

# ACA Financial Guaranty Corporation

Statutory-Basis Financial Statements as of and  
for the Years Ended December 31, 2012 and 2011,  
Supplemental Schedules as of December 31, 2012,  
and Independent Auditors' Report

# ACA FINANCIAL GUARANTY CORPORATION

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## INDEPENDENT AUDITORS' REPORT

To the Board of Directors of  
ACA Financial Guaranty Corporation:

We have audited the accompanying statutory-basis financial statements of ACA Financial Guaranty Corporation (the "Company"), which comprise the statutory-basis statements of admitted assets, liabilities and surplus as of December 31, 2012 and 2011, and the related statutory-basis statements of income and changes in surplus, and cash flow for the years then ended, and the related notes to the statutory-basis financial statements.

### Management's Responsibility for the Statutory-Basis 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 statutory-basis 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 audit to obtain reasonable assurance about whether the statutory-basis financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the statutory-basis financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the statutory-basis financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the Company's preparation and fair presentation of the statutory-basis 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 Company's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of the accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the statutory-basis 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 4 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.

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, 2012 and 2011, 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 surplus of the Company as of December 31, 2012 and 2011, 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 4 to the statutory-basis financial statements.

#### **Report on Supplemental Schedules**

Our 2012 audit was conducted for the purpose of forming an opinion on the 2012 statutory-basis financial statements as a whole. The supplemental summary of investment schedule, the supplemental schedule of investment risk interrogatories, and the supplemental schedule of reinsurance risk interrogatories as of and for the year ended December 31, 2012 are presented for purposes of additional analysis and are not a required part of the 2012 statutory-basis financial statements. These schedules are the responsibility of the Company's management and were derived from and relate directly to the underlying accounting and other records used to prepare the statutory-basis financial statements. Such schedules have been subjected to the auditing procedures applied in our audit of the 2012 statutory-basis financial statements and certain additional procedures, including comparing and reconciling such schedules directly to the underlying accounting and other records used to prepare the statutory-basis financial statements or to the statutory-basis financial statements themselves, and other additional procedures in accordance with auditing standards generally accepted in the United States of America. In our opinion, such schedules are fairly stated in all material respects in relation to the 2012 statutory-basis financial statements as a whole.

*Deloitte & Touche LLP*

May 23, 2013

# ACA FINANCIAL GUARANTY CORPORATION

## STATUTORY-BASIS STATEMENTS OF ADMITTED ASSETS, LIABILITIES AND SURPLUS AS OF DECEMBER 31, 2012 AND 2011 (Dollars in thousands)

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	2012	2011
<b>ADMITTED ASSETS</b>		
BONDS — At NAIC carrying value	\$ 397,472	\$ 430,358
CASH AND SHORT-TERM INVESTMENTS	24,241	12,856
RECEIVABLE FOR SECURITIES	<u>3</u>	<u>20</u>
Total cash and investments	421,716	443,234
ACCRUED INVESTMENT INCOME	2,836	3,169
OTHER ASSETS	<u>38</u>	<u>1,768</u>
TOTAL ADMITTED ASSETS	<u>\$ 424,590</u>	<u>\$ 448,171</u>
<b>LIABILITIES AND SURPLUS</b>		
UNEARNED PREMIUMS	\$ 146,732	\$ 174,425
LOSSES AND LOSS ADJUSTMENT EXPENSES	86,580	75,889
CONTINGENCY RESERVE	76,919	73,919
PAYABLE TO SUBSIDIARIES	83	86
ACCRUED EXPENSES AND OTHER LIABILITIES	<u>5,082</u>	<u>6,537</u>
Total liabilities	<u>315,396</u>	<u>330,856</u>
COMMON STOCK — 1,000,000 shares authorized, issued and outstanding at December 31, 2012 and 2011; par value of \$15 per share	15,000	15,000
GROSS PAID-IN AND CONTRIBUTED SURPLUS	363,974	363,974
UNASSIGNED DEFICIT	<u>(269,780)</u>	<u>(261,659)</u>
Surplus as regards policyholders	<u>109,194</u>	<u>117,315</u>
TOTAL LIABILITIES AND SURPLUS	<u>\$ 424,590</u>	<u>\$ 448,171</u>

See notes to statutory-basis financial statements.

## ACA FINANCIAL GUARANTY CORPORATION

### STATUTORY-BASIS STATEMENTS OF INCOME AND CHANGES IN SURPLUS FOR THE YEARS ENDED DECEMBER 31, 2012 AND 2011 (Dollars in thousands)

	2012	2011
PREMIUM EARNED	<u>\$ 27,755</u>	<u>\$ 16,333</u>
LOSSES AND LOSS ADJUSTMENT EXPENSES	31,199	46,670
UNDERWRITING EXPENSES INCURRED	<u>25,311</u>	<u>22,969</u>
TOTAL UNDERWRITING DEDUCTIONS	<u>56,510</u>	<u>69,639</u>
NET UNDERWRITING LOSS	<u>(28,755)</u>	<u>(53,306)</u>
NET INVESTMENT INCOME	16,594	17,981
NET REALIZED CAPITAL GAINS	<u>1,018</u>	<u>1,649</u>
NET INVESTMENT GAIN	<u>17,612</u>	<u>19,630</u>
OTHER INCOME	<u>5,190</u>	<u>7,415</u>
LOSS BEFORE FEDERAL INCOME TAXES	(5,953)	(26,261)
FEDERAL INCOME TAXES	<u>-</u>	<u>-</u>
NET LOSS	<u>\$ (5,953)</u>	<u>\$ (26,261)</u>
SURPLUS AS REGARDS POLICYHOLDERS — Beginning of year	<u>\$ 117,315</u>	<u>\$ 122,466</u>
Net loss	(5,953)	(26,261)
Change in net unrealized capital gains (losses)	122	(142)
Change in contingency reserve	(3,000)	22,910
Change in deferred income tax	1,087	(7,946)
Change in non-admitted assets	<u>(377)</u>	<u>6,288</u>
Change in surplus as regards policyholders	<u>(8,121)</u>	<u>(5,151)</u>
SURPLUS AS REGARDS POLICYHOLDERS — End of year	<u>\$ 109,194</u>	<u>\$ 117,315</u>

See notes to statutory-basis financial statements.

# ACA FINANCIAL GUARANTY CORPORATION

## STATUTORY-BASIS STATEMENTS OF CASH FLOW FOR THE YEARS ENDED DECEMBER 31, 2012 AND 2011 (Dollars in thousands)

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	2012	2011
CASH FLOWS FROM OPERATIONS:		
Premiums collected net of reinsurance	\$ 62	\$ 309
Net investment income	18,616	19,829
Other income	5,190	7,415
Losses and loss related payments	(16,415)	(17,478)
Commissions, expenses paid and aggregate write-ins for deductions	<u>(30,874)</u>	<u>(26,310)</u>
Net cash used in operations	<u>(23,421)</u>	<u>(16,235)</u>
CASH FLOWS FROM INVESTMENTS:		
Proceeds from investments sold or matured	122,241	126,563
Cost of investments acquired	<u>(87,755)</u>	<u>(123,712)</u>
Net cash provided by investments	<u>34,486</u>	<u>2,851</u>
CASH FLOWS FROM FINANCING AND MISCELLANEOUS SOURCES:		
Other applications	<u>320</u>	<u>241</u>
Net cash provided by financing and miscellaneous sources	<u>320</u>	<u>241</u>
NET CHANGE IN CASH AND SHORT-TERM INVESTMENTS	11,385	(13,143)
CASH AND SHORT-TERM INVESTMENTS — Beginning of year	<u>12,856</u>	<u>25,999</u>
CASH AND SHORT-TERM INVESTMENTS — End of year	<u>\$ 24,241</u>	<u>\$ 12,856</u>

See notes to statutory-basis financial statements.

# ACA FINANCIAL GUARANTY CORPORATION

## NOTES TO STATUTORY-BASIS FINANCIAL STATEMENTS AS OF AND FOR THE YEARS ENDED DECEMBER 31, 2012 AND 2011

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### 1. GENERAL

ACA Financial Guaranty Corporation (the “Company” or “ACA FG”) 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 2, 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 76.6% by ACA Holding, L.L.C. (ACAH), a Delaware limited liability company, and 23.4% by KPR Ltd, (KPR), a company with limited liability organized under the laws of the Cayman Islands. KPR is a wholly owned subsidiary of ACAH and ACAH is a wholly owned subsidiary of Manifold Capital Corp. (ACACH), formerly ACA Capital Holdings, Inc., a Delaware corporation. Effective at the closing of the Restructuring Transaction discussed in Note 2, 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 Maryland Insurance Administration (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 and 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, in turn, passes on these funds to the Company, also in the form of a dividend.

## **2. 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 of 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.

### 3. 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 4, ACA FG recognizes losses and establishes related loss reserves on bond obligations it has insured only 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 remaining unpaid ultimate loss over the life of the policy, discounted to reflect the time value of money (not the amount of the claim under the policy received upon the initial payment default which generally reflects the shortfall by the obligor of the scheduled principal and/or interest payment then due under the terms of the bond indenture). However, ACA FG has policies in-force upon which it expects that payment defaults will occur in the future resulting in losses that will be incurred by the Company. Such expected future losses are not recorded by the Company in the accompanying Statements of Admitted Assets, Liabilities and Surplus at December 31, 2012 and 2011, 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 the ultimate losses that it will incur in the future on such policies (where payment defaults have not yet occurred but are expected) ranged from \$80 million to \$100 million at December 31, 2012, on a discounted basis. Accordingly, the Company believes it will incur material losses in the future which will materially adversely affect its policyholders' surplus. Notwithstanding the de-recognition of the Company's contingency reserves approved by the Maryland Insurance Commissioner discussed in Note 4 and any further 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 \$750,000. However, the Company believes that its surplus will be in excess of the required minimum surplus over the twelve months succeeding the date of the accompanying Statement of Admitted Assets, Liabilities 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 materially exposed to risks associated with deterioration in the tax exempt bond market through its insurance guaranties (see Note 10), as well as to the economy generally. The extent and duration of any future deterioration in the tax exempt bond market 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, 2012, the Company had insured obligations with outstanding principal totaling \$359.9 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 \$365.3 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.

- 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 probability of default, the severity of loss upon default and the amount and timing of claim payments and 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, and changes in the expected timing of claims payments and recoveries, and 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 may involve significant expense and diversion of resources from other matters. 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 3-year period. 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.

If ACA FG undergoes an ownership change for purposes of Section 382 as a result of future transactions involving its surplus notes, ACA FG's ability to utilize its NOLs and recognize certain built-in losses would be subject to further limitations under Section 382. Depending on the resulting limitation, a significant portion of ACA FG's NOLs could be deferred or could expire before it would be able to use them to offset positive taxable income in current or future tax periods. ACA FG's inability to utilize its NOLs could have a significant adverse effect on its financial position and results of operations.

### *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 expected losses, (ii) increase the Company's 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. 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.

## 4. 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 (SAP) which has been adopted as a component of prescribed or permitted practices by the MIA effective January 1, 2001. The differences between NAIC SAP and MIA SAP are not material 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 SAP accounting policies which are significant to the preparation of the accompanying financial statements.

**Estimates and Assumptions** — The preparation of financial statements in conformity with 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 and the valuation of bonds.

**Cash and Short-Term Investments** — Cash and short-term investments include cash on hand, demand deposits with banks and short-term investments purchased with an original maturity of one year or less. Short-term investments are carried at amortized cost, which approximates market value.

**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 an 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 an 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 value loan-backed securities. The cost of bonds is adjusted for impairments in value deemed to be an other-than-temporary impairment (OTTI). These adjustments are recorded as realized capital losses.

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, are recorded as realized capital losses. In 2012 and 2011, the Company recognized \$0 and \$1.4 million, respectively, in other than temporary impairments on certain of its bonds.

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. 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 other than temporary impairment 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.

**Premium Revenue Recognition** — Typically, financial guaranty premium is received either on an upfront or installment basis. In general, premiums from insured tax-exempt obligations are received on an upfront basis. Upfront premiums 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. Unearned premiums represent that portion of premiums which is applicable to coverage of risk to be provided in the future on policies in force. Installment premiums are earned over each installment period, which is generally one year or less. When an insured issue is retired or defeased prior to the end of the expected period of coverage (hereafter referred to as "Refundings"), the remaining unearned premium relating to such insured issue is earned at that time since there is no longer risk to the Company. The amounts earned from refundings were \$19.7 million and \$6.7 million in 2012 and 2011, respectively.

**Other Income Revenue Recognition** — The Company collects dividends from its subsidiary, ACA Service, L.L.C. related to its prior CDO asset management business. These dividends are recorded as other income. The Company also collects 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.

**Losses and Loss Adjustment Expenses** — 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 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, 2012 and 2011, the discount rate used by the Company to present value its loss reserves was 3.65% and 4.15%, 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 average rate of return on admitted assets. 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, and 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.

See Note 3 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 insurance guaranties which have not yet been recorded in the accompanying Statements of Admitted Assets, Liabilities 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, 2012 and 2011.

**Surplus Notes** —As discussed in Note 2, as part of the Restructuring Transaction, the Company issued surplus notes with a face amount of \$1 billion to former structured credit counterparties and its existing shareholders. These notes have been recorded in the surplus notes section of the Statements of Admitted Assets, Liabilities and Surplus with an offsetting \$1.0 billion contra account since any payment of principal or interest on the surplus notes may not be recognized until approved by the MIA. Upon the MIA’s approval of the payment of principal (which includes accreted discount), the amount of the Company’s surplus notes and the contra account will be reduced by the amount of such payment. In

addition, any other distributions (including dividends or interest) relating to the surplus notes will only be recognized upon the approval by the MIA for such payment. As the accounting for interest accretion described above deviates from NAIC SAP, the Company requested and received approval from the MIA for such accounting. Under NAIC SAP, the accretion of the discount is recorded in the Company's income statement. This represents the only deviation from NAIC SAP and does not have a net impact on the Company's financial statements.

**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 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. Reductions in the contingency reserve may be recognized under certain stipulated conditions, subject to the approval of the MIA Commissioner.

On February 17, 2011, the MIA Commissioner approved a request by the Company to derecognize, under certain circumstances, contingency reserves on policies which were terminated or on which case reserves had been established. Pursuant to the approval, the Company may release the aforementioned contingency reserves in amounts equal to future adverse loss development recorded by the Company, but up to no more than the approved aggregate amount. The Company released \$34.0 million of such contingency reserves during the year ended December 31, 2011. The remaining amount of the approved contingency reserve release of \$8.2 million was released during the year ended December 31, 2012.

**Federal 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 nonadmitted asset and charged directly to surplus. Deferred taxes are also subject to a valuation allowance.

**New Accounting Pronouncements** —Effective December 31, 2011, the Company adopted the revised SSAP No. 5R, *Liabilities, Contingencies and Impairments of Assets* ("SSAP 5R"). SSAP 5R adopts, with modification, guidance from Financial Accounting Standards Board (FASB) Accounting Standard Codification 460, *Guarantees*. The substantive revisions require entities to recognize, at the inception of a guarantee, a liability for the obligations it has undertaken in issuing the guarantee, even if the likelihood of having to make payments under the guarantee is remote. Under the new guidance, a liability is required to be recognized at the inception of a related party guarantee. The guidance does exempt from measurement guarantees made to or on behalf of wholly owned subsidiaries, as well as intercompany and related party guarantees that are considered "unlimited". The Company's adoption of SSAP 5R did not have a significant impact on its statutory-basis financial statements.

Effective January 1, 2012, the Company adopted SSAP No. 101, *Income Taxes* ("SSAP 101"). SSAP 101 establishes statutory accounting principles for current and deferred federal income taxes and current state income taxes. In addition, SSAP 101 establishes statutory accounting principles for accounting for uncertainty in income taxes and defines recognition and measurement criteria that must be met for a reporting entity to recognize any benefit of any tax position in the reporting entity's financial statements. SSAP 101 provides statutory guidance on measurement, recognition, derecognition, reporting, interest and penalties, accounting in interim periods, disclosure, and transition. The Company has provided all disclosures required by SSAP 101. The Company's adoption of SSAP101 did not have a significant impact on its statutory financial statements.

## 5. SUMMARY OF SIGNIFICANT DIFFERENCE BETWEEN SAP AND GAAP

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

- Under 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 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 SAP no receivable is recorded unless the amounts are due pursuant to the insurance contract;
- Under 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 SAP, a mandatory contingency reserve is computed and recorded on the basis of statutory requirements, whereas under GAAP such reserves are not permitted;
- Under 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 policies are recognized based on the weighted average probability of net cash outflows to be paid under the insurance contract. In addition, under 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 SAP, certain assets which are determined to be non-admissible under 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 balance sheet 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 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 SAP are carried at 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 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 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 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, 2012 and 2011, respectively.

## 6. INVESTMENTS

Bonds, with an amortized cost of \$4.7 million were on deposit with various state regulatory authorities at December 31, 2012 and 2011 as required by insurance regulations. Net investment income consisted of the following (dollars in thousands) for the years ended December 31, 2012 and 2011:

	<b>2012</b>	<b>2011</b>
Income from fixed-maturity securities	\$ 17,378	\$ 18,770
Income from cash equivalents and short-term investments	1	4
Investment expenses	<u>(785)</u>	<u>(793)</u>
Net investment income	<u>\$ 16,594</u>	<u>\$ 17,981</u>

The amortized cost and estimated fair value of bonds as of December 31, 2012 and 2011, were as follows (dollars in thousands):

	<b>2012</b>			<b>Estimated Fair Value</b>
	<b>Amortized Cost</b>	<b>Gross Unrealized Gains</b>	<b>Gross Unrealized Losses</b>	
U.S. — Treasury securities	\$ 11,736	\$ 2,299	\$ (29)	\$ 14,006
Federal-agency securities	1,431	281	-	1,712
Obligations of states and political subdivisions	4,819	393	(3)	5,209
Corporate securities	163,536	13,524	(16)	177,044
Asset-backed securities	23,485	2,225	(67)	25,643
Mortgaged-backed securities	192,469	12,568	(219)	204,818
	<u>\$ 397,476</u>	<u>\$ 31,290</u>	<u>\$ (334)</u>	<u>\$ 428,432</u>
	<b>2011</b>			<b>Estimated Fair Value</b>
	<b>Amortized Cost</b>	<b>Gross Unrealized Gains</b>	<b>Gross Unrealized Losses</b>	
U.S. — Treasury securities	\$ 4,035	\$ 23	\$ -	\$ 4,058
Federal-agency securities	1,430	27	-	1,457
Obligations of states and political subdivisions	4,965	313	(16)	5,262
Corporate securities	174,825	7,597	(2,116)	180,306
Asset-backed securities	42,020	3,350	(818)	44,552
Mortgaged-backed securities	203,271	12,540	(267)	215,544
	<u>\$ 430,546</u>	<u>\$ 23,850</u>	<u>\$ (3,217)</u>	<u>\$ 451,179</u>

The amortized costs and estimated fair value of bonds at December 31, 2012, by contractual maturity, are shown below (dollars in thousands). 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.

	<b>Amortized Cost</b>	<b>Estimated Fair Value</b>
Due in one year or less	\$ 12,636	\$ 13,035
Due after one year through five years	79,083	84,461
Due after five years through ten years	65,632	71,526
Due after ten years	24,171	28,949
Subtotal	181,522	197,971
Asset-backed securities	23,485	25,643
Mortgaged-backed securities	192,469	204,818
Total	<u>\$ 397,476</u>	<u>\$ 428,432</u>

Proceeds from sales of bonds during 2012 and 2011 were \$51.3 million and \$62.5 million, respectively. Gross gains of \$1.2 million and \$3.2 million and gross losses of \$0.3 million and \$1.6 million were realized on those sales in 2012 and 2011, respectively.

The following table summarizes, for all securities in an unrealized loss position at December 31, 2012 and 2011, the aggregate fair value and gross unrealized loss by length of time the amounts have continuously been in an unrealized loss position (dollars in thousands):

	<b>2012</b>					
	<b>Less than 12 Months</b>		<b>12 Months or More</b>		<b>Total</b>	<b>Total</b>
	<b>Estimated</b>		<b>Estimated</b>		<b>Estimated</b>	
	<b>Fair Value</b>	<b>Unrealized Loss</b>	<b>Fair Value</b>	<b>Unrealized Loss</b>	<b>Fair Value</b>	<b>Unrealized Loss</b>
U.S. — Treasury securities	\$ 2,017	\$ (29)	\$ -	\$ -	\$ 2,017	\$ (29)
Federal agency securities	-	-	-	-	-	-
Obligations of states and political subdivisions	129	(2)	12	(1)	141	(3)
Corporate securities	1,981	(16)	-	-	1,981	(16)
Asset-backed securities	5,186	(28)	4,780	(39)	9,966	(67)
Mortgage-backed securities	<u>17,448</u>	<u>(177)</u>	<u>1,412</u>	<u>(42)</u>	<u>18,860</u>	<u>(219)</u>
<b>Total</b>	<u>\$ 26,761</u>	<u>\$ (252)</u>	<u>\$ 6,204</u>	<u>\$ (82)</u>	<u>\$ 32,965</u>	<u>\$ (334)</u>

	<b>2011</b>					
	<b>Less than 12 Months</b>		<b>12 Months or More</b>		<b>Total</b>	<b>Total</b>
	<b>Estimated</b>		<b>Estimated</b>		<b>Estimated</b>	
	<b>Fair Value</b>	<b>Unrealized Loss</b>	<b>Fair Value</b>	<b>Unrealized Loss</b>	<b>Fair Value</b>	<b>Unrealized Loss</b>
U.S. — Treasury securities	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -
Federal agency securities	275	(16)	-	-	275	(16)
Obligations of states and political subdivisions	-	-	-	-	-	-
Corporate securities	44,047	(2,116)	-	-	44,047	(2,116)
Asset-backed securities	18,874	(800)	1,255	(18)	20,129	(818)
Mortgage-backed securities	<u>20,981</u>	<u>(211)</u>	<u>1,748</u>	<u>(56)</u>	<u>22,729</u>	<u>(267)</u>
<b>Total</b>	<u>\$ 84,177</u>	<u>\$ (3,143)</u>	<u>\$ 3,003</u>	<u>\$ (74)</u>	<u>\$ 87,180</u>	<u>\$ (3,217)</u>

The Company did not record any other than temporary impairment charges during the year ended December 31, 2012.

The following table sets forth certain information regarding other than temporary impairment charges recorded during the year ended December 31, 2011.

CUSIP	Security Name	Year Ended December 31, 2011			
		Amortized Cost Prior to Impairment	Impairment	Fair Value	Amortized Cost After the Impairment
1248MBAJ4	Credit-Based Asset Servicing	\$ 1,449,000	\$ 302,700	\$ 1,051,280	\$ 1,146,300
76110W2X3	Residential Asset Securities C	2,928,640	76,450	2,852,190	2,852,190
81375WDS2	Securitized Asset Backed Rec	1,593,466	61,353	1,532,113	1,532,113
06050TJN3	Bank Of America NA	2,298,842	279,792	2,019,050	2,019,050
172967BU4	Citigroup Inc	1,338,412	292,824	1,048,438	1,045,588
693483AB5	POSCO	1,991,753	130,013	1,936,740	1,861,740
91913YAE0	Valero Energy Corp	499,073	31,053	468,020	468,020
61746BDC7	Morgan Stanley	1,800,917	243,837	-	1,557,080
	Total	<u>\$13,900,103</u>	<u>\$1,418,022</u>	<u>\$10,907,831</u>	<u>\$12,482,081</u>

## 7. LOSSES 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, 2012 and 2011 (dollars in thousands):

	2012	2011
Balance — January 1	\$ 75,889	\$ 49,743
Less reinsurance recoverable	<u>-</u>	<u>-</u>
Net balance — January 1	<u>75,889</u>	<u>49,743</u>
Incurred related to:		
Current year	28,619	39,047
Prior years	<u>2,580</u>	<u>7,623</u>
Total incurred	<u>31,199</u>	<u>46,670</u>
Paid related to:		
Current year	10,749	3,804
Prior years	<u>9,759</u>	<u>16,720</u>
Total paid	<u>20,508</u>	<u>20,524</u>
Net balance — December 31	86,580	75,889
Plus reinsurance recoverables	<u>-</u>	<u>-</u>
Balance — December 31	<u>\$ 86,580</u>	<u>\$ 75,889</u>

For the year ended December 31, 2012, the Company recorded a provision for losses of \$30.3 million, which consisted of \$2.3 million of incurred losses related to payment defaults that occurred in 2012 (“current accident year claims”) and \$28.0 million of incurred losses related to adverse development on reserves established in years prior to 2012 (“prior accident year claims”). As of December 31, 2012, the Company’s liability for unpaid losses was \$78.2 million, which related to fifteen insured transactions, with a remaining aggregate in-force par outstanding of \$125.1 million, excluding the aforementioned case reserves. The Company recorded LAE incurred of \$0.9 million in 2012 and unpaid LAE of \$8.3 million as of December 31, 2012.

For the year ended December 31, 2011, the Company recorded a provision for losses of \$34.0 million, which consisted of \$29.3 million of incurred losses related to current accident year claims and \$4.7 million of incurred losses related to adverse development on prior accident year claims. As of December 31, 2011, the Company’s liability for unpaid losses was \$64.4 million, which related to nine insured transactions, with a remaining aggregate in-force par outstanding of \$54.3 million, excluding the aforementioned case reserves. The Company recorded LAE incurred of \$12.7 million in 2011 and unpaid LAE of \$11.5 million as of December 31, 2011.

## 8. REINSURANCE

The Company ceded a portion of its business to other non-affiliated insurance and reinsurance companies and reduced its estimated or potential liabilities for unpaid losses and loss adjustment expenses and unearned premiums accordingly. A contingent liability exists relating to such reinsurance in the event that the reinsurer becomes unable to meet its obligations under the terms of the reinsurance agreement; in which event the Company would be liable for any amount of losses or LAE ceded to such reinsurer. There were no unpaid losses and loss adjustment expenses ceded to non-affiliated insurance and reinsurance companies at December 31, 2012 and 2011, while unearned premiums ceded were \$0.2 million and \$0.3 million at December 31, 2012 and 2011, respectively.

As of and for the years ended December 31, 2012 and 2011, amounts reinsured were as follows (dollars in thousands):

	2012	2011
Income and expenses:		
Written premiums ceded	\$ -	\$ -
Written premiums assumed	-	-
Earned premiums ceded	146	63
Earned premiums assumed	225	216
Loss and loss-adjustment-expense payments ceded	-	-
Loss and loss-adjustment-expense payments assumed	-	-
Assets and liabilities:		
Unearned-premium reserve ceded	166	312
Unearned-premium reserve assumed	5,541	5,765
Loss and loss-adjustment-expense reserves ceded	-	-
Loss and loss-adjustment-expense reserves assumed	-	-
Off balance sheet balances:		
Principal outstanding ceded	7,502	11,986
Principal outstanding assumed	805,411	819,823

## 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, 2012 and 2011, is set forth below (dollars in thousands):

	<b>2012</b>	<b>2011</b>
Loss before income taxes	<u>\$ (5,953)</u>	<u>\$ (26,261)</u>
Expected tax benefit at 35%	\$ (2,083)	\$ (9,191)
Change in contingency reserve	(1,050)	8,019
Dividends from subsidiaries	(323)	87
Tax exempt interest — net of proration	(94)	(75)
Change in statutory valuation allowance	33,692	(12,537)
Net operating loss	(29,483)	-
Capital loss carryforward	(1,383)	21,957
Prior year tax adjustment and other	<u>(363)</u>	<u>(314)</u>
Total statutory tax (benefit) expense	<u>\$ (1,087)</u>	<u>\$ 7,946</u>

At December 31, 2012, the Company had net operating loss carryforwards expiring through the year 2032 of \$176.0 million, capital loss carryforwards expiring through the year 2015 of \$12.7 million and AMT credit carryforwards, which do not expire, in the amount of \$0.6 million.

The Company files its tax return on a standalone basis and is currently under audit for its 2007 and 2008 tax years.

The components of the net deferred tax assets and deferred tax liabilities are as follows (dollars in thousands):

<b>Description</b>	<b>December 31,</b>	
	<b>2012</b>	<b>2011</b>
Gross deferred tax assets	\$ 99,186	\$ 64,444
Gross deferred tax liabilities	<u>(31)</u>	<u>-</u>
Net deferred tax asset	99,155	64,444
Statutory valuation allowance adjustment	(72,264)	(38,572)
Non-admitted deferred tax asset	<u>26,891</u>	<u>25,872</u>
Net admitted deferred tax asset	<u>-</u>	<u>-</u>
Decrease in non-admitted deferred tax assets	<u>\$ 1,019</u>	<u>\$ 7,878</u>

Pursuant to paragraphs 11.a. – 11. c. of SSAP 101, the admission calculation components at December 31, 2012 and 2011 are as follows (dollars in thousands):

	<u>December 31,</u>		
	<u>2012</u>	<u>2011</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>31</u>	<u>-</u>	<u>31</u>
(f) Total ordinary admitted under 11.a. - 11.c.	31	-	31
(g) Ordinary deferred tax liabilities	<u>(31)</u>	<u>-</u>	<u>(31)</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>\$ -</u></u>	<u><u>\$ -</u></u>

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

	<u>2012</u>	<u>2011</u>	<b>Change</b>
Deferred tax assets:			
Ordinary:			
Net operating loss carryforward	\$ 61,596	\$ 26,873	\$ 34,723
Contingency reserve	26,922	25,872	1,050
Unearned premiums reserve	5,102	6,105	(1,003)
Tax credit carryforward	615	615	-
Other temporary differences	<u>4</u>	<u>990</u>	<u>(986)</u>
Gross ordinary deferred tax assets	94,239	60,455	33,784
Statutory valuation adjustment — ordinary	(67,317)	(34,583)	(32,734)
Non-admitted ordinary deferred tax assets	<u>(26,891)</u>	<u>(25,872)</u>	<u>(1,019)</u>
Gross ordinary admitted deferred tax assets	<u>31</u>	<u>-</u>	<u>31</u>
Capital:			
Net capital loss carryforward	4,451	3,425	1,026
Investments	496	496	-
Unrealized capital losses	<u>-</u>	<u>68</u>	<u>(68)</u>
Gross capital deferred tax assets	4,947	3,989	958
Statutory valuation adjustment — capital	(4,947)	(3,989)	(958)
Non-admitted capital deferred tax assets	<u>-</u>	<u>-</u>	<u>-</u>
Gross capital admitted deferred tax assets	<u>-</u>	<u>-</u>	<u>-</u>
Gross ordinary deferred tax liabilities — fixed assets	<u>(31)</u>	<u>-</u>	<u>(31)</u>
Net admitted deferred tax assets	<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</u>

The Company has not elected to admit deferred tax assets pursuant to paragraph 10.e. of SSAP 10R for 2011.



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

	<u>December 31,</u>	
	<u>2012</u>	<u>2011</u>
Total deferred tax assets — January 1	\$ 25,872	\$ 33,750
Total deferred tax liabilities — January 1	<u>-</u>	<u>-</u>
Net deferred tax asset — January 1	25,872	33,750
Net deferred tax asset — December 31	<u>26,891</u>	<u>25,872</u>
Change in net deferred asset	1,019	(7,878)
Tax effect of unrealized losses	<u>68</u>	<u>(68)</u>
Change in net deferred income tax	<u>\$ 1,087</u>	<u>\$ (7,946)</u>

There were no reserves for tax contingencies as required under SSAP 5, *Liabilities, Contingencies and Impairments of Assets*, as of December 31, 2012 and 2011.

## 10. OUTSTANDING EXPOSURE UNDER IN-FORCE FINANCIAL GUARANTY INSURANCE CONTRACTS

While the Company establishes reserves for losses and loss adjustment expenses on obligations on which it has received a claim notice (see Note 4), 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 1). The tables below reflect certain information regarding the in-force par exposure guaranteed by the Company at December 31, 2012 and 2011 (dollars in millions):

	2012		2011	
	Net Par Outstanding	% of Net Par Outstanding	Net Par Outstanding	% of Net Par Outstanding
Tax-exempt:				
Healthcare	\$ 407	9.3 %	\$ 559	10.8 %
Tax backed	526	12.1	620	11.9
Education	904	20.7	1,136	21.9
Long-term care	298	6.8	474	9.1
General obligations	1,003	23.0	1,032	19.9
Utilities	93	2.1	106	2.0
Transportation	308	7.1	390	7.5
Not for profit	386	8.8	407	7.8
Housing	244	5.6	260	5.0
Other	187	4.3	207	4.0
Total public finance obligations	4,356	99.9	5,191	99.9
Taxable obligations — other	6	0.1	6	0.1
Total	<u>\$4,362</u>	<u>100.0 %</u>	<u>\$5,197</u>	<u>100.0 %</u>

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):

	December 31, 2012		December 31, 2011	
	Net Par Outstanding	% of Net Par Outstanding	Net Par Outstanding	% of Net Par Outstanding
California	\$ 814	18.7 %	\$ 1,029	19.8 %
New York	678	15.6	765	14.7
Texas	300	6.9	338	6.5
Washington	277	6.4	296	5.7
Massachusetts	267	6.1	292	5.6
Other states	2,020	46.4	2,471	47.6
Total tax-exempt obligations	<u>\$4,356</u>	<u>100.0 %</u>	<u>\$5,191</u>	<u>100.0 %</u>

The outstanding principal amount of obligations insured by the Company as of December 31, 2012, net of amounts ceded, and the terms to maturity of such insured obligations were as follows (dollars in

millions). Actual maturities could differ from final maturities because borrowers have the right to refund or prepay certain obligations.

**Terms to Maturity**

0 to 5 years	\$ 624
5 to 10 years	893
10 to 15 years	1,106
15 to 20 years	994
20 and above	<u>745</u>
Total	<u>\$4,362</u>

Debt service on insured obligations for 2013 is approximately \$373 million.

**11. RELATED PARTY TRANSACTIONS**

The payable to (receivable from) subsidiaries at December 31, 2012 and 2011, are as follows (dollars in thousands):

	<b>2012</b>	<b>2011</b>
Payable to Tactical Risk Management, LLC	\$ 84	\$ 86
Receivable from ACA Management LLC	<u>(1)</u>	<u>-</u>
Net intercompany payables	<u>\$ 83</u>	<u>\$ 86</u>

**12. 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 for the years ended December 31, 2012 and 2011 was \$0.3 million and \$0.2 million, respectively. As of December 31, 2012 and 2011, the fair value of the plan assets was \$5.7 million and \$5.4 million, respectively.

**13. FAIR VALUE OF FINANCIAL INSTRUMENTS**

**Fair Value Measurements** — 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 other than temporary impairment 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 Surplus at December 31, 2012, 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.

The tables below present the investments carried by the Company at fair value at December 31, 2012 and 2011:

<b>December 31, 2012</b>	<b>Level 1</b>	<b>Level 2</b>	<b>Level 3</b>	<b>Total</b>
Assets at fair value on a nonrecurring basis — bonds	\$ -	\$2,749,113	\$ -	\$2,749,113
Total assets at fair value	\$ -	\$2,749,113	\$ -	\$2,749,113
<b>December 31, 2011</b>	<b>Level 1</b>	<b>Level 2</b>	<b>Level 3</b>	<b>Total</b>
Assets at fair value on a nonrecurring basis — bonds	\$ -	\$7,833,320	\$ -	\$7,833,320
Total assets at fair value	\$ -	\$7,833,320	\$ -	\$7,833,320

The Company had no transfers of securities between levels during 2012 or 2011.

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 1. Generally, these are the most liquid of the Company's securities holdings and valuation of these securities does not involve management's judgment.

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.

The table below presents the aggregate estimated fair value and admitted value of the Company's total investment portfolio and cash and short-term investments at December 31, 2012 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 (dollars in thousands):

	<b>2012</b>				
	<b>Aggregate Fair Value</b>	<b>Admitted Value</b>	<b>Level 1</b>	<b>Level 2</b>	<b>Level 3</b>
<b>Assets</b>					
Bonds	\$ 428,432	\$ 397,472	\$ -	\$ 428,432	\$ -
Cash and short- term investments	<u>24,241</u>	<u>24,241</u>	<u>8,872</u>	<u>15,369</u>	<u>-</u>
Total	<u>\$ 452,673</u>	<u>\$ 421,713</u>	<u>\$ 8,872</u>	<u>\$ 443,801</u>	<u>\$ -</u>

#### **14. RESTRICTED BALANCES**

As mentioned in Note 6, Investments, the Company has assets on deposit with various regulatory authorities. In addition, as of December 31, 2012 and 2011, the Company had approximately \$53 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, 2012, the Company's policyholders' surplus, as determined in accordance with statutory-basis accounting practices, was \$109.2 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. As a runoff company, the Company continuously reviews its compliance with each of the state's various requirements.

As disclosed in Note 2, 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 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, as part of the Company's restructuring discussed in Note 2, 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 2013 other than extraordinary dividends as allowed by the MIA. No dividends were paid during 2012 or 2011.

The portion of unassigned surplus reduced by each item below at December 31, 2012 and 2011, is as follows (dollars in thousands):

	2012	2011
a. Unrealized losses on bonds, net of deferred tax benefit of \$0 and \$68 for 2012 and 2011, respectively	\$ (19)	\$ (142)
b. Non-admitted asset values	(28,447)	(28,070)

## 16. CONTINGENCIES

The Company is one of several defendants in a lawsuit in the Superior Court of the State of California (Los Angeles County) brought in December 2008 by Retirement Housing Foundation and several affiliates relating to the plaintiffs' issuance of auction-rate securities insured by the Company. The plaintiffs allege that the Company's insurance of securities backed by sub-prime mortgages was not financially responsible and was contrary to the Company's statement about its investment practices, and that when the Company's credit rating was downgraded from "A" to "CCC" after the collapse of the sub-prime market in December 2007, the plaintiffs were forced to refinance their securities. In response to various legal motions, as of March 29, 2011, the Court had dismissed with prejudice the plaintiffs' contract, implied contract and negligence claims, but did not dismiss the fraud, negligent misrepresentation and unfair competition claims. On April 19, 2011, the plaintiffs filed a fourth amended complaint, asserting causes of action for fraud, negligent misrepresentation and violations of California's unfair competition law. Since June 2012, following a period of stay, the parties have engaged in discovery.

The Company (specifically, ACA Management, LLC) is one of many defendants in an action pending in New Mexico state court brought in 2009 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, the State Investment Council and Employee Retirement Board, 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”). The Company moved to dismiss the complaint for lack of jurisdiction. As a result of various successful motions and defenses, the only surviving portions of the amended complaint are allegations of FATA violations occurring after July 1, 2007. In a companion case filed by Foy, the New Mexico Court of Appeals affirmed that FATA did not apply retroactively from its July 1, 2007 effective date. Foy may seek rehearing or petition for certiorari. Early in the proceedings, the Company moved to dismiss the complaint for lack of personal jurisdiction. The trial court deferred ruling on the Company's jurisdictional motion pending jurisdictional discovery, which is currently underway. The Company has responded to Foy's discovery requests and has served its own discovery requests upon Foy and awaits responses. The trial court denied a group motion to dismiss for failure to state a claim. Independently, the New Mexico Attorney General has asked the Court to dismiss portions of the lawsuit relating to “pay to play” allegations concerning the State Investment Council in favor of lawsuits filed by the Attorney General relating to the underlying “pay to play” scheme (the Company is not named in the Attorney General's lawsuits). That motion has been granted, narrowing the Foy case against the Company to claims for other alleged conduct associated with the State Investment Council's investment with Vanderbilt. The plaintiffs' claims as to the Employee Retirement Board's investment with Vanderbilt were unaffected by the grant of the Attorney General's motion.

The Company is named as a defendant in a putative class-action in the United States District Court for the Northern District of Mississippi. The putative class purports to consist of all owners and/or holders of Connector 2000 Association, Inc. Toll Road Revenue Bonds (the “Connector Bonds”) insured by the Company. The issuer of the Connector Bonds, Connector 2000 Association, Inc. (the “Issuer”), successfully confirmed a Chapter 9 plan (the “Plan”) and emerged from its bankruptcy proceeding on April 1, 2011. Pursuant to the terms of the Plan and by operation of law, the Connector Bonds were exchanged for new obligations of the Issuer (the “New Obligations”) and were effectively cancelled. As a result, based on the plain language of the relevant insurance policies and other legal theories, the Company asserts that it has no further liability or payment obligations under its secondary market insurance policies. The Company moved to dismiss plaintiffs' amended complaint in its entirety, and on August 10, 2012, the District Court, citing the July 23, 2012 decision in New York (see below), dismissed without prejudice the Company's motion to dismiss as well as the plaintiffs' motion for class certification. The Company filed a new motion to dismiss, and the plaintiffs filed a new motion for class certification, in accordance with the deadline of December 3, 2012 set by the Court. Such motions were fully briefed as of the end of January, 2013. The magistrate judge also permitted the plaintiffs to proceed with discovery against the Company consistent with the terms of a June 25, 2012 order, but urged the parties to focus initial discovery on issues related to the propriety of class certification. Plaintiffs agreed to stay discovery effectively until the decision in the New York appeal (see below).

Subsequent to the commencement of the above-referenced putative class-action pending in the Northern District of Mississippi, the Company was named as a defendant in an action filed in the Supreme Court of the State of New York in and for New York County, in which the plaintiffs therein, representing approximately 84% of the relevant outstanding policies, seek a declaration of the Company's obligations under its secondary market insurance policies the Company issued in connection with the Connector Bonds. The Company's position on its lack of any continuing obligation under these secondary market insurance policies is essentially the same in both lawsuits. The Company moved for summary judgment seeking, inter alia, an order denying the declaratory relief sought by the plaintiffs in their complaint and

declaring that the Company is relieved of liability of any further payment obligations under its secondary market insurance policies. The plaintiffs opposed the Company's motion for summary judgment and cross-moved for summary judgment on their claims for declaratory relief. On July 23, 2012, the Court denied the Company's motion for summary judgment and granted the plaintiffs' cross-motion for summary judgment. Notice of entry of the judgment was entered on September 14, 2012. The Company appealed the decision and oral arguments were heard on March 19, 2013.

The Company is currently a defendant in an action commenced by Baker County Medical Services, Inc. (the "Hospital") in the Fourth Judicial Circuit in Duval County, Florida (the "Florida Action"). The Florida Action involves the Hospital's failure to purchase and maintain a certain type and level of professional liability insurance required pursuant to the bond documents executed in connection with the issuance of \$11.65 million of bonds insured by the Company. In its second amended complaint, the Hospital asserts, among other things, breach of contract, tortious interference and negligence claims against the Company. The Company has answered the second amended complaint and asserted various cross and counter claims against the Hospital and the trustee. The parties are currently engaged in discovery and motion practice related to the scope of such discovery. By order entered on October 15, 2012, the court: (i) ordered that the parties must complete all discovery by August 29, 2013; (ii) scheduled the matter for a six (6) day trial beginning September 9, 2013 with a pre-trial conference on August 29, 2013; and (iii) referred the matter to mandatory mediation required pursuant to the local rules of the court to be held prior to the pre-trial conference.

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.

On January 6, 2011, the Company commenced a lawsuit against Goldman, Sachs & Co. ("Goldman") in the Supreme Court of the State of New York, County of New York (the "Lawsuit"). The lawsuit seeks compensatory damages against Goldman in the amount of at least \$30 million and punitive damages in the amount of at least \$90 million in connection with the development of a structured finance product, a synthetic collateralized debt obligation called ABACUS 2007-AC1 ("ABACUS"). On April 25, 2011, the Company filed its First Amended Complaint. On June 3, 2011, Goldman moved to dismiss the First Amended Complaint. On April 23, 2012, the Court issued an order denying Goldman's motion to dismiss ACA's fraud claims and granting Goldman's motion to dismiss ACA's unjust enrichment claim (the "Order"). On May 29, 2012, Goldman served notice of its intent to appeal the Order. Also on May 29, 2012, Goldman served its answer, asserting counterclaims for breach of contract and fraudulent inducement, together with a third-party complaint against ACA Management LLC ("ACAM"), asserting claims for breach of contract, unjust enrichment and indemnification. Goldman does not specify the amount of damages it seeks. Oral arguments were heard on Goldman's appeal of the Order on January 2, 2013. Also on January 2, 2013, the Company filed for leave to amend its First Amended Complaint to add Paulson & Co. ("Paulson") as an additional defendant, incorporating new allegations of fraud against both parties. The further amended complaint alleges that Paulson and Goldman conspired to fraudulently induce the Company to provide financial guaranty insurance for ABACUS by deceiving ACA into believing that Paulson was to be the equity investor in the product. See Note 20 for additional information relating to the Lawsuit.

## **17. LEASES**

ACA FG subleases office space at 600 Fifth Avenue, New York, New York through September 30, 2016.



At December 31, 2012, expected future minimum lease payments under its lease at 600 Fifth Avenue are as follows (dollars in thousands):

<b>Years Ending December 31</b>	<b>Operating Leases</b>
2013	\$ 548
2014	594
2015	624
2016	<u>479</u>
	<u>\$2,245</u>

The Company's rental expense for the years ended December 31, 2012 and 2011, was \$0.5 million and \$0.3 million, respectively.

## **18. SURPLUS NOTES**

Interests in the surplus notes issued in connection with the Restructuring Transaction (see Note 2) 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 4, 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, 2012, are as follows:

<b>Period</b>	<b>Amount</b>
1st Quarter 2013	\$ 1,822,749
2nd Quarter 2013	1,515,909
3rd Quarter 2013	2,298,377
4th Quarter 2013	<u>2,037,522</u>
Year 2013	7,674,557
Year 2014	7,742,361
Year 2015	7,459,305
Year 2016	7,529,053
Year 2017	7,668,727
2018 through 2022	36,944,290
2023 through 2027	32,344,596
2028 through 2032	24,857,834
2033 through 2037	13,666,124
2038 through 2042	695,185
2043 through 2047	<u>150,106</u>
Total	<u>\$ 146,732,137</u>

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

<b>Components</b>	<b>Amount</b>
Reserves for losses and LAE at December 31, 2011	<u>\$75,889,168</u>
Change in reserves:	
Prior accident years	(7,179,416)
Current accident year	<u>17,870,124</u>
Subtotal change in reserves	<u>10,690,708</u>
Reserves for losses and LAE at December 31, 2012	<u>\$86,579,876</u>

The Company's credit quality classifications are as follows:

**Category 1: Fully Performing**

Covenants have been met and there have been no significant negative deviations from expected performance.

**Category 2: Watch**

Performing below expected levels but current and projected revenues are adequate to service debt.

### Category 3: Deteriorating

Performing significantly below expected levels; corrective action is required to avert a longer-term risk of payment default.

### Category 4: Paid or Expected Claim

Material decline in creditworthiness and ability to pay debt service; unreimbursed draws on debt service reserves and/or payment defaults have occurred or are probable.

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 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.

Insured financial obligations as of December 31, 2012, are as follows:

	Credit Quality Categories				Total
	1	2	3	4	
Number of policies	247	85	22	29	383
Remaining weighted-average contract period (in years)	12	12	12	13	
Insured contractual payments outstanding:					
Principal	\$2,792,492,768	\$ 844,689,061	\$ 365,322,472	\$ 359,870,510	\$4,362,374,811
Interest	1,829,093,198	524,323,140	311,026,631	313,082,880	2,977,525,849
Total	\$4,621,585,966	\$1,369,012,201	\$ 676,349,103	\$ 672,953,390	\$7,339,900,660
Gross claim and LAE liability	\$ 21,000	\$ 394,000	\$ 300,000	\$ 150,314,086	\$ 151,029,086
Less:					
Gross potential recoveries	-	-	-	56,479,398	56,479,398
Discount — net	-	-	-	7,969,812	7,969,812
Net claim and LAE liability	\$ 21,000	\$ 394,000	\$ 300,000	\$ 85,864,876	\$ 86,579,876
Unearned premium revenue	\$ 74,527,670	\$ 29,163,277	\$ 19,186,961	\$ 23,854,229	\$ 146,732,137
Claim and LAE liability reported in the balance sheet	\$ 21,000	\$ 394,000	\$ 300,000	\$ 85,864,876	\$ 86,579,876
Reinsurance recoverables	\$ -	\$ -	\$ -	\$ -	\$ -

## 20. SUBSEQUENT EVENTS

The Company has evaluated all subsequent events through May 23, 2013, the date the statutory-basis financial statements were available to be issued. Except for that discussed below, there were no events that required adjustment to or disclosure in the statutory-basis financial statements.

On May 7, 2013, the Company made a claim payment on an insured debt obligation on which reserves for losses had not previously been established. As a result, the company expects to record approximately \$7.5 million of incurred losses and \$7.2 million of related reserves relating thereto during the quarterly period ended June 30, 2013. The aggregate par insured exposure on this debt obligation at December 31, 2012 was approximately \$9.0 million.

On May 14, 2013, the Appellate Division of the Supreme Court of the State of New York, County of New York, ordered the dismissal of the Lawsuit discussed in Note 16. The decision reversed the Order. The Company believes that the decision neither comports with the factual record nor the law on the relevant issues and intends to challenge it vigorously.

\* \* \* \* \*

## **SUPPLEMENTAL SCHEDULES**

# ACA FINANCIAL GUARANTY CORPORATION

## SUPPLEMENTAL SUMMARY OF INVESTMENT SCHEDULE AS OF DECEMBER 31, 2012

Investment Categories	Gross Investment Holdings Under NAIC Carrying Value		Admitted Assets as Reported in the Annual Statement	
Bonds:				
U.S. Treasury securities	\$ 11,735,633	2.8 %	\$ 11,735,633	2.8 %
U.S. government agency and corporate obligations (excluding mortgage-backed securities) — issued by U.S. government sponsored agencies	1,431,351	0.3	1,431,351	0.3
Securities issued by states, territories and possessions and political subdivisions in the U.S.:				
States, territories and possessions general obligations				
Political subdivisions of states, territories and possessions and political subdivisions general obligations				
Revenue and assessment obligations	4,970,077	1.2	4,970,077	1.2
Mortgage-backed securities (includes residential and commercial MBS) pass-through securities:				
Issued or guaranteed by GNMA	93,860,817	22.3	93,860,817	22.3
Issued or guaranteed by FNMA and FHLMC	24,963,791	5.9	24,963,791	5.9
CMOs and REMICs:				
Issued or guaranteed by GNMA, FNMA, FHLMC or VA				
Issued by non-U.S. government issuers and collateralized by mortgage-backed securities issued or guaranteed by GNMA, FNMA, FHLMC or VA	16,334,509	3.9	16,334,509	3.9
All other	57,309,965	13.6	57,309,965	13.6
Other debt and other fixed income securities (excluding short-term):				
Unaffiliated domestic securities (includes credit tenant loans rated by the SVO)	161,205,137	38.2	161,205,137	38.2
Unaffiliated foreign securities	25,660,882	6.1	25,660,882	6.1
Receivable for securities	3,000	0.0	3,000	0.0
Cash, cash equivalents and short-term investments	<u>24,241,349</u>	<u>5.7</u>	<u>24,241,349</u>	<u>5.7</u>
Total invested assets	<u>\$421,716,511</u>	<u>100.0 %</u>	<u>\$421,716,511</u>	<u>100.0 %</u>

# ACA FINANCIAL GUARANTY CORPORATION

## SUPPLEMENTAL SCHEDULE OF INVESTMENT RISK INTERROGATORIES AS OF DECEMBER 31, 2012

Answer the following interrogatories by reporting the applicable U.S. dollar amounts and percentages of the reporting entity's total admitted assets held in that category of investments.

Reporting entity's total admitted assets as reported on Page 3 of this annual statement

1. \$424,590,463
2. Ten largest exposures to a single issuer/borrower/investment.

Issuer	Description of Exposure	Amount	Percentage of Total Admitted Assets
2.01 Bear Stearns Commercial Mortgage	MBS CMO/REMIC/Unaffiliated Domestic	\$ 13,203,870	3.1 %
2.02 Morgan Stanley	MBS CMO/REMIC/Unaffiliated Domestic	11,939,320	2.8
2.03 Goldman Sachs Group Inc.	Other Debt/Unaffiliated Domestic	11,805,395	2.8
2.04 Citigroup Inc.	Other Debt/Unaffiliated Domestic	11,539,189	2.7
2.05 Bank of America	Other Debt/Unaffiliated Domestic	10,082,024	2.4
2.06 Commercial Mortgage Pass-Through	MBS CMO/REMIC/Other Debt	9,832,142	2.3
2.07 Residential Asset Mortgage	Other Debt/Unaffiliated Domestic	5,680,022	1.3
2.08 HSBC Finance Corp	Other Debt/Unaffiliated Domestic & Non-US	4,955,682	1.2
2.09 Coca Cola Co	Other Debt/Unaffiliated Domestic	4,745,853	1.1
2.10 General Electric Capital Corp	Other Debt/Unaffiliated Domestic	4,117,749	1.0

3. Amounts and percentages of the reporting entity's total admitted assets held in bonds and preferred stocks by NAIC rating.

Bonds				Preferred Stocks			
3.01	NAIC-1	\$ 317,249,083	74.7 %	3.07	P/RP-1	\$ -	- %
3.02	NAIC-2	90,224,857	21.2	3.08	P/RP-2		
3.03	NAIC-3	-	-	3.09	P/RP-3		
3.04	NAIC-4	858,500	0.2	3.10	P/RP-4		
3.05	NAIC-5	-	-	3.11	P/RP-5		
3.06	NAIC-6	4,509,182	1.1	3.12	P/RP-6		

4. Assets held in foreign investments:

4.01	Are assets held in foreign investments less than 2.5% of the reporting entity's total admitted assets?	Yes ( )	No(X)
4.02	Total admitted assets held in foreign investments:	\$24,068,295	5.7 %
4.03	Foreign-currency-denominated investments:	\$ _____	_____%
4.04	Insurance liabilities denominated in that same foreign currency:	\$ _____	_____%

If response to 4.01 is yes, responses are not required for interrogatories 5–10.

5. Aggregate foreign investment exposure categorized by NAIC sovereign rating:

Countries rated NAIC-1	\$24,068,295	5.7 %
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6. Two largest foreign investment exposures to a single country, categorized by NAIC sovereign rating:

Country: United Kingdom	\$9,346,427	2.2 %
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Country: Australia	\$5,056,217	1.2 %
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7. Aggregate unhedged foreign currency exposure	\$ -	- %
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8. Aggregate unhedged foreign currency exposure categorized by the country’s NAIC sovereign rating: N/A

9. Two largest unhedged foreign currency exposures to a single country, categorized by the country’s NAIC sovereign rating: N/A

10. Ten largest non-sovereign (i.e. non-governmental) foreign issues:

	<b>1</b>	<b>2</b>	<b>3</b>	<b>4</b>
	<b>Issuer</b>	<b>NAIC Rating</b>		
	Anglo America Capital	2	3,158,400	0.7 %
	Macquarie Group Ltd	1	3,060,844	0.7
	British Telecom Plc	2	2,154,794	0.5
	Credit Suisse New York	1	2,050,480	0.5
	Barclays Bank Plc	1	2,037,128	0.5
	Electricite De France	1	1,998,022	0.5
	HSBC Holdings PLC	1	1,996,105	0.5
	Woolworths Limited	1	1,995,374	0.5
	Posco	2	1,877,109	0.4
	Aspen Insurance	2	1,069,276	0.3

11. Amounts and percentages of the reporting entity’s total admitted assets held in Canadian investments and unhedged Canadian currency exposure.

11.01	Are assets held in Canadian investments less than 2.5% of the reporting entity’s total admitted assets?	Yes (X)	No ( )
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12. Report aggregate amounts and percentages of the reporting entity’s total admitted assets held in investments with contractual sales restrictions.

12.01	Are assets held in investments with contractual sales restrictions less than 2.5% of the reporting entity’s total admitted assets?	Yes (X)	No ( )
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12.02 If response to 12.01 is yes, responses are not required for the remainder of Interrogatory 12.



13. Amounts and percentages of admitted assets held in the largest 10 equity interests:

13.01 Are assets held in equity interests less than 2.5% of the reporting entity's total admitted assets?  
Yes (X) No ( )

If response to 13.01 above is yes, responses are not required for the remainder of interrogatory 13.

14. Amounts and percentages of the reporting entity's total admitted assets held in nonaffiliated, privately placed equities:

14.01 Are assets held in nonaffiliated, privately placed equities less than 2.5% of the reporting entity's total admitted assets?  
Yes (X) No ( )

If response to 14.01 is yes, responses are not required for remainder of Interrogatory 14.

15. Amounts and percentages of the reporting entity's total admitted assets held in general partnership interests:

15.01 Are assets held in general partnership interests less than 2.5% of the reporting entity's total admitted assets?  
Yes (X) No ( )

If response to 15.01 is yes, responses are not required for the remainder of Interrogatory 15.

16. Amounts and percentages of the reporting entity's total admitted assets held in mortgage loans:

16.01 Are mortgage loans reported in Schedule B less than 2.5% of the reporting entity's total admitted assets?  
Yes (X) No ( )

If response to 16.01 above is yes, responses are not required for the remainder of Interrogatory 16 and Interrogatory 17.

17. Aggregate mortgage loans having the following loan-to-value ratios as determined from the most current appraisal as of the annual statement date — N/A

18. Amounts and percentages of the reporting entity's total admitted assets held in each of the five largest investments in real estate:

1.01 Are assets held in real estate in less than 2.5% of the reporting entity's total admitted assets?  
Yes (X) No ( )

If response to 18.01 above is yes, responses are not required for the remainder of Interrogatory 18.

19. Report aggregate amounts and percentages of the reporting entity's total admitted assets held in investments held in mezzanine real estate loans:

19.01 Are assets held in investments held in mezzanine real estate loans less than 2.5% of the reporting entities total admitted assets?  
Yes (X) No ( )

If response to 19.01 above is yes, responses are not required for the remainder of Interrogatory 19.

20. Amounts and percentages of the reporting entity's total admitted assets subject to the following types of agreements:

	<b>At End of Each Quarter</b>			
	<b>At Year-End</b>	<b>1st Qtr</b>	<b>2nd Qtr</b>	<b>3rd Qtr</b>
19.01 Securities lending agreements (do not include assets held as collateral for such transactions)	\$ -	\$ -	\$ -	\$ -
19.02 Repurchase agreements	\$ -	\$ -	\$ -	\$ -
19.03 Reverse repurchase agreements	\$ -	\$ -	\$ -	\$ -
19.04 Dollar repurchase agreements	\$ -	\$ -	\$ -	\$ -
19.05 Dollar reverse repurchase agreements	\$ -	\$ -	\$ -	\$ -

21. Amounts and percentages of the reporting entity's total admitted assets for warrants not attached to other financial instruments, options, caps, and floors:

	<b>Owned</b>		<b>Written</b>	
	\$	%	\$	%
20.01 Hedging	\$ -	-	\$ -	-
20.02 Income generation	\$ -	-	\$ -	-
20.03 Other	\$ -	-	\$ -	-

22. Amounts and percentages of the reporting entity's admitted assets of potential exposure for collars, swaps, and forwards:

	<b>At End of Each Quarter</b>			
	<b>At Year-End</b>	<b>1st Qtr</b>	<b>2nd Qtr</b>	<b>3rd Qtr</b>
21.01 Hedging	\$ -	\$ -	\$ -	\$ -
21.02 Income generation	\$ -	\$ -	\$ -	\$ -
21.03 Replications	\$ -	\$ -	\$ -	\$ -
21.04 Other	\$ -	\$ -	\$ -	\$ -

23. Amounts and percentages indicated below of the reporting entity's total admitted assets of potential exposure for futures contracts:

	<b>At End of Each Quarter</b>			
	<b>At Year-End</b>	<b>1st Qtr</b>	<b>2nd Qtr</b>	<b>3rd Qtr</b>
21.01 Hedging	\$ -	\$ -	\$ -	\$ -
21.02 Income generation	\$ -	\$ -	\$ -	\$ -
21.03 Replications	\$ -	\$ -	\$ -	\$ -
21.04 Other	\$ -	\$ -	\$ -	\$ -

24. State the amounts and percentages of 10 largest investments included in the Write-ins for Invested Assets category included on the Summary Investment Schedule

23.01	Not applicable	\$	-	-	%
23.02					
23.03					
23.04					
23.05					
23.06					
23.07					
23.08					
23.09					
23.10					

# ACA FINANCIAL GUARANTY CORPORATION

## SUPPLEMENTAL SCHEDULE OF REINSURANCE INTERROGATORIES AS OF DECEMBER 31, 2012

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- 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]