Ambac Financial Group, Inc.
Fourth Quarter 2016 Earnings Call Transcript
March 1, 2017

OPERATOR
Good morning. My name is Kristen, and I will be your conference facilitator today. At this time, I would like to welcome everyone to the Ambac Financial Group, Inc. fourth quarter 2016 earnings teleconference. Our hosts for today's call are David Weissman, interim 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 10:30 eastern time today. The dial in number is 404-537-3406 and enter PIN number 71080269. 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. [Operator Instructions]

It is now my pleasure to turn the floor over to Mr. David Weissman.

DAVID WEISSMAN, Managing Director, Interim 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 financial results.

We'd like to remind you that today's presentation may contain forward-looking statements, which are based on management's current expectations and are subject to uncertainty and changes in circumstances. Any forward looking statements are not guarantees of future performance of events. Actual performance and events may differ, possibly materially, from such forward-looking statements.

Factors that could cause this include the factors described in our most recent SEC-filed quarterly or annual reports under Management's Discussion and Analysis of Financial Condition and Results of Operation and under Risk Factors. Ambac is not under any obligation and expressly disclaims any obligation to update any forward looking statement whether as a result of new information, future events or otherwise.

Today's presentation contains non-GAAP financial measures. The reconciliations of such measures to the most comparable GAAP figures are included in our earnings press release, which is available on our website at ambac.com. Please note we have posted slides on our website to accompany this call.

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

CLAUDE LEBLANC, Chief Executive Officer
Thank you David and welcome to everyone joining today's call. I'm excited to be here as Ambac's new CEO and I look forward to meeting many of you over the coming months. I have been here for 8 weeks now, and I would like to acknowledge a positive impression of the progress made by management and the board in getting the company to where it is today.

Given my background of financial guarantee, risk management, insurance, strategy, and corporate development, I found the opportunity to serve as Ambac's CEO both compelling and familiar. My expectation coming to Ambac was that I would be met with complex challenges and opportunities and I have not been disappointed. That said, I believe, under the strong leadership of the senior management team and the Board, and as a result of the dedication and hard work of all employees, Ambac is well positioned to meet its challenges and seize upon its opportunities to continue creating substantial value for shareholders.

Despite a challenging fourth quarter, 2016 was a successful year for AMBAC.

For the year, we reported net income of $75 million, or $1.64 per diluted share, and Adjusted Earnings of $315 million, or $6.89 per diluted share.

We recorded year-over-year increases in book value, reaching $1.7 billion, or $37.94 per share, and Adjusted Book Value, which was $1.3 billion, or $29.48 per share. Since emergence from bankruptcy, we've now generated $1.6 billion of net income, and $2.6 billion of adjusted earnings

Tolling payments to AFG continue to be a key value-driver for shareholders, and in 2016 AFG received $71.5 million as we continue to leverage our Net Operating Loss carry-forwards. As a result of our strong income generation throughout 2016, AFG is expecting to receive an additional $28.7 million in tolling payments in May of this year in accordance with the terms of the company's tax-sharing agreement.

Early in the year, we negotiated a $995 million cash settlement with JP Morgan as part of our RMBS litigation. We believe that our litigation efforts will remain a key value-driver for Ambac moving forward, with several high profile cases currently in progress.

We opportunistically purchased $659 million of Ambac-insured securities during the year. As of December 31, 2016, we owned $1.5 billion of Deferred Amounts (including interest) which represented approximately 41% of the total Deferred Amounts outstanding.

In our continued efforts to reduce risk in our portfolio, we decreased our insured portfolio by 27%, from $108 billion to $79 billion as of December 31, 2016. Importantly, we decreased our Adversely Classified Credits by 17% for the year from over $20 billion down to $17 billion.

As part of this risk reduction focus, and in an effort to continue capturing discount and maximizing accretive opportunities, we decreased our student loan net par exposure by 40%, or $0.9 billion, including approximately $400 million of commutations. We also canceled $458 million of net par exposure in Ambac-owned Local Insight Media bonds.

While our full year results were positive, we did experience net loss during the fourth quarter, which David will discuss in more detail momentarily. This was a primarily as a result of incurred losses associated with the RMBS and public finance exposures. Rising interest rates negatively impacted our

RMBS and student loan insured portfolios, which is mostly offset by a material benefit from our derivative portfolios. We believe this demonstrates the value of our focus on risk management as our macro hedge performed in line with expectations and counteracted in part the impact of higher interest rates on our business.

The second headwind involved the evolving situation in Puerto Rico which is being affected by several factors which I will elaborate on further in a few minutes. I would now like to turn the conversation to Ambac's strategy.

We will be discussing strategy more in the coming quarters, however, I wanted to share my initial thoughts with you today. We are initiating a comprehensive review of our business strategy in order to better define and accelerate execution of its key components. This review will cover both existing insurance operations as well as future potential business opportunities. I would now like to spend a few minutes reviewing the core pillars of our strategy and provide you some additional insight on our current priorities.

First, we will continue to focus on de-risking the insured portfolio and improving our claims-paying ability through transaction terminations, policy commutations, and settlements and restructurings that we believe will improve our risk profile, and by maximizing the risk-adjusted returns on our invested assets. As we strive to improve our risk profile, we will consider the implications for our balance sheet over the long-term, including the quality, stability, and growth of our adjusted book value. We believe that focus on the long-term stability of our balance sheet and quality of our ABV, in addition to its absolute value, will serve to maximize value for our shareholders.

Second, we will remain steadfastly committed to aggressively prosecuting our representation and warranty and other litigations to recover losses and protect our rights. In our flagship case against Countrywide, we await the decision of the appellate court regarding summary judgment rulings made by the trial court in late 2015.

Third, we will look to proactively identify and implement operational improvements to reduce costs and enhance operational effectiveness for the current and evolving nature of our business.

Fourth, we remain committed to the rationalization of Ambac and its subsidiaries' capital and liability structures, enabling simplification of corporate governance and facilitating the successful rehabilitation of the Segregated Account. The successful rehabilitation of the Segregated Account is a key focus in the near term that I'll discuss in more detail shortly.

Finally, we will explore new business opportunities offering attractive risk-adjusted returns that, among other things, may permit Ambac to fully utilize its net operating loss carry-forwards.
Against this backdrop, our two most immediate near term areas of strategic focus are the rehabilitation of the Segregated Account and Puerto Rico.

With respect to the possible Exit by the Segregated Account from Rehabilitation:

On December 16, 2016, the Rehabilitator filed a supplement to his Annual report relating to the segregated account. In the Supplement, the rehabilitator reiterated his goal of achieving a successful and durable conclusion to the segregated account rehabilitation proceedings. However, the Supplement also stated that at the present time, and absent further action, Ambac Assurance has insufficient capital to satisfy the rehabilitator that the Segregated Account rehabilitation proceedings could be concluded and leave Ambac Assurance with sufficient financial resource to meet all policy obligations as projected by the Rehabilitator – in his sole discretion and under a varying range of base and stress case scenarios.

The Company is evaluating the possibility of entering into one or more transactions to improve the financial condition and capital of Ambac Assurance which may, subject to OCI approval, facilitate the conclusion of the Segregated Account Rehabilitation Proceedings. In pursuing this objective, we have actively engaged in conversations with our regulator, and are considering the possibility of monetizing certain assets, restructuring or exchanging certain outstanding debt and insurance obligations, and/or commuting or reducing insured exposures. We also continue discussions with our regulator and stakeholders to obtain input which could assist us in determining possible courses of action. Despite our efforts and progress, there remains a significant amount of work and material complexities to navigate, and any eventual resolution will be entirely at the discretion of the OCI and the court overseeing the rehabilitation proceedings.

In addition, I would like to emphasize that we will not pursue a transaction or series of transactions unless it generates value for our shareholders.

Turning now to Puerto Rico. As you saw in our press release, one of the drivers of our fourth quarter loss was an increase in public finance reserves, which was driven mostly by the evolving situation in Puerto Rico.

Ambac looks forward to reviewing the Commonwealth's Fiscal Plan and audited financial statements to properly assess the path forward for Ambac and other stakeholders. Ambac views fiscal and structural reforms, economic growth, debt restructuring as a necessary element of a successful financial recovery and return to the capital markets for the Commonwealth. The Governor has taken steps to re-engineer the government, including: shrinking the number of agencies and authorities, reducing non-essential government spending, and will try to increase tax revenues through improved compliance – all of which Ambac views as positive, but more is certainly needed. Successful implementation of these initiatives as well as economic growth and appropriate funding for healthcare are all critical elements to stabilizing Puerto Rico's financial profile. Ambac will be engaging with stakeholders, including the Governor, FAFAA, the Oversight Board, and other creditors, in the coming days and weeks to progress our efforts towards a mutually acceptable solution.

Ambac and other creditors' ability to engage with the new Administration on-island and the Oversight Board has been challenged by the delayed appointment of legal and financial advisors and an executive director, which has also shortened timelines for negotiated solutions as the May 1st expiration of the PROMESA litigation stay approaches. In light of these conditions, what was supposed to be the "last resort" bankruptcy-like process of Title III has resurfaced in recent debt restructuring talks. We believe that any Title III discussion is premature and undermines the potential, constructive and beneficial path of Title VI consensual negotiations. Nevertheless, we are optimistic that with their advisors now in place and a baseline fiscal plan, that the Oversight Board, and the Commonwealth will focus on moving consensual discussions forward expeditiously. We would like to encourage the Oversight Board and the Commonwealth to carefully consider avoiding premature agreements with operating public corporations prior to considering the overall goals of the Commonwealth and the attainability of such goals. Such early agreements could lead to the ultimate failure of PROMESA's stated objectives and a worse outcome for creditors and the Puerto Rican public alike.

As concerns the recent district court decision allowing the GO lawsuit to proceed despite PROMESA's litigation stay, we disagree with the underlying logic of the decision and question its applicability in other potentially similar situations. At the same time, now that the court has permitted Ambac to join the lawsuit, we look forward to mounting a robust defense of the COFINA structure at the appropriate time. If successful, the GO bondholders' attack on Puerto Rico's most important securitization structure would cause significant harm to the people of Puerto Rico as the largest portion of COFINA bondholders are on-island creditors. It would also damage the Commonwealth's ability to regain access to the capital markets—one of Congress's explicit objectives in passing PROMESA. Combined these effects as well as others, would have dire long-term consequences for Puerto Rico, its people and its creditors. Therefore, we believe it is critical that the Commonwealth and the courts continue to protect and preserve the rule of law broadly and specifically with regards to the COFINA structure.

To conclude, we continue to assess all our options, refine our strategy and evaluate our exposures to the Commonwealth and its instrumentalities, and protect and enforce our rights. We also continue to advocate for solutions focused on fiscal reform, economic growth, and creating an environment that can attract private capital as we believe this is the best path forward for Puerto Rico, its people, its creditors and future. In the immediate term, we believe that Title VI is the best vehicle to reach these solutions and restore Puerto Rico to a path of long-term economic growth.

I'll now turn the call over to David Trick to walk you through our fourth quarter results after which we'll open up the floor to questions. David?

David Trick, Chief Financial Officer

Thank you Claude and good morning. I'd like to start off by describing two changes we made to our non-GAAP financial measures, as I will be referring to these measures during my review of our fourth quarter results.

These changes were made in response to a recent comment letter received from the Division of Corporation Finance of the Securities and Exchange Commission, and were effective December 31, 2016:

First was simply a name change whereby we changed "Operating Earnings" to "Adjusted Earnings" or "Adjusted Losses" as the case may be.

Secondly, with regards to the calculation of both Adjusted Earnings and Adjusted Book Value we are no longer adjusting for the impact of VIEs which allowed us to present our results on a consistent basis, and in conformity with financial guarantee insurance accounting. However, we have enhanced our disclosures to outline the effects of consolidating VIEs, in such a way that readers of our financial statements can make the same adjustments we previously made to our non-GAAP measures.

As for our results, during the fourth quarter 2016, Ambac produced a net loss of $94.7 million, or $(2.09) per diluted share, compared to net income $101.5 million, or $2.22 per diluted share, for the third quarter 2016. The Adjusted Loss in the fourth quarter was $(12.7) million, or $(0.28) per diluted share compared to Adjusted Earnings of $143.9 million, or $3.14 per diluted share in the third quarter.

The primary drivers of our fourth quarter results were the impact of higher interest rates on our insured RMBS and student loan portfolios and derivative portfolio; adverse development in our public finance insured portfolio; higher expenses primarily related to litigation, and the CEO change; and a decrease in accelerated premiums earned.

Now turning to some more specifics, premiums earned were $49.9 million during the fourth quarter versus $53.2 million during the third quarter. Included in the fourth quarter were $14.2 million of accelerated premiums versus $18.2 million during the third quarter. Normal earned premium increased modestly during the quarter to $35.7 million as a result of a reduction in the estimate of uncollectible future structured finance premiums, the impact of which was partially offset by the continued runoff of the insured portfolio. Accelerated premium on the other hand declined by approximately $4.0 million. While at approximately $3.0 billion, the level of public finance call activity was similar in both the third and fourth quarters, a change in the mix of insured transactions called negatively impacted accelerated premiums.

During the fourth quarter the Financial Guarantee insurance portfolio net par outstanding declined by a total of $7 billion, or just over 8%, to approximately $79 billion from $86 billion at the end of September 2016. The $7 billion decline in the insured portfolio was attributable to $5.0 billion in total runoff of the public finance sector, primarily in the GO, tax and lease backed areas, and declines in the structured finance and international sectors of $1.0 billion each. Run-off in the structured finance sector was mostly related to the RMBS and Investor-owned Utility portfolios, whereas the decline in the international sector was mostly as a result of foreign exchange movements.

Adversely Classified Credits declined in the quarter by $0.4 billion, or 2.2%, to $17.0 billion.

As net par continued to decline, we ended the year with a total claims-paying ratio of 14:1 compared to a 15:1 ratio at the end of September 2016.

Net investment income for the fourth quarter of 2016 was in line with the third quarter at $90.9 million. Notably, but not uniquely, during the fourth quarter of 2016, we did not make any incremental purchases of Ambac insured bonds. A few factors contributed to this: first, the supply of bonds that met our criteria was limited; second, our trading window was closed for the majority of the fourth quarter; and lastly, we have strategically decided to allocate a greater proportion of our domestic portfolios to short-term liquid assets. Nevertheless, our consolidated investment in Deferred Amounts, including interest thereon, totaled $1.5 billion or 41% of total amount, of the total amount outstanding as of December 31, 2016.

Losses incurred were $215.5 million for the fourth quarter compared to a benefit of $69.2 million in the third quarter. The fourth quarter incurred loss was driven by higher interest rates and adverse loss development.

RMBS incurred losses were $98.3 million in the fourth quarter of 2016, including $43.7 million of interest expense on Deferred Amounts, primarily due to (i) excess spread compression resulting from higher interest rates and (ii) a $16 million reduction to our estimate of representation and warranty recoveries, stemming from improved credit performance from the associated deals. These results were partially offset by improved credit performance across the book.

Public Finance incurred losses were $91.2 million, primarily related to Puerto Rico and a few other credits. The increase in Puerto Rico reserves is in line with our developing views of the situation there as Claude had spoke about earlier. As for the other Public Finance credits for which we experienced incurred losses, there were 2 single risks for which net par totaled an aggregate of approximately $300 million that accounted for the majority of the remaining adverse development.

Student loan incurred losses were $13 million, primarily due to higher interest rates; and

Ambac UK incurred losses were $12 million, resulting from the impact of foreign exchange rates of $20.7 million, partially offset by the net impact of higher interest rates.

Combined, RMBS and student loan losses associated with higher interest rates were estimated at $95 million.

Net loss and loss expenses paid in the fourth quarter were $9.2 million versus $63.2 million in the third quarter. Claims paid declined for both RMBS and Public finance partially offset by a decline in subrogation received and an increase in loss expenses paid.

Net gains reported in the derivative product revenues for the fourth quarter of 2016 were $84.0 million. The net gain for the fourth quarter included Ambac CVA losses of approximately $29.6 million and counterparty credit adjustment gains of $10.5 million. Given that we eliminate the impact of the Ambac CVA for our non-GAAP measures, our derivative results on an adjusted earnings basis for the fourth quarter 2016 were $113.6 million. As we have previously discussed, our interest rate derivative portfolio is positioned to benefit from rising interest rates as an economic hedge against interest rate exposure in the investment and financial guarantee portfolios, particularly within the RMBS and student loan portfolios.

Operating expenses for the fourth quarter of 2016 increased by $14.7 million sequentially to $36.2 million due to approximately $3.5 million of net cost related to the CEO change, approximately $1.0 million of incremental costs associated with the Segregated Account Rehabilitation, and the establishment of $10 million of litigation contingencies. Recall, that the third quarter 2016 expenses also benefited from the reversal of a $2.3 million accrual for US insurance related taxes.

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

Regarding taxes, the fourth quarter provision was $8.8 million, compared to $15.3 million in the third quarter. This included $7.2 million for Ambac UK and $1.2 million for Federal AMT.

For the 2016 tax year AAC has utilized NOLs in an amount that resulted in the accrual of $28.7 million of tolling payments for AFG. Subject to certain reviews and approvals, we expect AFG to receive this amount in May 2017. Our NOL's now total $4.0 billion, including $1.4 billion allocated to AFG and $2.6 billion allocated to AAC.

Stockholders' equity at December 31, 2016 was $1.7 billion, or $37.94 per share, down $196 million from September 30, 2016, primarily due to the net loss of $95 million, a reduction in unrealized gains on securities of $64.8 million, and losses on the translation of Ambac's foreign subsidiaries of $35.9 million. Adjusted Book Value was down $114.5 million to $1.3 billion, or $29.48 per share at December 31, 2016. The main contributor to the decline in ABV was the fourth quarter Adjusted Loss, adjusted for items that are either already included in ABV or do not impact Adjusted Earnings in the same way as earned premium, foreign exchange and the impact of higher interest rates on the PV of installment premiums.

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

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 our shareholders. In order to do so we are strategically focused on the economic outcome for our insurance operations, as job #1, as we progress a comprehensive strategic review to define our future opportunities. I look forward to updating you on our progress. We will now open it up for questions.

Operator
The floor is now opened for questions. At this time, if you have a question or comment please press *1 on your touch-tone phone. If at any point your question is answered, you may remove yourself from the "Q" by pressing the pound key.

Again, we do ask that while posing your question that you pick up your handset to provide optimal sound quality.

Our first question comes from the line of Andrew Gadlin with Odeon Capital Group

Andrew Gadlin, Odeon Capital Group
Good morning. Wanted to ask you about the timeline and milestones that we should look for on the rehabilitator's effort to bring the company out of rehab. I know you mentioned Claude in your prepared remarks that they communicated something in mid-December, that they'd be back to us by the end of the quarter. When do you think, kind of, where do you see the timeline for that taking place, and what should we be looking for?

Claude LeBlanc, Chief Executive Officer
Good morning, Andrew. I think at this point we don't have the OCI's timeline. They have indicated as you shared with us that they will be, or intend to communicate back to us, and to stakeholders, sometime before the end of the quarter, so we expect that to happen likely sometime in March. We have been in active dialogue with them as we've indicated to try and progress efforts on a plan. But at this time we do not have a specific timeline as to if and when they will make any determinations and as to which determinations they will proceed with. But obviously we will try to keep stakeholders informed as we progress matters, and we also look forward to hearing back their feedback at the end of March. It is our expectation as we indicated that we are actively pursuing our efforts to stabilize AAC and exit rehab. So I want to emphasize that we are actively pursuing that, but again it is completely in the hands of the regulator.

Andrew Gadlin, Odeon Capital Group
But what comes back in the end of March, or by the end of March let's say, do you expect that to be something that's a preliminary effort where there will be multiple iterations thereafter, or do you think that there's something coming shortly that is pretty, you know, clear cut and that will likely be 90% of the way there?

Claude LeBlanc, Chief Executive Officer
That's a great question I don't believe we have the answer to that. I think they've indicated there will be feedback. I would expect it'll be clearer feedback than we received in the past, and again I think it will depend in part on how much we're able to advance our discussions with them but again at this time we do not have a clear view as to the nature of the message and the clarity, but we are optimistic it will be more complete than what we've heard previously.

Andrew Gadlin, Odeon Capital Group
Got it. And then in terms of the portfolio concentration levels in Ambac-owned RMBS and other paper. I was a little surprised to see it come down this quarter, to about 41 percent, given that there's been such a sharp move up in surplus notes, and Ambac-wrapped paper. Can you talk about that a little bit?

David Trick, Chief Financial Officer
Yeah sure Andrew. So, I think that's really a function of a few things. First off, overall, anything with, really a function of how the overall book moved. And overall what we experienced during the quarter is that anything with spreads, so whether it's high yields, Ambac wrapped paper, or some of our other high yield positions, or, positions that we have in other asset classes outside fixed income really had good returns during the quarter. And then, so that more than offset what we experienced in terms of higher interest rates on sort of we'll call it the more investment-grade and higher-liquid portions of the book. Then on top of it we did experiences, what we normally do is normal pay-downs in the Ambac-insured RMBS portfolio, so when you sum those parts up the mix is that it had the effect that you outlined.

Andrew Gadlin, Odeon Capital Group
Got it thank you. That's it for me.

Operator
Again, to ask an audio question please press *1 on your touchtone phone. Our next question comes from Rob Bobman with Capital Returns.

Rob Bobman, Capital Returns
Hi. Thanks for the, thanks for the call. You mentioned during your prepared remarks that there were, there's a, you've initiated sort of a internal business review. And I was wondering if that review that you're referring to – is that all being undertaken by internal staff or whether you've hired any outside advisors to contribute to that? And then separate and apart you mentioned some transactions that you're considering, and I'm wondering if the transaction that you were referring to were at the stage where you were awaiting regulatory approval and that they had sort of been submitted and put in front of the regulator and you were waiting for them to approve them, or whether you're not quite at that stage yet? Thank you.

Claude LeBlanc, Chief Executive Officer
Thanks Ron. So, on your first question, we do anticipate getting the input from external parties. We have not engaged anybody at this time and are evaluating that and discussing with our board at this point in time but we will be undertaking a comprehensive review of strategy so you should think of it as a full encompassing review that may involve one or more advisors or input parties depending on the nature of the work that we're undertaking. It is something that we are going to move on quickly and I would hope that we would be in a position to update shareholders sometime in the third quarter as we progress things here at the company. As it relates to your second question, you're right, these are not transactions that we've teed up and are waiting for regulatory approval, there are potential transactions that we're evaluating internally, in terms of evaluating the value, capital, and risk profile benefit that we believe the company would benefit from such transactions. And we would also be as you would imagine discussing them with the regulator to get their thinking on it which we've yet to receive but are actively evaluating and discussing with the regulator and at the appropriate time if we believe the transactions are appropriate, if required we would go to the regulator to seek approval or we would just proceed on our own.

Rob Bobman, Capital Returns
Thanks for the clear replies. Best of luck.

Claude LeBlanc, Chief Executive Officer
Thank you.

Operator
Our next question comes from Michael Cohen with Opportunistic.

Michael Cohen, Opportunistic Research
Hi guys. Thanks for taking my question. Actually I have two questions. First for David, if you could, in the past as we've sort of monitored the subrogation recoverable and the excess spread, you've obviously communicated that it was somewhat hedged so could you just kind of provide a little background as to how the hedge works and how we should think about that line item and how it contributes to your financial results quarter to quarter?

David Trick, Chief Financial Officer
Sure Michael. Thanks for the question. So, broadly, what we do is we try to assess, and as you know the book is somewhat complex, but we do our best to try to assess the sensitivity of a few particular liability classes in particular and that's the RMBS and student loan books. While there are others, the bulk is really within those two liability classes, from a sensitivity, an interest rate sensitivity standpoint, along with our investment portfolio which as you know has a large concentration of investments in fixed income securities. So we try to assess the overall sensitivity of those areas in particular. While we do look at others, those are the main categories.

And within those, particularly the student loans and the RMBS, there's excess spread and really in the cases of student loans you have basically negative carry within those transactions because you have mismatches within those structures between the fixed assets in the case of RMBS and the floating rate liabilities, or in the case of student loans where you have basically deficit positions between the assets and the liabilities where you have more liabilities than you have assets. So even though you might have floating rate assets and liabilities in the student loan transaction, you're basically eating away at the asset base of student loans because of the high interest rates associated with the funding for those transactions, associated with auction rate deals and LIBOR floating deals that have gone to failed auctions or been put back to banks. So in both cases there's a fair amount of sensitivity between or associated with fluctuations in interest rates.

So that's the risk that we're really focused on. And so, we have over a few years positioned our derivatives portfolio, which mostly used to be a book that was built around client activity and client swaps and put that book in a position where it has a net sensitivity that partially will offset the risks associated with movements in interest rates between the student loan, RMBS, and investment portfolios. And so the sensitivity associated with what we often refer to as the macro hedge is about $600,000 a basis point currently. And that along with some other positions within the book broadly hedges the rate risk that we see within those categories I mentioned but not totally. So, depending on how you measure it, and there are different ways of measuring it, and at different points of the curve from a KRD standpoint, it may differ. But broadly speaking we view that hedge should be about a 65 percent hedge between the derivatives that we have or maintain on the books and the interest rate risk that is contained within the categories I described.

Michael Cohen, Opportunistic Research
Okay great. And then, my second question, relates to Ambac UK. Claude and David, could you just kind of talk about how you might think about monetizing that? Is that sort of one of the assets that you described that might be available for sale? It seemed to be the easiest and cleanest thing and particularly given the fact that the JP Morgan litigation is set to commence on March 13th. Could you kind of just talk about that and how shareholders should think about the value that exists within AUK?

Claude LeBlanc, Chief Executive Officer
Sure. Maybe I'll start and let David chime in. I think the way we think of the UK, it is an entity that we have, we own the outright economic interests in but it does operate independently. I think if you think about it as an asset that could be monetized I don't believe that we see that today as being ripe or ready as compared to possibly what happened at MBIA UK which was a clean entity and, in good financial condition and available for monetization. I think in the case of Ambac we still see some significant challenges on the risk side, which we're actively managing with their UK management team. And also some potential upside as it relates to potential significant litigation proceedings. So, I think for us we are actively progressing our remediation recovery stabilization efforts for the UK platform. Obviously very engaged with our regulators in the UK as well as it relates to this, and once we've gone through that I think we will then be in a position to evaluate options for that platform. But at this time we have not made any decisions and I think we'll look and wait to see how things progress on the remediation and asset recovery side before we make a decision on the UK.

David Trick, Chief Financial Officer
Yeah Mike I would just point out one sort of technical point is that comparing ourselves to some others in the UK market in terms of the financial guarantee operations, and we've disclosed this fully in our K's and Q's, is that our UK operation has from a solvency 2 standpoint, it has a capital deficit and, you know, any buyer for a business like that first thing they're looking at is what the potential dividend flow is from an entity like Ambac UK. So from our standpoint I think we're just the best owner of that equity right now and as Claude pointed out, depending on how the situation develops and what the effect of some of those events may be on our solvency 2 position, and we'll re-evaluate at that time.

Michael Cohen, Opportunistic Research
Okay great thank you and maybe if I might sneak one more question in. Puerto Rico, Claude, the process that you described or that you seem to be prescribing is somewhat different than what one of your other fellow financial guarantors has advocated which is that the corporations could be effectively solved or dealt with ahead of a broader solution for the overall island. Can you just sort of elaborate on that and maybe talk about how that gets resolved or how like minds come together with similar goals?

Claude LeBlanc, Chief Executive Officer
Sure. I think the way we think about it is that Puerto Rico holistically has a significant debt issue and we think it needs to be evaluated in the context holistically before decisions can be reached. And again I think the public corporations have made significant advances in trying to progress that which we think is great but I think before the OB and the governor, you know, conclude any deals I think we need to look at the full situation, understand the amount of debt concessions that need to be reached before any decisions are made. Again I think there may be situations where it's warranted so we're not suggesting that they shouldn't do that but we do think that we need to carefully consider, you know, the amount of debt haircuts that are being achieved in these public corporations in the context of the overall debt reduction that's going to be required before making any decisions. I think now that there's advisors in place and we do have a fiscal plan I think we are now all moving in the right direction to accelerate that review and we look forward to working with the OB, FAAFA, the governor as well as all the other creditors to progress our discussions around this and the overall restructuring of Puerto Rico.

Michael Cohen, Opportunistic Research
Great thank you so much, Claude.

Operator
Once again if you do have a question you may press *1 on your touchtone phone at this time. Our next question comes from Charles Post with Sterling Grace.

Charles Post, Sterling Grace
Morning guys. A couple of questions. Have you started making payments on student loans in Ambac UK yet?

David Trick, Chief Financial Officer
Hi, Cap. It's David Trick. No we have not, other than through commutation activity, paid any claims on student loan transactions. And with regards to Ambac UK we do have basically three deals there, I would say, as of the end of the year or fourth quarter more broadly, that are sort of risk positions that we are either monitoring closely or dealing with from a remediation standpoint. One everyone knows is Ballantyne, we occasionally make short term, what I'll call liquidity payments on Ballantyne that are reimbursed relatively quickly. We did commute a transaction, or re-structure a transaction, in the fourth quarter related to wind farms, so we made a small claim payment/restructuring payment on that deal in the fourth quarter. And we're also dealing with a transaction – a utility transaction in Spain that we have made claims on in the past. Altogether those are relatively minor, relatively small claim payments.

Charles Post, Sterling Grace
Okay. On Ballantyne have you guys acquired any more of that? I know you guys had bought about face value $150 million bucks. Has that changed at all?

David Trick, Chief Financial Officer
I don't have the specific amount of bonds that we own on Ballantyne off the top of my head but we did make some incremental purchases in 2016 but not in the fourth quarter.

Charles Post, Sterling Grace
Ok. And then I know that you said you weren't buying any Puerto Rico exposure in the fourth quarter, did that continue into 2017? I also noticed in the stat filing you sold a small piece of your COFINAs, just want to get some color on that.

David Trick, Chief Financial Officer
I can't really comment much on 17 at this point, you know, as we've said in the past, we will make capital allocation decisions based on what the sort of relative risk-reward characteristics are of a particular opportunity, and we'll continue to do so, also against the sort of backdrop of what our liquidity needs are with regards to just the normal operation of the book as well as some of the strategic items that we discussed today. With regards to the sale of the COFINA bonds I would say that was really just a portfolio management exercise as well as a little bit of, taking a little bit of an opportunistic sale approach in terms of creating some capacity and managing some risk, particularly interest rate risk in the book, but you know, no particular message being sent with regards to those sales.

Charles Post, Sterling Grace
And then, when the clawback credits, the rum tax, convention center and highways, do you have any color or views right now that you can share with us in terms of how that is going to play out over the next, you know, few months or year? The way it speaks- states is that they can clawback, use it for GO, but then it becomes a priority norm for the next year, I guess we're in the next year now, but just, want to get a sense for, what you're thinking there.

Claude LeBlanc, Chief Executive Officer
You know I think at this point, in terms of the clawback risk, it is something that we're obviously carefully evaluating, and have some legal positions that we've indicated and may continue to introduce, but I think it is something obviously that is a concern to us and we're evaluating a number of options to seek relief around that.

Charles Post, Sterling Grace
All right. Thank you.

Operator
There are no further questions at this time. Ladies and gentlemen, this does conclude today's conference call. Please disconnect your lines at this time and have a wonderful day.

END