

**ACA Financial
Guaranty Corporation**

**Statutory Financial Statements and
Supplementary Information
December 31, 2018 and 2017**



ACA Financial Guaranty Corporation
(dollars in thousands)

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December 31, 2018 and 2017

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Independent Auditors' Report

To the Board of Directors of
ACA Financial Guaranty Corporation

We have audited the accompanying financial statements of the ACA Financial Guaranty Corporation (the "Company") which comprise the statutory statements of admitted assets, liabilities, and capital and surplus as of December 31, 2018 and 2017, and the related statutory statements of operations and changes in capital and surplus and cash flows for the years then ended, and the related notes to the financial statements.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these statutory-basis financial statements in accordance with the accounting practices prescribed or permitted by the Maryland Insurance Administration. Management is also responsible for the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditors' Responsibility

Our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinions.

Basis for Adverse Opinion on Accounting Principles Generally Accepted in the United States of America

As described in Note 1 to the statutory-basis financial statements, the statutory-basis financial statements are prepared by the Company using the accounting practices prescribed or permitted by the Maryland Insurance Administration, which is a basis of accounting other than accounting principles generally accepted in the United States of America, to meet the requirements of the Maryland Insurance Administration.

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The effects on the statutory-basis financial statements of the variances between the statutory-basis of accounting described in Note 5 to the statutory-basis financial statements and accounting principles generally accepted in the United States of America, although not reasonably determinable, are presumed to be material.

Adverse Opinion on Accounting Principles Generally Accepted in the United States of America

In our opinion, because of the significance of the matter described in the Basis for Adverse Opinion on Accounting Principles Generally Accepted in the United States of America paragraph, the statutory-basis financial statements referred to above do not present fairly, in accordance with accounting principles generally accepted in the United States of America, the financial position of the Company as of December 31, 2018 and 2017, or the results of its operations or its cash flows for the years then ended.

Opinion on Statutory-Basis of Accounting

In our opinion, the statutory-basis financial statements referred to above present fairly, in all material respects, the admitted assets, liabilities and capital and surplus of the Company as of December 31, 2018 and 2017, and the results of its operations and its cash flows for the years then ended, in accordance with the accounting practices prescribed or permitted by the Maryland Insurance Administration as described in Note 1 to the statutory-basis financial statements.

Report on Supplemental Schedules

Our audit was conducted for the purpose of forming an opinion on the financial statements as a whole. The Summary Investment Schedule, Investment Risk Interrogatories, and Reinsurance Interrogatories are presented for purposes of additional analysis and are not a required part of the financial statements. Such information is the responsibility of management and was derived from and relates directly to the underlying accounting and other records used to prepare the financial statements. The information has been subjected to the auditing procedures applied in the audit of the financial statements and certain additional procedures, including comparing and reconciling such information directly to the underlying accounting and other records used to prepare the financial statements or to the financial statements themselves, and other additional procedures in accordance with auditing standards generally accepted in the United States of America. In our opinion, the information is fairly stated in all material respects in relation to the financial statements as a whole.

Mazars USA LLP

May 8, 2019

ACA Financial Guaranty Corporation
(dollars in thousands)

Statutory Statements of Admitted Assets, Liabilities and Capital and Surplus
December 31, 2018 and 2017

	<u>2018</u>	<u>2017</u>
Admitted Assets:		
Bonds — at NAIC carrying value	\$ 199,097	\$ 258,994
Cash, cash equivalent and short-term investments	<u>30,144</u>	<u>3,855</u>
Total cash and investments	229,241	262,849
Accrued investment income	1,396	1,620
Current federal income tax recoverable	364	-
Other assets	<u>5</u>	<u>2</u>
Total admitted assets	<u><u>\$ 231,006</u></u>	<u><u>\$ 264,471</u></u>
Liabilities and Capital and Surplus:		
Liabilities:		
Loss and loss adjustment expenses	\$ 49,308	\$ 75,640
Unearned premiums	26,370	32,764
Contingency reserve	95,926	95,926
Payable to subsidiaries	81	82
Accrued expenses and other liabilities	<u>3,569</u>	<u>3,726</u>
Total liabilities	<u>175,254</u>	<u>208,138</u>
Capital and Surplus:		
Common stock — 1,000,000 shares authorized, issued and outstanding at December 31, 2018 and 2017; par value of \$15 per share	15,000	15,000
Gross paid-in and contributed surplus	363,974	363,974
Unassigned deficit	<u>(323,222)</u>	<u>(322,641)</u>
Total capital and surplus	<u>55,752</u>	<u>56,333</u>
Total liabilities and capital and surplus	<u><u>\$ 231,006</u></u>	<u><u>\$ 264,471</u></u>

The accompanying notes are an integral part of these statutory financial statements.

ACA Financial Guaranty Corporation
(dollars in thousands)

Statutory Statements of Operations and Changes in Capital and Surplus
December 31, 2018 and 2017

	<u>2018</u>	<u>2017</u>
Underwriting income:		
Premiums earned	<u>\$ 6,397</u>	<u>\$ 18,825</u>
Underwriting expenses:		
Losses and loss adjustment expenses	9,713	10,011
Underwriting expenses incurred	<u>8,604</u>	<u>8,520</u>
Total underwriting expenses	<u>18,317</u>	<u>18,531</u>
Underwriting (loss) gain	(11,920)	294
Net investment income	8,142	10,644
Net realized capital gains	2,350	607
Other income	<u>500</u>	<u>2,720</u>
(Loss) Income before federal income taxes	(928)	14,265
Federal income taxes benefit	<u>(364)</u>	<u>-</u>
Net (loss) income	<u>\$ (564)</u>	<u>\$ 14,265</u>
Capital and surplus as regards policyholders — beginning of year	\$ 56,333	\$ 42,107
Net (loss) income	(564)	14,265
Change in net unrealized capital gain (losses)	(21)	(66)
Change in contingency reserve	-	-
Change in deferred income tax	132	(12,339)
Change in non-admitted assets	<u>(128)</u>	<u>12,366</u>
Capital and surplus as regards policyholders — end of year	<u>\$ 55,752</u>	<u>\$ 56,333</u>

The accompanying notes are an integral part of these statutory financial statements.

ACA Financial Guaranty Corporation
(dollars in thousands)

Statutory Statements of Cash Flows
Years Ended December 31, 2018 and 2017
(dollars in thousands)

	<u>2018</u>	<u>2017</u>
Cash from operations:		
Premiums collected net of reinsurance	\$ 3	\$ 11
Net investment income	8,886	11,282
Other income	500	2,720
Losses and loss related payments	(32,772)	(42,735)
Commissions, expenses paid and aggregate write-ins for deductions	(12,021)	(13,971)
Federal income taxes paid (recovered), net	<u>-</u>	<u>-</u>
Net cash from operations	<u>(35,404)</u>	<u>(42,693)</u>
Cash from investments:		
Proceeds from investments sold or matured	69,246	135,481
Cost of investments acquired	(7,549)	(92,565)
Net gains or (losses) on cash, cash equivalents and short-term investments	(3)	(2)
Miscellaneous proceeds (applications)	<u>-</u>	<u>-</u>
Net cash from investments	<u>61,694</u>	<u>42,914</u>
Cash from financing and miscellaneous sources:		
Other cash provided (applied), net	<u>(1)</u>	<u>47</u>
Net cash from financing and miscellaneous sources	<u>(1)</u>	<u>47</u>
Net change in cash, cash equivalents and short-term investments	26,289	268
Cash, cash equivalents and short-term investments — beginning of year	<u>3,855</u>	<u>3,587</u>
Cash, cash equivalents and short-term investments — end of year	<u>\$ 30,144</u>	<u>\$ 3,855</u>

The accompanying notes are an integral part of these statutory financial statements.

ACA Financial Guaranty Corporation

(dollars in thousands)

Notes to Statutory Financial Statements

Years Ended December 31, 2018 and 2017

1. Summary of Significant Accounting Policies

Basis of Presentation

The accompanying financial statements of the Company are presented in accordance with the National Association of Insurance Commissioners' ("NAIC") Accounting Practices and Procedures Manual Statement of Statutory Accounting Principles ("NAIC SAP") which has been adopted as a component of prescribed or permitted practices by the Maryland Insurance Administration ("MIA") effective January 1, 2001 ("MIA SAP"). The differences between NAIC SAP and MIA SAP are not applicable to the Company. These practices differ in certain material respects from accounting principles generally accepted in the United States of America ("GAAP"), as described in Note 5. Set forth below is a description of the NAIC SAP accounting policies which are significant to the preparation of the accompanying financial statements. The Company's financial statements are presented in U.S. dollars (USD) and all values are rounded to the nearest USD thousands except where stated otherwise. Percentages are rounded up to the nearest first decimal.

Estimates and Assumptions

The preparation of financial statements in conformity with NAIC SAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. The most significant estimates include those used in determining reserves for losses and loss adjustment expenses, contingent liabilities, and the valuation of bonds.

Cash, Cash Equivalents and Short-Term Investments

Cash, cash equivalents and short-term investments include cash on hand, demand deposits with banks, money market mutual funds and investments purchased with a maturity of one year or less. Short-term investments are carried at amortized cost, which approximates market value.

The Company maintains cash balances at several banks, which are insured by the Federal Deposit Insurance Corporation ("FDIC") up to \$250 thousand. On occasion during the normal course of business, balances are maintained above the FDIC insurance limit. The Company maintains cash equivalents in money market accounts that are insured by the Securities Investor Protection Corporation ("SIPC") up to \$500 thousand. Balances for these accounts are maintained in excess of the SIPC insurance limit.

Investments

Investments are valued in accordance with the valuation procedures of the NAIC. Investment grade bonds are generally carried at amortized cost and the amortization of premium or accretion of discount is determined using the constant yield method. Non-investment grade bonds, as determined by the Securities Valuation Office ("SVO") division of the NAIC or management, are carried at the lower of amortized cost or fair value.

Bonds and loan-backed securities assigned a NAIC Designation of 1 or 2 are valued at amortized cost, adjusted for amortization of premium and accretion of discount which is calculated using the constant yield method. Bonds and loan-backed securities assigned a NAIC rating of 3 or lower are valued at the lower of amortized cost, adjusted for amortization of premium and accretion of discount which is calculated using the constant yield method, or fair value. The prospective method is used to adjust amortization or accretion of loan-backed securities.

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Realized capital gains and losses on dispositions of investments are determined on the basis of specific identification and are included in net income. Declines in fair values, which are determined to be other than temporary (“OTTI”), are recorded as realized capital losses.

The Company continuously monitors securities that have an estimated fair value that is below amortized cost in order to determine if there is any evidence that the decline in estimated fair value is other-than-temporary. For securities expected to be sold, an OTTI charge is recognized if the Company does not expect the fair value of a security to recover its cost or amortized cost basis prior to the expected date of sale. Factors considered in evaluating whether a decline in value is other-than-temporary include: 1) whether the decline is attributable to credit related or interest rate related factors, 2) whether the decline is substantial; 3) the amount of time that the fair value has been continuously less than cost; 4) the financial condition and near-term prospects of the issuer; and 5) the Company’s ability and intent to retain the investment for a period of time sufficient to allow for an anticipated recovery in value.

For loan-backed bonds and structured securities, anticipated prepayments at the date of purchase are considered when determining the amortization of discount or premium. The cash flows of loan-backed and structured securities are reviewed to ensure that any movement in the expected prepayment assumptions of a security are reflected in the adjusted book value of the asset. If management determines that its best estimate of expected future cash flows discounted at the security’s effective yield prior to the impairment are less than its amortized cost, then an OTTI charge is recognized equal to the difference between the amortized cost and the Company’s best estimate of expected future cash flows discounted at the security’s effective yield prior to the impairment. An external service is used to determine the average prepayment speed adjustments. Significant changes in estimated cash flow from the original purchase assumptions are generally accounted for using the retrospective method. The prospective method is used for interest only securities or securities where the yield becomes negative, if any.

The Company receives dividends from its subsidiary, ACA Service L.L.C. related to its prior CDO asset management business. These dividends are recorded as net investment income (see Note 6).

Investment in the Company’s wholly-owned subsidiaries are accounted for under the statutory equity method of accounting. Investment in Subsidiaries, Controlled and Affiliates have no substantial value and are carried at zero as of December 31, 2018 and 2017.

Premium Revenue Recognition

Typically, financial guaranty premiums are received either upfront or in installments. Such premiums are recognized as written when due. Installment premiums written are earned ratably over the installment period, generally one year or less, which is consistent with the expiration of the underlying risk or amortization of the underlying insured principal. Upfront premiums written are earned based on the proportion of principal and interest scheduled to be paid on the underlying insured obligation during the period, as compared to the total amount of principal and interest to be paid over the contractual life of the insured debt obligation. When a full loss on a guaranteed obligation is reflected in the financial statements and no further variability exists as to the measurement of the loss, the remaining unearned premiums are recognized as earned since the Company is no longer exposed to insurance risk. Unearned premiums, net of prepaid reinsurance premiums, represent the unearned portion of upfront and installment premiums written.

In addition, when an insured issue is retired early, is called by the issuer or is, in substance, paid in advance through a refunding accomplished by placing U.S. Government securities in escrow (hereafter referred to collectively as “Refundings”), the remaining unearned premium revenue relating to such insured issue is earned at that time since there is no longer risk to the Company. For the years ended December 31, 2018 and 2017, the Company recorded earned premiums of \$4.1 million and \$16.0 million, respectively, related to Refundings.

ACA Financial Guaranty Corporation

(dollars in thousands)

Other Income Revenue Recognition

The Company may collect fees in connection with the granting of waivers and consents in connection with insured tax-exempt transactions. These fees are recognized by the Company as other income when the cash is received. In addition, the Company recognizes gain contingencies as other income when settled.

Loss and LAE Reserves

The Company records a loss with respect to an insurance guaranty upon a payment default by the issuer of the insured obligation (a payment default is generally considered the incident which gives rise to a claim under the Company's insurance policies and triggers loss recognition relating to the incident). The loss recorded by the Company represents its best estimate of the present value of its ultimate claim payments under the policy, net of its best estimate of the present value of any recoveries from salvage or subrogation rights under the policy. The Company's liability for losses reported on the accompanying statements of admitted assets, liabilities and surplus (and also known as "loss reserves" "reserves for unpaid losses", "case reserves", or "case basis reserves") represents the present value of the Company's estimated ultimate losses that remain unpaid at the balance sheet date with respect to policies meeting the aforementioned criteria for loss recognition. Loss adjustment expenses ("LAE") are recorded by the Company in regard to insurance guaranties when costs are incurred or expected to be incurred to remediate probable losses under its policies. Accordingly, LAE may be recorded on policies for which claims have been paid or losses have been recognized, as well as on policies where no claim payments have been made or losses have been recorded but may be incurred in the future. LAE represents the estimated ultimate cost of remediating losses or potential losses under policies. The Company does not discount LAE.

Losses on the Company's insurance guaranties and related case reserves are determined using cash flow models to estimate the net present value of the anticipated shortfall between (i) scheduled payments on the insured obligation and (ii) anticipated cash flow from the obligor or the collateral supporting the obligation and other anticipated recoveries or cash flows. At December 31, 2018 and 2017, the discount rate used by the Company to present value its loss reserves was 3.3% and 3.1%, respectively. A number of quantitative and qualitative factors are considered when determining whether the Company will incur a loss and the amount of any case reserve. These factors may include the creditworthiness of the underlying issuer of the insured obligation, whether the obligation is secured or unsecured, the projected cash flow or market value of any assets that collateralize or secure the insured obligation, and the historical and projected recoveries from such assets. Other factors that may affect the actual ultimate loss include the state of the economy, market conditions for municipal bond issuance, changes in interest rates, rates of inflation and the salvage values of specific collateral. Such factors and management's assessment thereof will be subject to the specific facts and circumstances associated with the specific insured transaction being considered for loss recognition. Loss reserves are discounted at a rate equal to the weighted average rate of return on admitted assets at the end of the year. Recognition of losses and related case reserves requires the use and exercise of significant judgment by management, including estimates regarding the amount and timing of a loss on an insured obligation. Actual experience may differ from estimates and such difference may be material, due to the fact that the ultimate dispositions of claims are subject to the outcome of events that have not yet occurred. Examples of these events include changes in the level of interest rates, credit deterioration of guaranteed obligations, changes in the value of specific assets supporting guaranteed obligations, changes in the expected timing of claims payments and recoveries, and the amounts of expected claims payments and recoveries. Any estimate of future costs is subject to the inherent limitation on the Company's ability to predict the aggregate course of future events. It should therefore be expected that the actual emergence of losses and LAE will vary, perhaps materially, from any estimate.

The Company purchases its own insured bonds in the marketplace for the purposes of loss remediation. These purchases are recorded as loss payments when made. A corresponding reduction of modeled losses is also recorded in the financial statements for those credits with a reserve or to the off-balance sheet amount disclosed in Note 4.

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See Note 4 for further information regarding the Company's accounting policy for loss recognition on its in-force insurance guaranties, as well as in regard to losses expected to be incurred by the Company on its credit quality classification 4 insurance guaranties which have not yet been recorded in the accompanying statements of admitted assets, liabilities and capital and surplus because a payment default by the issuer of the insured obligation has not yet occurred. In addition, see Note 7 for a reconciliation of the beginning and ending balances of the reserve for losses and loss adjustment expenses as of December 31, 2018 and 2017.

Surplus Notes

As discussed in Note 3, as part of the Restructuring Transaction, the Company made a cash payment and issued non-interest bearing surplus notes with a principal amount of \$1 billion to settle counterparty claims. Due to the unique nature of the transaction, and in consultation with the MIA, the Company recorded the issuance of surplus notes with a fully offsetting contra account. This accounting treatment has resulted in a net balance of \$0 reported as surplus notes. Payment of principal, or any other distributions, on the surplus notes may not be recognized until approved by the MIA. Upon the MIA's approval, unassigned funds (surplus) and the contra account will be adjusted to reflect the amount approved. Upon payment, the principal amount of the surplus notes would be reduced by the amount of such payment. No payments have been made under the surplus notes.

Contingency Reserve

A statutorily mandated contingency reserve is established net of reinsurance by an appropriation of unassigned surplus and is reflected in "Contingency Reserve" in the statements of admitted assets, liabilities and capital and surplus. This reserve is calculated as the greater of a prescribed percentage applied to original insured principal or 50% of premiums written, net of ceded reinsurance. The prescribed percentage varies by the type of business. Once the reserve is calculated, as described above, it is incrementally recognized in the financial statements over a prescribed time period based on type of business. Under Statutory Statement of Accounting Principles ("SSAP") 60, contributions to the contingency reserve may be discontinued if the total contingency reserve already recorded exceeds a calculated amount based upon unpaid principal guaranteed and prescribed percentages by bond category. The Company's established contingency reserve is in excess of this calculated amount. The Company has discontinued its contributions in the fourth quarter of 2014. Reductions in the contingency reserve may be recognized under certain stipulated conditions, subject to the approval of the MIA. In May 2015, the Company requested the MIA's approval to release contingency reserves equal to the amount in excess of the calculated maximum amount at December 31, 2014. The MIA denied the request in November 2015. In July 2018, the Company requested the MIA's approval to release contingency reserves equal to the amount in excess of the high-end of the off-balance sheet reserve range. In October 2018, the Company revised its request to reflect an updated off-balance sheet reserve range. The MIA is considering the request.

Income Taxes

Deferred tax assets and liabilities are provided for the expected future tax consequences of temporary differences between the carrying amount and tax basis of assets and liabilities. The change in the deferred tax assets and liabilities are charged or credited to surplus. Deferred tax assets that exceed statutory limits are designated as a non-admitted asset and charged directly to surplus. Deferred taxes are also subject to a valuation allowance.

Reclassification

The presentation of the statement of financial position in 2017 has been modified to conform with the current year presentation.

ACA Financial Guaranty Corporation

(dollars in thousands)

2. Business and Organization

ACA Financial Guaranty Corporation (the “Company”, “ACA FG”, or “ACA”) is organized and domiciled in the State of Maryland and is a licensed, authorized and accredited insurance company in all 50 states, the District of Columbia, Puerto Rico, the U.S. Virgin Islands and Guam. The Company is authorized to provide financial guaranty insurance on tax-exempt and other debt obligations, as well as on certain obligations related to asset-backed and corporate financings. As further discussed in Note 3, since December 2007, the Company has not issued any new financial guaranty insurance policies and is currently operating as a run-off insurance company.

Financial guaranty insurance provides an unconditional and irrevocable guaranty to the holder of a valid debt obligation to full and timely payment of the guaranteed principal and interest thereon when due. Financial guaranty insurance adds another potential source of repayment of principal and interest for an investor, namely the credit quality of the financial guarantor. Generally, in the event of any default on an insured debt obligation, payments made pursuant to the applicable insurance policy may not be accelerated by the holder of the insured debt obligation without the approval of the insurer. While the holder of such an insured debt obligation continues to receive guaranteed payments of principal and interest on schedule, as if no default had occurred, and each subsequent purchaser of the obligation generally receives the benefit of such guaranty, the insurer normally retains the option to pay the debt obligation in full at any time. Also, the insurer generally has recourse against the issuer of the defaulted obligation and/or any related collateral for amounts paid under the terms of the insurance policy as well as pursuant to general rights of subrogation. The issuer of an insured debt obligation generally pays the premium for financial guaranty insurance, either in full at the inception of the policy, as is the case in most public finance transactions, or in periodic installments funded by the cash flow generated by related pledged collateral, as is the case in most structured finance and international transactions. Typically, premium rates paid by an issuer are stated as a percentage of the total principal (in the case of structured finance and international transactions) or principal and interest (in the case of public finance transactions) of the insured obligation. Premiums are almost always non-refundable and are invested upon receipt.

The Company’s common stock is owned 100% by Manifold Capital, LLC (ACACH), a Delaware limited liability company, legal successor to Manifold Capital Corp. (formerly ACA Capital Holdings, Inc.), a Delaware corporation. As of April 7, 2016, ACACH is a wholly-owned subsidiary of Broadside Financial Ltd., a British Virgin Island limited company that is also ACACH’s sole member. Effective at the closing of the Restructuring Transaction discussed in Note 3, ACACH and its wholly-owned subsidiaries disclaimed control over the Company and voting control of the Company became vested in the surplus notes issued in connection with the restructuring. This disclaimer of control was approved by the MIA.

The Company, through its subsidiaries ACA Service L.L.C. and ACA Management, L.L.C., was historically engaged in the business of providing asset management services within targeted sectors of the fixed income capital markets. ACA FG’s affiliates participated in this market by structuring, managing and investing in collateralized debt obligations (“CDO”) in collaboration with investment banks which market the corresponding CDO securities to investors worldwide. The Company and its affiliates are no longer engaged in the CDO asset management business, except for a limited number of pre-existing arrangements, and have not originated any CDOs since the third quarter of 2007. The Company’s indirect wholly owned subsidiary, ACA Management, L.L.C., continues to receive fees related to these contracts from third parties to whom they assigned rights and obligations to manage these contracts and on a periodic basis pays dividends to ACA Service L.L.C., its direct parent and direct wholly-owned subsidiary of the Company. ACA Service L.L.C., in turn, passes on these funds to the Company, also in the form of a dividend.

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3. Restructuring Transaction

As a result of adverse developments in the credit markets generally and the mortgage market specifically that began in the second half of 2007 and continued to deepen in 2008 and thereafter, the Company experienced material adverse effects on its business, results of operations, and financial condition, which resulted in significant downgrades of the Company's financial strength ratings by Standard & Poor's Ratings Services ("S&P") and, ultimately, a restructuring of the Company to avoid a regulatory proceeding (the "Restructuring Transaction"). The Restructuring Transaction, which was consummated on August 8, 2008, was comprised of three main components. The first component of the Restructuring Transaction consisted of a Global Settlement Agreement whereby insured credit swap counterparties' claims were settled in consideration for a cash payment of approximately \$209 million and surplus notes with a face value of approximately \$950 million. In the aggregate, \$1 billion face amount of surplus notes were issued in connection with the Restructuring Transaction. Of such amount, the aforementioned insured credit swap counterparties received \$950 million and the balance of \$50 million was issued to ACACH. While certain of the surplus notes issued to the insured credit swap counterparties were issued to be non-voting at the request of certain such counterparties, the surplus notes issued to the counterparties, in the aggregate, represent a 100% voting interest in the Company. The surplus notes issued to ACACH are all non-voting.

The second component of the Restructuring Transaction provided for the settlement of a \$100 million medium term note guaranteed by the Company. This obligation was settled with the noteholders in exchange for a cash payment by the Company of approximately \$48 million and the transfer by the Company to the noteholders of investments in CDO equity with an estimated value of \$2.5 million. Of the total cash settlement, approximately \$32 million was paid out of a cash collateral account supporting the issued note while the remaining amount of approximately \$16 million was funded by cash from the Company and its other subsidiaries.

The third component of the Restructuring Transaction centered on the Intercompany Agreement which treated ACACH and its non-ACA FG subsidiaries as one sub-group and ACA FG and its subsidiary as a separate sub-group. By its terms, the Intercompany Agreement provided for the cancellation of a previously issued intercompany surplus note as well as intercompany balances between the Company's sub-group and the ACACH sub-group. It also provided for a global release of liability among the two sub-groups. In general, the release discharges the entities from any and all actions, cause of action, suits, debts, liens, contracts, rights and other legal obligations against each other, except those provided for in the Intercompany Agreement.

Subsequent to the closing of the Restructuring Transaction, the Company is required to and has operated under an order issued by the MIA, Case No.: MIA: 2008-08-011 dated August 7, 2008 (the "Order"). The Order provides, among other things, that the Company operate as a run-off company. In connection with the Order, following the Restructuring Transaction, the Company wound down all subsidiaries no longer necessary for the conduct of its ongoing business, including 73 special purpose entities created for the insured credit swap and CDO asset management businesses.

4. Description of Significant Risks and Uncertainties and the Company's On-Going Strategic Plan

Description of Significant Risks and Uncertainties

- As further discussed in Note 1, ACA FG recognizes losses and establishes related loss reserves on bond obligations it has insured upon the initial payment default by the issuer of such bond obligations (under the Company's accounting policy, the initial payment default is generally considered the incident which gives rise to a claim and triggers loss recognition relating to the incident). The loss recognized by ACA FG upon a payment default represents the Company's best estimate of its ultimate loss over the life of

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(dollars in thousands)

the policy, discounted to reflect the time value of money. However, ACA FG has policies in-force upon which it believes that it is probable that payment defaults will occur in the future. Such expected future losses (hereafter referred to as “Off-Balance Sheet Losses”) are not recorded by the Company in the accompanying Statements of Admitted Assets, Liabilities and Capital and Surplus at December 31, 2018 and December 31, 2017 because a payment default has not yet occurred. With consideration of the inherent uncertainty of estimating losses discussed further below, the Company’s estimate of its ultimate Off-Balance Sheet Losses ranged from \$14 million to \$19 million at December 31, 2018, on a discounted basis. Accordingly, the Company believes it will incur material losses in the future which will materially and adversely affect its policyholders’ surplus. Notwithstanding the de-recognition of contingency reserves that may be approved by the Maryland Insurance Commissioner in the future, no assurance can be given that the recognition of such losses in the future will not cause the Company to fail to comply with its regulatory required minimum policyholders’ surplus requirement of \$750 thousand. However, the Company believes that its surplus will be in excess of Maryland’s required minimum surplus over the twelve months succeeding the date of the accompanying Statement of Admitted Assets, Liabilities and Capital and Surplus and, that it has sufficient liquidity resources to satisfy its financial obligations as they come due for the foreseeable future.

- The Company is exposed to economic and political risks associated with its insurance guaranties (see Note 10). The extent and duration of any future deterioration in economic or political factors is unknown, as is the effect, if any, on potential claim payments and the ultimate amount of losses the Company may incur on obligations it has guaranteed. As discussed in Note 19, the Company classifies its insured in-force portfolio in one of four credit quality categories. As noted therein, as of December 31, 2018, the Company had insured obligations with outstanding principal totaling \$252.8 million classified in category 4, which means that it either has paid claims on such exposures or expects to pay claims on such exposures in the future. In addition, as of such date, the Company had insured obligations with outstanding principal totaling \$57.3 million classified in category 3, which means those credits have materially violated financial and operational covenants and require remedial action to avoid further performance deterioration. As discussed in Note 10, the risk of loss under the Company’s guaranties extends to the full amount of unpaid principal and interest on all debt obligations it has guaranteed. No assurance can be provided that further deterioration in ACA FG’s insured guaranties will not occur resulting in a further migration of insured exposure to categories 3 and/or 4 or that ACA FG will not incur losses that may be materially in excess of what it currently estimates.
- Losses incurred and reserves for losses are reported by the Company net of estimated recoveries from salvage and subrogation. Estimated salvage and subrogation are a material component of the Company’s incurred losses and reserves for losses (both on-balance sheet and off-balance sheet). Pursuant to the Company’s policies of insurance, should the Company pay a claim under a policy, subrogation rights enable the Company to pursue the obligor for recovery of all claims paid or losses incurred. In other cases, the Company may be assigned the rights to certain salvage as reimbursement for any claims paid or losses incurred. An important characteristic to recognize with respect to estimated salvage and subrogation recoveries is that such estimates are subject to both timing and credit risk. In many instances, the timing of such recoveries is expected to occur significantly later than the associated claim payments the Company is trying to recover. In addition, in regard to subrogation, credit risk exists with respect to the obligor’s ability to ultimately honor the insurer’s claim for recoveries, and in respect of salvage, risk exists as to whether such salvage will ultimately be sufficient to recover all of the insurer’s claims for recoveries. No assurance can be provided that estimated salvage and subrogation recoveries will be fully collected and any uncollected amount may be material to the Company’s financial position and results of operations.
- Establishment of case basis reserves for unpaid losses and loss adjustment expenses on the Company’s insured guaranties requires the use and exercise of significant judgment by management, including estimates regarding the severity of loss and the amount and timing of claim payments and

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recoveries on a guaranteed obligation. Case basis reserves reflect management's best estimate of the present value of the Company's remaining unpaid ultimate loss and not the worst possible outcome. Actual experience may, and likely will, differ from those estimates and such difference may be material due to the fact that the ultimate dispositions of claims are subject to the outcome of events that have not yet occurred and, in certain cases, will occur over many years in the future. Examples of these events include changes in the level of interest rates, credit deterioration of guaranteed obligations, changes in the value of specific assets supporting guaranteed obligations, willingness of the obligor or sponsor to honor its commitments, changes in the expected timing of claims payments and recoveries, and changes in the amounts of expected claims payments and recoveries. Both qualitative and quantitative factors are used in making such estimates. Each quarter, in connection with the preparation of its financial statements, the Company reevaluates all such estimates. Changes in these estimates may be material and may result in material changes in the Company's policyholders' surplus. Any estimate of future costs is subject to the inherent limitation on management's ability to predict the aggregate course of future events. It should, therefore, be expected that the actual emergence of losses and claims will vary, perhaps materially, from any estimate.

- The Company is involved in a number of legal proceedings, both as plaintiff and defendant, as well as regulatory inquiries and investigations. Management cannot predict the outcomes of these proceedings and other contingencies with certainty. In addition, it is not possible to predict whether additional suits will be filed or whether additional inquiries or investigations will be commenced. The outcome of some of these proceedings and other contingencies could require the Company to take or refrain from taking actions which could have a material adverse effect on its business, financial position or cash flows or could require the Company to pay (or fail to receive) substantial amounts of money. Additionally, prosecuting and defending these lawsuits and proceedings has caused the Company to incur significant expenses. See Note 16.
- ACA FG has experienced and likely will continue to experience substantial tax losses in the conduct of its business.

Section 382 of the Internal Revenue Code ("Section 382") contains rules that limit the ability of a corporation that experiences an "ownership change" to utilize its net operating loss carryforwards ("NOLs") and certain built-in losses recognized in periods following the ownership change. An ownership change is generally any change in ownership of more than 50 percentage points of a corporation's stock over a rolling 3-year period. Accordingly, the aggregate ownership change ("Aggregate Ownership Change") at any particular date represents the summation of the amount of ownership change resulting from all transactions in a corporation's stock occurring during the three year period ended on such date. These rules generally operate by focusing on ownership changes among shareholders owning directly or indirectly 5% or more of the stock of a corporation or any change in ownership arising from a new issuance of stock by the corporation. For purposes of the aforementioned test, ACA FG's surplus notes are considered stock and ACA FG's surplus note holders are considered shareholders.

Under Section 382, the transfer of ACA FG's surplus notes can cause an ownership change that would limit ACA FG's ability to utilize its NOLs and recognize certain built-in losses. Depending on the resulting limitation, a significant portion of ACA FG's NOLs could be deferred or could expire before ACA FG would be able to use them to offset positive taxable income in current or future tax periods.

ACA FG experienced an ownership change for purposes of Section 382 in 2014. As a consequence of the ownership change, ACA FG's ability to use its NOLs will be limited to approximately \$5.3 million on an annual basis.

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Since the ownership change mentioned above, the Company has generated significant net operating losses in 2016, 2015 and 2014. Another ownership change may further limit the initial NOL limitation and could impact the ability to fully utilize NOLs generated in 2016, 2015 and 2014.

Description of the Company's On-Going Strategic Plan

- Management is actively seeking to (i) remediate deteriorated insured exposures to minimize claim payments, maximize recoveries and mitigate ultimate losses, (ii) increase the Company's capital, surplus, liquidity and claims paying resources, (iii) realize maximum value from various legal proceedings described in Note 16 and from any other rights and remedies the Company may have, and (iv) take other actions to enhance its financial position (hereafter collectively referred to as "Strategic Actions"). In regard to the Strategic Actions, the Company is actively pursuing or exploring a number of options available to it to enhance the Company's policyholders' surplus or liquidity position or address other challenges that the Company faces. The Company has taken steps to reduce operating expenses and expects to take further steps in the future as the insured portfolio and remediation activities decrease. ACA's Board conducted a strategic review of the Company's finances and operations in 2014, including exploration of a sale or reinsurance assumption and outsourcing management of the Company's operations. The sale and reinsurance assumption efforts were not successful and there are no present efforts to sell the Company. In addition to the Strategic Actions mentioned above, management is seeking approval from the MIA to make a payout on its surplus notes. No assurances can be given that the Company will be successful in completing any of the aforementioned actions. Furthermore, certain of the Strategic Actions contemplated by the Company may be outside the ordinary course of the Company's operations or its control and may require consents or approvals of parties outside of the Company, including the MIA.

5. Summary of Significant Differences Between NAIC SAP and GAAP

The accompanying statutory-basis financial statements have been prepared in conformity with NAIC SAP, which differs in some respects from GAAP. The following is a description of the differences between the Company's significant NAIC SAP accounting policies and pertinent GAAP.

- Under NAIC SAP, upfront premiums are earned in proportion to current scheduled principal and interest payments due pursuant to the debt service schedule in the bond indenture to the total principal and interest payments scheduled to be paid over the life of the debt obligation. Additionally, under NAIC SAP, installment premiums are earned on a straight-line basis over each installment period (which periods are generally one year or less). Under GAAP, premium revenue is recognized over the period of the contract in proportion to the amount of insurance protection provided. Upfront and installment premium revenue is earned by applying a constant rate to the insured principal amount outstanding in a given period to recognize a proportionate share of the premium received or expected to be received on a financial guaranty insurance contract. Additionally, under GAAP, installment premiums receivable are recorded at the present value of the premiums due or expected to be collected over the period of the insurance contract using a discount rate which reflects the risk-free rate at the inception of the contract, whereas under NAIC SAP no receivable is recorded unless the amounts are due pursuant to the insurance contract;
- Under NAIC SAP, acquisition costs are charged to operations as incurred rather than GAAP's requirement to defer and amortize the costs as the related premiums are earned;
- Under NAIC SAP, a mandatory contingency reserve is computed and recorded on the basis of statutory requirements, whereas under GAAP such reserves are not permitted;
- Under NAIC SAP, losses on financial guaranty insurance policies are recognized upon a payment default by the issuer of the insured obligation whereas, under GAAP, losses on financial guaranty insurance

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policies are recognized when the weighted average probability of net cash outflows to be paid under the insurance contract exceed unearned premium reserves. In addition, under NAIC SAP, reserves for losses are discounted at a rate equal to the average rate of return on admitted assets, whereas under GAAP loss reserves are discounted using a risk-free rate as of the measurement date and are reported net of the liability at such date for unearned premium revenue;

- Under NAIC SAP, certain assets which are determined to be non-admissible under NAIC SAP (such as furniture and equipment, leasehold improvements, deferred income taxes in excess of certain limitations, prepaid expenses and any other assets deemed non-admittable) are excluded from the statements of admitted assets, liabilities and surplus and charged directly to unassigned surplus whereas, under GAAP, these amounts are reflected as assets;
- Investments in bonds are generally carried at amortized cost under NAIC SAP. Accordingly, unrealized changes in fair value are not reflected in the statutory-based statements of income and changes in capital and surplus or the statutory statements of admitted assets, liabilities and surplus. Bonds not qualified to be carried at amortized cost under NAIC SAP are carried at the lower of amortized cost or fair value as required by the NAIC with the differences between these values recorded directly to unassigned surplus net of an adjustment for deferred federal income taxes. Under GAAP, investments in bonds are classified at the time of purchase as “held to maturity” and reported at amortized cost, or “trading” and reported at fair value with unrealized gains and losses included in earnings, or “available for sale” and reported at fair value with unrealized gains and losses reported in a separate component of shareholders’ equity net of an adjustment for deferred federal income taxes;
- Under NAIC SAP, investment in the Company’s wholly-owned subsidiaries are accounted for under the statutory equity method of accounting, whereas under GAAP such subsidiaries are consolidated into the financial statements of the Company;
- Under NAIC SAP, reserves for unpaid losses and unearned premiums are presented net of reinsurance, whereas under GAAP such amounts are presented gross of reinsurance and corresponding assets for reinsurance recoverable on unpaid losses and prepaid reinsurance premiums are recorded;
- Under NAIC SAP, surplus notes are treated as equity and reported as part of capital and surplus, whereas under GAAP surplus notes may be recorded either as liabilities or equity depending upon whether the characteristics, or economic substance, of such securities are deemed to be more like debt or equity, respectively.

Although the net effect of the adjustments required to convert the accompanying statutory-basis financial statements to be in accordance with GAAP is not reasonably determinable, it is presumed that such adjustments would have a material effect on net income and surplus as regards policyholders for the years ended December 31, 2018 and 2017, respectively.

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6. Investments

Bonds, with a NAIC carrying value of \$4.1 million and \$4.9 million were on deposit with various state regulatory authorities at December 31, 2018 and 2017, respectively, as required by insurance regulations.

The NAIC carrying value, amortized cost and estimated fair value of bonds as of December 31, 2018 and 2017 were as follows:

Investment Categories	2018				
	NAIC Carrying Value	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
U.S. — Treasury securities	\$ 8,556	\$ 8,556	\$ -	\$ (67)	\$ 8,489
Federal-agency securities	51	51	4	-	55
Obligations of states and political subdivisions	13,085	13,163	162	(81)	13,244
Corporate securities	72,115	72,115	461	(1,378)	71,198
Asset-backed securities	13,251	13,251	117	(45)	13,323
Mortgaged-backed securities	92,039	92,124	957	(3,263)	89,818
Total	\$ 199,097	\$ 199,260	\$ 1,701	\$ (4,834)	\$ 196,127

Investment Categories	2017				
	NAIC Carrying Value	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
U.S. — Treasury securities	\$ 26,090	\$ 26,090	\$ -	\$ (103)	\$ 25,987
Federal-agency securities	64	64	5	-	69
Obligations of states and political subdivisions	13,165	13,196	90	(30)	13,256
Corporate securities	89,968	89,968	2,787	(55)	92,700
Asset-backed securities	21,917	21,917	212	(25)	22,104
Mortgaged-backed securities	107,790	107,902	1,442	(1,827)	107,517
Total	\$ 258,994	\$ 259,137	\$ 4,536	\$ (2,040)	\$ 261,633

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The NAIC carrying value and estimated fair value of bonds at December 31, 2018, by contractual maturity, are shown below. Actual maturities could differ from contractual maturities because borrowers have the right to call or prepay certain obligations which may or may not include call or prepayment penalties.

	NAIC Carrying Value	Estimated Fair Value
Due in one year or less	\$ 10,559	\$ 10,553
Due after one year through five years	38,627	38,545
Due after five years through ten years	34,734	34,007
Due after ten years	<u>9,887</u>	<u>9,881</u>
Subtotal	93,807	92,986
Asset-backed securities	13,251	13,323
Mortgaged-backed securities	<u>92,039</u>	<u>89,818</u>
Total	<u>\$ 199,097</u>	<u>\$ 196,127</u>

Proceeds from sales of bonds during 2018 and 2017 were \$19.8 million and \$84.8 million, respectively. Gross gains of \$0.7 million and \$0.8 million and gross losses of \$0.3 million and \$0.2 million were realized on those sales in 2018 and 2017, respectively.

Net investment income consisted of the following for the years ended December 31, 2018 and 2017:

	2018	2017
Income from fixed-maturity securities	\$ 8,377	\$ 9,768
Dividends from affiliate	120	1,300
Investment expenses	<u>(355)</u>	<u>(424)</u>
Net investment income	<u>\$ 8,142</u>	<u>\$ 10,644</u>

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The following table summarizes, for all securities in an unrealized loss position at December 31, 2018 and 2017, the aggregate fair value and gross unrealized loss by length of time the amounts have continuously been in an unrealized loss position:

	2018		2017	
	Fair Value	Gross Unrealized Loss	Fair Value	Gross Unrealized Loss
Less than 12 months:				
U.S. — Treasury securities	\$ -	\$ -	\$ 17,440	\$ (50)
Federal-agency securities	-	-	-	-
Obligations of states and political subdivisions	1,000	(4)	-	-
Corporate securities	42,519	(1,109)	-	-
Asset-backed securities	5,123	(10)	-	-
Mortgaged-backed securities	12,685	(94)	-	-
Total less than 12 months	61,327	(1,217)	17,440	(50)
	2018		2017	
	Fair Value	Gross Unrealized Loss	Fair Value	Gross Unrealized Loss
Greater than 12 months:				
U.S. — Treasury securities	\$ 8,489	\$ (67)	\$ 8,547	\$ (53)
Federal-agency securities	-	-	-	-
Obligations of states and political subdivisions	9,147	(77)	9,265	(30)
Corporate securities	4,015	(269)	5,029	(55)
Asset-backed securities	3,959	(35)	6,128	(25)
Mortgaged-backed securities	62,914	(3,169)	82,770	(1,827)
Total greater than 12 months	88,524	(3,617)	111,739	(1,990)
Total	\$ 149,851	\$ (4,834)	\$ 129,179	\$ (2,040)

For the years ended December 31, 2018 and 2017, the Company recognized total OTTI on its bonds in the amount of \$205 thousand and \$0 thousand, respectively. OTTI recognized for loan-backed securities for the years ended December 31, 2018 and 2017 amounted to \$103 thousand and \$0 thousand, respectively.

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OTTI on loan-backed securities was recognized due to the inability to retain the investment in the security for a period of time sufficient to recover the amortized cost basis. The following table shows the OTTI adjustment, by CUSIP, in 2018:

(1) CUSIP	(2) Book/Adjusted Carrying Value Amortized Cost Before OTTI	(3) Present Value of Projected Cash Flows	(4) Recognized OTTI in Loss	(5) Amortized Cost After OTTI	(6) Fair Value at time of OTTI
50179MAH4	\$ 312	\$ 265	\$ 103	\$ 209	\$ 209
Total			<u>\$ 103</u>		

7. Loss and Loss Adjustment Expenses

The following table is a reconciliation of the beginning and ending balances of the reserve for losses and loss adjustment expenses as of December 31, 2018 and 2017:

	2018	2017
Balance — January 1	\$ 75,640	\$ 113,974
Less reinsurance recoverable	-	-
Net balance — January 1	<u>75,640</u>	<u>113,974</u>
Incurred related to:		
Current year	9,658	9,877
Prior years	55	134
Total incurred	<u>9,713</u>	<u>10,011</u>
Less paid related to:		
Current year	382	2,638
Prior years	35,663	45,707
Total paid	<u>36,045</u>	<u>48,345</u>
Net balance — December 31	49,308	75,640
Plus reinsurance recoverables	-	-
Balance — December 31	<u>\$ 49,308</u>	<u>\$ 75,640</u>

For the year ended December 31, 2018, the Company's incurred loss and loss adjustment expenses of \$9.7 million consisted of \$8.1 million of losses and \$1.6 million of loss adjustment expenses.

For the year ended December 31, 2018, the Company incurred losses of \$8.1 million, which consisted of \$9.6 million of incurred losses related to payment defaults that occurred in 2018 ("current accident year claims"), \$3.4 million of net favorable development on reserves established in years prior to 2017 ("prior accident year claims") and \$1.9 million of discount accretion.

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The 2018 accident year losses are comprised of two credits that experienced an initial payment default. As of December 31, 2018, the Company's liability for unpaid losses was \$47.0 million, net of salvage and subrogation of \$19.1 million, which related to twenty-two insured transactions, with a remaining aggregate in-force par outstanding of \$189.4 million, excluding the aforementioned case reserves. The Company recorded LAE incurred of \$1.6 million in 2018 and unpaid LAE of \$2.3 million as of December 31, 2018.

As discussed in Note 4, the Company's estimate of its ultimate Off-Balance Sheet Losses at December 31, 2018 ranged from \$14 million to \$19 million. This range of Off-Balance Sheet Losses related to ten insured transactions classified as category 4 credits, with a remaining aggregate in-force par outstanding of approximately \$0.6 million, excluding the aforementioned Off-Balance Sheet Losses.

For the year ended December 31, 2017, the Company's incurred loss and loss adjustment expenses of \$10.0 million consisted of \$5.1 million of losses and \$4.9 million of loss adjustment expenses.

For the year ended December 31, 2017, the Company incurred losses of \$5.1 million, which consisted of \$9.4 million of incurred losses related to payment defaults that occurred in 2017 ("current accident year claims"), \$6.6 million of net favorable development on reserves established in years prior to 2017 ("prior accident year claims") and \$2.3 million of discount accretion.

The 2017 accident year losses are comprised of two credits that experienced an initial payment default, of which one credit was fully settled in 2017. As of December 31, 2017, the Company's liability for unpaid losses was \$71.7 million, net of salvage and subrogation of \$19.9 million, which related to twenty-four insured transactions, with a remaining aggregate in-force par outstanding of \$208.6 million, excluding the aforementioned case reserves. The Company recorded LAE incurred of \$4.9 million in 2017 and unpaid LAE of \$4.0 million as of December 31, 2017.

8. Reinsurance

The Company assumed a portion of its business with other non-affiliated insurance and reinsurance companies and adjusted its estimated or potential liabilities for unpaid losses and loss adjustment expenses and unearned premiums accordingly.

As of and for the years ended December 31, 2018 and 2017, amounts reinsured were as follows:

	<u>2018</u>	<u>2017</u>
Income and expenses:		
Earned premiums assumed	\$ 327	\$ 1,928
Assets and liabilities:		
Unearned-premium reserve assumed	\$ 1,105	\$ 1,432
Outstanding exposure assumed:		
Principal outstanding assumed	\$ 187,333	\$ 188,276

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9. Income Taxes

The actual tax expense on income from operations differs from tax expense calculated at the U.S. statutory tax rate. A reconciliation of the Company's income tax expense together with the significant book to tax adjustments for the years ended December 31, 2018 and 2017 is set forth below:

	<u>2018</u>	<u>2017</u>
Income before income taxes	\$ (928)	\$ 14,265
Expected tax benefit at 21%-2018, 35%-2017	\$ (195)	\$ 4,993
Dividends from subsidiaries	(10)	(42)
Tax exempt interest — net of proration	(50)	(52)
Change in statutory valuation allowance	(696)	(38,078)
TCJA 2017 rate change impact	-	45,513
Effect of Sequestration on AMT Credit Refund	51	-
Prior year tax adjustment and other	404	5
Total statutory income tax	<u>\$ (496)</u>	<u>\$ 12,339</u>
Federal income tax benefit	\$ (364)	\$ -
Change in deferred income tax	(132)	12,339
Total statutory income tax	<u>\$ (496)</u>	<u>\$ 12,339</u>

At December 31, 2018, the Company had net operating loss carryforwards expiring through the year 2036 of \$206.7 million and AMT credit carryforwards, which do not expire, in the amount of \$0.4 million.

In November 2015, the Internal Revenue Service ("IRS") concluded its examination of income tax returns for ACA through the 2008 tax year. No material adjustments arose as a result of the audit in relation to the financial position or results of operations of the Company for the tax years that were examined. As of December 31, 2018, no material adjustments are expected for tax years for which the statute of limitations remains open.

The Company's net operating and capital loss carryforwards are limited in its aggregate under Section 382 of the Internal Revenue Code. This limitation is reflected in the statutory valuation allowance determination. The cumulative remaining Section 382 limitation at December 31, 2018 is approximately \$14 million.

In December 2017, significant changes were enacted to the federal income tax code. The most significant change impacting the Company in 2018 is the tax rate change from 35% to 21%. The rate change has been reflected in the Company's deferred tax assets and deferred tax liabilities. Due to the level of the Company's valuation allowance and non-admitted assets, the change in tax rate had no impact on surplus.

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The components of the net deferred tax assets and deferred tax liabilities are as follows:

	<u>2018</u>	<u>2017</u>
Gross deferred tax assets	\$ 69,309	\$ 69,652
Gross deferred tax liabilities	<u>(823)</u>	<u>(602)</u>
Net deferred tax asset	68,486	69,050
Statutory valuation allowance adjustment	(48,801)	(49,497)
Non-admitted deferred tax asset	<u>(19,685)</u>	<u>(19,553)</u>
Net admitted deferred tax asset	<u>\$ -</u>	<u>\$ -</u>
Decrease in non-admitted deferred tax assets	<u>\$ 132</u>	<u>\$ (12,339)</u>

Pursuant to paragraphs 11.a.–11.c. of SSAP 101, the admission calculation components at December 31, 2018 and 2017 are as follows:

	<u>2018</u>	<u>2017</u>	<u>Change</u>
Ordinary:			
(a) Admitted pursuant to 11.a.	\$ -	\$ -	\$ -
(b) Admitted pursuant to 11.b. (lesser of 11.b.i. or 11.b.ii.)	-	-	-
(c) 11.b.i.	-	-	-
(d) 11.b.ii.	N/A	N/A	-
(e) Admitted pursuant to 11.c.	<u>823</u>	<u>602</u>	<u>221</u>
(f) Total ordinary admitted under 11.a. - 11.c.	823	602	221
(g) Ordinary deferred tax liabilities	<u>(823)</u>	<u>(602)</u>	<u>(221)</u>
Net ordinary admitted deferred tax assets	<u>-</u>	<u>-</u>	<u>-</u>
Capital:			
(a) Admitted pursuant to 11.a.	-	-	-
(b) Admitted pursuant to 11.b. (lesser of 11.b.i. or 11.b.ii.)	-	-	-
(c) 11.b.i.	-	-	-
(d) 11.b.ii.	N/A	N/A	-
(e) Admitted pursuant to 11.c.	<u>-</u>	<u>-</u>	<u>-</u>
(f) Total capital admitted under 11.a. - 11.c.	-	-	-
(g) Capital deferred tax liabilities	<u>-</u>	<u>-</u>	<u>-</u>
Net capital admitted deferred tax assets	<u>-</u>	<u>-</u>	<u>-</u>
Net admitted deferred tax assets	<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</u>

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The tax effects of temporary differences that give rise to significant portions of the deferred tax assets and liabilities are as follows:

	<u>2018</u>	<u>2017</u>	<u>Change</u>
Deferred tax assets:			
Ordinary:			
Net operating loss carryforward	\$ 43,410	\$ 45,337	\$ (1,927)
Contingency reserve	20,144	20,144	-
Unearned premium reserve	554	688	(134)
Tax credit carryforward	364	780	(416)
Salvage and Subrogation	3,867	2,496	1,371
Other (separately disclose items >5%)	-	11	(11)
	<u>68,339</u>	<u>69,456</u>	<u>(1,117)</u>
Gross ordinary deferred tax assets			
Statutory valuation adjustment - ordinary	(47,831)	(49,037)	1,206
Non-admitted ordinary deferred tax assets	<u>(19,685)</u>	<u>(19,553)</u>	<u>(132)</u>
Gross ordinary admitted deferred tax assets	<u>823</u>	<u>866</u>	<u>(43)</u>
Capital:			
Net capital loss carryforward	522	56	466
Investments	<u>448</u>	<u>405</u>	<u>43</u>
Gross capital deferred tax assets	970	461	509
Statutory valuation adjustment - capital	(970)	(461)	(509)
Non-admitted capital deferred tax assets	<u>-</u>	<u>-</u>	<u>-</u>
Gross capital admitted deferred tax assets	<u>-</u>	<u>-</u>	<u>-</u>
Deferred tax liabilities:			
Ordinary:			
Investments	(430)	(457)	27
Fixed assets	(195)	(145)	(50)
Deferred Comp-Bonus	(59)	-	(59)
Loss reserve discount	(139)	(264)	125
Other (separately disclose items >5%)	<u>-</u>	<u>-</u>	<u>-</u>
Gross ordinary deferred tax liabilities	<u>(823)</u>	<u>(866)</u>	<u>43</u>
Net admitted deferred tax assets	<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</u>

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The change in net deferred income taxes is comprised of the following (exclusive of non-admitted assets):

	<u>2018</u>	<u>2017</u>
Total deferred tax assets, net of valuation allowance — January 1	\$ 20,155	\$ 33,574
Total deferred tax liabilities — January 1	<u>(602)</u>	<u>(1,682)</u>
Net deferred tax asset — January 1	19,553	31,892
Net deferred tax asset — December 31	<u>19,685</u>	<u>19,553</u>
Change in net deferred asset	132	(12,339)
Tax effect of unrealized losses	<u>-</u>	<u>-</u>
Change in net deferred income tax	<u>\$ 132</u>	<u>\$ (12,339)</u>

There were no reserves for tax contingencies as required under SSAP 5 as of December 31, 2018 and 2017.

10. Outstanding Exposure Under In-Force Financial Guaranty Insurance Contracts

While the Company establishes reserves for losses and loss adjustment expenses on obligations in accordance with its accounting policies (see Note 1), the risk of loss under the Company's guaranties extends to the full amount of unpaid principal and interest on all debt obligations it has guaranteed (see description of financial guaranty insurance in Note 2). Net par outstanding in the tables below reflect only the outstanding principal balance for capital appreciation bond obligations that the Company has insured. The Company reports its remaining obligation, including any accreted values, as an interest obligation.

The table below reflects certain information regarding the in-force par exposure guaranteed by the Company at December 31, 2018 and 2017 (dollars in millions):

	<u>2018</u>		<u>2017</u>	
	Net Par Outstanding	% of Net Par Outstanding	Net Par Outstanding	% of Net Par Outstanding
Tax-exempt:				
Healthcare	\$ 18	2.5 %	\$ 32	3.7 %
Tax backed	69	9.4	100	11.5
Education	169	23.1	178	20.4
Long-term care	17	2.3	21	2.4
General obligations	204	27.8	206	23.7
Utilities	36	4.9	41	4.7
Transportation	80	10.9	85	9.8
Housing	33	4.5	41	4.7
Not for Profit	28	3.8	54	6.2
Other	<u>79</u>	<u>10.8</u>	<u>113</u>	<u>13.0</u>
Total public finance obligations	733	100.0	871	100.0
Taxable obligations — other	<u>-</u>	<u>0</u>	<u>-</u>	<u>0</u>
Total	<u>\$ 733</u>	<u>100.0 %</u>	<u>\$ 871</u>	<u>100.0 %</u>

ACA Financial Guaranty Corporation
(dollars in thousands)

The following table sets forth, by state, those states in which the Company has the largest net par outstanding of insured tax exempt obligations (dollars in millions):

	2018		2017	
	Net Par Outstanding	% of Net Par Outstanding	Net Par Outstanding	% of Net Par Outstanding
New York	\$ 212	28.9 %	\$ 221	25.4 %
California	54	7.4	81	9.3
Georgia	69	9.4	74	8.5
Florida	69	9.4	72	8.3
Illinois	47	6.4	55	6.3
Other states	282	38.5	368	42.3
Total tax-exempt obligations	<u>\$ 733</u>	<u>100.0 %</u>	<u>\$ 871</u>	<u>100.0 %</u>

The outstanding principal amount of obligations insured by the Company as of December 31, 2018, net of amounts ceded, and the terms to maturity of such insured obligations were as follows (dollars in millions):

Terms to Maturity

0 to 5 years	\$ 298
5 to 10 years	243
10 to 15 years	116
15 to 20 years	74
20 and above	<u>2</u>
Total	<u>\$ 733</u>

Actual maturities could differ from final maturities because borrowers have the right to refund or prepay certain obligations. Debt service on insured obligations for 2019 is approximately \$93.5 million.

11. Related Party Transactions

The payable to subsidiaries at December 31, 2018 and 2017 are as follows:

	2018	2017
Payable to Tactical Risk Management, LLC	<u>\$ 81</u>	<u>\$ 82</u>
Payable to subsidiaries	<u>\$ 81</u>	<u>\$ 82</u>

In 2013, ACA's board of directors approved the economic terms by which BedRok Securities LLC ("BedRok"), a broker dealer controlled by a board member, was authorized to purchase ACA-insured bonds on behalf of ACA. Such approved compensation earned by BedRok was in the range of spreads paid by ACA since its restructuring to non-affiliated brokers for similar transactions. In 2018, the Company did not conduct a trade with BedRok. In 2017, BedRok earned approximately \$36 thousand in connection with seven significant purchases of ACA insured bonds in the amount of \$7.3 million.

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(dollars in thousands)

12. Retirement Benefit Plans

The Company sponsors a defined contribution plan, which covers all full time employees as of their start date. Eligible participants may contribute a percentage of their salary, subject to IRS limitations. The Company's contributions are based on a fixed percentage of employees' contributions subject to IRS limitations. The Company's expense for the plan years ended December 31, 2018 and 2017 was \$0.1 million and \$0.1 million, respectively.

13. Fair Value of Financial Instruments

Pursuant to SSAP No. 100, Fair Value Measurements, the fair value of an asset is the amount at which that asset could be bought or sold in a current transaction between willing parties, that is, other than in a forced or liquidation sale. The fair value of a liability is the amount at which that liability could be incurred or settled in a current transaction between willing parties, that is, other than in a forced or liquidation sale.

Fair values are based on quoted market prices when available. When market prices are not available, fair value is generally estimated using discounted cash flow analyses, incorporating current market inputs for similar financial instruments with comparable terms and credit quality (matrix pricing). In instances where there is little or no market activity for the same or similar instruments, the Company estimates fair value using methods, models and assumptions that management believes market participants would use to determine a current transaction price. These valuation techniques involve some level of management estimation and judgment which becomes significant when valuing increasingly complex instruments. Where appropriate, adjustments are included to reflect the risk inherent in a particular methodology, model or input used.

The hierarchy defined by SSAP No. 100 gives the highest ranking to fair values determined using unadjusted quoted prices in active markets for identical assets and liabilities (Level 1) and the lowest ranking to fair values determined using methodologies and models with unobservable inputs (Level 3). An asset's or a liability's classification is based on the lowest level input that is significant to its measurement. For example, a Level 3 fair value measurement may include inputs that are both observable (Levels 1 and 2) and unobservable (Level 3). The levels of the fair value hierarchy are as follows:

Level 1 — Values are unadjusted quoted prices for identical assets and liabilities in active markets accessible at the measurement date.

Level 2 — Inputs include quoted prices for similar assets or liabilities in active markets, quoted prices from those willing to trade in markets that are not active, or other inputs that are observable or can be corroborated by market data for the term of the instrument. Such inputs include market interest rates and volatilities, spreads and yield curves.

Level 3 — Certain inputs are unobservable (supported by little or no market activity) and significant to the fair value measurement. Unobservable inputs reflect the Company's best estimate of what hypothetical market participants would use to determine a transaction price for the asset or liability at the reporting date.

With the exception of certain investments in bonds and loan-backed securities that are reported at the lower of cost or fair value, or such securities on which an OTTI has been recognized as of the balance sheet date, the Company has no assets or liabilities reported in the accompanying statement of admitted assets, liabilities and capital and surplus at December 31, 2018, that are measured at fair value. The aforementioned securities which are reported at fair value in the accompanying financial statements represent securities that are reported at fair value on a non-recurring basis.

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(dollars in thousands)

The tables below present the investments carried by the Company at fair value at December 31, 2018 and 2017:

December 31, 2018	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>	<u>Total</u>
a. Assets at fair value on a nonrecurring basis:				
Cash equivalents	\$ -	\$ -	\$ -	\$ -
Bonds	-	10,685	-	10,685
Total assets at fair value	<u>\$ -</u>	<u>\$ 10,685</u>	<u>\$ -</u>	<u>\$ 10,685</u>
b. Total liabilities at fair value	<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</u>
December 31, 2017	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>	<u>Total</u>
a. Assets at fair value on a nonrecurring basis:				
Cash equivalents	\$ -	\$ -	\$ -	\$ -
Bonds	-	9,662	-	9,662
Total assets at fair value	<u>\$ -</u>	<u>\$ 9,662</u>	<u>\$ -</u>	<u>\$ 9,662</u>
b. Total liabilities at fair value	<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</u>

The Company had no transfers of securities between levels during 2018 or 2017.

When available, the estimated fair value for bonds, including loan-backed and structured securities, and short-term investments are based on quoted prices in active markets that are readily and regularly obtainable. Generally, these investments are classified in Level 2.

When quoted prices in active markets are not available, the determination of estimated fair value is based on market standard valuation methodologies, giving priority to observable inputs. The significant inputs to the market standard valuation methodologies for certain types of securities with reasonable levels of price transparency are inputs that are observable in the market or can be derived principally from or corroborated by observable market data. Generally, these investments are classified in Level 2.

When observable inputs are not available, the market standard valuation methodologies for determining the estimated fair value of certain types of securities that trade infrequently, and therefore have little or no price transparency, rely on inputs that are significant to the estimated fair value that are not observable in the market or cannot be derived principally from or corroborated by observable market data. These unobservable inputs can be based in large part on management's judgment or estimation, and cannot be supported by reference to market activity. Even though these inputs are unobservable, management believes they are consistent with what other market participants would use when pricing such securities and are considered appropriate given the circumstances. Generally, these investments are classified in Level 3.

The estimated fair value for cash approximates carrying value and is classified as Level 1 given the nature of cash.

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(dollars in thousands)

The tables below present the aggregate estimated fair value and admitted value of the Company's total investment portfolio and cash and short-term investments at December 31, 2018 and 2017 along with how much of the aggregate estimated fair value represents Level 1, 2, and 3 estimates under the fair value hierarchy prescribed under SSAP No. 100:

	2018				
	Aggregate Fair Value	Admitted Value	Level 1	Level 2	Level 3
Assets:					
Bonds	\$ 196,127	\$ 199,097	\$ -	\$ 196,127	\$ -
Cash, cash equivalents and short-term investments	30,142	30,144	30,142	-	-
Total	<u>\$ 226,269</u>	<u>\$ 229,241</u>	<u>\$ 30,142</u>	<u>\$ 196,127</u>	<u>\$ -</u>
	2017				
	Aggregate Fair Value	Admitted Value	Level 1	Level 2	Level 3
Assets:					
Bonds	\$ 261,633	\$ 258,994	\$ -	\$ 261,633	\$ -
Cash, cash equivalents and short-term investments	3,855	3,855	3,855	-	-
Total	<u>\$ 265,488</u>	<u>\$ 262,849</u>	<u>\$ 3,855</u>	<u>\$ 261,633</u>	<u>\$ -</u>

14. Restricted Balances

As mentioned in Note 6, Investments, the Company has assets on deposit with various regulatory authorities. As of December 31, 2018 and 2017, the Company holds \$842 thousand of cash collateral relating to an insured transaction. In addition, as of December 31, 2018 and 2017, the Company had approximately \$28 thousand on deposit with its landlord as collateral under its office lease obligations (see Note 17), which was non-admitted.

15. Regulatory Matters

As of December 31, 2018, the Company's policyholders' surplus, as determined in accordance with statutory-basis accounting practices, was \$55.8 million. Such amount was in excess of the minimum capital and surplus level required by the MIA.

In addition to the MIA, the insurance departments of certain other states have various requirements relating to the maintenance of certain minimum statutory-basis capital and reserves, single risk limits and limits on non-investment grade obligations. The Company does not meet certain of these requirements. As a runoff company, the Company reviews its compliance with each of the state's various requirements, and to the extent that it is not compliant, the Company has not received any material adverse action from any state in the time since restructuring. The Company believes that the other states have declined to take action because remedies availability, such as the ability to write new business, are already addressed in the Order and by ongoing regulatory oversight of the MIA.

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(dollars in thousands)

As disclosed in Note 3, Restructuring Transaction, the Company is currently operating under the Order issued by the MIA. Pursuant to this Order, the Company is restricted from paying dividends or making payments to the surplus note holders without the prior approval of the Commissioner of the MIA. In addition, under Maryland insurance law, the Company may pay a dividend without the prior approval of the Commissioner of the MIA from earned surplus, as defined, subject to the maintenance of a minimum-capital requirement, and the dividend, which, together with all dividends declared or distributed by it during the preceding twelve months, may not exceed the lesser of 10% of policyholders' surplus shown on its last annual statement, or net investment income, as defined, for such twelve-month period. In addition, pursuant to the Restructuring Transaction discussed in Note 3, the surplus notes restrict the Company from paying dividends without the prior approval of the surplus note holders. The Company has negative earned surplus and therefore, is not able to pay dividends in 2018 other than extraordinary dividends as allowed by the MIA. No dividends or payments to surplus note holders were made during 2018 or 2017.

The portion of unassigned surplus reduced by each item below at December 31, 2018 and 2017 is as follows:

	<u>2108</u>	<u>2017</u>
a. Unrealized losses, net of deferred tax benefit of \$0 for 2018 and 2017	\$ (181)	\$ (161)
b. Non-admitted asset values	\$ (21,106)	\$ (20,978)

16. Contingencies

The Company (specifically, ACA Management, LLC) is one of many defendants in an action pending in New Mexico First Judicial District Court, in Santa Fe, filed in 2008 by Frank Foy on behalf of the State of New Mexico. The complaint alleges that Vanderbilt Capital Advisors (and certain affiliates) engaged in an unlawful "pay to play" scheme with various New Mexico state officials, causing two New Mexico state agencies to purchase certain worthless CDO investments, including some with which the Company was allegedly connected. The complaint seeks compensatory damages in excess of \$90 million, plus interest and civil penalties which the plaintiffs assert raise the claim to several hundred million dollars under certain New Mexico statutes, including the Fraud Against Taxpayers Act ("FATA"). Further, the complaint seeks to impose joint and several liability on all defendants. In April 2010, the then-presiding judge ruled that the retroactive nature of FATA was unconstitutional. The ruling was affirmed by the New Mexico Court of Appeals. However, on June 25, 2015, the Supreme Court of the State of New Mexico reversed and held that FATA is constitutional. The New Mexico Supreme Court also consolidated multiple related cases and reassigned the consolidated proceeding to a new district judge. On June 6, 2017, the district court granted both the New Mexico Attorney General's motion to dismiss and Vanderbilt's motion to confirm its settlement with the New Mexico Attorney General. The order was entered September 8, 2017. On October 8, 2017, Frank Foy appealed the dismissal. On January 19, 2018, the State of New Mexico moved to dismiss the appeal on the grounds that the docketing statement filed by Foy was not timely. On August 15, 2018, the New Mexico Court of Appeals entered an order denying the State's motion to dismiss the Foy appeal, and the appeal was assigned to the Court's general calendar. On December 12, 2018, the State filed a second motion to dismiss, on technical grounds. On January 3, 2019, the New Mexico Court of Appeals also denied the State's motion to dismiss on these grounds. Oral arguments are expected by mid-2019. To the extent activity directly involving the Company resumes in the case, the Company intends to continue to defend itself vigorously.

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(dollars in thousands)

Various lawsuits against the Company have arisen in the course of the Company's business. Contingent liabilities arising from such litigation and other matters are not considered material in relation to the financial position or the results of operations of the Company.

As a result of contractual rights in one particular ACA insured transaction, ACA could recognize salvage and subrogation recoveries in excess of its expected aggregate claim payments on a present value basis due to a perpetual pledge of revenue and the positive interest rate spread between the insured bond's rate and the current ACA discount rate. If the underlying bonds are refunded at par earlier, a portion of the contingent gain may not be realized.

In 2017, ACA negotiated a confidential settlement agreement with one of its former insurance carriers that was finalized during the first quarter of 2018 and resulted in payments to ACA in the quarter with respect to claims for coverage for certain investigations and lawsuits that are now closed. Such investigations and lawsuits related primarily to ACA's legacy structured finance business.

Pursuant to ACA's accounting policy, any estimated gains must be deferred and recognized only when the actual receipts of such recoveries occur. Accordingly, no assurance can be given that any or all expected recoveries will be received or that the amount of actual recoveries will not differ materially from that expected.

We have from time to time filed for damages, reserved rights and/or delivered notices of potential claims both to private parties and governmental entities, agencies and instrumentalities. We continually seek opportunities to obtain restitution and compensation for losses and related expenses incurred on previously issued financial guaranty insurance policies and on investment losses. The outcome of any such efforts remains uncertain at this time.

17. Leases

ACA FG subleased office space at 600 Fifth Avenue, New York, New York through September 29, 2016. The Company has signed a new lease for office space at 555 Theodore Fremd Avenue in Rye, NY with a commencement date of September 1, 2016 and a termination date of November 30, 2021.

At December 31, 2018, expected future minimum lease payments under its lease at 555 Theodore Fremd Avenue are as follows:

Year Ending <u>December 31,</u>	<u>Operating Leases</u>
2019	\$ 128
2020	130
2021	121
2022	-
2023	-
Beyond 5 years	-
Total	<u>\$ 379</u>

The Company's rental expense for the years ended December 31, 2018 and 2017 was \$145 thousand and \$125 thousand, respectively.

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(dollars in thousands)

18. Surplus Notes

Interests in the surplus notes issued in connection with the Restructuring Transaction (see Note 3) are either in the form of voting interests or non-voting interests. Surplus notes issued to the former insured swap counterparties represent voting and non-voting interests (at each counterparty's individual discretion) while notes issued to ACAH represent non-voting interests. By their terms the surplus notes are subordinate to the claims of policyholders, claimant and beneficiary claims, and to all other classes of creditors other than surplus note holders. However, claims under the surplus notes are superior to claims of preferred and common shareholders of the Company. Payments under the surplus notes of either principal or interest can only be paid out of the surplus of the Company after the Company provides for all reserves and other liabilities and only with the prior written approval of the MIA. The surplus note holders can request that the Company seek such approval.

Among others, holders of the surplus notes with voting interests have rights regarding the appointment of directors and amendments to the surplus notes. Each holder with greater than 10% initial voting rights has disclaimed control over the Company. This disclaimer has been approved by the MIA.

Pursuant to the surplus notes, the Company provides certain covenants which generally limit the activities of the Company and its subsidiaries to operating as a run-off business.

19. Financial Guaranty Insurance

As discussed in Note 1, the Company does not record premiums receivable on installment premium paying contracts unless such amounts are due, nor is any corresponding unearned premium recorded until such amounts are due.

The future expected earned premium revenue on upfront premium paying contracts as of December 31, 2018, assuming no Refundings, are as follows:

Period	
1st Quarter 2019	\$ 634
2nd Quarter 2019	486
3rd Quarter 2019	682
4th Quarter 2019	<u>464</u>
Year 2019	2,266
Year 2020	2,543
Year 2021	2,692
Year 2022	1,882
Year 2023	1,670
2024 through 2028	8,143
2029 through 2033	4,758
2034 through 2038	2,367
2039 through 2040	<u>49</u>
Total	<u>\$ 26,370</u>

ACA Financial Guaranty Corporation

(dollars in thousands)

Significant components of the change in the claim liability for the period are as follows:

Components

Reserves for losses and LAE at December 31, 2017	<u>\$ 75,640</u>
Change in reserves:	
Prior accident years	(35,608)
Current accident year	<u>9,276</u>
Subtotal change in reserves	<u>(26,332)</u>
Reserves for losses and LAE at December 31, 2018	<u><u>\$ 49,308</u></u>

The Company's credit quality classifications are as follows:

Category 1: Fully Performing

Credits are fully performing. Covenants have been met, financial reporting is timely and complete, and there have been no significant negative deviations from expected performance.

Category 2: Watch

Credits are performing below expected levels. Some covenants have been violated, projected budget and/or cash flow has not been achieved, operating performance or financial position is weakened. Although operating results are below underwriting expectations, current and projected revenues are adequate to service debt.

Category 3: Deteriorating

Credits show significant performance declines. Covenant violations are recurring and material; cashflow is significantly below projections, operating results are materially impaired. Corrective action is required to arrest credit deterioration and avert a longer-term risk of payment default.

Category 4: Paid or Expected Claim

Credits show material decline in creditworthiness and ability to pay. Operating results are increasingly negative, unreimbursed draws on debt service reserves have been made; payment defaults have occurred or are expected, and loss reserves have been established or are expected to be established in the financial statements.

Risk management activities are performed by ACA FG's portfolio management department. Portfolio analysts monitor all insured transactions in the portfolio to determine whether their financial performance is consistent with underwriting expectations and to identify any deterioration in the obligor's ability or willingness to pay insured debt service. Portfolio management staff are also responsible for recommending and undertaking remedial actions to prevent or mitigate losses.

All transactions in the insured portfolio are assigned one of four internal credit quality classifications that reflect the current and expected performance of the obligor. Ratings are reviewed and updated on a regular basis as analysts obtain more current financial and market information from the obligor, the trustee, or from public sources such as rating agencies and fixed income analysts. The frequency with which individual

ACA Financial Guaranty Corporation
(dollars in thousands)

obligors are reviewed is based on ACA FG's judgment of potential performance volatility and varies according to credit classification, sector, geography, size of exposure, and exogenous events.

The risk of loss under the Company's guaranties extends to the full amount of unpaid principal and interest on all debt obligations it has guaranteed. Net par outstanding in the table below reflects only the outstanding principal balance for capital appreciation bond obligations that the Company has insured. The Company reports its remaining obligation, including any accreted values, as an interest obligation.

Insured financial obligations as of December 31, 2018 are as follows:

	Credit Quality Categories				Total
	1	2	3	4	
Number of policies	49	16	6	27	98
Remaining weighted-average contract period (in years)	6	7	7	9	
Insured contractual payments outstanding:					
Principal	\$ 335,638	\$ 87,654	\$ 57,300	\$ 252,833	\$ 733,425
Interest	130,660	87,748	22,313	177,251	417,972
Total	\$ 466,298	\$ 175,402	\$ 79,613	\$ 430,084	\$ 1,151,397
Gross claim and LAE liability	\$ 15	\$ 20	\$ 30	\$ 78,866	\$ 78,931
Less:					
Gross potential recoveries	-	-	-	45,229	45,229
Discount — net	-	-	-	(15,606)	(15,606)
Net claim and LAE liability	\$ 15	\$ 20	\$ 30	\$ 49,243	\$ 49,308
Unearned premium revenue	\$ 5,360	\$ 3,770	\$ 2,183	\$ 15,057	\$ 26,370
Reinsurance recoverables	\$ -	\$ -	\$ -	\$ -	\$ -

The Company purchases ACA insured bonds periodically in the marketplace when available and the price meets internal prescribed limits for category 4 rated credits. For accounting purposes, the Company reflects the purchase as a loss payment and carries the bond at a zero value. Unless the bond is cancelled with the trustee, the par value remains outstanding. At December 31, 2018, the par value outstanding of category 4 bonds purchased and not cancelled is \$21.4 million.

20. Subsequent Events

The Company has evaluated all subsequent events through May 8, 2019, the date the statutory-basis financial statements were available to be issued. There were no events that required adjustment to the statutory-basis financial statements.

ACA Financial Guaranty Corporation
(dollars in thousands)

Summary Investment Schedule

December 31, 2018

(dollars in thousands)

Investment Categories	Gross Investment Holdings		Admitted Asset As Reported in the Annual Statement	
	Amount	Percentage	Amount	Percentage
U.S. Treasury securities	\$ 8,556	3.7%	\$ 8,556	3.7%
U.S. government agency and corporate obligations (excluding mortgage-backed securities) — issued by U.S. government sponsored agencies	-	0.0%	-	0.0%
Securities issued by states, territories and possessions and political subdivisions in the U.S.:				
States, territories and possessions general obligations	-	0.0%	-	0.0%
Political subdivisions of states, territories and possessions and political subdivisions general obligations	-	0.0%	-	0.0%
Revenue and assessment obligations	13,086	5.7%	13,086	5.7%
Industrial development and similar obligations	-	0.0%	-	0.0%
Mortgage-backed securities (includes residential and commercial MBS) pass-through securities:				
Issued or guaranteed by GNMA	18,705	8.2%	18,705	8.2%
Issued or guaranteed by FNMA and FHLMC	39,788	17.4%	39,788	17.4%
All other	4,365	1.9%	4,365	1.9%
CMOs and REMICs:				
Issued or guaranteed by GNMA, FNMA, FHLMC or VA	5,157	2.2%	5,157	2.2%
Issued by non-U.S. government issuers and collateralized by mortgage-backed securities issued or guaranteed by GNMA, FNMA, FHLMC or VA	-	0.0%	-	0.0%
All other	27,891	12.2%	27,891	12.2%
Other debt and other fixed income securities (excluding short-term):				
Unaffiliated domestic securities (includes credit tenant loans rated by the SVO)	58,991	25.7%	58,991	25.7%
Unaffiliated foreign securities	22,558	9.8%	22,558	9.8%
Receivable for securities	-	0.0%	-	0.0%
Receivable for securities	-	0.0%	-	0.0%
Cash, cash equivalents and short-term investments	30,144	13.1%	30,144	13.1%
Total cash and invested assets	\$ 229,241	100.0%	\$ 229,241	100.0%

ACA Financial Guaranty Corporation
(dollars in thousands)

Investment Risk Interrogatories

December 31, 2018

(dollars in thousands)

Provided below are management's responses to the Investment Risk Interrogatories and Summary Investment Schedule required by NAIC SAP. Questions/Categories not applicable to the Company have not been included below.

The Company's total admitted assets as of December 31, 2018 are: \$ 231,006

The Company's ten largest exposures to a single issuer based upon statement value listed by investment category are as follows:

Description of Exposure	Issuer	Amount	Percentage of Total Admitted Assets
MBS, CMO	Federal Home Loan Mortgage Corp	\$ 29,914	12.9%
MBS, CMO	Federal National Mortgage Association	15,018	6.5%
Municipal	Westchester County NY Ind Devel Agy	9,979	4.3%
Bonds, MBS	Morgan Stanley	7,084	3.1%
Bonds	AT&T Inc.	4,052	1.8%
Bonds	Bank of America Corporation	3,995	1.7%
Bonds	The Goldman Sachs Group, Inc.	3,576	1.5%
Bonds	Australia & New Zealand Banking Grp Ltd	3,499	1.5%
MBS	Morgan Stanley BAML Trust 2013-C8	3,223	1.4%
Bonds	AerCap Global Aviation Trust	3,080	1.3%

The Company's amounts and percentages of total admitted assets held in bonds by NAIC rating categories are as follows:

NAIC Rating Category	Amount	Percentage of Total Admitted Assets
NAIC-1	\$ 159,605	69.1%
NAIC-2	51,401	22.3%
NAIC-3	1,331	0.6%
NAIC-4	-	0.0%
NAIC-5	13,290	5.8%
NAIC-6	3	0.0%

ACA Financial Guaranty Corporation
(dollars in thousands)

Investment Risk Interrogatories (Cont'd)

December 31, 2018

(dollars in thousands)

	<u>Amount</u>	<u>Percentage of Total Admitted Assets</u>
Total admitted assets held in foreign investments	\$ 16,941	7.3%

Aggregate foreign investment exposure categorized by NAIC sovereign rating:

	<u>Amount</u>	<u>Percentage of Total Admitted Assets</u>
Countries rated NAIC-1	\$ 16,941	7.3%
Countries rated NAIC-2	-	0.0%

The Company's largest foreign investment exposures by country, by the country's NAIC sovereign rating:

	<u>Amount</u>	<u>Percentage of Total Admitted Assets</u>
Countries rated NAIC-1:		
Australia	\$ 9,872	4.3%
Great Britain	3,990	1.7%

The Company's ten largest non-sovereign (i.e. non-governmental) foreign issues are as follows:

<u>Issuer Description</u>	<u>NAIC Rating</u>	<u>Amount</u>	<u>Percentage of Total Admitted Assets</u>
Australia & New Zealand Banking Grp. Ltd	2FE	\$ 3,499	1.5%
AerCap Global Aviation Trust	2FE	3,080	1.3%
BHP Billiton Finance (USA) Limited	2FE	3,000	1.3%
HSBC Holdings PLC	1FE	1,999	0.9%
Westpac Banking Corporation	2FE	1,875	0.8%
Commonwealth Bank of Australia	2FE	1,497	0.6%
Reynolds American, Inc.	2FE	1,015	0.4%
B.A.T. Capital Corporation	2FE	976	0.4%
----	----	-	0.0%
----	----	-	0.0%

ACA Financial Guaranty Corporation
(dollars in thousands)

Reinsurance Interrogatories
December 31, 2018

7.1 Has the reporting entity reinsured any risk with any other entity under a quota share reinsurance contract that includes a provision that would limit the reinsurer's losses below the stated quota share percentage (e.g., a deductible, a loss ratio corridor, a loss cap, an aggregate limit or any similar provisions)?

Yes [] No [X]

9.1 Has the reporting entity ceded any risk under any reinsurance contract (or under multiple contracts with the same reinsurer or its affiliates) for which during the period covered by the statement: (i) it recorded a positive or negative underwriting result greater than 5% of prior yearend surplus as regards policyholders or it reported calendar year written premium ceded or year-end loss and loss expense reserves ceded greater than 5% of prior year-end surplus as regards policyholders; (ii) it accounted for that contract as reinsurance and not as a deposit; and (iii) the contract(s) contain one or more of the following features or other features that would have similar results:

- (a) A contract term longer than two years and the contract is noncancellable by the reporting entity during the contract term;
- (b) A limited or conditional cancellation provision under which cancellation triggers an obligation by the reporting entity, or an affiliate of the reporting entity, to enter into a new reinsurance contract with the reinsurer, or an affiliate of the reinsurer;
- (c) Aggregate stop loss reinsurance coverage;
- (d) A unilateral right by either party (or both parties) to commute the reinsurance contract, whether conditional or not, except for such provisions which are only triggered by a decline in the credit status of the other party;
- (e) A provision permitting reporting of losses, or payment of losses, less frequently than on a quarterly basis (unless there is no activity during the period); or
- (f) Payment schedule, accumulating retentions from multiple years or any features inherently designed to delay timing of the reimbursement to the ceding entity.

Yes [] No [X]

9.2 Has the reporting entity during the period covered by the statement ceded any risk under any reinsurance contract (or under multiple contracts with the same reinsurer or its affiliates), for which, during the period covered by the statement, it recorded a positive or negative underwriting result greater than 5% of prior year-end surplus as regards policyholders or it reported calendar year written premium ceded or year-end loss and loss expense reserves ceded greater than 5% of prior year-end surplus as regards policyholders; excluding cessions to approved pooling agreements or to captive insurance companies that are directly or indirectly controlling, controlled by, or under common control with (i) one or more unaffiliated policyholders of the reporting entity, or (ii) an association of which one or more unaffiliated policyholders of the reporting entity is a member, where:

- (a) The written premium ceded to the reinsurer by the reporting entity or its affiliates represents fifty percent (50%) or more of the entire direct and assumed premium written by the reinsurer based on its most recently available financial statement; or
- (b) Twenty-five percent (25%) or more of the written premium ceded to the reinsurer has been retroceded back to the reporting entity or its affiliates in a separate reinsurance contract.

Yes [] No [X]

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