Operator

Greetings and welcome to the Ambac Financial Group Inc. second quarter 2019 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, 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 second 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 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 obtain 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 supports 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. During the second quarter, we continued to make significant progress on our key strategic priorities, including the active de-risking of our insured portfolio – further reducing our insured net par by approximately $2.3 billion to $42.2 billion, with $1.6 billion of the decline representing Adversely Classified and Watch List Credits.

This represents a further 5.1% decline in our overall insured portfolio for the quarter and 10.1% year to date, following the 25% reduction achieved in 2018. More importantly, Adversely Classified and Watch List credits declined by 8.3% during the quarter, representing a large component of the overall portfolio decline.

The reduction in net par outstanding for the second quarter of 2019 was driven by several key de-risking transactions including the Ballantyne restructuring and commutation which closed on June 18. The successful execution of the Ballantyne restructuring, one of the largest credit exposures of Ambac UK, reduced our Adversely Classified Credit exposure by $900 million and dramatically improved Ambac UK’s regulatory capital position to near required levels.

We continue to actively explore various options to sculpt and de-risk our insured portfolio and reduce potential tail risks which may include large scale commutations, remediations or reinsurance transactions that could, in certain scenarios, negatively impact our Book Value and/or Adjusted Book Value, but that we believe will improve the overall quality of our Book Value as well as accelerate the timing and options to distribute capital from our insurance subsidiaries.

For the quarter ended June 30, 2019, Ambac reported a net loss of $128 million or $2.79 per diluted share and a decrease in Book Value per share of $2.85 to $32.78 from March 31, 2019. Adjusted Earnings were $86 million or $1.88 per diluted share for the second quarter of 2019, resulting in an increase in Adjusted Book Value per share of $2.05 to $29.57 at June 30, 2019.

The key difference between the negative GAAP results and favorable non-GAAP results during the quarter was primarily driven by the acceleration of an insurance intangible asset related to the Ballantyne transaction. David will provide us with more details when he reviews the financial results for the quarter.

In another major development, we were pleased to finally receive a decision on the allocation of funds to Ambac in connection with the SEC-Citigroup settlement. Yesterday, a federal court in New York approved the distribution plan allocating approximately $142 million of the settlement proceeds to Ambac Assurance. The amount allocated to Ambac is within the range of our expectations but was not accrued for previously and is not reflected in our second quarter results. However, we expect that the proceeds will be received and recorded in the third quarter.

Turning now to Puerto Rico, the island continues to show significant economic improvement and revenue outperformance, despite the relatively poor governance and elevated political risk. This week, the Puerto Rico Treasury announced that the Commonwealth’s general fund revenue for Fiscal Year 2019 increased by 22%, or $2 billion, over Fiscal Year 2018 levels, and exceeded the latest revenue projections of the PROMESA oversight board by approximately $670 million.

This significant year-over-year improvement in tax revenues was due to increased business and consumer activity as well as the growing momentum of the economic recovery aided by hurricane disaster related payments from private insurance and federal aid. These and other metrics underscore the Commonwealth’s improving financial strength and debt servicing capacity, which unfortunately has not been properly reflected in the Commonwealth’s Fiscal Plan certified by the Oversight Board.

As we have stated numerous times, The Oversight Board needs to act responsibly and ethically to revise the Fiscal Plan to reflect the actual performance and realistic expectations in order to facilitate acceptable and consensual debt restructuring deals and end the costly and increasingly destructive effects of a long-term bankruptcy on the people of Puerto Rico.

In addition, the Oversight Board needs to make progress on structural and legislative reforms that would meaningfully strengthen Puerto Rico’s institutional framework, improve policy effectiveness and enhance the government's policy implementation capacity. The governance challenges and pervasive corruption exposed by recent events is not surprising. Ambac hopes that the current political turmoil in Puerto Rico and any impact on the local economy is short-lived; that there is increased cooperation between the local government and the Oversight Board in addressing public policy and government reform issues; and that the next Governor has a renewed focus on long-term economic development and re-establishing credibility with the federal government and the capital markets alike.

Switching now to our loss recovery efforts, we are awaiting the appellate court’s decision on oral arguments heard on May 2, in our main RMBS litigation case against Countrywide and Bank of America. Once a decision is announced, we hope to progress towards the confirmation of a trial date, preparation for which is well underway.

With regards to new business initiatives, we continue to actively evaluate various strategic options that we believe will optimize our business model, diversify our platform and drive long-term shareholder value.

As we have previously stated, any decision on new business will be always measured against the return of capital to our shareholders.

In closing, we continue to actively progress our strategic priorities in 2019 and I remain optimistic about our ability to continue to generate material long-term value for our shareholders.

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 second quarter of 2019, Ambac incurred a net loss $128 million or $2.79 per diluted share, compared to a net loss of $43.2 million or $0.94 per diluted share in the first quarter of 2019.

As Claude discussed, the main driver of second quarter results was the execution of the Ballantyne restructuring and commutation, which resulted in a GAAP net loss of $83 million. The loss was a result of accelerated amortization of the insurance intangible asset.

In addition to the impact of Ballantyne, second quarter results were impacted by net positive development in loss and loss expenses and a higher net loss on derivative contracts compared to the first quarter of 2019.

Adjusted Earnings for the second quarter were $86 million, or $1.88 per diluted share compared to an Adjusted Loss of $9 million, or $0.20 per diluted share in the first quarter. Adjusted earnings were driven by a $119 million gain from the Ballantyne commutation; the primary difference between Adjusted Earnings from GAAP earnings being the exclusion of the insurance intangible asset amortization expense.

Notable items for the second quarter include, premiums earned of $8 million versus $28 million during the first quarter. While normal earned premiums only decreased by about $2 million to $14 million, due to the continued reduction of the insured portfolio, accelerated premiums declined $18 million from the first quarter. The swing in accelerated premium was mostly a result of $6 million of negative accelerated premiums realized in the second quarter, driven by the Ballantyne commutation, compared to $12 million of positive accelerated premium realized in the first quarter, mostly related to the COFINA transaction.

Investment income for the second quarter was $86 million, a $32 million increase from $55 million for the first quarter of 2019.

The increase in net investment income for the second quarter was due to accelerated discount on approximately $153 million fair value of Ballantyne bonds held in the investment portfolio.

Net realized investment gains were $36 million for the second quarter. The principal source of these gains was foreign exchange gains related to the Ballantyne restructuring and gains from sales of new COFINA bonds.

Proceeds from the sale of new COFINA bonds at AAC and other cash have and continue to be redeployed into a range of other investments which are designed to create greater diversity in the portfolio and generate attractive returns to defease our insurance and other obligations.

Loss and loss expenses incurred were a benefit of $133 million in the second quarter, compared to an expense of $12 million in the first quarter. The improvement was mostly due to favorable development within Ambac UK and RMBS, partially offset by an increase in Public Finance reserves.

Public Finance loss and loss expenses in the second quarter were $50 million, driven mostly by lower discount rates resulting from the drop in long-term interest rates.

Ambac UK and other credits experienced an incurred benefit of $111 million during the second quarter primarily as a result of the Ballantyne commutation.

RMBS and student loans, combined, produced an incurred benefit of $73 million driven by the impact of lower interest rates on excess spread and a $19 million recovery from the settlement of an Article 77 RMBS proceeding that we had not previously accrued for.

Net losses on derivative contracts were $35 million for the second quarter compared to $16 million for the first quarter, attributable in both periods to declines in forward interest rates.

Interest rate derivative losses in the second quarter were more than offset by approximately $96 million of gains recognized in the insured and investment portfolios driven by forward interest rate movements.

Turning to expenses, second quarter operating expenses were $29 million, an increase of $4 million from the first quarter.

The main driver of the increase was higher performance-based deferred compensation payable primarily to Ambac UK employees, triggered by the close of the Ballantyne commutation.

Non-compensation expenses were $11.6 million for the second quarter, up $1.3 million from $10.3 million in the first quarter driven by consulting and legal fees.

While expenses increased this quarter, the increase was mostly a function of our successes related to the de-risking of the insured portfolio which created significant value for stakeholders. That said, we remain focused on reducing our core operating expenses and note a few key successes this quarter towards this objective including:

- changes to our RMBS analytics platform which, beginning in the second quarter, will reduce annual expenses by $1 million;
- scheduled personnel and consultant reductions, beginning in the fourth quarter, related to the Ballantyne commutation and general risk reduction at Ambac UK, which will reduce annual operating expenses by over $1.2 million once fully implemented

This aside we do expect volatility quarter to quarter for expenses given the nature of our operations.

Insurance intangible amortization for the second quarter of 2019 increased $190 million to $226 million from $36 million in the first quarter of 2019. As noted earlier, this increase was due to the accelerated amortization recognized as a result of the Ballantyne commutation.

The provision for income taxes in the second quarter was $28 million, $26 million higher than the provision for the first quarter of 2019. The second quarter tax expense was related primarily to foreign income taxes on the gains from the Ballantyne commutation.

Turning now to the balance sheet, shareholder's equity decreased $2.85 per share from March 31, 2019 to $32.78 per share at June 30, 2019, due mostly to the net loss for the quarter.

Adjusted Book Value increased to $1.35 billion at June 30, 2019 from $1.25 billion at March 31, 2019 primarily driven by second quarter adjusted earnings. Adjusted Book Value on a per share basis increased by $2.05 to $29.57 per share at June 30, 2019.

On a stand-alone basis, as of June 30, 2019, AFG held cash, investments and receivables of approximately $469 million or $10.30 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 proud of our achievements for the second quarter. Our progress this quarter reflects our ongoing commitment to execute on strategies that we believe will deliver long-term value to our shareholders. Thank you again for joining us today. I will now turn the call back to the operator and open the line 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 * keys.

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

Giuliano Bologna, BTIG
Good morning. I was just trying to think about the Citi-CDO proceeds. Now that you have approval or that you expect to receive about a $142 million in the third quarter, do you have any goals related to the deployment of that capital? Would you deploy it for loss mitigation or essentially to buy down some of your outstanding debt?

Claude LeBlanc, Chief Executive Officer
Hi, good morning, Giuliano, that's a good question. It's something we're still evaluating from a capital allocation perspective. But we have a couple different uses that we're evaluating and expect to make a decision in a near-term but unfortunately, I don't have an answer for you this morning.

Giuliano Bologna, BTIG
That makes sense. Then I guess I'll follow-up on another similar question, now that you also have the Ballantyne transaction done, are there any opportunities for either new business or capital releases from Ambac UK?

David Trick, Chief Financial Officer
Yes Giuliano, so we're getting closer on the Solvency II capital position as we disclosed, the hole from a Solvency II standpoint is down to about a £133 million, that's about a £130 million improvement over first quarter, so we expect that will continue to improve over the next few quarters and hope to reach the solvency to thresholds in the next couple of years. We'll have to have discussions with the PRA because much of course of what happens in the UK, particularly from a capital release standpoint, is subject to regulatory approval. We'll have to have

discussions, engage with them about the path forward from there in terms of capital releases, but nonetheless we're optimistic that we'll be in a position to meet our solvency requirements in the next couple of years and as we de-risk the book and continue to produce positive earnings there in the UK we'll get there sooner rather than later.

In the new business front, again, that's in the UK, it is something that we are evaluating in terms of how to use what is a very talented staff in the UK well, albeit a relatively small staff. That's a process that's under evaluation and we're considering the opportunities for things that they can do primarily in a capital lite type of business approach. We'll have more to talk about that in the future if that's appropriate.

Giuliano Bologna, BTIG
That sounds very good. The only one follow-up on related to the comments you made about some of the expense savings, obviously the RMBS platform and the personnel that you brought up, are there any one-time costs associated with completing those cost savings initiatives?

David Trick, Chief Financial Officer
There is and will be some severance expenses we did have additional severance expenses at the margin in the second quarter. There'll be potentially additional marginal severance expenses in future periods but nothing too material.

Giuliano Bologna, BTIG
That's great. Thank you for taking my questions.

David Trick, Chief Financial Officer
Sure, thank you.

Operator
Thank you. Ladies and gentlemen, as a reminder if you'd like to join the question que, please press *1 at this time. We'll pause a moment to allow for any other questions.

Operator
Ladies and gentlemen, there are no further questions at this time. This concludes today's conference. We thank you for your participation. You may now disconnect your lines. Thank you once again.