OPERATOR
Good morning. My name is Krista and I will be your conference facilitator today. At this time, I would like to welcome everyone to the Ambac Financial Group, Inc. first quarter 2017 earnings teleconference.

Our host for today's call are Lisa Kampf, Head of Investor Relations; Claude LeBlanc, Chief Executive Officer; and David Trick, Chief Financial Officer.

Today's call is being recorded and will be available for replay beginning at 11:30 AM Eastern Standard Time. The dial-in number is 1-800-585-8367 domestic or 416-621-4642 internationally, using ID number 17187813.

At this time, all participants have been placed in a listen-only mode and the floor will be open for your questions following the presentation.

If you would like to ask a question at that time, please press *1 from your touchtone phone. If at any point your question has been answered, you may remove yourself from the queue by pressing the pound key. If you should require operator assistance, please press *0. We ask that you please pick up your handset to allow optimal sound quality.

It is now my pleasure to turn the floor over to Ms. Lisa Kampf.

Lisa Kampf, Head of Investor Relations
Good morning and thank you all for joining today's conference call to discuss Ambac Financial Group's first quarter financial results.

We'd like to remind you that today's presentation may contain forward-looking statements, which are based on management's current expectations and are subject to uncertainty and changes in circumstances. Any forward-looking statements are not guarantees of future performance 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 reports under Management's Discussion and Analysis of Financial Condition and Results of Operations, and under Risk Factors.

Ambac is not under any obligation and expressly disclaims any obligation to update any forward-looking statement, whether as a result of new information, future events or otherwise.

Today's presentation contains non-GAAP financial measures. The reconciliations of such measures to the most comparable GAAP figures are included in our earnings press release, which is available on our website at Ambac.com.

Please note we have posted slides on our website to accompany this call. I would 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. I'm pleased to report we've accomplished a lot over the past few months as we continue to successfully execute on our strategic priorities. During the quarter, we made considerable progress and achieved key milestones as we strive to improve our risk profile and financial stability.

We were aggressive in accomplishing risk remediations, bond purchases, realizing litigation settlements and developing our long-term strategic vision.

During the quarter, our financial results were significantly impacted by the deteriorating situation in Puerto Rico.

Yesterday, after the market closed, we reported a net loss for the first quarter of $125.4 million, or a loss of $2.77 per diluted share, and an adjusted loss of $91.2 million or $2.01 per diluted share reflecting continued material adverse development in our municipal finance exposures.

While we are disappointed with our bottom line performance in the quarter, I am encouraged by the successes achieved by our team. Included in these accomplishments, we were very active during the quarter to reduce our risk exposures.

Our insured portfolio decreased by 6% to $75 billion as of March 31, down from $79 billion at December 31st and our Adversely Classified Credits down 7.6% to $15.8 billion from $17 billion at year end. The reduction in Adversely Classified Credits resulted from RMBS runoff and remediation initiatives. In addition, we upgraded certain public finance and international exposures in part due to remediation actions we took to improve the credit profile of certain credits.

During the quarter we also purchased over $200 million of distressed Ambac insured securities and acquired $114 million par of surplus notes. We now own just over 12% of our PRIFA, and 16% of our COFINA-insured bonds.

Turning now to litigation, we had a very active quarter and recognized a number of key achievements. During the quarter, we announced a settlement of our Ballantyne lawsuit generating a gross benefit of $91.6 million, initiated new litigation by filing two lawsuits against an RMBS trustee, and filed four suits related to Puerto Rico. We also reached an agreement in principle to settle litigation brought against us in 2008 by certain California municipal bond issuers.

Our main rep and warranty litigations were relatively quiet during the quarter while we continue to wait to hear from the courts on the appeals that were argued at the beginning of the year. Our litigation efforts remained a key value driver for Ambac moving forward, and we plan to continue to aggressively pursue remedies to protect our rights and mitigate losses.

Turning now to Puerto Rico. As you read in our earnings release, the key driver of our first quarter results was an increase in public finance reserves. This increase was influenced heavily by the developing situation in the Commonwealth. During the quarter, a number of events occurred, the most significant of which was a certification of the Commonwealth's fiscal plan, which implies an opportunistic and unrealistic 77% haircut to debt service, doesn't respect lawful priorities and liens up for debt, and fails to live up to the standards required under PROMESA.

Following the close of the quarter, additional events occurred including: first, the passage of the Fiscal Plan compliance law which opens the door for the Commonwealth to opportunistically reroute sales and use tax revenue to the general fund instead of to the COFINA structure; the public release of restructuring proposals which seek to maximize recoveries for certain chosen creditors; and finally, the Title III filing of the Commonwealth Puerto Rico and COFINA by the Oversight Board.

Clearly, we are very disappointed with the developments in Puerto Rico, which we believe reflect a breakdown of process. Ambac and other creditors expected a Fiscal Plan with a laser focus on cutting expenses and promoting growth, while respecting creditors' rights and priorities at each of the instrumentalities of the Commonwealth.

Additionally, we expected the Fiscal Plan to prioritize a holistic restructuring of all Commonwealth debt including PRIFA, HTA and CCDA through a combination of negotiated debt deferrals and modifications to allow the Commonwealth to grow its way into debt sustainability. In this way, the Fiscal Plan will provide a credible path forward for Puerto Rico and renewed access to the capital markets. Unfortunately, the Fiscal Plan fails on all fronts.

Additionally and contrary to expectations, the Oversight Board and its advisors have shown no willingness to engage in broad consensual negotiations. There was limited engagement with GO and COFINA creditors and negotiations did not yield any progress. There have been no talks relating to, or a complete lack of engagement on, PRIFA, HTA and CCDA debt by the Commonwealth and the Oversight Board. Additionally, the Oversight Board has publicly stated that the assumptions behind the certified fiscal plan will not be revised. This despite the fact that the fiscal plan and its compliance with PROMESA has been publicly criticized, not only by creditors, but also by senators, including Thom Tillis and Tom Cotton.

The oversight board has derailed the debt restructuring process and certified a fiscal plan based on unrealistic and overly pessimistic assumptions. The result has been stalled negotiations and on-island strikes and protests. Moreover, the Commonwealth has put a legislation that violates laws and contracts in order to comply with a certified fiscal plan, prompting legal challenges from creditors, including Ambac.

It appears the oversight board and the Commonwealth have adopted a once-and-done strategy, premised entirely on cost cutting debt to a level well below that of any U.S. state or any country that has undergone an IMF restructuring.

Against this backdrop, we continue to assess all other options, refine our strategy and evaluate our Commonwealth exposures. We have been in conversations with various stakeholders to develop constructive proposals, as well as discuss solutions, based on fiscal reform, economic growth and creating an atmosphere that can attract private capital.

In summary, we are focused on arriving at a fair, holistic restructuring of the Commonwealth's debt. We believe this is possible, if: one, the oversight board significantly revises the fiscal plan to include more reasonable assumptions and to respect creditors' rights; two, any restructuring incorporate short-term deferrals and doesn't rely on outsized investor losses to subsidize the Commonwealth's budget; three, the recommendations of the Bipartisan Congressional Task Force on economic growth in Puerto Rico are adopted and implemented to provide the Commonwealth with appropriate support from the federal government; and four, the Commonwealth and the oversight board, and U.S. Congress recognize that the precedent that Puerto Rico sets with its debt restructuring now could materially and adversely impact municipal debt markets in the future. Puerto Rico was the biggest municipal bankruptcy in U.S. history, and its ramifications could be far reaching.

We believe restructuring proposals based on these four principles are critical. They are necessary to stabilize the Commonwealth's financial profile, reopen capital markets and establish an environment to support long-term economic prosperity for the citizens of Puerto Rico. We look forward to engaging with parties to identify and achieve a better path forward for all stakeholders.

While the situation in Puerto Rico will remain a key focus for us, it has not and will not distract from our continuing focus across all our priorities going forward. During the quarter, we actively engaged with the Rehabilitator and creditors in progressing a plan for the Segregated Account to exit rehabilitation and were pleased to receive, on April 10th, our regulator's expressed support to continue progressing our plan over a sixty-day period.

We can provide no assurance that a deal will be reached with creditors within the OCI's timeframe or if it is, whether the deal will be acceptable to the OCI or the court. If we do not develop a consensual plan acceptable to the Rehabilitator within its timeframe, the Rehabilitator may pursue a plan that he believes will provide for a durable exit and that is protective of policyholders. We do not know what that plan may be. However, as we have previously indicated in our risk factors, any changes to the Segregated Account Rehabilitation Plan could have an adverse effect on the interests of holders or a subset of holders of securities issued or insured by Ambac for the Segregated Account.

To advance our efforts, to improve the company's financial position and potentially allow for an exit from rehab, we took several key steps during the quarter, some that I've already mentioned including advancing certain de-risking initiatives, refining aspects of the plan, and engaging with creditors and their advisors.

In response to feedback from shareholders, we've also made significant changes to our compensation practices and revised our short-term incentive compensation program for our executive officers in 2017.

A structured and more objective approach was designed to determine bonus award payouts based on performance metrics.

In addition, beginning with 2016, a percentage of compensation became payable in equity. Certain additional policies were also adopted such as claw backs and holding requirements. These plans are detailed in our proxy. It is the board's view that as the company looks to move past the rehabilitation of the Segregated Account and works to develop a new long-term strategy, it is particularly important that management compensation be focused on and aligned with creating long-term value for shareholders.

During the quarter we were also active in commencing initiatives towards evaluating and establishing a business strategy for Ambac as well as making future operational improvements. We believe Ambac is well positioned to capitalize on a broad range of strategic options to create long-term shareholder value. We look forward to sharing more details of our plan with you later this year.

I'll now turn the call over to David Trick to walk you through our first quarter results. David?

David Trick, Chief Financial Officer

Thank you, Claude, and good morning. During the first quarter of 2017, Ambac produced a net loss of $125.4 million or $2.77 per diluted share compared to a net loss of $94.7 million or $2.09 per diluted share for the fourth quarter of 2016. Adjusted loss in the first quarter was $91.2 million or $2.01 per diluted share compared to an adjusted loss of $12.7 million or $0.28 per diluted share in the fourth quarter. The results were impacted by: adverse development in our public finance insured portfolio related mostly to Puerto Rico, and relative to fourth quarter 2016, lower investment income and interest rate derivatives revenue and higher foreign income taxes. These results were partially offset by a benefit from settling the Ballantyne litigation and lower operating expenses.

Turning now to some more specifics, premiums earned were $47.6 million during the first quarter versus $49.9 million during the fourth quarter. Normal earned premium decreased during the quarter to $31.3 million from $35.7 million, or 12 percent, primarily due to the continued runoff of the insured portfolio and as a result of a lower benefit recognized for the change in uncollectable future structured finance premiums relative to the fourth quarter. Accelerated premium, on the other hand, increased by approximately $2.1 million to $16.3 million during the first quarter.

While at approximately $3 billion, the level of public finance call activity was similar in both the fourth and first quarters, a change in the mix of insured transactions called, positively impacted accelerated premiums. As net par continued to decline, we ended the quarter with a total claims paying ratio of 13:1 compared to 14:1 at the end of December 31, 2016.

Net investment income for the first quarter of 2017 and the fourth quarter of 2016 was $81.6 million and $90.9 million respectively. Net investment income for the first quarter of 2017 declined due to cash flow volatility associated with Ambac's investments in insured RMBS, and lower mark-to-market gains in the trading portfolio, primarily related to investments at Ambac UK. Mark-to-market gains on invested assets classified as trading was $7.2 million in the first quarter of 2017, compared to $10.5 million in the fourth quarter of 2016.

During the first quarter, we acquired $200.2 million of the distressed Ambac insured securities, including $71.4 million of insured RMBS and $128.8 million of other securities including Puerto Rico-insured bonds. Our investment in deferred amounts, including interest thereon, totaled $1.5 billion or 41% of the total amount outstanding as of March 31, 2017. Losses incurred were $135 million for the first quarter, down from $215.5 million for the fourth quarter.

The first quarter incurred loss was primarily driven by a gross loss development in Puerto Rico, partially offset by the benefit realized from the Ballantyne litigation. This compares to the fourth quarter, which was driven by the impact of higher interest rates and adverse developments in Puerto Rico.

More specifically RMBS incurred losses were $34.9 million in the first quarter, including $43.6 million from interest expense on deferred amounts. During the quarter, the RMBS portfolio benefited from our continued remediation efforts, one of which yielded a benefit of approximately $15 million, improvements in credit performance and a relatively muted interest rate environment compared to the fourth quarter of 2016.

These results were partially offset by a $14 million reduction to our estimate of representation and warranty recoveries stemming from improved credit performance from the associated deals, and higher loss expenses incurred of approximately $6 million. The fourth quarter was negatively impacted by excess spread compression resulting from higher interest rates.

Public finance incurred losses were $169.4 million, due mostly to Puerto Rico, similar to last quarter, the increase in Puerto Rico reserves was in line with our developing views of the situation, as Claude spoke about earlier.

Ambac UK incurred losses were a benefit of $73.8 million, resulting from the impact of the confidential settlement of litigation brought in the name of Ballantyne Re against J.P. Morgan Investment Management. The benefit realized from the settlement was nearly $92 million, but was partially offset by $18 million of losses associated with changes in other assumptions. The net benefits from the settlement resulted from the reduction of loss and loss expenses previously established in relation to Ballantyne and not from a direct cash payment to Ambac UK.

Net losses reported in interest rate derivatives for the first quarter of 2017 were $1.5 million, compared to $84 million of gains in the fourth quarter of 2016. The net loss for the first quarter included an Ambac CVA loss of approximately $2 million. The decline in interest rate derivative revenues had a significant impact on our first quarter results relative to the fourth quarter.

During the fourth quarter, rising interest rates had a meaningfully negative impact on our RMBS and student loan insured portfolios, which adversely impacted incurred losses. By design, these losses were partially offset by our interest rate derivative position.

In contrast, during the first quarter of 2017, our incurred losses were impacted more by credit developments in Puerto Rico, and not due to the interest rate sensitivity of the insured portfolio. First quarter operating expenses decreased by $8.2 million from the fourth quarter to $28 million. During the first quarter, we incurred a $1.5 million litigation charge versus a $10 million charge in the fourth quarter. The $8.5 million reduction in litigation charges accounted for the sequential decline in expenses. Other expenses incurred in the fourth quarter of 2016, including a $3.5 million – including $3.5 million of net cost related to the CEO change did not reoccur this quarter, but were supplanted by incremental costs associated with our efforts to exit the Segregated Account from rehabilitation and cyclical compensation and other expenses. No further litigation charges are anticipated, thanks to the fact that we have reached an agreement in principal to settle litigation brought by a number of California municipal bond issuers subject to receipt of all necessary plaintiff and other approvals.

As we noted last quarter, we remain focused on reducing our core operating expenses, but also anticipate that we will experience volatility quarter-to-quarter associated with a normal course operations and various initiatives, including those related to the Segregated Account in our ongoing efforts towards a successful exit from rehabilitation.

With regards to taxes, the first quarter provision was $19.6 million compared to $8.8 million for the prior quarter. The first quarter included $19.3 million in foreign taxes, mostly associated with the impact of the Ballantyne litigation on AMBAC UK.

With regards to tolling payments, AAC is expected to make its 2016 payment of $28.7 million to AFG in the near-term. Upon payment AFG will have cash and investments of approximately $376 million, or over $8 per share.

Stockholders' equity at March 31, 2017 was $1.6 billion, or $35.92 per share, down $89.1 million from December 31, 2016, due to the total comprehensive loss of $89.2 million. Comprehensive losses were lower than our net loss primarily due to an increase in unrealized gains in the investment portfolio and the translation impact of foreign currency rates on our investment in Ambac UK. Adjusted book value was down $106.5 million to $1.2 billion, or $27.09 per share at March 31, 2017.

The main contributor to the decline in adjusted book value was the first quarter adjusted loss and the reversal of earned premiums already included in adjusted book value, partially offset by a benefit to UPR from favorable loss development on certain public finance credits.

That concludes my formal remarks. I will now turn the call back to Claude for some brief closing remarks, after which we will open the line for questions.

Claude LeBlanc, Chief Executive Officer
Thanks, David. I want to emphasize that the board, executive management and all employees at Ambac are committed to and working diligently towards generating long-term value for shareholders. In order to do so, we are focusing on executing on our strategic objectives as outlined and delivering results. I look forward to updating you on our progress next quarter. We will now open it up for questions.

Q&A

Operator

The floor is now open for questions. At this time if you have a question or comment please press *1 on your touchtone phone. If at any point your question is answered you may remove yourself from the queue by pressing the pound key. Again we do ask that while you pose your question that you pick up your handset to provide optimal sound quality.

Thank you. Our first question comes from Andrew Gadlin with Odeon Capital Group. Your line is now open.

Andrew E. Gadlin, Odeon Capital Group

Thank you. I want to know if you could provide some color on, the timeline for negotiations with creditors, and completing an exit. There was a 60-day, deadline imposed from regulator, what do you think the odds are that if a deal doesn't come together by then the regulator steps in at that time or is it likely that the regulator takes quite some time to develop plan of, of his own?

Claude LeBlanc, Chief Executive Officer

Thanks, Andrew. Well I think the regulator has been fairly consistent and clear with us. I think they, at year-end indicated they would provide feedback to the market and to Ambac, by the end of the first quarter, which they did, in and around that timeframe. And I believe that the assessment of the 60-day period, was formulated with an understanding of the company's plan in mind and I think their expectations and certainty around the date would suggest that there is a hard stop at 60 days and they've expressed clear objectives to see us progress our plan and we remain in active dialog with the regulator. I would assume that if we're not making progress that that timeline could be shorter, but I believe that at this point they will provide us a 60-day timeframe to evaluate options and to present a consensual plan to the regulator for their consideration and support.

Andrew E. Gadlin, Odeon Capital Group

And how long do you think it would take to effectuate a deal once it's been reached?

Claude LeBlanc, Chief Executive Officer

That's a great question. I think the plan that we have outlined in our discussions and with a regulator on, we believe with core proceedings and other aspects involved in that transaction, it could – it's likely something that would, if successful will close in the latter part of the year possibly late third quarter, maybe early fourth quarter.

Andrew E. Gadlin, Odeon Capital Group

Okay. Thanks. And then, I was wondering if you could talk a little bit about the decision to purchase a considerable amount of surplus notes at the holding company and swap out of DPOs and into surplus notes in that plan. It's now almost $200 million of surplus notes following the additional purchases in April out of the $300-odd million of liquidity at the holding company, so could you talk about that strategic decision?

Claude LeBlanc, Chief Executive Officer
Sure. I am not sure I characterize it completely strategic, but we did exit certain AAC DPO positions. We still maintain some at AFG and as you pointed out, we did purchase and replace that with more general account surplus notes. We also purchased a sizable interest in our senior Segregated Account surplus notes, which also I think – that component makes up more than half the increase. And I would say part of the decision was made based on relative value and capital allocation decisions and the other part as it relates to the senior Segregated Account surplus notes, we believe, we now control 100% at AFG of those notes or hold 100% of the outstanding, Segregated Account surplus notes and we also believe that those notes have strategic value to us given they have certain consents under plan amendments as well as the bank settlement agreement, which could be valuable to us in the future.

Andrew E. Gadlin, Odeon Capital Group
Got it. Okay. Thank you very much.

Claude LeBlanc, Chief Executive Officer
Thanks, Andrew.

Operator
Once again if you do have a question you may press *1 on your touchtone phone at this time. Your next question comes from the line of Mark Doyle with Sterling Grace. Your line is now open.

Mark Doyle, Sterling Grace
Hey, guys. Good morning. I have a question concerning the clawback credits in Puerto Rico, and whether or not in your opinion, there is room to negotiate or whether or not those clawback credits are going to continue to be clawed back, despite the fact that it would seem that that money is being used to make appropriations rather than to pay the general obligation debt.

Claude LeBlanc, Chief Executive Officer
Yeah. I think – thank you for the question. First of all, I – and I know that the nomenclature has been used as clawback debt, but we actually define those as revenue bonds. There are in the case of certain of the revenue bonds, as you noted certain very narrow prescribed manners in which there could be periodic clawback of funds specifically for the purpose of payments on GOs where payments are not being made on GOs. And I think the way that it's been presented by the OB and the Commonwealth is more of a disregard for the structure of these bonds and really suggesting almost a perpetual clawback right, which does not exist nor does it exist for a broader set of purposes other than again the narrow definitions and it varies by revenue bond. And there are also very strict repayment requirements and priorities in the following year that there was a clawback that has also not been recognized by the OB or the Commonwealth. So, I think we obviously have a significant concerns in that what has been presented doesn't appear to respect lawful priorities and liens for debt, and we also believe it to be unconstitutional, so for a variety of reasons, I think our position on this is very different than what has been expressed by the Commonwealth at least by a way of its fiscal plan and narrative shared with us.

So it is something that we're very interested in engaging with the Commonwealth, as I mentioned earlier, there has been a little or no discussion or mediation vis-à-vis a number of these revenue bonds which further concerns us, given we do view them as significant and important exposures and instrumentalities in Puerto Rico. And for those reasons as we've initiated and as other creditors have initiated significant litigation we think will form part of the process in getting to resolve, as I also indicated we're also – we also maintain a very open position to engaging in active negotiations around these revenue bonds. But I think for now, we don't have a specific timeline, but we are very focused on finding a reasonable and acceptable solution around the revenue bonds. But a lot of this as we mentioned earlier, has to come back with a revised fiscal plan and understanding, and respect of law priorities, lawful priorities and liens for debt. So, again we're hopeful that with the new Title III in process and Judge Swain leading the process, we remain optimistic that there'll be a clear process towards that resolution and we look forward to engage in discussions.

Mark Doyle, Sterling Grace
A follow-up question. Thank you for the answer. In the past, you guys have mentioned with regard to the substantial net operating loss carryforwards that you have, that you're looking for a business that would throw off some cash in order to use those NOLs. And in the past couple of years, where after you first mentioned it, we haven't seen any movement on that front – has the company's attitude towards that changed or you still looking to acquire another business or create a new business to use the NOLs?

Claude LeBlanc, Chief Executive Officer
Great question. And I think as we know the last quarter and again this quarter, we have undertaken and as of today, we have initiated the review of our strategic options, as I mentioned earlier and the purpose of that is really focused on exploring new businesses, that would provide long-term sustainable value for shareholders and as part of that equation, obviously we also consider the tax attributes that we have at both the holding company and AAC. But we are focused on developing a plan and we look forward to updating shareholders likely sometime in the third quarter.

Mark Doyle, Sterling Grace
Thank you.

Claude LeBlanc, Chief Executive Officer
It is still our plan and again we look forward to taking more about it at our next set call.

Mark Doyle, Sterling Grace
Thanks, Claude.

Operator
And this does conclude today's conference call. Please disconnect your lines at this time. And have a wonderful day.