ACA Capital Holdings Inc
Form 10-Q
December 20, 2006

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, DC 20549

Form 10-Q

x **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the Quarter Ended September 30, 2006

or

o **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the transition period from _______ to _______

Commission file number 1-33111

ACA Capital Holdings, Inc.

(Exact name of registrant as specified in its charter)

Delaware	**75-3170112**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification Number)

140 Broadway
New York, New York 10005
(212) 375-2000

(Address, including zip code, and telephone number, including area code, of registrant s principal executive offices)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes o No x

Indicate by check mark whether the Registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer o Accelerated filer o Non-accelerated filer x

Indicate by check mark whether the Registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes o No x

As of December 15, 2006, 36,523,281 shares of Common Stock, par value $0.10 per share, were outstanding.

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PART I - FINANCIAL INFORMATION

PART I FINANCIAL INFORMATION

Item 1. Financial Statements of ACA Capital Holdings, Inc. and Subsidiaries (Unaudited)

ACA CAPITAL HOLDINGS, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED BALANCE SHEETS (UNAUDITED)

AS OF SEPTEMBER 30, 2006 AND DECEMBER 31, 2005

(Dollars in thousands)

	September 30, 2006	**December 31, 2005**
ASSETS		
Investments:		
Fixed-maturity securities available for sale at fair value, amortized cost of $5,138,326 and $5,292,081, respectively	$ 5,149,949	$ 5,298,739
Fixed-maturity securities trading at fair value, amortized cost of $217,994 and $0, respectively	217,986	
Securities purchased under agreements to resell	32,066	
Guaranteed investment contract	119,340	119,340
Total investments	5,519,341	5,418,079
Cash:		
Cash and cash equivalents	224,860	174,420
Restricted cash	57,519	50,185
Total cash	282,379	224,605
Accrued investment income	21,631	17,258
Derivative assets	15,653	15,250
Deferred policy acquisition costs, net	47,834	47,414
Deferred debt issuance costs, net	35,768	40,843
Receivable for securities sold	70,950	
Prepaid reinsurance premiums	599	848
Other assets	52,012	27,903
Total assets	$ 6,046,167	$ 5,792,200
LIABILITIES, MINORITY INTEREST AND STOCKHOLDERS EQUITY		
LIABILITIES		
Unearned premiums	$ 191,250	$ 187,739
Reserve for losses and loss adjustment expenses	39,378	34,306
Short-term debt	2,679,926	2,674,698
Long-term debt	2,147,636	2,254,650
Related party debt	100,000	100,000
Fixed-maturity liabilities held for trading	7,632	
Securities sold under agreements to repurchase	235,679	
Derivative liabilities	35,121	46,538
Accrued interest payable	16,930	15,347
Accrued expenses and other liabilities	50,310	32,277
Payable for securities purchased	64,438	30,138
Current income tax payable	3,126	3,044
Deferred income taxes	12,035	6,909
Total liabilities	5,583,461	5,385,646
MINORITY INTEREST	32,334	22,241
COMMITMENTS AND CONTINGENCIES		
STOCKHOLDERS EQUITY		
	9,296	7,339

Senior convertible preferred stock 220 shares authorized, 154 shares and 129 shares issued and outstanding at September 30, 2006 and December 31, 2005, respectively		
Convertible preferred stock 1,500 shares authorized, 959 shares issued and outstanding at September 30, 2006 and December 31, 2005, respectively	54,858	54,858
Series B senior convertible preferred stock 3,000,000 shares authorized, 2,785,769 shares issued and outstanding at September 30, 2006 and December 31, 2005, respectively	164,263	164,263
Common stock of 100,000,000 shares authorized at September 30, 2006 and 12,000,000 shares authorized at December 31, 2005; 7,106,490 and 6,442,950 shares issued and outstanding at September 30, 2006 and December 31, 2005, respectively; par value of $0.10	710	644
Gross paid-in and contributed capital	133,786	125,184
Treasury stock at cost 851,847 shares and 351,876 shares at September 30, 2006 and December 31, 2005, respectively	(12,088)	(5,500)
Notes receivable from stockholders	(3,121)	(1,355)
Deferred compensation	(1,160)	(2,030)
Accumulated other comprehensive income net of deferred income tax of $7,257 and $5,369 at September 30, 2006 and December 31, 2005, respectively	13,757	11,132
Retained earnings	70,071	29,778
Total stockholders equity	430,372	384,313
Total liabilities, minority interest and stockholders equity	$ 6,046,167	$ 5,792,200

See notes to unaudited condensed consolidated financial statements.

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ACA CAPITAL HOLDINGS, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS (UNAUDITED)

FOR THE THREE AND NINE MONTHS ENDED SEPTEMBER 30, 2006 AND 2005

(Dollars and shares in thousands, except per share amounts)

	Three months ended September 30, 2006	Three months ended September 30, 2005	Nine months ended September 30, 2006	Nine months ended September 30, 2005
REVENUES:				
Gross premiums written	5,570	$ 17,733	$ 26,085	$ 35,538
Less premiums ceded	(189)	(2)	(375)	764
Net premiums written	5,381	17,731	25,710	36,302
(Increase) decrease in unearned premium reserve - net	3,213	(9,178)	(3,759)	(11,528)
Premiums earned	8,594	8,553	21,951	24,774
Net insured credit swap revenue	17,079	12,529	39,190	17,072
Net investment income	87,888	66,887	248,052	181,361
Net realized and unrealized losses on investments	(752)	(930)	(3,975)	(2,153)
Net realized and unrealized gains on derivative instruments	755	3,290	6,894	7,330
Other net credit swap revenue	2,090	1,146	7,634	3,670
Fee income	6,516	3,210	17,589	7,576
Other income (loss)	342	(170)	446	125
Total revenues	122,512	94,515	337,781	239,755
EXPENSES:				
Loss and loss adjustment expenses	2,576	4,768	6,258	8,907
Policy acquisition costs	2,638	2,694	6,798	6,678
Other operating expenses	11,999	7,506	35,293	22,175
Interest expense	76,095	56,716	213,478	152,220
Depreciation and amortization	2,456	2,366	7,173	6,430
Total expenses	95,764	74,050	269,000	196,410
Income of minority interest	(897)	(1,440)	(3,126)	(3,125)
Income before income taxes	25,851	19,025	65,655	40,220
Provision for income tax expense	9,790	7,556	23,405	15,634
Net income	$ 16,061	$ 11,469	$ 42,250	$ 24,586
Share and Per Share Data				
Earnings per share				
Basic	$ 0.70	$ 0.50	$ 1.85	$ 1.08
Diluted	$ 0.53	$ 0.39	$ 1.40	$ 0.83
Weighted average shares outstanding				
Basic	23,027	22,806	22,897	22,757
Diluted	30,235	29,789	30,129	29,740

See notes to unaudited condensed consolidated financial statements.

ACA CAPITAL HOLDINGS, INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF STOCKHOLDERS EQUITY (UNAUDITED)
FOR THE NINE MONTHS ENDED SEPTEMBER 30, 2006 AND 2005
(Dollars in thousands, except for share amounts)

	Preferred Stock Shares	Preferred Stock Amount	Common Stock Shares	Common Stock Par Value	Gross Paid in and Contri-buted Capital	Treasury Stock	Notes Receiv-able from Stock-holders	Deferred Compe-nsation	Accum-ulated Other Compre-hensive Income	Retained Earnings	Total Stock-holders Equity
BALANCE January 1, 2005	2,781,857	$ 226,088	6,442,950	$ 644	$ 125,184	$ (5,426)	$ (1,656)	$ (3,190)	$ 21,952	$ 1,018	$ 364,614
Comprehensive income:											
Net income										24,586	24,586
Change in unrealized gain on investments, net of change in deferred income tax of $(4,083)									(7,597)		(7,597)
Change in derivative hedges, net of change in deferred income tax of $3,186									5,916		5,916
Total comprehensive income											22,905
Issuance of Series C senior convertible preferred stock	5,000	311									311
Vesting of Series B senior conv. prf stock to CEO								870			870
Employee stock buyback						(74)					(74)
Employee stock principal paydown							301				301
BALANCE September 30, 2005	2,786,857	$ 226,399	6,442,950	$ 644	$ 125,184	$ (5,500)	$ (1,355)	$ (2,320)	$ 20,271	$ 25,604	$ 388,927
BALANCE January 1, 2006	2,786,857	$ 226,460	6,442,950	$ 644	$ 125,184	$ (5,500)	$ (1,355)	$ (2,030)	$ 11,132	$ 29,778	$ 384,313
Comprehensive income:											
Net income										42,250	42,250
Change in unrealized gain on investments, net of change in deferred income tax of $1,904									2,670		2,670
Change in derivative hedges, net of change in deferred income tax of $(15)									(27)		(27)
Foreign exchange unrealized loss									(18)		(18)
Total comprehensive income											44,875
Vesting of Series B senior conv. prf stock to CEO								870			870
Exercise of stock options by former executives			663,540	66	8,024						8,090
Common stock purchased from former executive						(6,588)					(6,588)
Stock based compensation expense					578						578
Issuance of note receivable from							(2,262)				(2,262)

stockholder											
Discharge of note receivable from stockholders							496				496
Senior convertible preferred stock dividend	25	1,957								(1,957)	
BALANCE September 30, 2006	2,786,882	$ 228,417	7,106,490	$ 710	$ 133,786	$ (12,088)	$ (3,121)	$ (1,160)	$ 13,757	$ 70,071	$ 430,372

See notes to unaudited condensed consolidated financial statements.

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ACA CAPITAL HOLDINGS, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)

FOR THE NINE MONTHS ENDED SEPTEMBER 30, 2006 AND 2005

(Dollars in thousands)

	2006	2005
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income	$ 42,250	$ 24,586
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	7,173	6,430
Accrual of discount and amortization of premium on investment net	(171)	(82)
Income of minority interest	3,126	3,125
Net realized losses on fixed-maturity securities-available-for-sale	3,857	2,153
Net realized and unrealized losses on fixed-maturity securities- trading	118	
Net realized and unrealized gains on derivative instruments	(6,894)	(7,330)
Net realized and unrealized (gains) losses on net insured credit swap revenue	(4,167)	3,066
Net realized and unrealized (gains) losses on other net credit swap revenue	149	2,374
Share based compensation	578	
Discharge of note receivable from shareholders	496	264
Deferred compensation	870	870
Purchase of securities under agreement to sell	(32,066)	
Purchases of fixed-maturity securities-trading	(82,792)	
Proceeds from sales of fixed-maturity securities- trading	(145,118)	
Securities sold under agreement to repurchase	235,679	
Changes in assets and liabilities:		
Income taxes payable	82	28
Deferred income tax expense	3,219	2,608
Prepaid reinsurance premiums	249	915
Derivative liabilities	(2,871)	18,689
Payable and accrued expenses	(6,785)	(2,884)
Deferred policy acquisition costs	(420)	148
Unearned premium reserve	3,511	10,611
Loss and loss adjustment expenses	5,072	(1,910)
Interest payable	1,583	1,855
Interest receivable	(4,373)	(3,200)
Other	(1,193)	(3,165)
Net cash provided by operating activities	21,162	59,151
CASH FLOWS FROM INVESTING ACTIVITIES:		
Net deposit of restricted cash	(7,334)	(24,126)
Purchases of fixed maturity securities available for sale	(786,738)	(998,610)
Proceeds from sales of fixed maturity securities available for sale	89,843	164,424
Proceeds from maturities of fixed maturity securities available for sale	827,751	661,325
Net purchase of property and equipment	(298)	(444)
Net cash provided by (used in) investing activities	123,224	(197,431)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Proceeds from issuance of debt		103,405
Proceeds from issuance of commercial paper net	5,228	199,743
Paydown on long-term debt	(107,014)	(152,338)
Payment of issuance costs for debt		(1,462)
Proceeds from issuance of preferred stock net of issuance costs		311

Purchase of treasury stock	(760)	(74)
Minority interest investment in credit fund	8,600	
Notes receivable from shareholders		37
Net cash (used in) provided by financing activities	(93,946)	149,622
NET INCREASE IN CASH AND CASH EQUIVALENTS	50,440	11,342
CASH AND CASH EQUIVALENTS beginning of period	174,420	228,927
CASH AND CASH EQUIVALENTS end of period	$ 224,860	$ 240,269
SUPPLEMENTAL CASH FLOW DISCLOSURES:		
Federal and local income taxes paid	$ 20,236	$ 14,297
Interest paid	$ 211,894	$ 150,365
SUPPLEMENTAL DISCLOSURE OF NON-CASH FINANCING ACTIVITIES		
Common stock acquired in exchange for note receivable	$ 2,262	$

See notes to unaudited condensed consolidated financial statements.

ACA CAPITAL HOLDINGS, INC. AND SUBSIDIARIES
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
SEPTEMBER 30, 2006

1. BUSINESS, ORGANIZATION AND OPERATIONS

ACA Capital Holdings, Inc. (ACA Capital or the Company), a Delaware domiciled holding company, is engaged in providing financial guaranty insurance products to participants in the global credit derivatives markets, structured finance capital markets and municipal finance capital markets, as well as providing asset management services. The Company s principal activities include financial guaranty insurance of municipal and non-municipal debt obligations, structured credit risk assumption through credit derivatives and collateralized debt obligation asset management. ACA Capital conducts its business through four wholly-owned subsidiaries. Its financial guaranty business is conducted through ACA Financial Guaranty Corporation (ACA FG), a Maryland domiciled insurance company. ACA FG is licensed to conduct insurance business, which provides credit enhancement on municipal and other public finance obligations, in 50 states, the District of Columbia, Guam, the U.S. Virgin Islands and Puerto Rico. Standard & Poor s Rating Services has assigned a financial strength rating of A to ACA FG. ACA FG also provides the credit support for the Company s structured credit business activities. Through ACA Service L.L.C., ACA Risk Solutions, L.L.C. and ACA Management, L.L.C., the Company conducts its collateralized debt obligation asset management business. This business encompasses the origination (in collaboration with investment banks), structuring and management of collateralized debt obligations (including collateralized loan obligations and other similarly securitized asset classes, collectively CDOs).

The Company defines its business as being composed of three distinct continuing lines of business or segments. They are Municipal Finance, Structured Credit and CDO Asset Management. A fourth line of business, Other, includes business in areas and markets in which the Company is no longer active. Although the Municipal Finance and Structured Credit businesses are reported in separate segments, together they form the Company s financial guaranty business. Municipal Finance provides financial guaranty insurance policies guaranteeing the timely payment of scheduled principal and interest on municipal debt obligations. Structured Credit structures and sells credit protection, principally in the form of insured credit swaps (CDS), against a variety of asset classes in the institutional fixed income markets. CDO Asset Management focuses on CDO origination, structuring and management. The Company will at times assume risk in the CDOs it manages through investment in some portion of the capital structure.

ACA Capital was originally incorporated in Delaware on January 3, 1997. On November 22, 2002, ACA Capital changed its jurisdiction of incorporation from Delaware to Bermuda. During 2004, the Board of Directors determined that re-domesticating to Delaware would eliminate certain adverse consequences of remaining in Bermuda, facilitate ACA Capital s access to U.S. capital markets, simplify its tax filings, accounting and operations, and reduce the costs of compliance with two sets of filing obligations and laws (as ACA Capital stockholders are U.S. entities and individuals). On September 15, 2004, therefore, ACA Capital re-domesticated from Bermuda to Delaware through a process called a discontinuation under Bermuda law and a domestication under Delaware law. As a result, it became a Delaware domiciled holding company and changed its name from American Capital Access Holdings, Ltd. to its current name.

On November 9, 2006, the Company priced its initial public offering of 6,875,000 shares of newly issued common stock and 23,541 shares of existing common stock. The Company realized gross proceeds of $13 per share on the newly issued common stock, or $89.4 million. Net proceeds to the Company were $79.1 million, after issuance costs. On November 10, 2006, the Company s common stock commenced trading on the New York Stock Exchange under the symbol ACA. In conjunction with the initial public offering, the Company s senior convertible preferred stock, convertible preferred stock and series B senior convertible preferred stock all converted to common stock concurrently with the closing of our offering on November 15, 2006 at their conversion ratios of 6,000:1 shares, 6,000:1 shares and 6:1 shares, respectively. Additionally, in connection with the completion of the initial public offering, the Company issued 543,000 stock options and 240,154 shares of restricted common stock under the Company s Amended and Restated 2006 Stock Incentive Plan (see Notes 12 and 13).

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

These unaudited condensed consolidated financial statements have been prepared pursuant to the rules and regulations of the Securities and Exchange Commission (SEC) regarding interim financial reporting. Accordingly, they do not include all of the information and footnotes required by accounting principles generally accepted in the United States of America (GAAP) for complete financial statements and should be read in conjunction with the Company s audited consolidated financial statements as of December 31, 2005 and 2004 and for the years ended December 31, 2005, 2004 and 2003 and the notes thereto. These unaudited condensed consolidated financial statements include all adjustments, consisting only of normal recurring adjustments, that we consider necessary for the fair presentation of our financial position and results of operations for these periods. The preparation of financial statements in conformity with GAAP 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 the reported amounts of revenues and expenses during the reporting periods. Actual results could differ from those estimates.

Operating results for the nine months ended September 30, 2006 are not necessarily indicative of the results that may be expected for the year ended December 31, 2006.

Securities Purchased under Agreements to Resell and Securities Sold under Agreements to Repurchase - Securities purchased under agreements to resell and securities sold under agreements to repurchase are treated as collateralized financing transactions and are recorded at the amounts at which the securities were acquired or sold plus accrued interest. These items are related to the Company s Credit Fund activities (the Company s Credit Fund is defined and explained in more detail in Note 10 below). The Company s policy is to take possession of securities purchased under agreements to resell. The market value of the underlying securities, which collateralize the related receivable on agreements to resell, is monitored to ensure that the market value exceeds contractually stated levels of principal at all times. If the seller defaults on its obligation to repay the Company, and the fair value of the collateral decline, realization of the collateral by the Company may be delayed or limited. Securities owned that are financed under repurchase agreements are carried at market value, with unrealized gains and losses reflected in net realized and unrealized gains (losses) on investments in the condensed consolidated statements of operations. Obligations under securities sold under agreement to repurchase bear interest that approximates LIBOR and at September 30, 2006, had settlement dates less than thirty days.

Fixed Maturity Liabilities Held For Trading - Financial instruments utilized in trading activities are stated at fair value. These items are related to the Company s Credit Fund activities. Fair value is based on quoted market prices. Fixed-maturity liabilities held for trading represents obligations of the Credit Fund to deliver the specified security at the contracted price, and thereby, create a liability to purchase the security in the market at prevailing prices. At September 30, 2006, the fixed maturity liabilities held represents a short position on a U.S. Treasury Note, which was closed out in October 2006. Realized and unrealized gains and losses on these financial instruments are recorded in net realized and unrealized gains (losses) on investments in the condensed consolidated statements of operations.

In August 2006, the Company s Board of Directors authorized a dividend of stock in order to effect a six-for-one stock split. All prior share and per share amounts have been restated to reflect the stock split.

3. RELEVANT RECENT ACCOUNTING PRONOUNCEMENTS

In December 2004, the Financial Accounting Standard Board (FASB) issued Statement of Financial Accounting Standards No. (FAS) 123(R), *Shared-Based Payments.* FAS 123(R) is a revision of FAS 123, *Accounting for Stock Based Compensation* and supersedes Accounting Principles Board Opinion No. (APB) 25, *Accounting for Stock Issued to Employees.* FAS 123(R) requires the Company to expense the fair value of employee stock options and other forms of stock based compensation. Effective January 1, 2006, the Company adopted the requirements of FAS 123(R) using the prospective application as permitted by
FAS 123(R), accordingly prior period amounts have not been restated. Under this application, the Company is required to record compensation expense for all awards granted after the date of adoption. Awards granted prior to the date of adoption of FAS 123(R) continue to be accounted for under APB 25, the Company s prior accounting method for stock based compensation. For the three and nine months ended September 30, 2006, the Company recognized compensation expense under FAS 123(R) of $0.4 million and $0.6 million, respectively.

In May 2005, the FASB issued FAS 154, *Accounting Changes and Error Corrections*. This pronouncement changes the requirements for the accounting and reporting of a change in accounting principle. This statement applies to all voluntary changes in accounting principle as well as to changes required by an accounting pronouncement that does not include specific transition provisions. This statement eliminates the requirement in APB 20, *Accounting Changes,* to include the cumulative effect of changes in accounting principle in the statement of operations in the period of change. Instead, to enhance the comparability of prior period financial statements, FAS 154 requires that changes in accounting principle be retroactively applied, with the cumulative effect of the accounting principle reflected as an asset or liability and an offsetting adjustment to retained earnings in the first period presented as if that accounting principle had always been used. Each subsequent period presented is then adjusted to reflect the period specific effects of applying the change. The implementation of this statement did not have a material impact on the Company s financial statements.

In November 2005, the FASB released Staff Position (FSP) Nos. FAS 115-1 and FAS 124-1, *The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments.* This pronouncement addresses the determination as to when an investment is considered impaired, whether that impairment is other than temporary, and the measurement of an impairment loss. It also includes accounting considerations subsequent to the recognition of an other-than-temporary impairment and requires certain disclosures about unrealized losses that have not been recognized as other-than-temporary impairments. The implementation of this pronouncement did not have a material impact on the Company s financial statements.

In September 2005, the American Institute of Certified Public Accountants (AICPA) issued Statement of Position No. (SOP) 05-1, *Accounting by Insurance Enterprises for Deferred Acquisition Costs in Connection with Modifications or Exchanges of Insurance Contracts*. SOP 05-1 provides guidance on accounting by insurance enterprises for deferred acquisition costs on internal replacements of many types of insurance and investment contracts, including those covered by FAS 60. Contract modifications meeting all of the conditions set out in SOP 05-1 result in a replacement contract that is substantially unchanged from the replaced contract and a contract that is accounted for as a continuation of the replaced contract. If SOP 05-1 did not apply, the modification would be treated as if the original contract was extinguished and replaced by a new contract, with unamortized deferred acquisition costs, unearned revenue liabilities and deferred sales inducements associated with the original contract recognized currently in income. The implementation of this pronouncement did not have a material impact on the Company s financial statements.

In February 2006, the FASB issued FAS 155, *Accounting for Certain Hybrid Financial Instruments*, an amendment of FAS 133 and 140. FAS 155 (i) permits fair value remeasurement for any hybrid financial instrument that contains an embedded derivative that otherwise would require bifurcation, (ii) clarifies which interest-only strips and principal-only strips are not subject to the requirements of FAS 133, (iii) clarifies that concentrations of credit risk in the form of subordination are not embedded derivatives, and (iv) amends FAS 140 to eliminate the exemption from applying the requirements of FAS 133 on a qualifying special-purpose entity from holding a derivative financial instrument that pertains to a beneficial interest other than another derivative financial instrument. Additionally, on November 8, 2006, the Derivatives Implementation Group of the

FASB released Issue No. B40, *Embedded Derivatives: Application of Paragraph 13(b) to Securitized Interests in Prepayable Financial Assets.* This issue provides additional guidance on the implementation of FAS 155 as it relates to certain types of securitizations of prepayable financial assets. FAS 155 is effective for all financial instruments acquired or issued after the beginning of an entity s first fiscal year that begins after September 15, 2006. Management will implement the requirements of FAS 155 after its effective date, as applicable. Since this guidance is applicable to future transactions, its effect on the financial statements cannot be estimated at this time.

In March 2006, the FASB issued FAS 156, *Accounting for Servicing of Financial Assets*, an amendment of FAS 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*. FAS 156 requires that all separately recognized servicing assets and servicing liabilities be initially measured at fair value, if practicable, and permits for subsequent measurement using either fair value measurement with changes in fair value reflected in earnings or the amortization and impairment requirements of FAS 140. The subsequent measurement of separately recognized servicing assets and servicing liabilities at fair value eliminates the necessity for entities that manage the risks inherent in servicing assets and servicing liabilities with derivatives to qualify for hedge accounting treatment and eliminates the characterization of declines in fair value as impairments or direct write-downs. FAS 156 is effective for an entity s first fiscal year beginning after September 15, 2006. The implementation of this statement is not expected to have a material impact on the Company s financial statements.

In April 2006, the FASB issued FSP FIN 46(R)-6, *Determining the Variability to Be Considered in Applying FASB Interpretation No. 46(R).* FSP FIN 46(R)-6 addresses whether certain arrangements associated with variable interest entities (VIEs) should be treated as variable interests or considered as creators of variability, and indicates that the variability to be considered shall be on based on an analysis of the design of the entity. FSP FIN 46(R)-6 was adopted on June 15, 2006. The adoption of this statement did not have a material impact on the Company s financial statements.

In July 2006, the FASB issued FASB Interpretation No. (FIN) 48, *Accounting for Uncertainty in Income Taxes* . FIN 48 prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. The Interpretation also provides guidance on de-recognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition. FIN 48 is effective in fiscal years beginning after December 15, 2006. The provisions of FIN 48 are to be applied to all tax positions upon initial adoption, with the cumulative effect adjustment reported as an adjustment to the opening balance of retained earnings. Management is currently evaluating the potential impact, if any, which the adoption of FIN 48 will have on the Company s financial statements.

In September 2006, the FASB issued FAS 157, *Fair Value Measurements*. FAS 157 enhances existing guidance for measuring assets and liabilities using fair value, such as emphasizing that fair value is a market-based measurement, not an entity-specific measurement, and sets out a fair value hierarchy with the highest priority being quoted prices in active markets. FAS 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. Management is currently evaluating the potential impact, if any, which the adoption of FAS 157 will have on the Company s financial statements.

In September 2006, the FASB also issued FAS 158, *Employers Accounting for Defined Benefit Pension and Other Postretirement Plans an amendment of FASB Statements No. 87, 88, 106 and 132(R).* FAS 158 requires companies that sponsor a defined benefit pension plan to fully recognize, as an asset or liability, the overfunded or underfunded status of its benefit plan(s) in its balance sheet. FAS 158 is effective for companies with publicly traded equity securities for fiscal years ending after December 15, 2006. The implementation of this statement is not expected to have a material impact on the Company s financial statements.

In January and February 2005, the SEC staff discussed with several financial guaranty industry participants the difference in loss reserve recognition practices in the industry. In June 2005, at the request of the SEC, the FASB added a project to their agenda to review and codify accounting standards for financial guaranty insurance contracts as they relate to loss reserving policies and later added a review of accounting policies in the financial guaranty insurance industry as they relate to premium recognition and deferred policy acquisition costs. Proposed guidance is expected to be released in early 2007 with the final guidance expected to be issued later in the year. When the FASB issues final guidance, the financial guaranty insurance industry, including the Company, may have to change certain aspects of its relevant accounting policies. Until a final standard is released, the Company cannot predict how the FASB will resolve this issue and the resulting impact on its financial statements. Further, until the issue is resolved, the Company will continue to apply the accounting policies as disclosed in its audited financials statements as of December 31, 2005 and 2004 and for the years ended December 31, 2005, 2004 and 2003.

In September 2006, the SEC issued Staff Accounting Bulletin No. 108 (SAB 108), *Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements*, which provides interpretive guidance on how the effects of the carryover or reversal of prior year misstatements should be considered in quantifying a current year misstatement. The provisions of SAB 108 will be effective for the Company for the year ended December 31, 2006. Management is currently evaluating the potential impact, if any, which the adoption of SAB 108 will have on the Company s financial statements.

4. CDO ASSET MANAGEMENT BUSINESS

One of the ways the Company participates in the structured finance market is through structuring and managing CDOs originated in collaboration with investment banks. CDOs can be issued in funded, unfunded or partially funded form. Funded CDOs issue debt instruments and purchase investment assets, while unfunded CDOs synthetically acquire assets and issue liabilities (i.e., assets and liabilities are in derivative form). Partially funded CDOs are a combination of these two forms. From an accounting perspective, funded and partially funded CDOs are determined to be VIEs. Each time such CDOs are formed, the

Company performs an analysis to determine whether it is the primary beneficiary and thus required to consolidate the CDO under the provisions of FASB Staff Position (FSP) FIN 46(R)-6.

The following table lists each of the Company s CDOs outstanding as of September 30, 2006 (dollars in millions):

CDO name	Year Deal Closed	Transaction Type	Collateral Type (1)	Notional Deal Size (3)	Consolidated	Original Investment in Retained Equity	Retained Equity %	First Optional Call Date	Maturity Date
Asset-Backed CDOs:									
ACA ABS 2002-1	2002	Funded	Investment Grade	$ 404	Yes	$ 18.0	100	8/2005	8/2037
ACA ABS 2003-1	2003	Funded	Investment Grade	400	Yes	18.0	100	6/2007	6/2038
Grenadier Funding	2003	Funded	High-Grade	1,500	Yes	22.5	100	8/2008	8/2038
ACA ABS 2003-2	2003	Funded	Investment Grade	725	Yes	33.5	100	12/2007	12/2038
ACA ABS 2004-1	2004	Funded	Investment Grade	450	Yes	10.0	61	7/2007	7/2039
Zenith Funding	2004	Funded	High-Grade	1,500	Yes	13.0	52	12/2009	12/2039
ACA ABS 2005-1	2005	Funded	Investment Grade	452	No	4.4	24	4/2008	4/2040
ACA ABS 2005-2	2005	Funded	Investment Grade	450	No	2.1	10	9/2009	12/2044
Khaleej II	2005	Partially funded	Investment Grade	750	No	4.5	14	9/2009	9/2040
Lancer Funding	2006	Funded	High-Grade	1,500	No	1.5	10	7/2010	4/2046
ACA Aquarius 2006-1	2006	Partially funded	Investment Grade	2,000	No			9/2010	9/2046
ACA ABS 2006-1	2006	Funded	Investment Grade	750	No	1.4	5	12/2009	6/2041
Total Asset-Backed CDOs				10,881		128.9			
Corporate Credit CDOs:									