative impact from lower discount rates and higher expected losses due to the decline in economic conditions from the COVID-19 pandemic.

Net loss and loss expenses for our student loans was $14 million, up from $5 million in the fourth quarter of 2019, due to incurred losses driven by changes in assumptions and lower discount rates that were partially offset by additional expected excess spread resulting from lower interest rates. In the aggregate, estimated incurred losses, excluding the impact of any interest and discount rate shifts for the first quarter were approximately $97 million, which primarily reflects the proactive establishment of new and increased reserves related to the impact of COVID-19 on our insured transactions and other assumption changes. These losses were more than offset by additional expected excess spread from RMBS and student loans of $170 million.

Net losses on derivative contracts were $70 million for the first quarter compared to a gain of $12 million for the fourth quarter. The loss in the first quarter was driven by significant declines in forward interest rates, which were more than offset by gains in RMBS excess spread and elsewhere and $30 million of adverse counterparty credit adjustments on interest rate derivative assets. The interest rate derivatives portfolio is positioned as a partial economic hedge against the interest rate exposure in the financial guarantee and investment portfolios.

As forward rates declined, the hedge position was reduced materially during the first quarter. The first quarter counterparty credit adjustment relates to the impact of widening counterparty credit spreads and the downgrade of 1 counterparty against the backdrop of an increase in the associated swap receivable assets.

We perform active credit surveillance on all of our derivative counterparties and do not anticipate any counterparty credit losses, and therefore, we consider any CVA adjustments to be temporary in nature.

Operating expenses for the first quarter of $23.5 million were relatively flat to $23.1 million in the fourth quarter. The modest difference was due to higher compensation and consulting fees, mostly offset by a reversal of U.K. VAT charges, lower legal expenses and lower premises cost. The increase in compensation cost was mostly due to cyclical costs related to incentive compensation, including payroll taxes, whereas the higher consulting fees were due to an accrual reversal that occurred in the fourth quarter of 2019.

Interest expense decreased $3 million in the first quarter to $63 million, resulting from the partial redemption of $149 million of AAC's outstanding secured notes made at year-end and lower interest rates. During the first quarter, we redeemed an additional $77 million of the secured notes, which will contribute to further interest expense reductions in future periods.

Turning to the balance sheet. Shareholders' equity of $1 billion decreased $10.53 per share from December 31, 2019, to $21.88 per share at March 31, 2020, due to the net loss for the quarter, combined with a decline in unrealized gains on securities of $146 million and foreign currency translation losses of $46 million. Reduction in unrealized gains are further reflective of an increase in risk premiums, with the majority of the decrease related to investments in Ambac-insured RMBS and ABS securities.

Adjusted book value decreased to $1.01 billion at March 31, 2020, from $1.31 billion at December 31, 2019. On a per share basis, adjusted book value decreased $6.72 to $22.11 per share at March 31, 2020. This ABV decrease was primarily driven by the adjusted loss for the first quarter and the impact of lower foreign exchange rates on assets held in Ambac UK.

As for AFG, on a stand-alone basis, as of March 31, 2020, AFG had cash, investments and net receivables of approximately $482 million or $10.53 per share.

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

Claude LeBlanc, Chief Executive Officer
Thank you, David. While we are in a period of great volatility and the severity and duration of the pandemic will ultimately determine our success in mitigating any potential losses, we are in a better position today to face these challenges based on our actions taken to date. Our value drivers and fundamentals remain strong, including: One, we have no debt and $482 million of net assets at AFG, our holding company; two, our claims paying resources of $5.2 billion and the timely payment of all our claims in full; three, our consolidated investment portfolio of $3.4 billion in assets with historically strong market performance; four, our gross rep and warranty receivable of approximately $1.8 billion; five, a total of $3.7 billion of NOLs available to shelter future taxable income at both AFG and AAC; and lastly, our significant expertise and resources that we will bring to bear to navigate through this period of uncertainty in order to maximize shareholder value.

I would like to conclude by thanking our shareholders for your ongoing support and our employees for their incredible effort and unwavering commitment to ensure the continued uninterrupted operation of our business.

I would now like to turn the call back to the operator 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.

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

Giuliano Bologna, *BTIG*
Good Morning and thanks for taking my question. I guess starting off, if -- you guys mentioned that there were some opportunities to buy Ambac-wrapped securities in -- at the end of the first quarter. I'd be curious if you still see opportunities out there and if there are also potentially opportunities to buy back some of Ambac's debt at a discount to par?

David Trick, Chief Financial Officer
Hi Giuliano, thanks for the call and the question. So yes, we did have the opportunity to buy some Ambac securities later in the third quarter and in particular, in the first quarter, and in particular, in the

early part of the second quarter. So there are opportunities out there to buy back Ambac secured and other debt as well. There are certain restrictions that we have to operate under based on some of the governing guidelines of those instruments, particularly when it comes to liquidity management. But we did buy some actually Ambac LSNI notes during the quarter at our holding company at a reasonable discount to par and to take advantage of some of the trading opportunities there. But there are other capital and liquidity considerations that we need to manage when looking at opportunities to buy different parts of our capital structure.

Giuliano Bologna, *BTIG*
That makes a lot of sense. And then thinking about the discussion around potentially buying a business or building a business with the holding company capital, I know that you've said that you've looked at many opportunities over the years. I'd be curious if you're seeing some opportunities come up and if there's any shift in the industries and sectors that are kind of the subsectors that you might be looking at given the volatility?

Claude LeBlanc, Chief Executive Officer
Giuliano, I think the answer is yes. There are certainly more opportunities that we are seeing in a broader set of industries. Clearly, there's also a lot of uncertainty in the markets in some of the industries that we are focused on, in insurance and credit as well. So I think while there are more opportunities, there's also more challenges in evaluating the risk associated with certain opportunities. But we have identified and are seeing some that are interesting, and we'll be continuing our active exploration of these opportunities.

Operator
Thank you. This concludes our question and answer session and thus concludes our call today. Thank you ladies and gentlemen for your time and interest today. You may disconnect your lines and have a wonderful day.

#