

Assured Guaranty Municipal Corp.

Combined Financial Statements

December 31, 2017 and 2016

ASSURED GUARANTY MUNICIPAL CORP.

INDEX TO COMBINED FINANCIAL STATEMENTS

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Report of Independent Auditors

To the Board of Directors of Assured Guaranty Municipal Corp.:

We have audited the accompanying combined financial statements of Assured Guaranty Municipal Corp. and its subsidiaries (the Company), which comprise the combined balance sheets as of December 31, 2017 and December 31, 2016, and the related combined statements of operations, of comprehensive income, of shareholder's equity and of cash flows for the years then ended.

Management's Responsibility for the Combined Financial Statements

Management is responsible for the preparation and fair presentation of the combined financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of combined financial statements that are free from material misstatement, whether due to fraud or error.

Auditors' Responsibility

Our responsibility is to express an opinion on the combined 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 combined financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the combined financial statements. The procedures selected depend on our judgment, including the assessment of the risks of material misstatement of the combined financial statements, whether due to fraud or error. In making those risk assessments, we consider internal control relevant to the Company's preparation and fair presentation of the combined 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 accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the combined financial statements. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the combined financial statements referred to above present fairly, in all material respects, the financial position of Assured Guaranty Municipal Corp. and its subsidiaries at December 31, 2017 and December 31, 2016, and the results of their operations and their cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.

/s/ PricewaterhouseCoopers LLP

New York, New York
March 20, 2018

Assured Guaranty Municipal Corp.
Combined Balance Sheets
(dollars in millions except per share and share amounts)

	As of December 31, 2017	As of December 31, 2016
Assets		
Investment portfolio:		
Fixed-maturity securities, available-for-sale, at fair value (amortized cost of \$5,479 and \$5,475)	\$ 5,659	\$ 5,547
Short-term investments, at fair value	364	165
Other invested assets (includes Surplus Note from affiliate of \$300 and \$300)	378	357
Total investment portfolio	6,401	6,069
Cash	36	32
Premiums receivable	730	358
Ceded unearned premium reserve	757	827
Reinsurance recoverable on unpaid losses	227	310
Salvage and subrogation recoverable	297	249
Credit derivative assets	1	7
Deferred tax asset, net	11	166
Financial guaranty variable interest entities' assets, at fair value	577	644
Other assets	147	151
Total assets	\$ 9,184	\$ 8,813
Liabilities and shareholder's equity		
Unearned premium reserve	\$ 2,746	\$ 2,530
Loss and loss adjustment expense reserve	931	816
Reinsurance balances payable, net	197	153
Credit derivative liabilities	49	97
Current income tax payable	121	75
Financial guaranty variable interest entities' liabilities with recourse, at fair value	495	602
Financial guaranty variable interest entities' liabilities without recourse, at fair value	128	110
Other liabilities	267	249
Total liabilities	4,934	4,632
Commitments and contingencies (see Note 15)		
Preferred stock (\$1,000 par value, 5,000.1 shares authorized; 0 shares issued and outstanding)	—	—
Common stock (\$92,025 par value, 163 shares authorized, issued and outstanding in 2017 and \$73,171 par value, 205 shares authorized, issued and outstanding in 2016)	15	77
Additional paid-in capital	702	778
Retained earnings	3,199	3,019
Accumulated other comprehensive income, net of tax of \$32 and \$17	118	12
Total shareholder's equity attributable to Assured Guaranty Municipal Corp.	4,034	3,886
Noncontrolling interest	216	295
Total shareholder's equity	4,250	4,181
Total liabilities and shareholder's equity	\$ 9,184	\$ 8,813

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

Assured Guaranty Municipal Corp.
Combined Statements of Operations
(in millions)

	Year Ended December 31,	
	2017	2016
Revenues		
Net earned premiums	\$ 353	\$ 446
Net investment income	222	242
Net realized investment gains (losses):		
Other-than-temporary impairment losses	(29)	(37)
Less: portion of other-than-temporary impairment loss recognized in other comprehensive income	8	8
Net impairment loss	(37)	(45)
Other net realized investment gains (losses)	43	10
Net realized investment gains (losses)	6	(35)
Net change in fair value of credit derivatives:		
Realized gains (losses) and other settlements	(17)	(18)
Net unrealized gains (losses)	43	51
Net change in fair value of credit derivatives	26	33
Fair value gains (losses) on committed capital securities	(1)	1
Fair value gains (losses) on financial guaranty variable interest entities	24	25
Other income (loss) (includes commutation gains of \$324 in 2017 and \$13 in 2016, see Note 13)	389	18
Total revenues	1,019	730
Expenses		
Loss and loss adjustment expenses	257	198
Amortization of deferred ceding commissions	(15)	(15)
Other operating expenses	133	120
Total expenses	375	303
Income (loss) before income taxes	644	427
Provision (benefit) for income taxes:		
Current	181	122
Deferred	36	(13)
Total provision (benefit) for income taxes	217	109
Net income (loss)	427	318
Less: Noncontrolling interest	32	44
Net income (loss) attributable to Assured Guaranty Municipal Corp.	\$ 395	\$ 274

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

Assured Guaranty Municipal Corp.
Combined Statements of Comprehensive Income (Loss)
(in millions)

	Year Ended December 31,	
	2017	2016
Net income (loss)	\$ 427	\$ 318
Unrealized holding gains (losses) arising during the period on:		
Investments with no other-than-temporary impairment, net of tax provision (benefit) of \$38 and \$(46)	84	(89)
Investments with other-than-temporary impairment, net of tax provision (benefit) of \$(4) and \$(7)	(8)	(13)
Unrealized holding gains (losses) arising during the period, net of tax	76	(102)
Less: reclassification adjustment for gains (losses) included in net income (loss), net of tax provision (benefit) of \$2 and \$(11)	5	(21)
Change in net unrealized gains (losses) on investments	71	(81)
Change in cumulative translation adjustment, net of tax provision (benefit) of \$2 and \$(5)	16	(21)
Other comprehensive income (loss)	87	(102)
Comprehensive income (loss)	514	216
Less: Comprehensive income (loss) attributable to noncontrolling interest	32	36
Comprehensive income (loss) attributable to Assured Guaranty Municipal Corp.	\$ 482	\$ 180

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

Assured Guaranty Municipal Corp.
Combined Statements of Shareholder's Equity
Years Ended December 31, 2017 and 2016
(dollars in millions, except share data)

	Assured Guaranty Municipal Corp. Common Shares Outstanding	Common Stock Par Value	Additional Paid-in Capital	Retained Earnings	Accumulated Other Comprehensive Income	Total Shareholder's Equity Attributable to Assured Guaranty Municipal Corp.	Noncontrolling Interest	Total Shareholder's Equity
Balance at December 31, 2015	330	\$ 30	\$ 1,088	\$ 2,992	\$ 106	\$ 4,216	\$ 377	\$ 4,593
Net income	—	—	—	274	—	274	44	318
Dividends	—	—	—	(247)	—	(247)	(114)	(361)
Common stock repurchases (see Note 11)	(125)	—	(300)	—	—	(300)	—	(300)
Other comprehensive loss	—	—	—	—	(94)	(94)	(8)	(102)
Return of capital	—	—	—	—	—	—	(4)	(4)
Effect of common control acquisitions (see Note 2)	—	47	(10)	—	—	37	—	37
Balance at December 31, 2016	205	77	778	3,019	12	3,886	295	4,181
Net income	—	—	—	395	—	395	32	427
Dividends	—	—	—	(196)	—	(196)	(42)	(238)
Common stock repurchases (see Note 11)	(42)	—	(101)	—	—	(101)	—	(101)
Other comprehensive income	—	—	—	—	87	87	0	87
Reclassification of stranded tax effects (see Note 1)	—	—	—	(19)	19	—	—	—
Return of capital	—	—	—	—	—	—	(69)	(69)
Effect of common control acquisitions (see Note 2)	—	(62)	25	—	—	(37)	—	(37)
Balance at December 31, 2017	163	15	702	3,199	118	4,034	216	4,250

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

Assured Guaranty Municipal Corp.
Combined Statements of Cash Flows
(in millions)

	Year Ended December 31,	
	2017	2016
Operating Activities:		
Net Income	\$ 427	\$ 318
Adjustments to reconcile net income to net cash flows provided by operating activities:		
Net amortization of premium (discount) on investments	8	(9)
Provision (benefit) for deferred income taxes	36	(13)
Net realized investment losses (gains)	(6)	35
Net unrealized losses (gains) on credit derivatives	(43)	(51)
Fair value losses (gains) on committed capital securities	1	(1)
Change in deferred ceding commissions, net	9	(3)
Change in premiums receivable, net of premiums payable	(86)	85
Change in unearned premium reserve net of ceded unearned premium reserve	(101)	(390)
Change in loss and loss adjustment expense reserve and salvage and subrogation, net	172	24
Change in current income tax	68	59
Change in financial guaranty variable interest entities' assets and liabilities, net	(12)	(14)
Other	(12)	(8)
Net cash flows provided by (used in) operating activities	461	32
Investing activities		
Fixed-maturity securities:		
Purchases	(1,432)	(675)
Sales	1,086	504
Maturities	481	736
Net sales (purchases) of short-term investments	(86)	116
Net proceeds from paydowns on financial guaranty variable interest entities' assets	118	118
Effect of common control combination for acquisitions (see Note 2)	72	—
Cash paid to acquire European Subsidiaries from affiliate (see Note 2)	(139)	—
Other	(29)	(9)
Net cash flows provided by (used in) investing activities	71	790
Financing activities		
Dividends paid to Assured Guaranty Municipal Holdings Inc.	(196)	(247)
Dividends paid to AGC (see Note 11)	(42)	(114)
Repurchases of common stock	(101)	(300)
Return of capital to AGC (see Note 11)	(70)	(4)
Repayment of notes payable	(3)	(2)
Net paydowns of financial guaranty variable interest entities' liabilities	(128)	(135)
Net cash flows provided by (used in) financing activities	(540)	(802)
Effect of foreign exchange rate changes	4	(3)
Increase (decrease) in cash and restricted cash	(4)	17
Cash and restricted cash at beginning of period (see Note 10)	40	23
Cash and restricted cash at end of period (see Note 10)	\$ 36	\$ 40
Supplemental cash flow information		
Cash paid (received) during the period for:		
Income taxes	\$ 113	\$ 57
Interest	\$ 0	\$ 0

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

Assured Guaranty Municipal Corp.
Notes to Combined Financial Statements
December 31, 2017 and 2016

1. Business and Basis of Presentation

Business

Assured Guaranty Municipal Corp. (AGM, or together with its subsidiaries, the Company), a New York domiciled insurance company, is a wholly owned subsidiary of Assured Guaranty Municipal Holdings Inc. (AGMH). AGMH is an indirect, wholly owned subsidiary of Assured Guaranty Ltd. (AGL and, together with its subsidiaries, Assured Guaranty). AGL is a Bermuda-based holding company that provides, through its operating subsidiaries, credit protection products to the United States (U.S.) and international public finance (including infrastructure) and structured finance markets. AGM was formerly known as Financial Security Assurance Inc.

The Company applies its credit underwriting judgment, risk management skills and capital markets experience primarily to offer financial guaranty insurance that protects holders of debt instruments and other monetary obligations from defaults in scheduled payments. If an obligor defaults on a scheduled payment due on an obligation, including a scheduled principal or interest payment (debt service), the Company is required under its unconditional and irrevocable financial guaranty to pay the amount of the shortfall to the holder of the obligation. Obligations insured by the Company include bonds issued by U.S. state or municipal governmental authorities and notes issued to finance international infrastructure projects. AGM had previously offered insurance and reinsurance in the global structured finance market, but has not done so since mid-2008. AGM and its indirect subsidiary Municipal Assurance Corp. (MAC) each markets its financial guaranty insurance directly to issuers and underwriters of, and investors in, public finance securities. In addition, AGM's direct subsidiary, Assured Guaranty (Europe) plc (AGE, formerly Assured Guaranty (Europe) Ltd.), provides financial guaranties for the international public finance (including infrastructure) market and, with the approval of the U.K. Prudential Regulation Authority (PRA), the asset-backed and other structured finance market. AGM provides reinsurance and second-to-pay financial guaranties on financial guaranties provided by AGE for the international public finance (including infrastructure) market. The Company guarantees obligations issued principally in the U.S. and the United Kingdom (U.K.), and also guarantees obligations issued in other countries and regions, including Australia and Western Europe.

In the past, the Company sold credit protection by issuing policies that guaranteed payment obligations under credit derivatives, primarily credit default swaps (CDS). Contracts accounted for as credit derivatives are generally structured such that the circumstances giving rise to the Company's obligation to make loss payments are similar to those for financial guaranty insurance contracts. The Company's credit derivative transactions are governed by International Swaps and Derivative Association, Inc. (ISDA) documentation. The Company has not entered into any new CDS in order to sell credit protection in the U.S. since 2008. Regulatory guidelines were issued in 2009 that limited the terms under which such protection could be sold. The capital and margin requirements applicable under the Dodd-Frank Wall Street Reform and Consumer Protection Act also contributed to the Company not entering into such new CDS in the U.S. since 2009. The Company actively pursues opportunities to terminate existing CDS, which terminations have the effect of reducing future fair value volatility in income and/or reducing rating agency capital charges.

On June 26, 2017, AGM purchased from its affiliate, Assured Guaranty Corp. (AGC), all of the shares of AGC's direct, wholly owned subsidiaries, Assured Guaranty (UK) plc (AGUK, formerly Assured Guaranty (UK) Ltd.), CIFG Europe S.A. (CIFGE) and Assured Guaranty (London) plc (AGLN, formerly MBIA UK Insurance Ltd) (collectively, the European Subsidiaries), and then immediately contributed the European Subsidiaries to AGM's wholly owned subsidiary, AGE. See Note 2, Common Control Acquisition.

Basis of Presentation

The financial statements have been prepared in conformity with accounting principles generally accepted in the United States of America (GAAP) and, in the opinion of management, reflect all material adjustments that are of a normal recurring nature, necessary for a fair statement of the financial condition, results of operations and cash flows of the Company and its consolidated variable interest entities (VIEs) for the periods presented. 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 as of the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

The financial statements include the accounts of AGM, its direct and indirect subsidiaries (collectively, the Subsidiaries), and its consolidated FG VIEs. In addition, amounts for all periods prior to June 26, 2017 have been retrospectively adjusted to include the European Subsidiaries from the date the common control began for each subsidiary (combined basis). See Note 2, Common Control Acquisition for additional information.

Intercompany accounts and transactions between and among all consolidated and combined entities have been eliminated. Certain prior year balances have been reclassified to conform to the current year's presentation.

AGM owns 100% of AGE, organized in the U.K., and 60.7% of Municipal Assurance Holdings Inc. (MAC Holdings), incorporated in Delaware. AGM's affiliate, AGC owns the remaining 39.3% of MAC Holdings. MAC Holdings owns 100% of MAC, domiciled in New York.

Accounting Policies

The Company revalues assets, liabilities, revenue and expenses denominated in non-U.S. currencies into U.S. dollars using applicable exchange rates. Gains and losses relating to translating foreign functional currency financial statements for U.S. GAAP reporting are recorded in other comprehensive income (loss) (OCI). Gains and losses relating to transactions in foreign denominations in subsidiaries where the functional currency is the U.S. dollar, are reported in the combined statement of operations.

The chief operating decision maker manages the operations of the Company at a consolidated level. Therefore, all results of operations are reported as one segment.

Other accounting policies are included in the following notes.

Accounting Policies

Common Control Acquisition	Note 2
Expected loss to be paid (insurance, credit derivatives and FG VIE contracts)	Note 5
Contracts accounted for as insurance (premium revenue recognition, loss and loss adjustment expense and policy acquisition cost)	Note 6
Fair value measurement	Note 7
Credit derivatives (at fair value)	Note 8
Variable interest entities (at fair value)	Note 9
Investments and cash	Note 10
Income taxes	Note 12
Reinsurance and other monoline exposures	Note 13
Commitments and contingencies	Note 15
Employee benefit plans	Note 17

Adopted Accounting Standards

Accounting for the 2017 Tax Cuts and Jobs Act

In January 2018, the Securities and Exchange Commission issued Staff Accounting Bulletin 118 (SAB 118), providing guidance to companies on the accounting for the income tax effects of the 2017 Tax Cuts and Jobs Act (Tax Act) in financial statements for the period that includes the date of enactment, December 22, 2017. SAB 118 states that:

- for income tax effects of the Tax Act for which the accounting is incomplete and for which the Company cannot reasonably estimate an amount, qualitative disclosures must be provided;
- for income tax effects of the Tax Act for which the accounting is incomplete but for which the Company has determined a reasonable estimate and recorded a provisional amount, disclosures of such items; and

- for income tax effects of the Tax Act for which the Company has completed its accounting and determined a final amount, disclosure of such amounts.

For those effects for which the accounting has not been completed by the time the financial statements that include the enactment date are released, SAB 118 allows for a measurement period not to extend beyond one year after the enactment date to adjust those tax effects. In 2017, the Company recorded a provisional tax expense of \$44 million attributable to the Tax Act. See Note 12, Income Taxes for the Company's disclosures regarding the effects of the Tax Act.

In February 2018, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) 2018-02, *Income Statement - Reporting Comprehensive Income (Topic 220): Reclassification of Certain Tax Effects from Accumulated Comprehensive Income*, which allows entities to elect to reclassify, from accumulated other comprehensive income (AOCI) to retained earnings, stranded tax effects resulting from the Tax Act.

Under existing U.S. GAAP, deferred tax assets and liabilities are required to be adjusted for the effect of a change in tax laws or rates, with the effect included in income from continuing operations in the reporting period that includes the enactment date, even in situations in which the related income tax effects of items in AOCI were originally recognized in other comprehensive income (rather than in net income). This results in the tax rate for items within AOCI continuing to be recorded at the previous tax rate (stranded tax effects).

The Company adopted this ASU in its 2017 financial statements and elected to reclassify approximately \$19 million from AOCI to retained earnings, which is primarily attributable to the reduction in the corporate tax rate.

Statement of Cash Flows

In November 2016, the FASB issued ASU 2016-18, *Statement of Cash Flows (Topic 230): Restricted Cash* (a consensus of the Emerging Issues Task Force), which addresses the presentation of changes in restricted cash and restricted cash equivalents in the statement of cash flows with the objective of reducing the existing diversity in practice. Under the ASU, entities are required to show the changes in the total of cash, cash equivalents, restricted cash and restricted cash equivalents in the statement of cash flows. As a result, entities will no longer present transfers between cash and cash equivalents and restricted cash and restricted cash equivalents in the statement of cash flows. When cash, cash equivalents, restricted cash and restricted cash equivalents are presented in more than one line item on the balance sheet, the ASU requires a reconciliation be presented either on the face of the statement of cash flows or in the notes to the financial statements showing the totals in the statement of cash flows to the related captions in the balance sheet. The ASU was adopted on January 1, 2017 and was applied retrospectively. The required reconciliation is shown in Note 10, Investments and Cash.

In August 2016, the FASB issued ASU 2016-15, *Statement of Cash Flows (Topic 230): Classification of Certain Cash Receipts and Cash Payments* (a consensus of the Emerging Issues Task Force), which addresses eight specific cash flow issues with the objective of reducing the existing diversity in practice. The ASU was adopted on January 1, 2017 and did not have an effect on the Company's statements of cash flows for the periods presented.

Share-Based Payments

In March 2016, the FASB issued ASU 2016-09, *Compensation - Stock Compensation (Topic 718) - Improvements to Employee Share-Based Payment*, which simplifies several aspects of the accounting for employee share-based payment transactions, including the accounting for income taxes, forfeitures, and statutory tax withholding requirements, as well as classification in the statement of cash flows. The new guidance requires all income tax effects of awards to be recognized in the income statement when the awards vest or are settled. It also allows an employer to repurchase more of an employee's shares than it previously could for tax withholding purposes without triggering liability accounting and to make a policy election to account for forfeitures as they occur. The ASU was adopted on January 1, 2017 with no material effect on the financial statements.

Future Application of Accounting Standards

Income Taxes

In October 2016, the FASB issued ASU 2016-16, *Income Taxes (Topic 740) - Intra-Entity Transfers of Assets Other Than Inventory*, which removes the current prohibition against immediate recognition of the current and deferred income tax effects of intra-entity transfers of assets other than inventory. Under the ASU, the selling (transferring) entity is required to recognize a current income tax expense or benefit upon transfer of the asset. Similarly, the purchasing (receiving) entity is

required to recognize a deferred tax asset or deferred tax liability, as well as the related deferred tax benefit or expense, upon receipt of the asset. The ASU is to be applied on a modified retrospective basis (i.e. by recording a cumulative effect adjustment to the statement of financial position as of the beginning of the first reporting period in which the guidance is adopted). The ASU was adopted on January 1, 2018 with no material effect on its financial statements.

Financial Instruments

In January 2016, the FASB issued ASU 2016-01, *Financial Instruments - Overall (Subtopic 825-10) - Recognition and Measurement of Financial Assets and Financial Liabilities*. The amendments in this ASU are intended to make targeted improvements to GAAP by addressing certain aspects of recognition, measurement, presentation, and disclosure of financial instruments. Amendments under this ASU apply to the Company's financial guaranty (FG) VIE liabilities, for which the Company has historically elected to measure through the income statement under the fair value option, and to certain equity securities in the Company's investment portfolio.

For FG VIE liabilities, the portion of the change in fair value caused by instrument specific credit risk will be separately presented in OCI as opposed to the income statement. Equity securities, except those that are accounted for under the equity method of accounting or that resulted in consolidation of the investee by the Company, will need to be accounted for at fair value with changes in fair value recognized through net income instead of OCI. Effective January 1, 2018, the Company adopted this ASU with a cumulative-effect adjustment to the statement of financial position as of January 1, 2018. This resulted in a reclassification of a \$27 million loss, net of tax, from retained earnings to AOCI.

Premium Amortization on Purchased Callable Debt Securities

In March 2017, the FASB issued ASU 2017-08, *Receivables-Nonrefundable Fees and Other Costs (Topic 310-20) - Premium Amortization on Purchased Callable Debt Securities*. This ASU shortens the amortization period for the premium on certain purchased callable debt securities to the earliest call date. This ASU has no effect on the accounting for purchased callable debt securities held at a discount. It is to be applied using a modified retrospective approach and the ASU is effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2018. The Company does not expect this ASU to have a material effect on its financial statements.

Leases

In February 2016, the FASB issued ASU 2016-02, *Leases (Topic 842)*. This ASU requires lessees to present right-of-use assets and lease liabilities on the balance sheet. ASU 2016-02 is to be applied using a modified retrospective approach and is effective for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. The Company intends to adopt this ASU on January 1, 2019. The Company is evaluating the effect that this ASU will have on its financial statements. The Company currently accounts for its lease agreements where the Company is the lessee as operating leases and, therefore, recognizes its lease expense on a straight-line basis. See Note 15, Commitments and Contingencies for additional information on the Company's leases.

Credit Losses on Financial Instruments

In June 2016, the FASB issued ASU 2016-13, *Financial Instruments - Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments*. The amendments in this ASU are intended to improve financial reporting by requiring timelier recording of credit losses on loans and other financial instruments held by financial institutions and other organizations. The ASU requires the measurement of all expected credit losses for financial assets held at the reporting date based on historical experience, current conditions, and reasonable and supportable forecasts. Financial institutions will be required to use forward-looking information to better inform their credit loss estimates as a result of the ASU. While many of the loss estimation techniques applied today will still be permitted, the inputs to those techniques will change to reflect the full amount of expected credit losses. The ASU requires enhanced disclosures to help investors and other financial statement users to better understand significant estimates and judgments used in estimating credit losses, as well as credit quality and underwriting standards of an organization's portfolio.

In addition, the ASU amends the accounting for credit losses on available-for-sale securities and purchased financial assets with credit deterioration. The ASU also eliminates the concept of "other than temporary" from the impairment model for available-for-sale debt securities. Accordingly, the ASU states that an entity must use an allowance approach, must limit the allowance to an amount by which the security's fair value is less than its amortized cost basis, may not consider the length of time fair value has been less than amortized cost, and may not consider recoveries in fair value after the balance sheet date

when assessing whether a credit loss exists. For purchased financial assets with credit deterioration, the ASU requires an entity's method for measuring credit losses to be consistent with its method for measuring expected losses for originated and purchased non-credit-deteriorated assets.

The ASU is effective for fiscal years beginning after December 15, 2019, including interim periods within those fiscal years. For debt instruments such as reinsurance recoverables, loans and held to maturity securities, entities will be required to record a cumulative-effect adjustment to the statement of financial position as of the beginning of the first reporting period in which the guidance is adopted. The changes to the impairment model for available-for-sale securities and changes to purchased financial assets with credit deterioration are to be applied prospectively. The Company is evaluating the effect that this ASU will have on its financial statements. See Note 10, Investments and Cash for the Company's current accounting policy with respect to available-for-sale securities.

2. Common Control Acquisition

The purchase of the European Subsidiaries on June 26, 2017 was an initial step in Assured Guaranty's efforts to merge the operations of its four affiliated European insurance companies (the European Subsidiaries and AGE). The acquisition from AGM of the European Subsidiaries was approved by the New York State Department of Financial Services (NYDFS), the Maryland Insurance Administration (MIA) and the PRA. While Assured Guaranty, the European Subsidiaries and AGE received regulatory approvals for this initial step of the proposed combination of the European Subsidiaries and AGE, that combination is subject to further regulatory approvals and to certain court approvals. As a result, the Company cannot predict whether, or when, such combination will be completed.

Accounting Policy

As the Company and the European Subsidiaries were under common control at the time of the acquisition, it is required under U.S. GAAP to account for this acquisition in a method that is similar to the pooling-of-interests method. Under this method of accounting, AGM's combined financial statements and disclosures reflect the European Subsidiaries' historical carryover basis in the assets and liabilities instead of reflecting the fair value of the assets and liabilities.

The financial statements and disclosures for all periods presented in this report prior to June 26, 2017 have been retrospectively adjusted, as applicable, to reflect the combination of AGM and the European Subsidiaries as if the combinations had been in effect from the date common control began for each of the subsidiaries. As such, AGUK is reflected within these financial statements for all periods presented, while CIFGE is reflected for the periods subsequent to its purchase by Assured Guaranty on July 1, 2016, and AGLN is reflected for the periods subsequent to its purchase by Assured Guaranty on January 10, 2017. The consideration paid is reflected on June 26, 2017, the date of transfer.

Overview

The total consideration of \$411 million paid by AGM to purchase AGC's European Subsidiaries consisted of: (i) \$344 million gross principal amount of the Series A-1 Floating Rate Guaranteed Notes due December 21, 2035 issued by Orkney Re II plc (the Orkney Bonds), with a fair value of \$272 million; and (ii) \$139 million of cash. The GAAP book value of the European Subsidiaries transferred to AGM as of June 26, 2017 was \$651 million. In addition, AGC's \$55 million deferred tax liability on unremitted earnings of the European Subsidiaries was transferred to AGM resulting in net assets transferred to AGM of \$596 million.

AGUK guarantees the Orkney Bonds through a financial guarantee; it cedes 90% of the exposure to AGC and retains the remaining 10%. The \$344 million principal amount of Orkney Bonds included in consideration transferred constituted 90% of the total \$383 million of Orkney Bonds owned by AGM. AGM then immediately sold the remaining 10% of the Orkney Bonds it held to AGUK. As AGUK is now an indirect subsidiary of AGM, in accordance with the Company's accounting policy for loss mitigation bonds, the 10% of the Orkney Bonds owned by AGUK are recorded excluding the value of the AGUK's financial guarantee, and are carried in the financial statements on the same basis as the common parent, Assured Guaranty US Holdings Inc. (AGUS).

The net gain on the purchase of the European Subsidiaries of approximately \$185 million is recorded as a direct increase to shareholder's equity. The cumulative effect on shareholder's equity, as of June 30, 2017, is shown in the table below. As previously discussed, the financial statements for periods prior to June 26, 2017 have been presented on a combined basis as if the European Subsidiaries had been part of the AGM group as of the inception of common control. As each of the European Subsidiaries came under common control on a different date, the components of the net carrying value transferred are reflected

in the financial statements in various periods prior to June 26, 2017. The consideration paid is reflected on the date of the transfer (June 26, 2017).

**Impact of Purchase of the European Subsidiaries
As of June 30, 2017**

	(in millions)
Consideration paid	\$ 411
Carrying value of European Subsidiaries (1)	651
Deferred tax liabilities transferred	(55)
Net carrying value transferred	596
Net increase in shareholder's equity	\$ 185

- (1) Includes a \$2.4 million gain related to the elimination of the AGUK financial guaranty on its 10% net retained exposure on Orkney Bonds

3. Ratings

The financial strength ratings (or similar ratings) for the Company and its insurance company subsidiaries, along with the date of the most recent rating action (or confirmation) by the rating agency, are shown in the table below. Ratings are subject to continuous rating agency review and revision or withdrawal at any time. In addition, the Company periodically assesses the value of each rating assigned to it and its insurance company subsidiaries, and as a result of such assessment may request that a rating agency add or drop a rating.

	S&P Global Ratings, a division of Standard & Poor's Financial Services LLC	Kroll Bond Rating Agency	Moody's Investors Service Inc.
AGM	AA (stable) (6/26/17)	AA+ (stable) (1/23/18)	A2 (stable) (8/8/16)
MAC	AA (stable) (6/26/17)	AA+ (stable) (7/14/17)	—
AGE	AA (stable) (6/26/17)	—	A2 (stable) (8/8/16)
AGUK	AA (stable) (6/26/17)	—	(1)
AGLN	BB (positive) (1/12/17)	—	(2)
CIFGE	—	—	—

- (1) AGC requested that Moody's Investors Service, Inc. (Moody's) withdraw its financial strength ratings of AGC and AGUK in January 2017, but Moody's denied that request. Moody's continues to rate AGC A3 (stable) and AGUK A3. Moody's put AGUK on review for upgrade on June 27, 2017, following its transfer to AGM.
- (2) Assured Guaranty did not request that Moody's rate AGLN. Moody's continues to rate AGLN, and upgraded its rating to Baa2 (stable) on January 13, 2017, following its acquisition by AGC, and then to Baa1 on review for further upgrade on June 27, 2017, following its transfer to AGM.

There can be no assurance that any of the rating agencies will not take negative action on the financial strength ratings of AGM or its insurance subsidiaries in the future.

For a discussion of the effects of rating actions on the Company, see Note 6, Contracts Accounted for as Insurance, and Note 13, Reinsurance and Other Monoline Exposures.

4. Outstanding Exposure

The Company primarily writes financial guaranty contracts in insurance form. Until 2008, the Company also wrote some of its financial guaranty contracts in derivative form. Whether written as an insurance contract or as a credit derivative, the Company considers these financial guaranty contracts. The Company seeks to limit its exposure to losses by underwriting

obligations that it views as investment grade at inception, although, as part of its loss mitigation strategy for existing troubled exposures, it may underwrite new issuances that it views as below-investment-grade (BIG). The Company diversifies its insured portfolio across asset classes and, in the structured finance portfolio, requires rigorous subordination or collateralization requirements. Reinsurance may be used in order to reduce net exposure to certain insured transactions.

The Company has issued financial guaranty insurance policies on public finance obligations and, prior to mid-2008, structured finance obligations. Public finance obligations insured by the Company consist primarily of general obligation bonds supported by the taxing powers of U.S. state or municipal governmental authorities, as well as tax-supported bonds, revenue bonds and other obligations supported by covenants from state or municipal governmental authorities or other municipal obligors to impose and collect fees and charges for public services or specific infrastructure projects. The Company also includes within public finance obligations those obligations backed by the cash flow from leases or other revenues from projects serving substantial public purposes, including utilities, toll roads, health care facilities and government office buildings. The Company also includes within public finance similar obligations issued by territorial and non-U.S. sovereign and sub-sovereign issuers and governmental authorities.

Structured finance obligations insured by the Company are generally issued by special purpose entities, including VIEs, and backed by pools of assets having an ascertainable cash flow or market value or other specialized financial obligations. Some of these VIEs are consolidated as described in Note 9, Consolidated Variable Interest Entities. Unless otherwise specified, the outstanding par and debt service amounts presented in this note include outstanding exposures on VIEs whether or not they are consolidated. While AGM has ceased insuring new originations of asset-backed securities, a significant portfolio of such obligations remains outstanding. AGM's wholly owned subsidiary AGE provides financial guarantees in the international public finance market and intends to provide such guarantees in the international structured finance market, subject to regulatory approval.

Debt service and par outstanding exposures presented in these financial statements are presented on a consolidated and combined basis. That is, amounts presented include 100% of the exposures of AGM, AGE, the European Subsidiaries and MAC, despite the fact that AGM indirectly owns only 60.7% of MAC.

Significant Risk Management Activities

Assured Guaranty's Portfolio Risk Management Committee, which includes members of AGM's senior management and senior risk and surveillance officers, sets specific risk policies and limits and is responsible for enterprise risk management, establishing the Company's risk appetite, credit underwriting of new business, surveillance and work-out.

All transactions in the insured portfolio are assigned internal credit ratings, which are updated based on changes in transaction credit quality. As part of the surveillance process, the Company monitors trends and changes in transaction credit quality, and recommends such remedial actions as may be necessary or appropriate. The Company also develops strategies to enforce its contractual rights and remedies and to mitigate its losses, engage in negotiation discussions with transaction participants and, when necessary, manage the Company's litigation proceedings.

Surveillance Categories

The Company segregates its insured portfolio into investment grade and BIG surveillance categories to facilitate the appropriate allocation of resources to monitoring and loss mitigation efforts and to aid in establishing the appropriate cycle for periodic review for each exposure. BIG exposures include all exposures with internal credit ratings below BBB-. The Company's internal credit ratings are based on internal assessments of the likelihood of default and loss severity in the event of default. Internal credit ratings are expressed on a ratings scale similar to that used by the rating agencies and are generally reflective of an approach similar to that employed by the rating agencies, except that the Company's internal credit ratings focus on future performance, rather than lifetime performance.

The Company monitors its insured portfolio and refreshes its internal credit ratings on individual exposures in quarterly, semi-annual or annual cycles based on the Company's view of the exposure's quality, loss potential, volatility and sector. Ratings on exposures in sectors identified as under the most stress or with the most potential volatility are reviewed every quarter.

Exposures identified as BIG are subjected to further review to determine the probability of a loss. See Note 5, Expected Loss to be Paid, for additional information. Surveillance personnel then assign each BIG transaction to the appropriate BIG surveillance category based upon whether a future loss is expected and whether a claim has been paid. The Company uses a tax-equivalent yield, which reflects long-term trends in interest rates, to calculate the present value of

projected payments and recoveries and determine whether a future loss is expected in order to assign the appropriate BIG surveillance category to a transaction. On the other hand, the Company uses risk-free rates, which are determined each quarter, to calculate the expected loss for financial statement measurement purposes.

More extensive monitoring and intervention is employed for all BIG surveillance categories, with internal credit ratings reviewed quarterly. The Company expects “future losses” on a transaction when the Company believes there is at least a 50% chance that, on a present value basis, it will pay more claims on that transaction in the future than it will have reimbursed. The three BIG categories are:

- BIG Category 1: Below-investment-grade transactions showing sufficient deterioration to make future losses possible, but for which none are currently expected.
- BIG Category 2: Below-investment-grade transactions for which future losses are expected but for which no claims (other than liquidity claims, which are claims that the Company expects to be reimbursed within one year) have yet been paid.
- BIG Category 3: Below-investment-grade transactions for which future losses are expected and on which claims (other than liquidity claims) have been paid.

Unless otherwise noted, ratings disclosed herein on the Company's insured portfolio reflect its internal ratings. The Company classifies those portions of risks benefiting from reimbursement obligations collateralized by eligible assets held in trust in acceptable reimbursement structures as the higher of 'AA' or their current internal rating.

Components of Outstanding Exposure

The Company purchases securities that it has insured, and for which it has expected losses to be paid, in order to mitigate the economic effect of insured losses (loss mitigation securities). The Company excludes amounts attributable to loss mitigation securities from par and debt service outstanding, which amounts are included in the investment portfolio, because it manages such securities as investments and not insurance exposure. As of December 31, 2017 and December 31, 2016, the Company excluded \$678 million and \$752 million, respectively, of net par attributable to loss mitigation securities (which are mostly BIG), and other loss mitigation strategies. The following table presents the gross and net debt service for financial guaranty contracts.

Financial Guaranty Debt Service Outstanding

	Gross Debt Service Outstanding		Net Debt Service Outstanding(1)	
	December 31, 2017	December 31, 2016	December 31, 2017	December 31, 2016
	(in millions)			
Public finance	\$ 341,451	\$ 351,989	\$ 247,424	\$ 248,518
Structured finance	7,386	15,979	6,828	14,299
Total financial guaranty	\$ 348,837	\$ 367,968	\$ 254,252	\$ 262,817

(1) Includes 100% of MAC's gross and net debt service outstanding. However, AGM's indirect ownership of MAC is only 60.7%. The net debt service outstanding amount includes \$56.3 billion and \$77.5 billion as of December 31, 2017 and 2016, respectively, from MAC.

Outstanding commitments are contingent on the satisfaction of all conditions set forth in them and may expire unused or be canceled at the counterparty's request. Therefore, any total commitment amount would not necessarily reflect actual future guaranteed amounts. All of the outstanding commitments AGM had as of December 31, 2017 have expired as of the date of this filing.

**Financial Guaranty Portfolio by Internal Rating
As of December 31, 2017**

Rating Category	Public Finance U.S.		Public Finance Non-U.S.		Structured Finance U.S.		Structured Finance Non-U.S.		Total	
	Net Par Outstanding	%	Net Par Outstanding	%	Net Par Outstanding	%	Net Par Outstanding	%	Net Par Outstanding	%
(dollars in millions)										
AAA	\$ 736	0.6%	\$ 809	2.5%	\$ 666	14.6%	\$ 124	22.3%	\$ 2,335	1.5%
AA	19,797	15.2	200	0.6	1,822	39.7	27	4.8	21,846	13.0
A	74,860	57.5	12,011	37.4	74	1.6	71	12.7	87,016	51.9
BBB	31,453	24.1	17,680	55.0	60	1.3	246	44.2	49,439	29.5
BIG	3,403	2.6	1,452	4.5	1,965	42.8	89	16.0	6,909	4.1
Total net par outstanding (1)	\$ 130,249	100.0%	\$ 32,152	100.0%	\$ 4,587	100.0%	\$ 557	100.0%	\$ 167,545	100.0%

(1) Includes \$41.5 billion of net par outstanding as of December 31, 2017 from MAC, which represents 100% of MAC's net par outstanding. However, AGM's indirect ownership of MAC is only 60.7%.

**Financial Guaranty Portfolio by Internal Rating
As of December 31, 2016**

Rating Category	Public Finance U.S.		Public Finance Non-U.S.		Structured Finance U.S.		Structured Finance Non-U.S.		Total	
	Net Par Outstanding	%	Net Par Outstanding	%	Net Par Outstanding	%	Net Par Outstanding	%	Net Par Outstanding	%
(dollars in millions)										
AAA	\$ 1,684	1.1%	\$ 546	3.4%	\$ 5,727	54.5%	\$ 1,177	67.4%	\$ 9,134	5.1%
AA	30,808	20.5	165	1.0	2,465	23.4	32	1.8	33,470	18.7
A	83,901	55.5	4,557	28.4	67	0.6	144	8.2	88,669	49.4
BBB	31,887	21.1	9,969	62.3	80	0.8	223	12.7	42,159	23.5
BIG	2,789	1.8	781	4.9	2,175	20.7	174	9.9	5,919	3.3
Total net par outstanding (1)	\$ 151,069	100.0%	\$ 16,018	100.0%	\$ 10,514	100.0%	\$ 1,750	100.0%	\$ 179,351	100.0%

(1) Includes \$56.6 billion of net par outstanding as of December 31, 2016 from MAC, which represents 100% of MAC's net par outstanding. However, AGM's indirect ownership of MAC is only 60.7%.

**Financial Guaranty Portfolio
by Sector**

Sector	Gross Par Outstanding		Net Par Outstanding	
	As of December 31, 2017	As of December 31, 2016	As of December 31, 2017	As of December 31, 2016
	(in millions)			
Public finance:				
U.S.:				
General obligation	\$ 82,184	\$ 96,667	\$ 60,024	\$ 71,026
Tax backed	38,513	42,258	27,255	30,126
Municipal utilities	29,025	33,498	21,480	25,237
Transportation	13,037	14,615	9,528	10,890
Higher education	6,673	7,514	4,678	5,479
Healthcare	6,388	7,713	4,391	5,059
Infrastructure finance	1,762	1,034	1,092	574
Housing	1,258	1,423	916	1,117
Other public finance	1,091	1,789	885	1,561
Total public finance-U.S.	179,931	206,511	130,249	151,069
Non-U.S.:				
Infrastructure finance	18,426	11,006	14,687	7,228
Regulated utilities	17,050	10,413	11,881	4,727
Other public finance	6,675	5,633	5,584	4,063
Total public finance-non-U.S.	42,151	27,052	32,152	16,018
Total public finance	222,082	233,563	162,401	167,087
Structured finance:				
U.S.:				
Residential Mortgage-Backed Securities (RMBS)	3,120	3,767	2,908	3,293
Financial products	1,418	1,540	1,418	1,540
Consumer receivables	99	120	95	113
Pooled corporate obligations	30	5,618	24	5,395
Commercial receivables	24	25	23	24
Other structured finance	232	285	119	149
Total structured finance-U.S.	4,923	11,355	4,587	10,514
Non-U.S.:				
RMBS	500	501	390	357
Pooled corporate obligations	117	1,564	72	1,106
Other structured finance	97	310	95	287
Total structured finance- non-U.S.	714	2,375	557	1,750
Total structured finance	5,637	13,730	5,144	12,264
Total par outstanding	\$ 227,719	\$ 247,293	\$ 167,545	\$ 179,351

Actual maturities of insured obligations could differ from contractual maturities because borrowers have the right to call or prepay certain obligations. The expected maturities of structured finance obligations are, in general, considerably shorter than the contractual maturities for such obligations.

**Expected Amortization of
Net Par Outstanding
As of December 31, 2017**

	Public Finance	Structured Finance	Total
	(in millions)		
0 to 5 years	\$ 51,409	\$ 2,339	\$ 53,748
5 to 10 years	34,538	1,019	35,557
10 to 15 years	30,244	1,121	31,365
15 to 20 years	21,471	585	22,056
20 years and above	24,739	80	24,819
Total net par outstanding	<u>\$ 162,401</u>	<u>\$ 5,144</u>	<u>\$ 167,545</u>

**Components of BIG Net Par Outstanding
As of December 31, 2017**

	BIG Net Par Outstanding				Net Par
	BIG 1	BIG 2	BIG 3	Total BIG (1)	Outstanding
	(in millions)				
Public finance:					
U.S. public finance	\$ 1,334	\$ 264	\$ 1,805	\$ 3,403	\$ 130,249
Non-U.S. public finance	1,231	221	—	1,452	32,152
Public finance	2,565	485	1,805	4,855	162,401
Structured finance:					
U.S. RMBS	190	163	1,535	1,888	2,908
Other structured finance	90	38	38	166	2,236
Structured finance	280	201	1,573	2,054	5,144
Total	<u>\$ 2,845</u>	<u>\$ 686</u>	<u>\$ 3,378</u>	<u>\$ 6,909</u>	<u>\$ 167,545</u>

(1) There is no BIG net par outstanding for credit derivatives as of December 31, 2017.

**Components of BIG Net Par Outstanding
As of December 31, 2016**

	BIG Net Par Outstanding				Net Par
	BIG 1	BIG 2	BIG 3	Total BIG (1)	Outstanding
	(in millions)				
Public finance:					
U.S. public finance	\$ 967	\$ 1,082	\$ 740	\$ 2,789	\$ 151,069
Non-U.S. public finance	781	—	—	781	16,018
Public finance	1,748	1,082	740	3,570	167,087
Structured finance:					
U.S. RMBS	45	255	1,793	2,093	3,293
Other structured finance	174	48	34	256	8,971
Structured finance	219	303	1,827	2,349	12,264
Total	<u>\$ 1,967</u>	<u>\$ 1,385</u>	<u>\$ 2,567</u>	<u>\$ 5,919</u>	<u>\$ 179,351</u>

(1) Includes \$53 million of BIG net par outstanding comprising three risks for credit derivatives.

The Company seeks to maintain a diversified portfolio of insured obligations designed to spread its risk across a number of geographic areas.

**Geographic Distribution of
Net Par Outstanding
As of December 31, 2017**

	Number of Risks	Net Par Outstanding (dollars in millions)	Percent of Total Net Par Outstanding
U.S.:			
U.S. Public finance:			
California	1,220	\$ 23,400	14.0%
Pennsylvania	714	12,196	7.3
Texas	1,163	11,253	6.7
Illinois	640	10,836	6.5
New York	823	9,674	5.8
New Jersey	420	7,433	4.4
Florida	230	6,149	3.7
Michigan	407	4,181	2.5
Arizona	150	3,231	1.9
Georgia	133	3,160	1.9
Other	2,822	38,736	23.1
Total U.S. public finance	8,722	130,249	77.8
U.S. Structured finance (multiple states)	161	4,587	2.7
Total U.S.	8,883	134,836	80.5
Non-U.S.:			
United Kingdom	113	22,066	13.2
France	10	2,492	1.5
Canada	8	2,479	1.5
Australia	6	1,385	0.8
Italy	9	1,062	0.6
Other	29	3,225	1.9
Total non-U.S.	175	32,709	19.5
Total	9,058	\$ 167,545	100.0%

Exposure to Puerto Rico

The Company has insured exposure to general obligation bonds of the Commonwealth of Puerto Rico (Puerto Rico or the Commonwealth) and various obligations of its related authorities and public corporations aggregating \$2.3 billion net par as of December 31, 2017. Of that amount, \$2.2 billion is rated BIG, while the remainder is rated AA since it relates to second-to-pay policies on obligations insured by an affiliate of the Company. Puerto Rico experienced significant general fund budget deficits and a challenging economic environment since at least the financial crisis. Beginning on January 1, 2016, a number of Puerto Rico exposures have defaulted on bond payments, and the Company has now paid claims on all of its BIG Puerto Rico exposures except for Municipal Finance Agency (MFA).

On November 30, 2015 and December 8, 2015, the former governor of Puerto Rico (the Former Governor) issued executive orders (Clawback Orders) directing the Puerto Rico Department of Treasury and the Puerto Rico Tourism Company to "claw back" certain taxes pledged to secure the payment of bonds issued by the Puerto Rico Highways and Transportation

Authority (PRHTA). The Puerto Rico credits insured by the Company subject to clawback are shown in the table “Puerto Rico Net Par Outstanding” below.

On June 30, 2016, the Puerto Rico Oversight, Management, and Economic Stability Act (PROMESA) was signed into law by the President of the United States. PROMESA established a seven-member federal financial oversight board (Oversight Board) with authority to require that balanced budgets and fiscal plans be adopted and implemented by Puerto Rico. PROMESA provides a legal framework under which the debt of the Commonwealth and its related authorities and public corporations may be voluntarily restructured, and grants the Oversight Board the sole authority to file restructuring petitions in a federal court to restructure the debt of the Commonwealth and its related authorities and public corporations if voluntary negotiations fail, provided that any such restructuring must be in accordance with an Oversight Board approved fiscal plan that respects the liens and priorities provided under Puerto Rico law.

In May and July 2017 the Oversight Board filed petitions under Title III of PROMESA with the Federal District Court of Puerto Rico for the Commonwealth, the Puerto Rico Sales Tax Financing Corporation (COFINA), PRHTA, and Puerto Rico Electric Power Authority (PREPA). Title III of PROMESA provides for a process analogous to a voluntary bankruptcy process under chapter 9 of the United States Bankruptcy Code (Bankruptcy Code).

Judge Laura Taylor Swain of the Southern District of New York was selected by Chief Justice John Roberts of the United States Supreme Court to preside over any legal proceedings under PROMESA. Judge Swain has selected a team of five federal judges to act as mediators for certain issues and disputes.

On September 20, 2017, Hurricane Maria made landfall in Puerto Rico as a Category 4 hurricane on the Saffir-Simpson scale, causing loss of life and widespread devastation in the Commonwealth. Damage to the Commonwealth’s infrastructure, including the power grid, water system and transportation system, was extensive, and rebuilding and economic recovery are expected to take years. While the federal government is expected to provide substantial resources for relief and rebuilding -- which is expected to help economic activity and address the Commonwealth’s infrastructure needs in the intermediate and longer term -- economic activity in general and tourism in particular, as well as tax collections, have declined in the aftermath of the storm, and out migration to the mainland also has increased.

In December 2017 the Tax Act was enacted. Many of the provisions under the new law are geared toward increasing production in the U.S. and discouraging companies from having operations or intangibles off-shore. Since Puerto Rico is considered a foreign territory under the U.S. tax system, it is possible the new law may have adverse consequences to Puerto Rico’s economy. However, the Company is unable to predict the full impact of the new law on Puerto Rico.

On January 24, 2018, Puerto Rico released new fiscal plans for the Commonwealth and PREPA. In response to comments from the Oversight Board and the enactment of a significant federal disaster relief package by the U.S. Congress, Puerto Rico released a further revised Commonwealth fiscal plan on February 12, 2018. The further revised Commonwealth fiscal plan indicates a primary budget surplus of \$2.8 billion that would be available for debt service over the six-year forecast period (as compared to contractual debt service of approximately \$17.5 billion over the same period). The PREPA fiscal plan is silent as to the treatment of legacy debt and the current governor of Puerto Rico (the Governor) announced an intention to privatize PREPA.

The Company believes that a number of the actions taken by the Commonwealth, the Oversight Board and others with respect to obligations the Company insures are illegal or unconstitutional or both, and has taken legal action, and may take additional legal action in the future, to enforce its rights with respect to these matters. See “Puerto Rico Recovery Litigation” below.

Litigation and mediation related to the Commonwealth’s debt have been delayed by Hurricane Maria. The final form and timing of responses to Puerto Rico’s financial distress and the devastation of Hurricane Maria eventually taken by the federal government or implemented under the auspices of PROMESA and the Oversight Board or otherwise, and the final impact, after resolution of legal challenges, of any such responses on obligations insured by the Company, are uncertain.

The Company groups its Puerto Rico exposure into three categories:

- *Constitutionally Guaranteed.* The Company includes in this category public debt benefiting from Article VI of the Constitution of the Commonwealth, which expressly provides that interest and principal payments on the public debt are to be paid before other disbursements are made.

- *Public Corporations – Certain Revenues Potentially Subject to Clawback.* The Company includes in this category the debt of public corporations for which applicable law permits the Commonwealth to claw back, subject to certain conditions and for the payment of public debt, at least a portion of the revenues supporting the bonds the Company insures. As a constitutional condition to clawback, available Commonwealth revenues for any fiscal year must be insufficient to pay Commonwealth debt service before the payment of any appropriations for that year. The Company believes that this condition has not been satisfied to date, and accordingly that the Commonwealth has not to date been entitled to claw back revenues supporting debt insured by the Company. Prior to the enactment of PROMESA, the Company sued various Puerto Rico governmental officials in the United States District Court, District of Puerto Rico asserting that Puerto Rico's attempt to “claw back” pledged taxes is unconstitutional, and demanding declaratory and injunctive relief. See "Puerto Rico Recovery Litigation" below.
- *Other Public Corporations.* The Company includes in this category the debt of public corporations that are supported by revenues it does not believe are subject to clawback.

Constitutionally Guaranteed

General Obligation. As of December 31, 2017, the Company had \$670 million insured net par outstanding of the general obligations of Puerto Rico, which are supported by the good faith, credit and taxing power of the Commonwealth. Despite the requirements of Article VI of its Constitution, the Commonwealth defaulted on the debt service payment due on July 1, 2016, and the Company has been making claim payments on these bonds since that date. As noted above, the Oversight Board filed a petition under Title III of PROMESA with respect to the Commonwealth. Also as noted above, on February 12, 2018, Puerto Rico released a further revised Commonwealth fiscal plan that indicates a primary budget surplus of \$2.8 billion that would be available for debt service over the six-year forecast period (as compared to contractual debt service of approximately \$17.5 billion over the same period). The Company does not believe the Commonwealth's fiscal plan in its current form complies with certain mandatory requirements of PROMESA.

Puerto Rico Public Buildings Authority (PBA). As of December 31, 2017, the Company had \$9 million insured net par outstanding of PBA bonds, which are supported by a pledge of the rents due under leases of government facilities to departments, agencies, instrumentalities and municipalities of the Commonwealth, and that benefit from a Commonwealth guaranty supported by a pledge of the Commonwealth's good faith, credit and taxing power. Despite the requirements of Article VI of its Constitution, the PBA defaulted on most of the debt service payment due on July 1, 2016, and the Company has been making claim payments on these bonds since then.

Public Corporations - Certain Revenues Potentially Subject to Clawback

PRHTA. As of December 31, 2017, the Company had \$252 million insured net par outstanding of PRHTA (transportation revenue) bonds and \$358 million insured net par of PRHTA (highways revenue) bonds. The transportation revenue bonds are secured by a subordinate gross lien on gasoline and gas oil and diesel oil taxes, motor vehicle license fees and certain tolls, plus a first lien on up to \$120 million annually of taxes on crude oil, unfinished oil and derivative products. The highways revenue bonds are secured by a gross lien on gasoline and gas oil and diesel oil taxes, motor vehicle license fees and certain tolls. The non-toll revenues consisting of excise taxes and fees collected by the Commonwealth on behalf of PRHTA and its bondholders that are statutorily allocated to PRHTA and its bondholders are potentially subject to clawback. Despite the presence of funds in relevant debt service accounts that the Company believes should have been employed to fund debt service, PRHTA defaulted on the full July 1, 2017 insured debt service payment, and the Company has been making claim payments on these bonds since that date.

Other Public Corporations

PREPA. As of December 31, 2017, the Company had \$547 million insured net par outstanding of PREPA obligations, which are secured by a lien on the revenues of the electric system.

On December 24, 2015, AGM and AGC entered into a Restructuring Support Agreement (RSA) with PREPA, an ad hoc group of uninsured bondholders and a group of fuel-line lenders that subject to certain conditions, would have resulted in, among other things, modernization of the utility and a restructuring of current debt.

The Oversight Board did not certify the RSA under Title VI of PROMESA as the Company believes was required by PROMESA, but rather, on July 2, 2017, commenced proceedings for PREPA under Title III of PROMESA. The Company has been making claim payments on these bonds since July 1, 2017.

As noted above, on January 24, 2018, PREPA released a new fiscal plan that is silent with respect to the treatment of its legacy debt, and the Governor announced an intention to privatize PREPA. The Company believes that a number of the actions taken by the Commonwealth, the Oversight Board and others with respect to the PREPA obligations it insures and the RSA are illegal or unconstitutional or both, and has taken legal action, and may take additional legal action in the future, to enforce its rights with respect to these matters. See “Puerto Rico Recovery Litigation” below.

MFA. As of December 31, 2017, the Company had \$221 million net par outstanding of bonds issued by MFA secured by a lien on local property tax revenues. The MFA bond accounts contained sufficient funds to make the MFA bond payments due through the date of this filing that were guaranteed by the Company, and those payments were made in full.

COFINA. As of December 31, 2017, the Company had \$263 million insured net par outstanding of junior COFINA bonds, which are secured primarily by a second lien on certain sales and use taxes. As noted above, the Oversight Board filed a petition on behalf of COFINA under Title III of PROMESA. COFINA bond debt service payments were not made on August 1, 2017, and the Company made its first claim payments on these bonds. The Company has continued to make claim payments on these bonds.

Puerto Rico Recovery Litigation

The Company believes that a number of the actions taken by the Commonwealth, the Oversight Board and others with respect to obligations it insures are illegal or unconstitutional or both, and has taken legal action, and may take additional legal action in the future, to enforce its rights with respect to these matters.

On January 7, 2016, AGM, AGC and Ambac Assurance Corporation (Ambac) commenced an action for declaratory judgment and injunctive relief in the U.S. District Court for the District of Puerto Rico (Federal District Court in Puerto Rico) to invalidate the executive orders issued by the Former Governor on November 30, 2015 and December 8, 2015 directing that the Secretary of the Treasury of the Commonwealth of Puerto Rico and the Puerto Rico Tourism Company claw back certain taxes and revenues pledged to secure the payment of bonds issued by the PRHTA, Puerto Rico Convention Center District Authority and Puerto Rico Infrastructure Financing Authority. The Commonwealth defendants filed a motion to dismiss the action for lack of subject matter jurisdiction, which the Court denied on October 4, 2016. On October 14, 2016, the Commonwealth defendants filed a notice of PROMESA automatic stay. While the PROMESA automatic stay expired on May 1, 2017, on May 17, 2017, the Court stayed the action under Title III of PROMESA.

On May 16, 2017, The Bank of New York Mellon, as trustee for the bonds issued by COFINA, filed an adversary complaint for interpleader and declaratory relief with the Federal District Court in Puerto Rico to resolve competing and conflicting demands made by various groups of COFINA bondholders, insurers of certain COFINA Bonds and COFINA, regarding funds held by the trustee for certain COFINA bond debt service payments scheduled to occur on and after June 1, 2017. On May 19, 2017, an order to show cause was entered permitting AGC and AGM to intervene in this matter. While AGM has insured COFINA Bonds, AGC has not.

On June 3, 2017, AGC and AGM filed an adversary complaint in Federal District Court in Puerto Rico seeking (i) a judgment declaring that the application of pledged special revenues to the payment of the PRHTA Bonds is not subject to the PROMESA Title III automatic stay and that the Commonwealth has violated the special revenue protections provided to the PRHTA Bonds under the Bankruptcy Code; (ii) an injunction enjoining the Commonwealth from taking or causing to be taken any action that would further violate the special revenue protections provided to the PRHTA Bonds under the Bankruptcy Code; and (iii) an injunction ordering the Commonwealth to remit the pledged special revenues securing the PRHTA Bonds in accordance with the terms of the special revenue provisions set forth in the Bankruptcy Code. On January 30, 2018, the Court rendered an opinion dismissing the complaint and holding, among other things, that (i) even though the special revenue provisions of the Bankruptcy Code protect a lien on pledged special revenues, those provisions do not mandate the turnover of pledged special revenues to the payment of bonds and (ii) actions to enforce liens on pledged special revenues remain stayed. On February 9, 2018, AGC and AGM filed a notice of appeal of the Court’s decision to the United States Court of Appeals for the First Circuit.

On June 26, 2017, AGM and AGC filed a complaint in Federal District Court in Puerto Rico seeking (i) a declaratory judgment that the PREPA RSA is a “Preexisting Voluntary Agreement” under Section 104 of PROMESA and the Oversight Board’s failure to certify the PREPA RSA is an unlawful application of Section 601 of PROMESA; (ii) an injunction enjoining the Oversight Board from unlawfully applying Section 601 of PROMESA and ordering it to certify the PREPA RSA; and (iii) a writ of mandamus requiring the Oversight Board to comply with its duties under PROMESA and certify the PREPA RSA. On July 21, 2017, in light of its PREPA Title III petition on July 2, 2017, the Oversight Board filed a notice of stay under PROMESA.

On July 18, 2017, AGM and AGC filed a motion for relief from the automatic stay in the PREPA Title III bankruptcy proceeding and a form of complaint seeking the appointment of a receiver for PREPA. That motion was denied on September 14, 2017. On January 31, 2018, AGM and AGC filed a brief appealing the trial court's decision with the United States Court of Appeals for the First Circuit.

Complaints voluntarily withdrawn without prejudice following Hurricane Maria.

On May 3, 2017, AGM and AGC had filed in the Federal District Court in Puerto Rico an adversary complaint seeking a judgment that the Commonwealth's Fiscal Plan violates various sections of PROMESA and the Contracts, Takings and Due Process Clauses of the U.S. Constitution, an injunction enjoining the Commonwealth and Oversight Board from presenting or proceeding with confirmation of any plan of adjustment based on the Fiscal Plan, and a stay on the confirmation of any plan of adjustment based on the Fiscal Plan pending development of a fiscal plan that complies with PROMESA and the U.S. Constitution. On October 6, 2017, AGC and AGM voluntarily withdrew without prejudice the complaint, based on their expectation that the Fiscal Plan would be modified as a result of Hurricane Maria.

On August 7, 2017, AGC and AGM had filed an adversary complaint in Federal District Court in Puerto Rico seeking, among other things, judgment against defendants (i) declaring that the application of pledged special revenues to the payment of the PREPA Bonds is not subject to the PROMESA Title III automatic stay and that the Commonwealth has violated the special revenue protections provided to the PREPA Bonds under the Bankruptcy Code; (ii) declaring that capital expenditures and all other expenses that do not constitute current, reasonable and necessary operating expenses may not be paid from pledged special revenues prior to the payment of debt service on the PREPA Bonds, and (iii) enjoining defendants from taking or causing to be taken any action that would further violate the special revenue protections provided to the PREPA Bonds under the Bankruptcy Code; and (iv) ordering defendants to remit the pledged special revenues securing the PREPA Bonds in accordance with the terms of the special revenue provisions set forth in the Bankruptcy Code. On October 13, 2017, AGC and AGM voluntarily withdrew without prejudice the complaint, in order to allow PREPA to focus on emergency efforts to restore electricity to the island's residents and businesses in the wake of Hurricane Maria.

Puerto Rico Par and Debt Service Schedules

All Puerto Rico exposures are internally rated BIG, except the General Obligation, PBA and PRHTA (Transportation revenue) second-to-pay policies on an affiliate exposure which are rated AA based on the obligation of the Company's affiliate to pay under its insurance policy if the obligor fails to pay. The following tables show the Company's insured exposure to general obligation bonds of Puerto Rico and various obligations of its related authorities and public corporations.

Puerto Rico Gross Par and Gross Debt Service Outstanding

	Gross Par Outstanding		Gross Debt Service Outstanding	
	December 31, 2017	December 31, 2016	December 31, 2017	December 31, 2016
	(in millions)			
Exposure to Puerto Rico	\$ 3,368	\$ 3,542	\$ 5,318	\$ 5,672

**Puerto Rico
Net Par Outstanding (1)**

	As of December 31, 2017	As of December 31, 2016
	(in millions)	
Commonwealth Constitutionally Guaranteed		
Commonwealth of Puerto Rico - General Obligation Bonds (2)	\$ 669	\$ 677
Commonwealth of Puerto Rico - General Obligation Bonds (Second-to-pay policies on affiliate exposure)	1	3
Commonwealth of Puerto Rico - General Obligation Bonds total	670	680
PBA (Second-to-pay policies on affiliate exposure)	9	11
Public Corporations - Certain Revenues Potentially Subject to Clawback		
PRHTA (Transportation revenue) (2)	167	190
PRHTA (Transportation revenue) (Second-to-pay policies on affiliate exposure)	85	83
PRHTA (Transportation revenue) total	252	273
PRHTA (Highways revenue) (2)	358	213
Other Public Corporations		
PREPA (2)	547	417
COFINA (2)	263	262
MFA	221	175
Total net exposure to Puerto Rico	<u>\$ 2,320</u>	<u>\$ 2,031</u>

- (1) The December 31, 2017 amounts include \$391 million (which comprises \$36 million of General Obligation Bonds, \$134 million of PREPA, \$144 million of PRHTA (Highways revenue), \$75 million of MFA, and \$2 million of PRHTA (Transportation revenue)) related to 2017 commutations of previously ceded business. See Note 13, Reinsurance and Other Monoline Exposures, for more information.
- (2) As of the date of this filing, the Oversight Board has certified a filing under Title III of PROMESA for these exposures.

The following table shows the scheduled amortization of the insured general obligation bonds of Puerto Rico and various obligations of its related authorities and public corporations rated BIG by the Company. The Company guarantees payments of interest and principal when those amounts are scheduled to be paid and cannot be required to pay on an accelerated basis. In the event that obligors default on their obligations, the Company would only be required to pay the shortfall between the principal and interest due in any given period and the amount paid by the obligors.

**Amortization Schedule of Puerto Rico BIG Net Par Outstanding
and Net Debt Service Outstanding
As of December 31, 2017**

	Scheduled BIG Net Par Amortization	Scheduled BIG Net Debt Service Amortization
	(in millions)	
2018 (January 1 - March 31)	\$ 0	\$ 54
2018 (April 1 - June 30)	0	2
2018 (July 1 - September 30)	77	131
2018 (October 1 - December 31)	0	2
Subtotal 2018	<u>77</u>	<u>189</u>
2019	107	215
2020	111	214
2021	69	167
2022	70	164
2023-2027	633	1,017
2028-2032	426	682
2033-2037	481	612
2038-2043	251	307
Total	<u>\$ 2,225</u>	<u>\$ 3,567</u>

Exposure to the U.S. Virgin Islands

As of December 31, 2017, the Company had \$331 million insured net par outstanding to the U.S. Virgin Islands and its related authorities (USVI), of which it rated \$148 million BIG. The \$183 million USVI net par the Company rated investment grade was comprised primarily of bonds secured by a lien on matching fund revenues related to excise taxes on products produced in the USVI and exported to the U.S., primarily rum. The \$148 million BIG USVI net par comprised (a) Public Finance Authority bonds secured by a gross receipts tax and the general obligation, full faith and credit pledge of the USVI and (b) bonds of the Virgin Islands Water and Power Authority secured by a net revenue pledge of the electric system.

Hurricane Irma caused significant damage in St. John and St. Thomas, while Hurricane Maria made landfall on St. Croix as a Category 4 hurricane on the Saffir-Simpson scale, causing loss of life and substantial damage to St. Croix's businesses and infrastructure, including the power grid. The USVI is benefiting from the federal response to the 2017 hurricanes and has made its debt service payments to date.

5. Expected Loss to be Paid

Management compiles and analyzes loss information for all exposures on a consistent basis, in order to effectively evaluate and manage the economics and liquidity of the entire insured portfolio. The Company monitors and assigns ratings and calculates expected losses in the same manner for all its exposures regardless of form or differing accounting models. This note provides information regarding expected claim payments to be made under all contracts in the insured portfolio.

Expected loss to be paid is important from a liquidity perspective in that it represents the present value of amounts that the Company expects to pay or recover in future periods for all contracts. The expected loss to be paid is equal to the present value of expected future cash outflows for claim and loss adjustment expenses (LAE) payments, net of inflows for expected salvage and subrogation (e.g., excess spread on the underlying collateral, and estimated recoveries, including those for breaches of representations and warranties (R&W)), using current risk-free rates. Expected cash outflows and inflows are probability weighted cash flows that reflect management's assumptions about the likelihood of all possible outcomes based on all information available to it. Those assumptions consider the relevant facts and circumstances and are consistent with the information tracked and monitored through the Company's risk-management activities. The Company updates the discount rates each quarter and reflects the effect of such changes in economic loss development. Net expected loss to be paid is defined as expected loss to be paid, net of amounts ceded to reinsurers.

In circumstances where the Company has purchased its own insured obligations that have expected losses, expected loss to be paid is reduced by the proportionate share of the insured obligation that is held in the investment portfolio. The difference between the purchase price of the obligation and the fair value excluding the value of the Company's insurance is treated as a paid loss. Assets that are purchased by the Company are recorded in the investment portfolio, at fair value excluding the value of the Company's insurance. Additionally, in certain cases, issuers of insured obligations elected, or the Company and an issuer mutually agreed as part of a negotiation, to deliver the underlying collateral or insured obligation to the Company. See Note 10, Investments and Cash and Note 7, Fair Value Measurement.

Economic loss development represents the change in net expected loss to be paid attributable to the effects of changes in assumptions based on observed market trends, changes in discount rates, accretion of discount and the economic effects of loss mitigation efforts.

The insured portfolio includes policies accounted for under three separate accounting models depending on the characteristics of the contract and the Company's control rights. The three models are: (1) insurance as described in "Financial Guaranty Insurance Losses" in Note 6, Contracts Accounted for as Insurance, (2) derivative as described in Note 7, Fair Value Measurement and Note 8, Contracts Accounted for as Credit Derivatives, and (3) VIE consolidation as described in Note 9, Consolidated Variable Interest Entities. The Company has paid and expects to pay future losses (net of recoveries) on policies which fall under each of the three accounting models.

Loss Estimation Process

The Company's loss reserve committees estimate expected loss to be paid for all contracts by reviewing analyses that consider various scenarios with corresponding probabilities assigned to them. Depending upon the nature of the risk, the Company's view of the potential size of any loss and the information available to the Company, that analysis may be based upon individually developed cash flow models, internal credit rating assessments, sector-driven loss severity assumptions and/or judgmental assessments. The Company monitors the performance of its transactions with expected losses and each quarter the Company's loss reserve committees review and refresh their loss projection assumptions, scenarios and the probabilities they assign to those scenarios based on actual developments during the quarter and their view of future performance.

The financial guaranties issued by the Company insure the credit performance of the guaranteed obligations over an extended period of time, in some cases over 30 years, and in most circumstances the Company has no right to cancel such financial guaranties. As a result, the Company's estimate of ultimate losses on a policy is subject to significant uncertainty over the life of the insured transaction. Credit performance can be adversely affected by economic, fiscal and financial market variability over the life of most contracts.

The determination of expected loss to be paid is an inherently subjective process involving numerous estimates, assumptions and judgments by management, using both internal and external data sources with regard to frequency, severity of loss, economic projections, governmental actions, negotiations and other factors that affect credit performance. These estimates, assumptions and judgments, and the factors on which they are based, may change materially over a reporting period, and as a result the Company's loss estimates may change materially over that same period.

Changes over a reporting period in the Company's loss estimates for municipal obligations supported by specified revenue streams, such as revenue bonds issued by toll road authorities, municipal utilities or airport authorities, generally will be influenced by factors impacting their revenue levels, such as changes in demand; changing demographics; and other economic factors, especially if the obligations do not benefit from financial support from other tax revenues or governmental authorities. Changes over a reporting period in the Company's loss estimates for its tax-supported public finance transactions generally will be influenced by factors impacting the public issuer's ability and willingness to pay, such as changes in the economy and population of the relevant area; changes in the issuer's ability or willingness to raise taxes, decrease spending or receive federal assistance; new legislation; rating agency actions that affect the issuer's ability to refinance maturing obligations or issue new debt at a reasonable cost; changes in the priority or amount of pensions and other obligations owed to workers; developments in restructuring or settlement negotiations; and other political and economic factors. Changes in loss estimates may also be affected by the Company's loss mitigation efforts.

Changes in the Company's loss estimates for structured finance transactions generally will be influenced by factors impacting the performance of the assets supporting those transactions. For example, changes over a reporting period in the Company's loss estimates for its RMBS transactions may be influenced by such factors as the level and timing of loan defaults experienced; changes in housing prices; results from the Company's loss mitigation activities; and other variables.

The Company does not use traditional actuarial approaches to determine its estimates of expected losses. Actual losses will ultimately depend on future events or transaction performance and may be influenced by many interrelated factors that are difficult to predict. As a result, the Company's current projections of losses may be subject to considerable volatility and may not reflect the Company's ultimate claims paid.

In some instances, the terms of the Company's policy gives it the option to pay principal losses that have been recognized in the transaction but which it is not yet required to pay, thereby reducing the amount of guaranteed interest due in the future. The Company has sometimes exercised this option, which uses cash but reduces projected future losses.

The following tables present a roll forward of net expected loss to be paid for all contracts. The Company used risk-free rates for U.S. dollar denominated obligations that ranged from 0.0% to 2.78% with a weighted average of 2.40% as of December 31, 2017 and from 0.0% to 3.23% with a weighted average of 2.69% as of December 31, 2016. Expected losses to be paid for transactions denominated in currencies other than the U.S. dollar represented approximately 5.5% and 4.3% of the total as of December 31, 2017 and December 31, 2016, respectively.

**Net Expected Loss to be Paid
Roll Forward**

	Year Ended December 31,	
	2017	2016
	(in millions)	
Net expected loss to be paid, beginning of period	\$ 521	\$ 584
Net expected loss to be paid on the AGLN portfolio as of January 10, 2017	21	—
Economic loss development (benefit) due to:		
Accretion of discount	14	10
Changes in discount rates	10	(10)
Changes in timing and assumptions	173	96
Total economic loss development (benefit)	197	96
Net (paid) recovered losses	(43)	(159)
Net expected loss to be paid, end of period	<u>\$ 696</u>	<u>\$ 521</u>

**Net Expected Loss to be Paid,
Roll Forward by Sector
Year Ended December 31, 2017**

	Net Expected Loss to be Paid (Recovered) as of December 31, 2016 (2)	Net Expected Loss to be Paid on AGLN as of January 10, 2017	Economic Loss Development / (Benefit)	(Paid) Recovered Losses(1)	Net Expected Loss to be Paid (Recovered) as of December 31, 2017 (2)
	(in millions)				
Public finance:					
U.S. public finance	\$ 323	\$ —	\$ 244	\$ (85)	\$ 482
Non-U.S. public finance	22	13	(4)	5	36
Public finance	<u>345</u>	<u>13</u>	<u>240</u>	<u>(80)</u>	<u>518</u>
Structured finance:					
U.S. RMBS	147	—	(24)	40	163
Other structured finance	29	8	(19)	(3)	15
Structured finance	<u>176</u>	<u>8</u>	<u>(43)</u>	<u>37</u>	<u>178</u>
Total	<u>\$ 521</u>	<u>\$ 21</u>	<u>\$ 197</u>	<u>\$ (43)</u>	<u>\$ 696</u>

**Net Expected Loss to be Paid,
Roll Forward by Sector
Year Ended December 31, 2016**

	Net Expected Loss to be Paid (Recovered) as of December 31, 2015	Economic Loss Development / (Benefit)	(Paid) Recovered Losses(1)	Net Expected Loss to be Paid (Recovered) as of December 31, 2016 (2)
(in millions)				
Public finance:				
U.S. public finance	\$ 214	\$ 184	\$ (75)	\$ 323
Non-U.S. public finance	26	(4)	—	22
Public finance	240	180	(75)	345
Structured finance:				
U.S. RMBS	302	(72)	(83)	147
Other structured finance	42	(12)	(1)	29
Structured finance	344	(84)	(84)	176
Total	\$ 584	\$ 96	\$ (159)	\$ 521

- (1) Net of ceded paid losses, whether or not such amounts have been settled with reinsurers. Ceded paid losses are typically settled 45 days after the end of the reporting period. Such amounts are recorded in reinsurance recoverable on paid losses included in other assets. The Company paid \$9 million and \$7 million in LAE for the years ended December 31, 2017 and 2016, respectively.
- (2) Includes expected LAE to be paid of \$9 million as of December 31, 2017 and \$3 million as of December 31, 2016.

The following table presents the present value of net expected loss to be paid and the net economic loss development for all contracts by accounting model.

**Net Expected Loss to be Paid (Recovered) and
Net Economic Loss Development (Benefit)
By Accounting Model**

	Net Expected Loss to be Paid (Recovered)		Net Economic Loss Development (Benefit)	
	As of December 31, 2017	As of December 31, 2016	Year Ended December 31, 2017	Year Ended December 31, 2016
(in millions)				
Financial guaranty insurance	\$ 618	\$ 434	\$ 208	\$ 110
FG VIEs (1) and other	78	90	(4)	(6)
Credit derivatives (2)	—	(3)	(7)	(8)
Total	\$ 696	\$ 521	\$ 197	\$ 96

- (1) See Note 9, Consolidated Variable Interest Entities.
- (2) See Note 8, Contracts Accounted for as Credit Derivatives.

Selected U.S. Public Finance Transactions

The Company insures general obligation bonds of the Commonwealth of Puerto Rico and various obligations of its related authorities and public corporations aggregating \$2.3 billion net par as of December 31, 2017, \$2.2 billion of which is rated BIG. For additional information regarding the Company's exposure to general obligations of the Commonwealth of Puerto Rico and various obligations of its related authorities and public corporations, see "Exposure to Puerto Rico" in Note 4, Outstanding Exposure.

As of December 31, 2017, the Company has insured \$209 million net par outstanding of general obligation bonds issued by the City of Hartford, Connecticut, which has recently experienced financial distress. The Company rates \$208 million net par of that BIG, with the remainder being a second-to-pay policy rated investment grade. The mayor of Hartford announced that the city would be unable to meet its financial obligations by early November 2017 if the State of Connecticut failed to enact a budget, and hired bankruptcy consultants. On October 31, 2017, the State adopted a budget providing for substantial payments to the City, placing the City under State oversight and providing an avenue for the City to issue debt backed by the State. While these are welcome developments, the City remains in financial distress and its bonds are still rated BIG by the Company.

On February 25, 2015, a plan of adjustment resolving the bankruptcy filing of the City of Stockton, California under chapter 9 of the U.S. Bankruptcy Code became effective. As of December 31, 2017, the Company's net par subject to the plan consists of \$61 million of pension obligation bonds. As part of the plan of adjustment, the City will repay any claims paid on the pension obligation bonds from certain fixed payments and certain variable payments contingent on the City's revenue growth.

The Company projects that its total net expected loss across its troubled U.S. public finance exposures as of December 31, 2017, including those mentioned above, will be \$482 million compared with a net expected loss of \$323 million as of December 31, 2016. Economic loss development in 2017 was \$244 million, which was primarily attributable to Puerto Rico exposures.

Selected Non - U.S. Public Finance Transactions

The Company insures and reinsures exposures with sub-sovereign exposure to various Spanish and Portuguese issuers where a Spanish and Portuguese sovereign default may cause the sub-sovereigns also to default. The Company's exposure net of reinsurance to these Spanish and Portuguese exposures is \$376 million and \$72 million, respectively. The Company rates all of these exposures BIG due to the financial condition of Spain and Portugal and their dependence on the sovereign. The Company's Hungary exposure is to infrastructure bonds dependent on payments from Hungarian governmental entities. The Company's exposure net of reinsurance to these Hungarian exposures is \$169 million, all of which is rated BIG.

As part of the acquisition of the European Subsidiaries, the Company now also insures an obligation backed by the availability and toll revenues of a major arterial road into a city in the U.K. with \$221 million of net par outstanding as of December 31, 2017. This transaction has been underperforming due to lower traffic volume and higher costs compared with expectations at underwriting.

These transactions, together with other non-U.S. public finance insured obligations, had expected loss to be paid of \$36 million as of December 31, 2017, compared with \$22 million as of December 31, 2016. The common control acquisition of AGLN added \$13 million of net expected loss as of January 2017. The economic benefit of approximately \$4 million during 2017 was due mainly to the improved internal outlook of certain European sovereigns and sub-sovereign entities.

U.S. RMBS

The Company projects losses on its insured U.S. RMBS on a transaction-by-transaction basis by projecting the performance of the underlying pool of mortgages over time and then applying the structural features (i.e., payment priorities and tranching) of the RMBS and any expected R&W recoveries/payables to the projected performance of the collateral over time. The resulting projected claim payments or reimbursements are then discounted using risk-free rates.

The further behind a mortgage borrower falls in making payments, the more likely it is that he or she will default. The rate at which borrowers from a particular delinquency category (number of monthly payments behind) eventually default is referred to as the "liquidation rate." The Company derives its liquidation rate assumptions from observed roll rates, which are the rates at which loans progress from one delinquency category to the next and eventually to default and liquidation. The Company applies liquidation rates to the mortgage loan collateral in each delinquency category and makes certain timing assumptions to project near-term mortgage collateral defaults from loans that are currently delinquent.

Mortgage borrowers that are not more than one payment behind (generally considered performing borrowers) have demonstrated an ability and willingness to pay throughout the recession and mortgage crisis, and as a result are viewed as less likely to default than delinquent borrowers. Performing borrowers that eventually default will also need to progress through delinquency categories before any defaults occur. The Company projects how many of the currently performing loans will default and when they will default, by first converting the projected near term defaults of delinquent borrowers derived from liquidation rates into a vector of conditional default rates (CDR), then projecting how the CDR will develop over time. Loans

that are defaulted pursuant to the CDR after the near-term liquidation of currently delinquent loans represent defaults of currently performing loans and projected re-performing loans. A CDR is the outstanding principal amount of defaulted loans liquidated in the current month divided by the remaining outstanding amount of the whole pool of loans (or collateral pool balance). The collateral pool balance decreases over time as a result of scheduled principal payments, partial and whole principal prepayments, and defaults.

In order to derive collateral pool losses from the collateral pool defaults it has projected, the Company applies a loss severity. The loss severity is the amount of loss the transaction experiences on a defaulted loan after the application of net proceeds from the disposal of the underlying property. The Company projects loss severities by sector and vintage based on its experience to date. The Company continues to update its evaluation of these loss severities as new information becomes available.

The Company had been enforcing claims for breaches of R&W regarding the characteristics of the loans included in the collateral pools. The Company calculates R&W recoveries and payables to include in its cash flow projections based on its agreements with R&W providers.

The Company projects the overall future cash flow from a collateral pool by adjusting the payment stream from the principal and interest contractually due on the underlying mortgages for the collateral losses it projects as described above; assumed voluntary prepayments; and servicer advances. The Company then applies an individual model of the structure of the transaction to the projected future cash flow from that transaction's collateral pool to project the Company's future claims and claim reimbursements for that individual transaction. Finally, the projected claims and reimbursements are discounted using risk-free rates. The Company runs several sets of assumptions regarding mortgage collateral performance, or scenarios, and probability weights them.

The Company's RMBS loss projection methodology assumes that the housing and mortgage markets will continue improving. Each period the Company makes a judgment as to whether to change the assumptions it uses to make RMBS loss projections based on its observation during the period of the performance of its insured transactions (including early stage delinquencies, late stage delinquencies and loss severity) as well as the residential property market and economy in general, and, to the extent it observes changes, it makes a judgment as to whether those changes are normal fluctuations or part of a trend.

U.S. RMBS Loss Projections

Based on its observation during the period of the performance of its insured transactions (including delinquencies, liquidation rates and loss severities) as well as the residential property market and economy in general, the Company chose to make the changes to the assumptions it uses to project RMBS losses shown in the tables of assumptions in the sections below. In 2017 the economic loss development was \$29 million for first lien U.S. RMBS and the economic benefit was \$53 million for second lien U.S. RMBS. In 2016 the economic benefit was \$46 million for first lien U.S. RMBS and \$26 million for second lien U.S. RMBS.

U.S. First Lien RMBS Loss Projections: Alt-A First Lien, Option ARM and Subprime

The majority of projected losses in first lien RMBS transactions are expected to come from non-performing mortgage loans (those that are or in the past twelve months have been two or more payments behind, have been modified, are in foreclosure, or have been foreclosed upon). Changes in the amount of non-performing loans from the amount projected in the previous period are one of the primary drivers of loss development in this portfolio. In order to determine the number of defaults resulting from these delinquent and foreclosed loans, the Company applies a liquidation rate assumption to loans in each of various non-performing categories. The Company arrived at its liquidation rates based on data purchased from a third party provider and assumptions about how delays in the foreclosure process and loan modifications may ultimately affect the rate at which loans are liquidated. Each quarter the Company reviews the most recent twelve months of this data and (if necessary) adjusts its liquidation rates based on its observations. The following table shows liquidation assumptions for various non-performing categories.

First Lien Liquidation Rates

	December 31, 2017	December 31, 2016
Delinquent/Modified in the Previous 12 Months		
Alt-A	20%	25%
Option ARM	20	25
Subprime	20	25
30 - 59 Days Delinquent		
Alt-A	30	35
Option ARM	35	35
Subprime	40	40
60 - 89 Days Delinquent		
Alt-A	40	45
Option ARM	50	50
Subprime	50	50
90 + Days Delinquent		
Alt-A	55	55
Option ARM	60	55
Subprime	55	55
Bankruptcy		
Alt-A	45	45
Option ARM	50	50
Subprime	40	40
Foreclosure		
Alt-A	65	65
Option ARM	70	65
Subprime	65	65
Real Estate Owned		
All	100	100

While the Company uses liquidation rates as described above to project defaults of non-performing loans (including current loans modified or delinquent within the last 12 months), it projects defaults on presently current loans by applying a CDR trend. The start of that CDR trend is based on the defaults the Company projects will emerge from currently nonperforming, recently nonperforming and modified loans. The total amount of expected defaults from the non-performing loans is translated into a constant CDR (*i.e.*, the CDR plateau), which, if applied for each of the next 36 months, would be sufficient to produce approximately the amount of defaults that were calculated to emerge from the various delinquency categories. The CDR thus calculated individually on the delinquent collateral pool for each RMBS is then used as the starting point for the CDR curve used to project defaults of the presently performing loans.

In the most heavily weighted scenario (the base case), after the initial 36-month CDR plateau period, each transaction's CDR is projected to improve over 12 months to an intermediate CDR (calculated as 20% of its CDR plateau); that intermediate CDR is held constant for 36 months and then trails off in steps to a final CDR of 5% of the CDR plateau. In the base case, the Company assumes the final CDR will be reached 5.5 years after the initial 36-month CDR plateau period. Under the Company's methodology, defaults projected to occur in the first 36 months represent defaults that can be attributed to loans that were modified or delinquent in the last 12 months or that are currently delinquent or in foreclosure, while the defaults projected to occur using the projected CDR trend after the first 36 month period represent defaults attributable to borrowers that are currently performing or are projected to reperform.

Another important driver of loss projections is loss severity, which is the amount of loss the transaction incurs on a loan after the application of net proceeds from the disposal of the underlying property. Loss severities experienced in first lien transactions have reached historically high levels, and the Company is assuming in the base case that these high levels generally will continue for another 18 months. The Company determines its initial loss severity based on actual recent experience. Each quarter the Company reviews available data and (if necessary) adjusts its severities based on its observations.

The Company then assumes that loss severities begin returning to levels consistent with underwriting assumptions beginning after the initial 18 month period, declining to 40% in the base case over 2.5 years.

The following table shows the range as well as the average, weighted by outstanding net insured par, for key assumptions used in the calculation of expected loss to be paid for individual transactions for direct vintage 2004 - 2008 first lien U.S. RMBS.

**Key Assumptions in Base Case Expected Loss Estimates
First Lien RMBS**

	As of December 31, 2017		As of December 31, 2016	
	Range	Weighted Average	Range	Weighted Average
Alt-A First Lien				
Plateau CDR	3.1% - 9.8%	5.5%	3.9% - 10.5%	6.1%
Final CDR	0.2% - 0.5%	0.3%	0.2% - 0.5%	0.3%
Initial loss severity:				
2005 and prior	60%		60%	
2006	80%		80%	
2007+	70%		70%	
Option ARM				
Plateau CDR	3.4% - 7.0%	6.0%	3.2% - 7.0%	5.7%
Final CDR	0.2% - 0.3%	0.3%	0.2% - 0.3%	0.3%
Initial loss severity:				
2005 and prior	60%		60%	
2006	70%		70%	
2007+	75%		75%	
Subprime				
Plateau CDR	4.3% - 11.5%	7.8%	4.3% - 10.1%	8.1%
Final CDR	0.2% - 0.6%	0.4%	0.2% - 0.5%	0.4%
Initial loss severity:				
2005 and prior	80%		80%	
2006	90%		90%	
2007+	95%		90%	

The rate at which the principal amount of loans is voluntarily prepaid may impact both the amount of losses projected (since that amount is a function of the CDR, the loss severity and the loan balance over time) as well as the amount of excess spread (the amount by which the interest paid by the borrowers on the underlying loan exceeds the amount of interest owed on the insured obligations). The assumption for the voluntary conditional prepayment rate (CPR) follows a similar pattern to that of the CDR. The current level of voluntary prepayments is assumed to continue for the plateau period before gradually increasing over 12 months to the final CPR, which is assumed to be 15% in the base case. For transactions where the initial CPR is higher than the final CPR, the initial CPR is held constant and the final CPR is not used. These CPR assumptions are the same as those the Company used for December 31, 2016.

In estimating expected losses, the Company modeled and probability weighted sensitivities for first lien transactions by varying its assumptions of how fast a recovery is expected to occur. One of the variables used to model sensitivities was how quickly the CDR returned to its modeled equilibrium, which was defined as 5% of the initial CDR. The Company also stressed CPR and the speed of recovery of loss severity rates. The Company probability weighted a total of five scenarios as of December 31, 2017.

Total expected loss to be paid on all first lien U.S. RMBS was \$109 million and \$81 million as of December 31, 2017 and December 31, 2016, respectively. The Company used a similar approach to establish its pessimistic and optimistic

scenarios as of December 31, 2017 as it used as of December 31, 2016, increasing and decreasing the periods of stress from those used in the base case.

In the Company's most stressful scenario where loss severities were assumed to rise and then recover over nine years and the initial ramp-down of the CDR was assumed to occur over 15 months, expected loss to be paid would increase from current projections by approximately \$57 million for all first lien U.S. RMBS transactions.

In the Company's least stressful scenario where the CDR plateau was six months shorter (30 months, effectively assuming that liquidation rates would improve) and the CDR recovery was more pronounced (including an initial ramp-down of the CDR over nine months) expected loss to be paid would decrease from current projections by approximately \$43 million for all first lien U.S. RMBS transactions.

U.S. Second Lien RMBS Loss Projections

Second lien RMBS transactions include both home equity lines of credit (HELOC) and closed end second lien mortgages. The Company believes the primary variable affecting its expected losses in second lien RMBS transactions is the amount and timing of future losses in the collateral pool supporting the transactions. Expected losses are also a function of the structure of the transaction, the voluntary prepayment rate (typically also referred to as CPR of the collateral); the interest rate environment, and assumptions about loss severity.

In second lien transactions the projection of near-term defaults from currently delinquent loans is relatively straightforward because loans in second lien transactions are generally "charged off" (treated as defaulted) by the securitization's servicer once the loan is 180 days past due. The Company estimates the amount of loans that will default over the next six months by calculating current representative liquidation rates. Similar to first liens, the Company then calculates a CDR for six months, which is the period over which the currently delinquent collateral is expected to be liquidated. That CDR is then used as the basis for the plateau CDR period that follows the embedded plateau losses.

For the base case scenario, the CDR (the plateau CDR) was held constant for six months. Once the plateau period has ended, the CDR is assumed to gradually trend down in uniform increments to its final long-term steady state CDR. (The long-term steady state CDR is calculated as the constant CDR that would have yielded the amount of losses originally expected at underwriting.) In the base case scenario, the time over which the CDR trends down to its final CDR is 28 months. Therefore, the total stress period for second lien transactions is 34 months, comprising six months of delinquent data, and 28 months of decrease to the steady state CDR, the same as of December 31, 2016.

HELOC loans generally permit the borrower to pay only interest for an initial period (often ten years) and, after that period, require the borrower to make both the monthly interest payment and a monthly principal payment. This causes the borrower's total monthly payment to increase, sometimes substantially, at the end of the initial interest-only period. In the prior periods, as the HELOC loans underlying the Company's insured HELOC transactions reached their principal amortization period, the Company incorporated an assumption that a percentage of loans reaching their principal amortization periods would default around the time of the payment increase.

Most of the HELOC loans underlying the Company's insured HELOC transactions are now past their interest only reset date, although a significant number of HELOC loans were modified to extend the interest only period for another five years. As a result, in 2017, the Company eliminated the CDR increase that was applied when such loans reached their principal amortization period. In addition, based on the average performance history, starting in third quarter 2017, the Company applied a CDR floor of 2.5% for the future steady state CDR on all its HELOC transactions and reduced the liquidation rate assumption for selected delinquency categories.

When a second lien loan defaults, there is generally a very low recovery. The Company assumed as of December 31, 2017 that it will generally recover only 2% of future defaulting collateral at the time of charge-off, with additional amounts of post charge-off recoveries assumed to come in over time. This is the same assumption used as of December 31, 2016.

The rate at which the principal amount of loans is prepaid may impact both the amount of losses projected as well as the amount of excess spread. In the base case, an average CPR (based on experience of the past year) is assumed to continue until the end of the plateau before gradually increasing to the final CPR over the same period the CDR decreases. The final CPR is assumed to be 15% for second lien transactions (in the base case), which is lower than the historical average but reflects the Company's continued uncertainty about the projected performance of the borrowers in these transactions. For transactions where the initial CPR is higher than the final CPR, the initial CPR is held constant and the final CPR is not used. This pattern is

generally consistent with how the Company modeled the CPR as of December 31, 2016. To the extent that prepayments differ from projected levels it could materially change the Company's projected excess spread and losses.

In estimating expected losses, the Company modeled and probability weighted five possible CDR curves applicable to the period preceding the return to the long-term steady state CDR. The Company used five scenarios at December 31, 2017 and December 31, 2016. The Company believes that the level of the elevated CDR and the length of time it will persist and the ultimate prepayment rate, are the primary drivers behind the likely amount of losses the collateral will suffer.

The Company continues to evaluate the assumptions affecting its modeling results. The Company believes the most important driver of its projected second lien RMBS losses is the performance of its HELOC transactions. Total expected loss to be paid on all second lien U.S. RMBS was \$54 million as of December 31, 2017 and \$66 million as of December 31, 2016, respectively.

The following table shows the range as well as the average, weighted by outstanding net insured par, for key assumptions for the calculation of expected loss to be paid for individual transactions for direct vintage 2004 - 2008 HELOCs.

**Key Assumptions in Base Case Expected Loss Estimates
HELOCs**

	As of December 31, 2017		As of December 31, 2016	
	Range	Weighted Average	Range	Weighted Average
Plateau CDR	2.7% - 19.9%	11.4%	3.5% - 22.4%	13.5%
Final CDR trended down to	2.5% - 3.2%	2.5%	0.6% - 3.2%	1.2%
Liquidation rates:				
Delinquent/Modified in the Previous 12 Months	20%		25%	
30 - 59 Days Delinquent	45		50	
60 - 89 Days Delinquent	60		65	
90+ Days Delinquent	75		80	
Bankruptcy	55		55	
Foreclosure	70		75	
Real Estate Owned	100		100	
Loss severity	98%		98%	

The Company's base case assumed a six month CDR plateau and a 28 month ramp-down (for a total stress period of 34 months). The Company also modeled a scenario with a longer period of elevated defaults and another with a shorter period of elevated defaults. Increasing the CDR plateau to eight months and increasing the ramp-down by three months to 31-months (for a total stress period of 39 months) would increase the expected loss by approximately \$9 million for HELOC transactions. On the other hand, reducing the CDR plateau to four months and decreasing the length of the CDR ramp-down to 25 months (for a total stress period of 29 months), and lowering the ultimate prepayment rate to 10% would decrease the expected loss by approximately \$10 million for HELOC transactions.

Breaches of Representations and Warranties

As of December 31, 2017 the Company had a net R&W payable of \$25 million to R&W counterparties, compared to an R&W payable of \$41 million as of December 31, 2016.

Other Structured Finance

The Company's other structured finance sector has BIG net par of \$166 million comprising primarily transactions backed by manufactured housing loans, international RMBS and perpetual repackagings and triple-X life insurance transactions, where the amounts initially raised by the sale of the notes insured by the Company were used to capitalize special purpose vehicles that provide life reinsurance; the special purpose vehicles' funds were invested in accounts managed by third-party investment managers. The economic benefit during 2017 was \$19 million, which was attributable primarily to a settlement with the former investment manager for certain Triple-X transactions and certain loss mitigation activities.

Recovery Litigation

In the ordinary course of their respective businesses, the Company asserts claims in legal proceedings against third parties to recover losses paid in prior periods or prevent losses in the future.

Public Finance Transactions

The Company has asserted claims in a number of legal proceedings in connection with its exposure to Puerto Rico. See Note 4, Outstanding Exposure, for a discussion of the Company's exposure to Puerto Rico and related recovery litigation being pursued by the Company.

6. Contracts Accounted for as Insurance

Premiums

The portfolio of outstanding exposures discussed in Note 4, Outstanding Exposure, includes contracts that meet the definition of insurance contracts, contracts that meet the definition of a derivative, and contracts that are accounted for as consolidated FG VIEs. Amounts presented in this note relate to insurance contracts. See Note 8, Contracts Accounted for as Credit Derivatives for amounts that relate to CDS and Note 9, Consolidated Variable Interest Entities for amounts that relate to FG VIEs.

Accounting Policies

Accounting for financial guaranty contracts that meet the scope exception under derivative accounting guidance are subject to industry specific guidance for financial guaranty insurance. The accounting for contracts that fall under the financial guaranty insurance definition are consistent whether the contract was written on a direct basis, assumed from another financial guarantor under a reinsurance treaty, ceded to another insurer under a reinsurance treaty, or acquired in a business combination.

Premiums receivable comprise the present value of contractual or expected future premium collections discounted using risk free rates. Unearned premium reserve represents deferred premium revenue, less claim payments made and recoveries received that have not yet been recognized in the statement of operations (contra-paid). The following discussion relates to the deferred premium revenue component of the unearned premium reserve, while the contra-paid is discussed below under "Financial Guaranty Insurance Losses."

The amount of deferred premium revenue at contract inception is determined as follows:

- For premiums received upfront on financial guaranty insurance contracts that were originally underwritten by the Company, deferred premium revenue is equal to the amount of cash received. Upfront premiums typically relate to public finance transactions.
- For premiums received in installments on financial guaranty insurance contracts that were originally underwritten by the Company, deferred premium revenue is the present value of either (1) contractual premiums due or (2) in cases where the underlying collateral is comprised of homogeneous pools of assets, the expected premiums to be collected over the life of the contract. To be considered a homogeneous pool of assets, prepayments must be contractually allowable, the amount of prepayments must be probable, and the timing and amount of prepayments must be reasonably estimable. When the Company adjusts prepayment assumptions or expected premium collections, an adjustment is recorded to the deferred premium revenue, with a corresponding adjustment to the premium receivable. Premiums receivable are discounted at the risk-free rate at inception and such discount rate is updated only when changes to prepayment assumptions are made that change the expected date of final maturity. Installment premiums typically relate to structured finance transactions, where the insurance premium rate is determined at the inception of the contract but the insured par is subject to prepayment throughout the life of the transaction.
- For financial guaranty insurance contracts subject to push down accounting, deferred premium revenue is equal to the fair value of the Company's stand-ready obligation portion of the insurance contract at the date of acquisition based on what a hypothetical similarly rated financial guaranty insurer would have charged for the contract at that date and not the actual cash flows under the insurance contract. The amount of deferred premium revenue may differ significantly from cash collections due primarily to fair value adjustments recorded in connection with a business combination.

The Company recognizes deferred premium revenue as earned premium over the contractual period or expected period of the contract in proportion to the amount of insurance protection provided. As premium revenue is recognized, a corresponding decrease to the deferred premium revenue is recorded. The amount of insurance protection provided is a function of the insured principal amount outstanding. Accordingly, the proportionate share of premium revenue recognized in a given reporting period is a constant rate calculated based on the relationship between the insured principal amounts outstanding in the reporting period compared with the sum of each of the insured principal amounts outstanding for all periods. When an insured financial obligation is retired before its maturity, the financial guaranty insurance contract is extinguished. Any nonrefundable deferred premium revenue related to that contract is accelerated and recognized as premium revenue. When a premium receivable balance is deemed uncollectible, it is written off to bad debt expense.

Deferred premium revenue ceded to reinsurers (ceded unearned premium reserve) is recorded as an asset. Direct, assumed and ceded earned premiums are presented together as net earned premiums in the statement of operations, and comprise the following:

Net Earned Premiums

	Year Ended December 31,	
	2017	2016
	(in millions)	
Scheduled net earned premiums	\$ 222	\$ 203
Accelerations		
Refundings	106	170
Terminations	14	66
Total Accelerations	120	236
Accretion of discount on net premiums receivable	11	7
Net earned premiums (1)	<u>\$ 353</u>	<u>\$ 446</u>

- (1) Excludes \$13 million and \$16 million for the year ended December 31, 2017 and 2016, respectively, related to consolidated FG VIEs.

Gross Premium Receivable Roll Forward

	Year Ended December 31,	
	2017	2016
	(in millions)	
December 31,	\$ 358	\$ 457
Premiums receivable from acquisitions	274	2
Gross written premiums	299	189
Gross premiums received	(276)	(227)
Adjustments:		
Changes in the expected term	2	(27)
Accretion of discount	10	5
Foreign exchange translation	63	(41)
December 31,	<u>\$ 730</u>	<u>\$ 358</u>

- (1) Excludes \$4 million and \$4 million as of December 31, 2017 and 2016, respectively, related to consolidated FG VIEs.

Foreign exchange translation relates to installment premiums receivable denominated in currencies other than the U.S. dollar. As of December 31, 2017, 89% of installment premiums are denominated in currencies other than the U.S. dollar, primarily the euro and pound sterling. This represents an increase from 81% as of December 31, 2016, due mainly to the acquisition of MBIA UK.

The timing and cumulative amount of actual collections may differ from expected collections in the tables below due to factors such as foreign exchange rate fluctuations, counterparty collectability issues, accelerations, commutations and changes in expected lives.

**Expected Collections of
Financial Guaranty Insurance Gross Premiums Receivable
(Undiscounted)**

	As of December 31, 2017 (in millions)
2018 (January 1 - March 31)	\$ 27
2018 (April 1 - June 30)	25
2018 (July 1 - September 30)	17
2018 (October 1 - December 31)	13
2019	62
2020	61
2021	59
2022	55
2023-2027	232
2028-2032	159
2033-2037	85
After 2037	92
Total (1)	\$ 887

(1) Excludes expected cash collections on FG VIEs of \$5 million.

Scheduled Financial Guaranty Insurance Net Earned Premiums

	As of December 31, 2017
	(in millions)
2018 (January 1 - March 31)	\$ 54
2018 (April 1 - June 30)	53
2018 (July 1 - September 30)	51
2018 (October 1 - December 31)	50
Subtotal 2018	208
2019	177
2020	158
2021	145
2022	132
2023-2027	513
2028-2032	328
2033-2037	195
After 2037	173
Net deferred premium revenue(1)	2,029
Future accretion	112
Total future net earned premiums	\$ 2,141

(1) Excludes scheduled net earned premiums on consolidated FG VIEs of \$69 million and contra-paid related to FG VIEs of \$17 million.

Selected Information for Financial Guaranty Insurance Policies Paid in Installments

	As of December 31, 2017	As of December 31, 2016
	(dollars in millions)	
Premiums receivable	\$ 730	\$ 358
Gross deferred premium revenue	994	782
Weighted-average risk-free rate used to discount premiums	2.3%	3.2%
Weighted-average period of premiums receivable (in years)	9.6	9.8

Financial Guaranty Insurance Acquisition Costs

Accounting Policy

Policy acquisition costs that are directly related and essential to successful insurance contract acquisition, as well as ceding commission income on ceded reinsurance contracts are deferred and reported net. Amortization of deferred ceding commissions includes the accretion of discount on ceding commission receivable and payable.

Capitalized policy acquisition costs include expenses such as ceding commission expense on assumed reinsurance contracts and the cost of underwriting personnel attributable to successful underwriting efforts. Ceding commission expense on assumed reinsurance contracts and ceding commission income on ceded reinsurance contracts that are associated with premiums received in installments are calculated at their contractually defined commission rates, discounted consistent with premiums receivable for all future periods, and included in deferred acquisition costs (DAC), with a corresponding offset to net premiums receivable or reinsurance balances payable. Management uses its judgment in determining the type and amount of costs to be deferred. The Company conducts an annual study to determine which operating costs qualify for deferral and how

much to defer. Costs incurred for soliciting potential customers, market research, training, administration, unsuccessful acquisition efforts, and product development as well as all overhead type costs are charged to expense as incurred. DAC is amortized in proportion to net earned premiums. When an insured obligation is retired early, the remaining related DAC is recognized at that time.

**Rollforward of
Deferred Ceding Commissions,
Net of DAC(1)**

	Year Ended December 31,	
	2017	2016
	(in millions)	
December 31,	\$ (80)	\$ (84)
DAC adjustments from acquisitions	(3)	—
Costs deferred during the period:		
Commissions on ceded business	(38)	(21)
Premium taxes	4	4
Compensation and other acquisition costs	10	6
Total	(24)	(11)
Costs amortized during the period	14	13
Foreign exchange translation	0	2
December 31,	<u>\$ (93)</u>	<u>\$ (80)</u>

(1) The balances are included in other liabilities on the balance sheets.

Financial Guaranty Insurance Losses

Accounting Policies

Loss and LAE Reserve

Loss and LAE reserve reported on the balance sheet relates only to contracts that are accounted for as insurance, substantially all of which are financial guaranty insurance contracts. The corresponding reserve ceded to reinsurers is reported as reinsurance recoverable on unpaid losses. As discussed in Note 7, Fair Value Measurement, contracts that meet the definition of a derivative, as well as consolidated FG VIE assets and liabilities, are recorded separately at fair value. Any expected losses related to consolidated FG VIEs are eliminated upon consolidation.

Under financial guaranty insurance accounting, the sum of unearned premium reserve and loss and LAE reserve represents the Company's stand-ready obligation. Unearned premium reserve is deferred premium revenue, less claim payments and recoveries received that have not yet been recognized in the statement of operations (contra-paid). At contract inception, the entire stand-ready obligation is represented by unearned premium reserve. A loss and LAE reserve for an insurance contract is recorded only to the extent, and for the amount, that expected loss to be paid plus contra-paid (total losses) exceed the deferred premium revenue, on a contract by contract basis. As a result, the Company has expected loss to be paid that has not yet been expensed. Such amounts will be recognized in future periods as deferred premium revenue amortizes into income.

When a claim or LAE payment is made on a contract, it first reduces any recorded loss and LAE reserve. To the extent there is no loss and LAE reserve on a contract, then such claim payment is recorded as "contra-paid," which reduces the unearned premium reserve. The contra-paid is recognized in the line item "loss and LAE" in the statement of operations when and for the amount that total losses exceed the remaining deferred premium revenue on the insurance contract. Loss and LAE in the combined statement of operations is presented net of cessions to reinsurers.

Salvage and Subrogation Recoverable

When the Company becomes entitled to the cash flow from the underlying collateral of an insured exposure under salvage and subrogation rights as a result of a claim payment or estimated future claim payment, it reduces the expected loss to be paid on the contract. Such reduction in expected loss to be paid can result in one of the following:

- a reduction in the corresponding loss and LAE reserve with a benefit to the income statement,
- no entry recorded, if “total loss” is not in excess of deferred premium revenue, or
- the recording of a salvage asset with a benefit to the income statement if the transaction is in a net recovery position at the reporting date.

To the extent that the estimated amount of recoveries increases or decreases, due to changes in facts and circumstances, the Company would recognize a benefit or expense consistent with how changes in the expected recovery of all other claim payments are recorded. The ceded component of salvage and subrogation recoverable is recorded in the line item reinsurance balances payable.

Expected Loss to be Expensed

Expected loss to be expensed represents past or expected future net claim payments that have not yet been expensed. Such amounts will be expensed in future periods as deferred premium revenue amortizes into income on financial guaranty insurance policies. Expected loss to be expensed is the Company's projection of incurred losses that will be recognized in future periods, excluding accretion of discount.

Insurance Contracts' Loss Information

The following table provides information on net reserve (salvage), comprised of loss and LAE reserves and salvage and subrogation recoverable, both net of reinsurance. The Company used risk-free rates for U.S. dollar denominated financial guaranty insurance obligations that ranged from 0.0% to 2.78% with a weighted average of 2.40% as of December 31, 2017 and from 0.0% to 3.23% with a weighted average of 2.69% as of December 31, 2016.

Net Reserve (Salvage)

	<u>As of December 31, 2017</u>	<u>As of December 31, 2016</u>
	(in millions)	
Public finance:		
U.S. public finance	\$ 447	\$ 289
Non-U.S. public finance	15	13
Public finance	462	302
Structured finance:		
U.S. RMBS	53	19
Other structured finance	10	25
Structured finance	63	44
Subtotal	525	346
Elimination of losses attributable to FG VIEs	(47)	(55)
Total	<u>\$ 478</u>	<u>\$ 291</u>

Components of Net Reserves (Salvage)

	As of December 31, 2017	As of December 31, 2016
	(in millions)	
Loss and LAE reserve	\$ 931	\$ 816
Reinsurance recoverable on unpaid losses	(227)	(310)
Loss and LAE reserve, net	704	506
Salvage and subrogation recoverable	(297)	(249)
Salvage and subrogation payable(1)	71	34
Salvage and subrogation recoverable, net	(226)	(215)
Net reserves (salvage)	<u>\$ 478</u>	<u>\$ 291</u>

(1) Recorded as a component of reinsurance balances payable.

The table below provides a reconciliation of net expected loss to be paid to net expected loss to be expensed. Expected loss to be paid differs from expected loss to be expensed due to: (i) the contra-paid which represents the claim payments made and recoveries received that have not yet been recognized in the statement of operations, (ii) salvage and subrogation recoverable for transactions that are in a net recovery position where the Company has not yet received recoveries on claims previously paid (and therefore recognized in income but not yet received), and (iii) loss reserves that have already been established (and therefore expensed but not yet paid).

Reconciliation of Net Expected Loss to be Paid and Net Expected Loss to be Expensed Financial Guaranty Insurance Contracts

	As of December 31, 2017
	(in millions)
Net expected loss to be paid - financial guaranty insurance (1)	618
Contra-paid, net	40
Salvage and subrogation recoverable, net of reinsurance	226
Loss and LAE reserve, net of reinsurance	(704)
Net expected loss to be expensed (present value) (2)	<u>\$ 180</u>

(1) See "Net Expected Loss to be Paid (Recovered) by Accounting Model" table in Note 5, Expected Loss to be Paid.

(2) Excludes \$48 million as of December 31, 2017, related to consolidated FG VIEs.

The following table provides a schedule of the expected timing of net expected losses to be expensed. The amount and timing of actual loss and LAE may differ from the estimates shown below due to factors such as accelerations, commutations, changes in expected lives and updates to loss estimates. This table excludes amounts related to FG VIEs, which are eliminated in consolidation.

**Net Expected Loss to be Expensed
Financial Guaranty Insurance Contracts**

	As of December 31, 2017
	(in millions)
2018 (January 1 - March 31)	\$ 3
2018 (April 1 - June 30)	3
2018 (July 1 - September 30)	5
2018 (October 1 - December 31)	5
Subtotal 2018	<u>16</u>
2019	21
2020	19
2021	16
2022	14
2023-2027	55
2028-2032	24
2033-2037	12
After 2037	<u>3</u>
Net expected loss to be expensed	180
Future accretion	<u>40</u>
Total expected future loss and LAE	<u><u>\$ 220</u></u>

The following table presents the loss and LAE recorded in the combined statements of operations by sector for insurance contracts. Amounts presented are net of reinsurance.

**Loss and LAE
Reported on the
Combined Statements of Operations**

	Year Ended December 31,	
	2017	2016
	(in millions)	
Public finance:		
U.S. public finance	\$ 270	\$ 191
Non-U.S. public finance	<u>(1)</u>	<u>(2)</u>
Public finance	<u>269</u>	<u>189</u>
Structured finance:		
U.S. RMBS	5	23
Other structured finance	<u>(9)</u>	<u>(6)</u>
Structured finance	<u>(4)</u>	<u>17</u>
Loss and LAE on insurance contracts before FG VIE consolidation	<u>265</u>	<u>206</u>
Gain (loss) related to FG VIE consolidation	<u>(8)</u>	<u>(8)</u>
Loss and LAE	<u><u>\$ 257</u></u>	<u><u>\$ 198</u></u>

The following table provides information on financial guaranty insurance contracts categorized as BIG.

**Financial Guaranty Insurance
BIG Transaction Loss Summary
As of December 31, 2017**

	BIG Categories								Effect of Consolidating VIEs	Total
	BIG 1		BIG 2		BIG 3		Total BIG, Net			
	Gross	Ceded	Gross	Ceded	Gross	Ceded				
	(dollars in millions)									
Number of risks(1)	65	(54)	7	(6)	51	(49)	123	—	123	
Remaining weighted-average contract period (in years)	9.1	8.0	11.6	5.0	9.0	10.2	9.3	—	9.3	
Outstanding exposure:										
Principal	\$ 3,712	\$ (867)	\$ 751	\$ (65)	\$ 4,517	\$ (1,139)	\$ 6,909	\$ —	\$ 6,909	
Interest	1,860	(351)	481	(24)	2,027	(544)	3,449	—	3,449	
Total(2)	<u>\$ 5,572</u>	<u>\$ (1,218)</u>	<u>\$ 1,232</u>	<u>\$ (89)</u>	<u>\$ 6,544</u>	<u>\$ (1,683)</u>	<u>\$ 10,358</u>	<u>\$ —</u>	<u>\$ 10,358</u>	
Expected cash outflows (inflows)	\$ 140	\$ (42)	\$ 325	\$ (16)	\$ 2,451	\$ (591)	\$ 2,267	\$ (258)	\$ 2,009	
Potential recoveries(3)	(255)	36	(64)	1	(1,692)	462	(1,512)	161	(1,351)	
Subtotal	(115)	(6)	261	(15)	759	(129)	755	(97)	658	
Discount	30	(3)	(73)	3	20	(36)	(59)	19	(40)	
Present value of expected cash flows	<u>\$ (85)</u>	<u>\$ (9)</u>	<u>\$ 188</u>	<u>\$ (12)</u>	<u>\$ 779</u>	<u>\$ (165)</u>	<u>\$ 696</u>	<u>\$ (78)</u>	<u>\$ 618</u>	
Deferred premium revenue	\$ 73	\$ (15)	\$ 88	\$ (4)	\$ 283	\$ (35)	\$ 390	\$ (69)	\$ 321	
Reserves (salvage)	\$ (110)	\$ (3)	\$ 160	\$ (10)	\$ 631	\$ (143)	\$ 525	\$ (47)	\$ 478	

**Financial Guaranty Insurance
BIG Transaction Loss Summary
As of December 31, 2016**

	BIG Categories						Total BIG, Net	Effect of Consolidating VIEs	Total
	BIG 1		BIG 2		BIG 3				
	Gross	Ceded	Gross	Ceded	Gross	Ceded			
	(dollars in millions)								
Number of risks(1)	57	(49)	13	(13)	51	(51)	121	—	121
Remaining weighted- average contract period (in years)	8.0	7.2	10.8	9.2	8.4	10.4	8.9	—	8.9
Outstanding exposure:									
Principal	\$ 2,878	\$ (965)	\$ 2,208	\$ (823)	\$ 3,525	\$ (957)	\$ 5,866	\$ —	\$ 5,866
Interest	1,279	(384)	1,230	(386)	1,467	(443)	2,763	—	2,763
Total(2)	<u>\$ 4,157</u>	<u>\$ (1,349)</u>	<u>\$ 3,438</u>	<u>\$ (1,209)</u>	<u>\$ 4,992</u>	<u>\$ (1,400)</u>	<u>\$ 8,629</u>	<u>\$ —</u>	<u>\$ 8,629</u>
Expected cash outflows (inflows)	\$ 108	\$ (40)	\$ 771	\$ (182)	\$ 1,316	\$ (413)	\$ 1,560	\$ (274)	\$ 1,286
Potential recoveries (3)	(286)	41	(111)	8	(633)	126	(855)	164	(691)
Subtotal	(178)	1	660	(174)	683	(287)	705	(110)	595
Discount	34	(7)	(175)	35	(166)	98	(181)	20	(161)
Present value of expected cash flows	<u>\$ (144)</u>	<u>\$ (6)</u>	<u>\$ 485</u>	<u>\$ (139)</u>	<u>\$ 517</u>	<u>\$ (189)</u>	<u>\$ 524</u>	<u>\$ (90)</u>	<u>\$ 434</u>
Deferred premium revenue	\$ 45	\$ (11)	\$ 68	\$ (14)	\$ 309	\$ (60)	\$ 337	\$ (82)	\$ 255
Reserves (salvage)	\$ (168)	\$ 3	\$ 439	\$ (128)	\$ 351	\$ (151)	\$ 346	\$ (55)	\$ 291

- (1) A risk represents the aggregate of the financial guaranty policies that share the same revenue source for purposes of making debt service payments. The ceded number of risks represents the number of risks for which the Company ceded a portion of its exposure.
- (2) Includes BIG amounts related to FG VIEs.
- (3) Includes excess spread and R&W receivables and payables.

Ratings Impact on Financial Guaranty Business

A downgrade of the Company may result in increased claims under financial guaranties issued by the Company, if the insured obligors were unable to pay.

For example, AGM has issued financial guaranty insurance policies in respect of the obligations of municipal obligors under interest rate swaps. AGM insures periodic payments owed by the municipal obligors to the bank counterparties. In certain cases, AGM also insures termination payments that may be owed by the municipal obligors to the bank counterparties. If (i) AGM has been downgraded below the rating trigger set forth in a swap under which it has insured the termination payment, which rating trigger varies on a transaction by transaction basis; (ii) the municipal obligor has the right to cure by, but has failed in, posting collateral, replacing AGM or otherwise curing the downgrade of AGM; (iii) the transaction documents include as a condition that an event of default or termination event with respect to the municipal obligor has occurred, such as the rating of the municipal obligor being downgraded past a specified level, and such condition has been met; (iv) the bank counterparty has elected to terminate the swap; (v) a termination payment is payable by the municipal obligor; and (vi) the municipal obligor has failed to make the termination payment payable by it, then AGM would be required to pay the termination payment due by the municipal obligor, in an amount not to exceed the policy limit set forth in the financial guaranty insurance policy. At AGM's current financial strength ratings, if the conditions giving rise to the obligation of AGM to make a termination payment under the swap termination policies were all satisfied, then AGM could pay claims in an amount not exceeding approximately \$133 million in respect of such termination payments. Taking into consideration whether the rating of the municipal obligor is below any applicable specified trigger, if the financial strength ratings of AGM were further downgraded below "A" by S&P or below "A2" by Moody's, and the conditions giving rise to the obligation of AGM to make a

payment under the swap policies were all satisfied, then AGM could pay claims in an additional amount not exceeding approximately \$260 million in respect of such termination payments.

As another example, with respect to variable rate demand obligations (VRDOs) for which a bank has agreed to provide a liquidity facility, a downgrade of AGM may provide the bank with the right to give notice to bondholders that the bank will terminate the liquidity facility, causing the bondholders to tender their bonds to the bank. Bonds held by the bank accrue interest at a “bank bond rate” that is higher than the rate otherwise borne by the bond (typically the prime rate plus 2.00% - 3.00%, and capped at the lesser of 25% and the maximum legal limit). In the event the bank holds such bonds for longer than a specified period of time, usually 90-180 days, the bank has the right to demand accelerated repayment of bond principal, usually through payment of equal installments over a period of not less than five years. In the event that a municipal obligor is unable to pay interest accruing at the bank bond rate or to pay principal during the shortened amortization period, a claim could be submitted to AGM under its financial guaranty policy. As of December 31, 2017, the Company had insured approximately \$3.0 billion net par of VRDOs, of which approximately \$38 million of net par constituted VRDOs issued by municipal obligors rated BBB- or lower pursuant to the Company’s internal rating. The specific terms relating to the rating levels that trigger the bank’s termination right, and whether it is triggered by a downgrade by one rating agency or a downgrade by all rating agencies then rating the insurer, vary depending on the transaction.

In addition, AGM may be required to pay claims in respect of AGMH’s former financial products business if Dexia SA and its affiliates, from which Assured Guaranty had purchased AGMH and its subsidiaries, do not comply with their obligations following a downgrade of the financial strength rating of AGM. A downgrade of the financial strength rating of AGM could trigger a payment obligation of AGM in respect to AGMH’s former guaranteed investment contracts (GIC) business. Most GICs insured by AGM allow for the termination of the GIC contract and a withdrawal of GIC funds at the option of the GIC holder in the event of a downgrade of AGM below a specified threshold, generally below A- by S&P or A3 by Moody’s. AGMH’s former subsidiary FSA Asset Management LLC is expected to have sufficient eligible and liquid assets to satisfy any expected withdrawal and collateral posting obligations resulting from future rating actions affecting AGM.

7. Fair Value Measurement

The Company carries a significant portion of its assets and liabilities at fair value. Fair value is defined as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date (i.e., exit price). The price represents the price available in the principal market for the asset or liability. If there is no principal market, then the price is based on a hypothetical market that maximizes the value received for an asset or minimizes the amount paid for a liability (i.e., the most advantageous market).

Fair value is based on quoted market prices, where available. If listed prices or quotes are not available, fair value is based on either internally developed models that primarily use, as inputs, market-based or independently sourced market parameters, including but not limited to yield curves, interest rates and debt prices or with the assistance of an independent third-party using a discounted cash flow approach and the third party’s proprietary pricing models. In addition to market information, models also incorporate transaction details, such as maturity of the instrument and contractual features designed to reduce the Company’s credit exposure, such as collateral rights as applicable.

Valuation adjustments may be made to ensure that financial instruments are recorded at fair value. These adjustments include amounts to reflect counterparty credit quality, the Company’s creditworthiness and constraints on liquidity. As markets and products develop and the pricing for certain products becomes more or less transparent, the Company may refine its methodologies and assumptions. During 2017, no changes were made to the Company’s valuation models that had, or are expected to have, a material impact on the Company’s balance sheets or statements of operations and comprehensive income.

The Company’s methods for calculating fair value produce a fair value that may not be indicative of net realizable value or reflective of future fair values. The use of different methodologies or assumptions to determine fair value of certain financial instruments could result in a different estimate of fair value at the reporting date.

The categorization within the fair value hierarchy is determined based on whether the inputs to valuation techniques used to measure fair value are observable or unobservable. Observable inputs reflect market data obtained from independent sources, while unobservable inputs reflect Company estimates of market assumptions. The fair value hierarchy prioritizes model inputs into three broad levels as follows, with Level 1 being the highest and Level 3 the lowest. An asset’s or liability’s categorization is based on the lowest level of significant input to its valuation.

Level 1—Quoted prices for identical instruments in active markets. The Company generally defines an active market as a market in which trading occurs at significant volumes. Active markets generally are more liquid and have a lower bid-ask spread than an inactive market.

Level 2—Quoted prices for similar instruments in active markets; quoted prices for identical or similar instruments in markets that are not active; and observable inputs other than quoted prices, such as interest rates or yield curves and other inputs derived from or corroborated by observable market inputs.

Level 3—Model derived valuations in which one or more significant inputs or significant value drivers are unobservable. Financial instruments are considered Level 3 when their values are determined using pricing models, discounted cash flow methodologies or similar techniques and at least one significant model assumption or input is unobservable. Level 3 financial instruments also include those for which the determination of fair value requires significant management judgment or estimation.

Transfers between Levels 1, 2 and 3 are recognized at the end of the period when the transfer occurs. The Company reviews the classification between Levels 1, 2 and 3 quarterly to determine whether a transfer is necessary. During the periods presented, there were no transfers between Levels 1, 2 and 3.

Measured and Carried at Fair Value

Fixed-Maturity Securities and Short-Term Investments

The fair value of bonds in the investment portfolio is generally based on prices received from third party pricing services or alternative pricing sources with reasonable levels of price transparency. The pricing services prepare estimates of fair value measurements using their pricing models, which take into account: benchmark yields, reported trades, broker/dealer quotes, issuer spreads, two-sided markets, benchmark securities, bids, offers, reference data, industry and economic events and sector groupings. Additional valuation factors that can be taken into account are nominal spreads and liquidity adjustments. The pricing services evaluate each asset class based on relevant market and credit information, perceived market movements, and sector news.

Benchmark yields have in many cases taken priority over reported trades for securities that trade less frequently or those that are distressed trades, and therefore may not be indicative of the market. The extent of the use of each input is dependent on the asset class and the market conditions. The valuation of fixed-maturity investments is more subjective when markets are less liquid due to the lack of market based inputs.

Short-term investments that are traded in active markets are classified within Level 1 in the fair value hierarchy and their value is based on quoted market prices. Securities such as discount notes are classified within Level 2 because these securities are typically not actively traded due to their approaching maturity and, as such, their cost approximates fair value.

Annually, the Company reviews each pricing service's procedures, controls and models, as well as the competency of the pricing service's key personnel. In addition, on a quarterly basis, the Company holds a meeting of the internal valuation committee (comprised of individuals within the Company with market, valuation, accounting, and/or finance experience) that reviews and approves prices and assumptions used by the pricing services.

The Company, on a quarterly basis:

- reviews methodologies for Level 3 securities, any model updates and inputs for Level 3 securities, and compares such information to management's own market information and, where applicable, the internal models,
- reviews internally developed analytic packages for all securities that highlight, at a CUSIP level, price changes from the previous quarter to the current quarter, and evaluates, documents, and resolves any significant pricing differences with the assistance of the third party pricing source, and
- compares prices received from different third party pricing sources for Level 3, and evaluates, documents the rationale for, and resolves any significant pricing differences for Level 3.

As of December 31, 2017, the Company used models to price 41 securities (primarily securities that were purchased or obtained for loss mitigation or other risk management purposes), which were 9% or \$526 million of the Company's fixed-

maturity securities and short-term investments at fair value. Most Level 3 securities were priced with the assistance of an independent third-party. The pricing is based on a discounted cash flow approach using the third-party's proprietary pricing models. The models use inputs such as projected prepayment speeds; severity assumptions; recovery lag assumptions; estimated default rates (determined on the basis of an analysis of collateral attributes, historical collateral performance, borrower profiles and other features relevant to the evaluation of collateral credit quality); home price appreciation/depreciation rates based on macroeconomic forecasts and recent trading activity. The yield used to discount the projected cash flows is determined by reviewing various attributes of the bond including collateral type, weighted average life, sensitivity to losses, vintage, and convexity, in conjunction with market data on comparable securities. Significant changes to any of these inputs could materially change the expected timing of cash flows within these securities which is a significant factor in determining the fair value of the securities.

Other Invested Assets

As of December 31, 2017 and December 31, 2016, other invested assets include investments carried and measured at fair value on a recurring basis of \$47 million and \$49 million, respectively, and include primarily an investment in the global property catastrophe risk market and an investment in a fund that invests primarily in senior loans and bonds. Fair values for the majority of these investments are based on their respective net asset value (NAV) per share or equivalent.

Other Assets

Committed Capital Securities (CCS)

The fair value of AGM Committed Preferred Trust Securities (the AGM CPS), which is recorded in "other assets" on the balance sheets, represents the difference between the present value of remaining expected put option premium payments under AGM CPS agreements, and the estimated present value that the Company would hypothetically have to pay currently for a comparable security (see Note 16, Notes Payable and Credit Facilities). The AGM CPS are carried at fair value with changes in fair value recorded in the statement of operations. The estimated current cost of the AGM CPS is based on several factors, including AGM CDS spreads, London Interbank Offered Rate (LIBOR) curve projections, Assured Guaranty's publicly traded debt and the term the securities are estimated to remain outstanding.

Contracts Accounted for as Credit Derivatives

The Company's credit derivatives consist primarily of insured CDS contracts, and also include interest rate swaps that fall under derivative accounting standards requiring fair value accounting through the statement of operations. The following is a description of the fair value methodology applied to the Company's insured CDS that are accounted for as credit derivatives, which constitute the vast majority of the net credit derivative liability in the balance sheets. The Company did not enter into CDS with the intent to trade these contracts and the Company may not unilaterally terminate a CDS contract absent an event of default or termination event that entitles the Company to terminate such contracts; however, the Company has mutually agreed with various counterparties to terminate certain CDS transactions. In transactions where the counterparty does not have the right to terminate, such transactions are generally terminated for an amount that approximates the present value of future premiums or for a negotiated amount, rather than at fair value.

The terms of the Company's CDS contracts differ from more standardized credit derivative contracts sold by companies outside the financial guaranty industry. The non-standard terms generally include the absence of collateral support agreements or immediate settlement provisions. In addition, the Company employs relatively high attachment points and does not exit derivatives it sells, except under specific circumstances such as mutual agreements with counterparties. Management considers the non-standard terms of its credit derivative contracts in determining the fair value of these contracts.

Due to the lack of quoted prices and other observable inputs for its instruments or for similar instruments, the Company determines the fair value of its credit derivative contracts primarily through internally developed, proprietary models that use both observable and unobservable market data inputs. There is no established market where financial guaranty insured credit derivatives are actively traded, therefore, management has determined that the exit market for the Company's credit derivatives is a hypothetical one based on its entry market. Management has tracked the historical pricing of the Company's transactions to establish historical price points in the hypothetical market that are used in the fair value calculation. These contracts are classified as Level 3 in the fair value hierarchy since there is reliance on at least one unobservable input deemed significant to the valuation model, most importantly the Company's estimate of the value of the non-standard terms and conditions of its credit derivative contracts and how the Company's own credit spread affects the pricing of its transactions.

The fair value of the Company's credit derivative contracts represents the difference between the present value of remaining premiums the Company expects to receive or pay and the estimated present value of premiums that a financial guarantor of comparable credit-worthiness would hypothetically charge or pay at the reporting date for the same protection. The fair value of the Company's credit derivatives depends on a number of factors, including notional amount of the contract, expected term, credit spreads, changes in interest rates, the credit ratings of referenced entities, the Company's own credit risk and remaining contractual cash flows. The expected remaining contractual premium cash flows are the most readily observable inputs since they are based on the CDS contractual terms. Credit spreads capture the effect of recovery rates and performance of underlying assets of these contracts, among other factors. Consistent with previous years, market conditions at December 31, 2017 were such that market prices of the Company's CDS contracts were not available.

Assumptions and Inputs

The various inputs and assumptions that are key to the establishment of the Company's fair value for CDS contracts are as follows: the gross spread, the allocation of gross spread among the bank profit, net spread and hedge cost, and the weighted average life which is based on debt service schedules. The Company obtains gross spreads on its outstanding contracts from market data sources published by third parties (e.g., dealer spread tables for the collateral similar to assets within the Company's transactions), as well as collateral-specific spreads provided by trustees or obtained from market sources. The bank profit represents the profit the originator, usually an investment bank, realizes for structuring and funding the transaction; the net spread represents the premiums paid to the Company for the Company's credit protection provided; and the hedge cost represents the cost of CDS protection purchased by the originator to hedge its counterparty credit risk exposure to the Company.

With respect to CDS transactions for which there is an expected claim payment within the next twelve months, the allocation of gross spread reflects a higher allocation to the cost of credit rather than the bank profit component. In the current market, it is assumed that a bank would be willing to accept a lower profit on distressed transactions in order to remove these transactions from its financial statements.

The following spread hierarchy is utilized in determining which source of gross spread to use. Market sources determine credit spreads by reviewing new issuance pricing for specific asset classes and receiving price quotes from their trading desks for the specific asset in question. Management validates these quotes by cross-referencing quotes received from one market source against quotes received from another market source to ensure reasonableness. In addition, the Company compares the relative change in price quotes received from one quarter to another, with the relative change experienced by published market indices for a specific asset class. Collateral specific spreads obtained from third-party, independent market sources are unpublished spread quotes from market participants or market traders who are not trustees. Management obtains this information as the result of direct communication with these sources as part of the valuation process.

- Actual collateral specific credit spreads (if up-to-date and reliable market-based spreads are available).
- Transactions priced or closed during a specific quarter within a specific asset class and specific rating. No transactions closed during the periods presented.
- Credit spreads interpolated based upon market indices adjusted to reflect the non-standard terms of the Company's CDS contracts.
- Credit spreads provided by the counterparty of the CDS.
- Credit spreads extrapolated based upon transactions of similar asset classes, similar ratings, and similar time to maturity.

The rates used to discount future expected premium cash flows ranged from 1.97% to 2.29% at December 31, 2017 and 1.00% to 2.08% at December 31, 2016.

The Company interpolates a curve based on the historical relationship between the premium the Company receives when a credit derivative is closed to the daily closing price of the market index related to the specific asset class and rating of the transaction. This curve indicates expected credit spreads at each indicative level on the related market index. For transactions with unique terms or characteristics where no price quotes are available, management extrapolates credit spreads based on a similar transaction for which the Company has received a spread quote from one of the first three sources within the Company's spread hierarchy. This alternative transaction will be within the same asset class, have similar underlying assets, similar credit ratings, and similar time to maturity. The Company then calculates the percentage of relative spread change

quarter over quarter for the alternative transaction. This percentage change is then applied to the historical credit spread of the transaction for which no price quote was received in order to calculate the transaction's current spread.

The premium the Company receives is referred to as the “net spread.” The Company’s pricing model takes into account not only how credit spreads on risks that it assumes affect pricing, but also how the Company’s own credit spread affects the pricing of its transactions. The Company’s own credit risk is factored into the determination of net spread based on the impact of changes in the quoted market price for credit protection bought on the Company, as reflected by quoted market prices on CDS referencing AGM. For credit spreads on the Company’s name the Company obtains the quoted price of CDS contracts traded on AGM from market data sources published by third parties. The cost to acquire CDS protection referencing AGM affects the amount of spread on CDS transactions that the Company retains and, hence, their fair value. As the cost to acquire CDS protection referencing AGM increases, the amount of premium the Company retains on a transaction generally decreases.

In the Company’s valuation model, the premium the Company captures is not permitted to go below the minimum rate that the Company would currently charge to assume similar risks. This assumption can have the effect of mitigating the amount of unrealized gains that are recognized on certain CDS contracts. Given the current market conditions and the Company’s own credit spreads, approximately 1%, and 8%, based on fair value, of the Company's CDS contracts are fair valued using this minimum premium as of December 31, 2017 and December 31, 2016, respectively. The percentage of transactions that price using the minimum premiums fluctuates due to changes in AGM's credit spreads. In general when AGM's credit spreads narrow, the cost to hedge AGM's name declines and more transactions price above previously established floor levels. Meanwhile, when AGM's credit spreads widen, the cost to hedge AGM's name increases causing more transactions to price at previously established floor levels. The Company corroborates the assumptions in its fair value model, including the portion of exposure to AGM hedged by its counterparties, with independent third parties each reporting period. The current level of AGM’s own credit spread has resulted in the bank or transaction originator hedging a significant portion of its exposure to AGM. This reduces the amount of contractual cash flows AGM can capture as premium for selling its protection.

The amount of premium a financial guaranty insurance market participant can demand is inversely related to the cost of credit protection on the insurance company as measured by market credit spreads assuming all other assumptions remain constant. This is because the buyers of credit protection typically hedge a portion of their risk to the financial guarantor, due to the fact that the contractual terms of the Company's contracts typically do not require the posting of collateral by the guarantor. The extent of the hedge depends on the types of instruments insured and the current market conditions.

A credit derivative liability on protection sold is the result of contractual cash inflows on in-force transactions that are less than what a hypothetical financial guarantor could receive if it sold protection on the same risk as of the reporting date. If the Company were able to freely exchange these contracts (i.e., assuming its contracts did not contain proscriptions on transfer and there was a viable exchange market), it would realize a loss representing the difference between the lower contractual premiums to which it is entitled and the current market premiums for a similar contract. The Company determines the fair value of its CDS contracts by applying the difference between the current net spread and the contractual net spread for the remaining duration of each contract to the notional value of its CDS contracts and taking the present value of such amounts discounted at the corresponding LIBOR over the weighted average remaining life of the contract.

Strengths and Weaknesses of Model

The Company's credit derivative valuation model, like any financial model, has certain strengths and weaknesses.

The primary strengths of the Company's CDS modeling techniques are:

- The model takes into account the transaction structure and the key drivers of market value.
- The model maximizes the use of market-driven inputs whenever they are available.
- The model is a consistent approach to valuing positions.

The primary weaknesses of the Company's CDS modeling techniques are:

- There is no exit market or any actual exit transactions, therefore, the Company’s exit market is a hypothetical one based on the Company’s entry market.

- There is a very limited market in which to validate the reasonableness of the fair values developed by the Company's model.
- The markets for the inputs to the model are highly illiquid, which impacts their reliability.
- Due to the non-standard terms under which the Company enters into derivative contracts, the fair value of its credit derivatives may not reflect the same prices observed in an actively traded market of credit derivatives that do not contain terms and conditions similar to those observed in the financial guaranty market.

Fair Value Option on FG VIEs' Assets and Liabilities

The Company elected the fair value option for all the FG VIEs' assets and liabilities and classifies them as Level 3 in the fair value hierarchy as the lowest level input that is significant to their fair value is unobservable. The prices are generally determined with the assistance of an independent third-party, based on a discounted cash flow approach. The FG VIEs issued securities collateralized by first lien and second lien RMBS as well as loans and receivables.

The fair value of the Company's FG VIE assets is generally sensitive to changes related to estimated prepayment speeds; estimated default rates (determined on the basis of an analysis of collateral attributes such as: historical collateral performance, borrower profiles and other features relevant to the evaluation of collateral credit quality); yields implied by market prices for similar securities; and house price depreciation/appreciation rates based on macroeconomic forecasts. Significant changes to some of these inputs could materially change the market value of the FG VIE's assets and the implied collateral losses within the transaction. In general, the fair value of the FG VIE assets is most sensitive to changes in the projected collateral losses, where an increase in collateral losses typically leads to a decrease in the fair value of FG VIE assets, while a decrease in collateral losses typically leads to an increase in the fair value of FG VIE assets. The third-party utilizes an internal model to determine an appropriate yield at which to discount the cash flows of the security, by factoring in collateral types, weighted-average lives, and other structural attributes specific to the security being priced. The expected yield is further calibrated by utilizing algorithms designed to aggregate market color, received by the independent third-party, on comparable bonds.

The models to price the FG VIEs' liabilities used, where appropriate, the same inputs used in determining fair value of FG VIE assets and, for those liabilities insured by the Company, the benefit from the Company's insurance policy guaranteeing the timely payment of principal and interest, taking into account the Company's own credit risk.

Significant changes to any of the inputs described above could materially change the timing of expected losses within the insured transaction which is a significant factor in determining the implied benefit from the Company's insurance policy guaranteeing the timely payment of principal and interest for the tranches of debt issued by the FG VIE that is insured by the Company. In general, extending the timing of expected loss payments by the Company into the future typically leads to a decrease in the value of the Company's insurance and a decrease in the fair value of the Company's FG VIE liabilities with recourse, while a shortening of the timing of expected loss payments by the Company typically leads to an increase in the value of the Company's insurance and an increase in the fair value of the Company's FG VIE liabilities with recourse.

Not Carried at Fair Value

Financial Guaranty Insurance Contracts

For financial guaranty insurance contracts that are acquired in a business combination, the Company measures each contract at fair value on the date of acquisition, and then follows insurance accounting guidance on a recurring basis thereafter. In addition, the Company discloses the fair value of its outstanding financial guaranty insurance contracts. In both cases, fair value is based on management's estimate of what a similarly rated financial guaranty insurance company would demand to acquire the Company's in-force book of financial guaranty insurance business. It is based on a variety of factors that may include pricing assumptions management has observed for portfolio transfers, commutations, and acquisitions that have occurred in the financial guaranty market, as well as prices observed in the credit derivative market with an adjustment for illiquidity so that the terms would be similar to a financial guaranty insurance contract, and includes adjustments to the carrying value of unearned premium reserve for stressed losses, ceding commissions and return on capital. The Company classified this fair value measurement as Level 3.

Other Invested Assets

The other invested assets not carried at fair value consisted primarily of a surplus note issued by AGC to AGM. The fair value of the surplus note was determined by calculating the effect of changes in U.S. Treasury yield adjusted for a credit factor at the end of each reporting period. The fair value measurement of the surplus note was classified as Level 3.

Other Assets and Other Liabilities

The Company's other assets and other liabilities consist predominantly of accrued interest, receivables for securities sold and payables for securities purchased, the carrying values of which approximate fair value.

The fair value of the notes payable, which are included in other liabilities, was determined by calculating the present value of the expected cash flows. The fair value measurement was classified as Level 3 in the fair value hierarchy.

Financial Instruments Carried at Fair Value

Amounts recorded at fair value in the Company's financial statements are presented in the tables below.

Fair Value Hierarchy of Financial Instruments Carried at Fair Value As of December 31, 2017

	Fair Value	Fair Value Hierarchy		
		Level 1	Level 2	Level 3
(in millions)				
Assets:				
Investment portfolio, available-for-sale:				
Fixed-maturity securities				
Obligations of state and political subdivisions	\$ 3,615	\$ —	\$ 3,594	\$ 21
U.S. government and agencies	25	—	25	—
Corporate securities	941	—	874	67
Mortgage-backed securities:				
RMBS	374	—	74	300
Commercial mortgage-backed securities (CMBS)	257	—	257	—
Asset-backed securities	142	—	4	138
Foreign government securities	305	—	305	—
Total fixed-maturity securities	5,659	—	5,133	526
Short-term investments	364	220	144	—
Other invested assets (1)	6	—	—	6
Credit derivative assets	1	—	—	1
FG VIEs' assets, at fair value	577	—	—	577
Other assets	29	—	—	29
Total assets carried at fair value	\$ 6,636	\$ 220	\$ 5,277	\$ 1,139
Liabilities:				
Credit derivative liabilities	\$ 49	\$ —	\$ —	\$ 49
FG VIEs' liabilities with recourse, at fair value	495	—	—	495
FG VIEs' liabilities without recourse, at fair value	128	—	—	128
Total liabilities carried at fair value	\$ 672	\$ —	\$ —	\$ 672

**Fair Value Hierarchy of Financial Instruments Carried at Fair Value
As of December 31, 2016**

	Fair Value	Fair Value Hierarchy		
		Level 1	Level 2	Level 3
(in millions)				
Assets:				
Investment portfolio, available-for-sale:				
Fixed-maturity securities				
Obligations of state and political subdivisions	\$ 3,615	\$ —	\$ 3,579	\$ 36
U.S. government and agencies	39	—	39	—
Corporate securities	621	—	561	60
Mortgage-backed securities:				—
RMBS	434	—	107	327
CMBS	259	—	259	—
Asset-backed securities	346	—	32	314
Foreign government securities	233	—	233	—
Total fixed-maturity securities	5,547	—	4,810	737
Short-term investments	165	154	11	—
Other invested assets (1)	5	—	—	5
Credit derivative assets	7	—	—	7
FG VIEs' assets, at fair value	644	—	—	644
Other assets	30	—	—	30
Total assets carried at fair value	\$ 6,398	\$ 154	\$ 4,821	\$ 1,423
Liabilities:				
Credit derivative liabilities	\$ 97	\$ —	\$ —	\$ 97
FG VIEs' liabilities with recourse, at fair value	602	—	—	602
FG VIEs' liabilities without recourse, at fair value	110	—	—	110
Total liabilities carried at fair value	\$ 809	\$ —	\$ —	\$ 809

- (1) Excluded from the table above are investments of \$45 million and \$48 million as of December 31, 2017 and December 31, 2016, respectively, measured using NAV per share. Includes Level 3 mortgage loans that are recorded at fair value on a non-recurring basis.

Changes in Level 3 Fair Value Measurements

The tables below present a roll forward of the Company's Level 3 financial instruments carried at fair value on a recurring basis during the years ended December 31, 2017 and 2016.

Fair Value Level 3 Rollforward Recurring Basis Year Ended December 31, 2017

	Fixed-Maturity Securities									
	Obligations of State and Political Subdivisions	Corporate Securities	RMBS	Asset- Backed Securities	FG VIEs' Assets at Fair Value	Other (7)	Credit Derivative Asset (Liability), net (5)	FG VIEs' Liabilities with Recourse, at Fair Value	FG VIEs' Liabilities without Recourse, at Fair Value	
	(in millions)									
Fair value as of December 31, 2016	\$ 36	\$ 60	\$ 327	\$ 314	\$ 644	\$ 31	\$ (90)	\$ (602)	\$ (110)	
AGLN Acquisition	—	—	—	7	—	—	—	—	—	
Total pretax realized and unrealized gains/(losses) recorded in:(1)										
Net income (loss)	(12) (2)	6 (2)	28 (2)	8 (2)	30 (3)	0 (4)	26 (6)	(11) (3)	(7) (3)	
Other comprehensive income (loss)	(1)	1	19	(5)	—	0	—	—	—	
Additional paid-in capital	—	—	—	13	—	—	—	—	—	
Purchases	—	—	42	79	—	—	—	—	—	
Settlements	(2)	—	(116)	(278)	(118)	—	16	118	10	
FG VIE consolidations	—	—	—	—	39	—	—	0	(39)	
FG VIE deconsolidations	—	—	—	—	(18)	—	—	0	18	
Fair value as of December 31, 2017	<u>\$ 21</u>	<u>\$ 67</u>	<u>\$ 300</u>	<u>\$ 138</u>	<u>\$ 577</u>	<u>\$ 31</u>	<u>\$ (48)</u>	<u>\$ (495)</u>	<u>\$ (128)</u>	
Change in unrealized gains/(losses) related to financial instruments held as of December 31, 2017	<u>\$ (1)</u>	<u>1</u>	<u>\$ 18</u>	<u>7</u>	<u>52 (3)</u>	<u>0 (4)</u>	<u>40 (6)</u>	<u>(8) (3)</u>	<u>(7) (3)</u>	

**Fair Value Level 3 Rollforward
Recurring Basis
Year Ended December 31, 2016**

	Fixed-Maturity Securities									
	Obligations of State and Political Subdivisions	Corporate Securities	RMBS	Asset- Backed Securities	Short-Term Investments	FG VIEs' Assets at Fair Value	Other (7)	Credit Derivative Asset (Liability), net (5)	FG VIEs' Liabilities with Recourse, at Fair Value	FG VIEs' Liabilities without Recourse, at Fair Value
	(in millions)									
Fair value as of December 31, 2015	\$ 8	\$ 71	\$ 324	\$ 343	\$ 60	\$ 735	\$ 30	\$ (91)	\$ (713)	\$ (121)
Total pretax realized and unrealized gains/(losses) recorded in:(1)										
Net income (loss)	2 (2)	(16) (2)	7 (2)	14 (2)	0 (2)	47 (3)	1 (4)	(17) (6)	(15) (3)	(18) (3)
Other comprehensive income (loss)	(4)	5	(10)	30	0	—	0	—	—	—
Purchases	31	—	66	4	—	—	—	—	—	—
Settlements	(1)	—	(60)	(77)	(60)	(118)	—	18	126	9
FG VIE deconsolidations	—	—	—	—	—	(20)	—	—	—	20
Fair value as of December 31, 2016	<u>\$ 36</u>	<u>\$ 60</u>	<u>\$ 327</u>	<u>\$ 314</u>	<u>\$ —</u>	<u>\$ 644</u>	<u>\$ 31</u>	<u>\$ (90)</u>	<u>\$ (602)</u>	<u>\$ (110)</u>
Change in unrealized gains/ (losses) related to financial instruments held as of December 31, 2016	<u>\$ (4)</u>	<u>\$ 5</u>	<u>\$ (12)</u>	<u>\$ 30</u>	<u>\$ —</u>	<u>\$ 82 (3)</u>	<u>\$ 1 (4)</u>	<u>\$ 43 (6)</u>	<u>\$ (14) (3)</u>	<u>\$ (18) (3)</u>

- (1) Realized and unrealized gains (losses) from changes in values of Level 3 financial instruments represent gains (losses) from changes in values of those financial instruments only for the periods in which the instruments were classified as Level 3.
- (2) Included in net realized investment gains (losses) and net investment income.
- (3) Included in fair value gains (losses) on FG VIEs.
- (4) Recorded in fair value gains (losses) on CCS, net investment income and other income.
- (5) Represents net position of credit derivatives. The balance sheet presents gross assets and liabilities based on net counterparty exposure.
- (6) Reported in net change in fair value of credit derivatives and other income.
- (7) Includes CCS and other invested assets.

Level 3 Fair Value Disclosures

Quantitative Information About Level 3 Fair Value Inputs At December 31, 2017

Financial Instrument Description (1)	Fair Value at December 31, 2017 (in millions)	Significant Unobservable Inputs	Range	Weighted Average as a Percentage of Current Par Outstanding
Assets (2):				
Fixed-maturity securities:				
Obligations of state and political subdivisions	\$ 21	Yield	4.5% - 39.5%	15.7%
Corporate securities	67	Yield	22.5%	
RMBS	300	CPR	3.5% - 13.0%	5.9%
		CDR	3.7% - 9.2%	6.1%
		Loss severity	55.0% - 100.0%	82.4%
		Yield	4.7% - 7.5%	5.4%
Asset-backed securities:				
Triple-X life insurance transactions	58	Yield	6.2% - 6.4%	6.3%
CLO	80	Yield	3.0% - 3.4%	3.2%
FG VIEs' assets, at fair value	577	CPR	3.0% - 14.9%	9.4%
		CDR	1.3% - 21.7%	5.5%
		Loss severity	60.0% - 100.0%	77.2%
		Yield	3.7% - 10.0%	6.2%
Other assets	29	Implied Yield	5.2%	
		Term (years)	10 years	
Liabilities:				
Credit derivative liabilities, net	(48)	Hedge cost (in bps)	20.5 - 61.5	25.5
		Bank profit (in bps)	16.5 - 366.9	90.1
		Internal floor (in bps)	10.0 - 30.0	10.9
		Internal credit rating	AA+ - BBB-	A-
FG VIEs' liabilities, at fair value	(623)	CPR	3.0% - 14.9%	9.4%
		CDR	1.3% - 21.7%	5.5%
		Loss severity	60.0% - 100.0%	77.2%
		Yield	3.4% - 10.0%	4.9%

(1) Discounted cash flow is used as valuation technique for all financial instruments.

(2) Excludes several investments recorded in other invested assets with fair value of \$6 million.

**Quantitative Information About Level 3 Fair Value Inputs
At December 31, 2016**

Financial Instrument Description (1)	Fair Value at December 31, 2016 (in millions)	Significant Unobservable Inputs	Range	Weighted Average as a Percentage of Current Par Outstanding
Assets (2):				
Fixed-maturity securities:				
Obligations of state and political subdivisions	\$ 36	Yield	4.3% - 22.8%	10.7%
Corporate securities	60	Yield	20.1%	
RMBS	327	CPR	2.1% - 8.5%	3.7%
		CDR	3.4% - 10.1%	7.0%
		Loss severity	60.0% - 100.0%	77.3%
		Yield	4.8% - 9.7%	5.8%
Asset-backed securities:				
Triple-X life insurance transactions	314	Yield	5.7% - 6.0%	5.7%
FG VIEs' assets, at fair value	644	CPR	3.5% - 12.0%	8.0%
		CDR	2.5% - 21.6%	5.9%
		Loss severity	50.0% - 100.0%	78.1%
		Yield	2.9% - 20.0%	6.8%
Other assets	30	Implied Yield	4.5%	
		Term (years)	10 years	
Liabilities:				
Credit derivative liabilities, net	(90)	Hedge cost (in bps)	7.2 - 118.1	10.0
		Bank profit (in bps)	3.9 - 655.6	26.2
		Internal floor (in bps)	7.0 - 100.0	10.7
		Internal credit rating	AAA - BB	AAA
FG VIEs' liabilities, at fair value	(712)	CPR	3.5% - 12.0%	8.0%
		CDR	2.5% - 21.6%	5.9%
		Loss severity	50.0% - 100.0%	78.1%
		Yield	2.4% - 20.0%	5.1%

(1) Discounted cash flow is used as valuation technique for all financial instruments.

(2) Excludes several investments recorded in other invested assets with fair value of \$5 million.

The carrying amount and estimated fair value of the Company's financial instruments are presented in the following table.

Fair Value of Financial Instruments

	As of December 31, 2017		As of December 31, 2016	
	Carrying Amount	Estimated Fair Value	Carrying Amount	Estimated Fair Value
	(in millions)			
Assets:				
Fixed-maturity securities	\$ 5,659	\$ 5,659	\$ 5,547	\$ 5,547
Short-term investments	364	364	165	165
Other invested assets	354	359	357	363
Credit derivative assets	1	1	7	7
FG VIEs' assets, at fair value	577	577	644	644
Other assets	88	88	85	85
Liabilities:				
Financial guaranty insurance contracts (1)	1,861	3,137	1,755	4,603
Credit derivative liabilities	49	49	97	97
FG VIEs' liabilities with recourse, at fair value	495	495	602	602
FG VIEs' liabilities without recourse, at fair value	128	128	110	110
Other liabilities	6	6	10	10

- (1) Carrying amount includes the assets and liabilities related to financial guaranty insurance contract premiums, losses, and salvage and subrogation and other recoverables net of reinsurance.

8. Contracts Accounted for as Credit Derivatives

The Company has a portfolio of financial guaranty contracts that meet the definition of a derivative in accordance with GAAP (primarily CDS). The credit derivative portfolio also includes interest rate swaps.

Credit derivative transactions are governed by ISDA documentation and have different characteristics from financial guaranty insurance contracts. For example, the Company's control rights with respect to a reference obligation under a credit derivative may be more limited than when the Company issues a financial guaranty insurance contract. In addition, there are more circumstances under which the Company may be obligated to make payments. Similar to a financial guaranty insurance contract, the Company would be obligated to pay if the obligor failed to make a scheduled payment of principal or interest in full. However, the Company may also be required to pay if the obligor becomes bankrupt or if the reference obligation were restructured if, after negotiation, those credit events are specified in the documentation for the credit derivative transactions. Furthermore, the Company may be required to make a payment due to an event that is unrelated to the performance of the obligation referenced in the credit derivative. If events of default or termination events specified in the credit derivative documentation were to occur, the non-defaulting or the non-affected party, which may be either the Company or the counterparty, depending upon the circumstances, may decide to terminate a credit derivative prior to maturity. In that case, the Company may be required to make a termination payment to its swap counterparty upon such termination. Absent such an event of default or termination event, the Company may not unilaterally terminate a CDS contract; however, the Company on occasion has mutually agreed with various counterparties to terminate certain CDS transactions.

Accounting Policy

Credit derivatives are recorded at fair value. Changes in fair value are recorded in "net change in fair value of credit derivatives" on the combined statement of operations. Realized gains (losses) and other settlements on credit derivatives include credit derivative premiums received and receivable for credit protection the Company has sold under its insured CDS contracts, premiums paid and payable for credit protection the Company has purchased, claims paid and payable and received and receivable related to insured credit events under these contracts, ceding commission expense or income and realized gains or losses related to their early termination. Fair value of credit derivatives is reflected as either net assets or net liabilities

determined on a contract by contract basis in the Company's combined balance sheets. See Note 7, Fair Value Measurement, for a discussion on the fair value methodology for credit derivatives.

Credit Derivative Net Par Outstanding by Sector

The estimated remaining weighted average life of credit derivatives was 6.7 years at December 31, 2017 and 1.8 years at December 31, 2016. The increase in the weighted average life of the credit derivative portfolio was primarily attributable to the run-off of short-dated pooled corporate obligations. The components of the Company's credit derivative net par outstanding are presented below.

Credit Derivatives

Asset Type	As of December 31, 2017		As of December 31, 2016	
	Net Par Outstanding	Weighted Average Credit Rating	Net Par Outstanding	Weighted Average Credit Rating
(dollars in millions)				
Pooled corporate obligations:				
Collateralized loan obligations (CLO)/ collateralized bond obligations (CBO)	\$ —	--	\$ 1,404	AAA
Synthetic investment grade pooled corporate	—	--	4,845	AAA
Total pooled corporate obligations	—	--	6,249	AAA
U.S. RMBS	25	AA	80	AA
Other(1)	1,099	A-	1,434	A-
Total	\$ 1,124	A-	\$ 7,763	AAA

- (1) This comprises numerous transactions across various asset classes, such as commercial receivables, international RMBS, municipal and regulated utilities and consumer receivables.

Distribution of Credit Derivative Net Par Outstanding by Internal Rating

Ratings	As of December 31, 2017		As of December 31, 2016	
	Net Par Outstanding	% of Total	Net Par Outstanding	% of Total
(dollars in millions)				
AAA	\$ —	—%	\$ 5,845	75.3%
AA	185	16.5	723	9.3
A	526	46.8	618	8.0
BBB	413	36.7	524	6.7
BIG	—	—	53	0.7
Credit derivative net par outstanding	\$ 1,124	100.0%	\$ 7,763	100.0%

Fair Value of Credit Derivatives

Net Change in Fair Value of Credit Derivative Gain (Loss)

	Year Ended December 31,	
	2017	2016
	(in millions)	
Realized gains on credit derivatives	\$ 10	\$ 18
Net credit derivative losses (paid and payable) recovered and recoverable and other settlements	(27)	(36)
Realized gains (losses) and other settlements	(17)	(18)
Net unrealized gains (losses):		
Pooled corporate obligations	(3)	11
U.S. RMBS	6	(1)
Other	40	41
Net unrealized gains (losses)	43	51
Net change in fair value of credit derivatives	\$ 26	\$ 33

Terminations and Settlements of Direct Credit Derivative Contracts

	Year Ended December 31,	
	2017	2016
	(in millions)	
Net par of terminated credit derivative contracts	\$ 38	\$ 1,086
Realized gains on credit derivatives	0	2
Net credit derivative losses (paid and payable) recovered and recoverable and other settlements	(13)	—
Net unrealized gains (losses) on credit derivatives	5	8

During 2017, unrealized fair value gains were generated primarily as a result of CDS terminations, run-off of net par outstanding, and price improvements on the underlying collateral of the Company's CDS. During the period the Company agreed to terminate several CDS transactions. This was the primary driver of the unrealized fair value gains in the U.S. RMBS sector. The cost to buy protection in AGM's name did not change materially during the period, and therefore did not have a material impact on the Company's unrealized fair value gains and losses on CDS.

During 2016, unrealized fair value gains were generated primarily as a result of CDS terminations in the pooled corporate and other sectors, run-off of CDS par and price improvements on the underlying collateral of the Company's CDS. The majority of the CDS transactions that were terminated were as a result of settlement agreements with several CDS counterparties. The unrealized fair value gains were partially offset by unrealized losses resulting from wider implied net spreads across all sectors. The wider implied net spreads were primarily a result of the decreased cost to buy protection in AGM's name, as the market cost of AGM's credit protection decreased significantly during the period. For those CDS transactions that were pricing at or above their floor levels, when the cost of purchasing CDS protection on AGM, which management refers to as the CDS spread on AGM, decreased the implied spreads that the Company would expect to receive on these transactions increased.

The impact of changes in credit spreads will vary based upon the volume, tenor, interest rates, and other market conditions at the time these fair values are determined. In addition, since each transaction has unique collateral and structural terms, the underlying change in fair value of each transaction may vary considerably. The fair value of credit derivative contracts also reflects the change in the Company's own credit cost based on the price to purchase credit protection on AGM. The Company determines its own credit risk based on quoted CDS prices traded on the Company at each balance sheet date.

CDS Spread on AGM
Quoted price of CDS contract (in basis points)

	As of December 31,		
	2017	2016	2015
Five-year CDS spread	145	158	366
One-year CDS spread	28	29	131

Fair Value of Credit Derivatives Assets (Liabilities)
and Effect of AGM Credit Spreads

	As of December 31, 2017	As of December 31, 2016
	(in millions)	
Fair value of credit derivatives before effect of AGM credit spread	\$ (51)	\$ (97)
Plus: Effect of AGM credit spread	3	7
Net fair value of credit derivatives	<u>\$ (48)</u>	<u>\$ (90)</u>

The fair value of CDS contracts at December 31, 2017, before considering the implications of AGM's credit spreads, is a direct result of continued wide credit spreads in the fixed income security markets and ratings downgrades. The asset classes that remain most affected are U.S. RMBS and regulated utility securities. The mark to market benefit between December 31, 2017 and December 31, 2016, resulted primarily from several CDS terminations, run-off of net par outstanding and a narrowing of credit spreads.

Management believes that the trading level of AGM's credit spreads over the past several years has been due to the correlation between AGM's risk profile and the current risk profile of the broader financial markets. Offsetting the benefit attributable to AGM's credit spread were higher credit spreads in the fixed income security markets. The higher credit spreads in the fixed income security market are due to the lack of liquidity.

Sensitivity to Changes in Credit Spread

The following table summarizes the estimated change in fair values on the net balance of the Company's credit derivative positions assuming immediate parallel shifts in credit spreads on AGM and on the risks that it assumes.

Effect of Changes in Credit Spread
As of December 31, 2017

Credit Spreads(1)	Estimated Net Fair Value (Pre-Tax)	Estimated Change in Gain/(Loss) (Pre-Tax)
	(in millions)	
100% widening in spreads	\$ (57)	\$ (9)
50% widening in spreads	(52)	(4)
25% widening in spreads	(50)	(2)
10% widening in spreads	(48)	0
Base Scenario	(48)	—
10% narrowing in spreads	(46)	2
25% narrowing in spreads	(45)	3
50% narrowing in spreads	(42)	6

(1) Includes the effects of spreads on both the underlying asset classes and the Company's own credit spread.

9. Consolidated Variable Interest Entities

The Company provides financial guaranties with respect to debt obligations of special purpose entities, including VIEs. AGM does not act as the servicer or collateral manager for any VIE obligations that it insures. The transaction structure generally provides certain financial protections to the Company. This financial protection can take several forms, the most common of which are overcollateralization, first loss protection (or subordination) and excess spread. In the case of overcollateralization (i.e., the principal amount of the securitized assets exceeds the principal amount of the structured finance obligations guaranteed by the Company), the structure allows defaults of the securitized assets before a default is experienced on the structured finance obligation guaranteed by the Company. In the case of first loss, the financial guaranty insurance policy only covers a senior layer of losses experienced by multiple obligations issued by special purpose entities, including VIEs. The first loss exposure with respect to the assets is either retained by the seller or sold off in the form of equity or mezzanine debt to other investors. In the case of excess spread, the financial assets contributed to special purpose entities, including VIEs, generate interest income that are in excess of the interest payments on the debt issued by the special purpose entity. Such excess spread is typically distributed through the transaction's cash flow waterfall and may be used to create additional credit enhancement, applied to redeem debt issued by the special purpose entities, including VIEs (thereby, creating additional overcollateralization), or distributed to equity or other investors in the transaction.

AGM is not primarily liable for the debt obligations issued by the VIEs it insures and would only be required to make payments on those insured debt obligations in the event that the issuer of such debt obligations defaults on any principal or interest due and only for the amount of the shortfall. AGM's creditors do not have any rights with regard to the collateral supporting the debt issued by the FG VIEs. Proceeds from sales, maturities, prepayments and interest from such underlying collateral may only be used to pay debt service on VIE liabilities. Net fair value gains and losses on FG VIEs are expected to reverse to zero at maturity of the VIE debt, except for net premiums received and net claims paid by AGM under the financial guaranty insurance contract. The Company's estimate of expected loss to be paid for FG VIEs is included in Note 5, Expected Loss to be Paid.

Accounting Policy

The Company evaluates whether it is the primary beneficiary of its VIEs. If the Company concludes that it is the primary beneficiary, it is required to consolidate the entire VIE in the Company's financial statements and eliminate the effects of the financial guaranty insurance contracts issued by AGM on the consolidated FG VIEs debt obligations.

The primary beneficiary of a VIE is the enterprise that has both 1) the power to direct the activities of a VIE that most significantly impact the entity's economic performance; and 2) the obligation to absorb losses of the entity that could potentially be significant to the VIE or the right to receive benefits from the entity that could potentially be significant to the VIE.

As part of the terms of its financial guaranty contracts, the Company, under its insurance contract, obtains certain protective rights with respect to the VIE that give the Company additional controls over a VIE. These protective rights are triggered by the occurrence of certain events, such as failure to be in compliance with a covenant due to poor deal performance or a deterioration in a servicer or collateral manager's financial condition. At deal inception, the Company typically is not deemed to control a VIE; however, once a trigger event occurs, the Company's control of the VIE typically increases. The Company continuously evaluates its power to direct the activities that most significantly impact the economic performance of VIEs that have debt obligations insured by the Company and, accordingly, where the Company is obligated to absorb VIE losses or receive benefits that could potentially be significant to the VIE. The Company is deemed to be the control party for certain VIEs under GAAP, typically when its protective rights give it the power to both terminate and replace the deal servicer, which are characteristics specific to the Company's financial guaranty contracts. If the protective rights that could make the Company the control party have not been triggered, then the VIE is not consolidated. If the Company is deemed no longer to have those protective rights, the VIE is deconsolidated.

The FG VIEs' liabilities that are insured by the Company are considered to be with recourse, because the Company guarantees the payment of principal and interest regardless of the performance of the related FG VIEs' assets. FG VIEs' liabilities that are not insured by the Company are considered to be without recourse, because the payment of principal and interest of these liabilities is wholly dependent on the performance of the FG VIEs' assets.

The Company has limited contractual rights to obtain the financial records of its consolidated FG VIEs. The FG VIEs do not prepare separate GAAP financial statements; therefore, the Company compiles GAAP financial information for them based on trustee reports prepared by and received from third parties. Such trustee reports are not available to the Company until approximately 30 days after the end of any given period. The time required to perform adequate reconciliations and analyses of

the information in these trustee reports results in a one quarter lag in reporting the FG VIEs' activities. The Company records the fair value of FG VIE assets and liabilities based on modeled prices. The Company updates the model assumptions each reporting period for the most recent available information, which incorporates the impact of material events that may have occurred since the quarter lag date. The net change in the fair value of consolidated FG VIE assets and liabilities is recorded in "fair value gains (losses) on FG VIEs" in the statements of operations. Interest income and interest expense are derived from the trustee reports and also included in "fair value gains (losses) on FG VIEs." The Company has elected the fair value option for assets and liabilities classified as FG VIEs' assets and liabilities because the carrying amount transition method was not practical.

The cash flows generated by the FG VIE assets, are classified as cash flows from investing activities. Paydowns of FG liabilities are supported by the cash flows generated by FG VIE assets, and for liabilities with recourse, possibly claim payments made by AGM under its financial guaranty insurance contracts. Paydowns of FG liabilities both with and without recourse are classified as cash flows used in financing activities by the Company. Interest income, interest expense and other expenses of the FG VIE assets and liabilities are classified as operating cash flows. Claim payments made by AGM under the financial guaranty contracts issued to the FG VIEs are eliminated upon consolidation and therefore such claim payments are treated as paydowns of FG VIE liabilities as a financing activity as opposed to an operating activity of AGM.

Consolidated FG VIEs

Number of FG VIEs Consolidated

	Year Ended December 31,	
	2017	2016
Beginning of the period, December 31	23	24
Consolidated	2	—
Deconsolidated	(1)	(1)
End of the period, December 31	24	23

The total unpaid principal balance for the FG VIEs' assets that were over 90 days or more past due was approximately \$84 million at December 31, 2017 and \$103 million at December 31, 2016. The aggregate unpaid principal of the FG VIEs' assets was approximately \$313 million greater than the aggregate fair value at December 31, 2017. The aggregate unpaid principal of the FG VIEs' assets was approximately \$360 million greater than the aggregate fair value at December 31, 2016.

The change in the instrument-specific credit risk of the FG VIEs' assets held as of December 31, 2017 that was recorded in the statements of operations for 2017 were gains of \$29 million. The change in the instrument-specific credit risk of the FG VIEs' assets held as of December 31, 2016 that was recorded in the statements of operations for 2016 were gains of \$45 million. To calculate the instrument specific credit risk, the changes in the fair value of the FG VIE assets are allocated between changes that are due to the instrument specific credit risk and changes due to other factors, including interest rates. The instrument specific credit risk amount is determined by using expected contractual cash flows versus current expected cash flows discounted at original contractual rate. The net present value is calculated by discounting the expected cash flows of the underlying security, at the relevant effective interest rate.

The unpaid principal for FG VIE liabilities with recourse, which represent obligations insured by AGM, was \$535 million and \$651 million as of December 31, 2017 and December 31, 2016, respectively. FG VIE liabilities with recourse will mature at various dates ranging from 2025 to 2038. The aggregate unpaid principal balance of the FG VIE liabilities with and without recourse was approximately \$64 million greater than the aggregate fair value of the FG VIEs' liabilities as of December 31, 2017. The aggregate unpaid principal balance was approximately \$80 million greater than the aggregate fair value of the FG VIEs' liabilities as of December 31, 2016.

The table below shows the carrying value of the consolidated FG VIEs' assets and liabilities in the financial statements, segregated by the types of assets that collateralize their respective debt obligations for FG VIE liabilities with recourse.

**Consolidated FG VIEs
By Type of Collateral**

	As of December 31, 2017		As of December 31, 2016	
	Assets	Liabilities	Assets	Liabilities
(in millions)				
With recourse:				
U.S. RMBS first lien	\$ 337	\$ 363	\$ 390	\$ 428
U.S. RMBS second lien	112	132	144	174
Total with recourse	449	495	534	602
Without recourse	128	128	110	110
Total	<u>\$ 577</u>	<u>\$ 623</u>	<u>\$ 644</u>	<u>\$ 712</u>

The consolidation of FG VIEs affects net income and shareholder's equity due to (i) changes in fair value gains (losses) on FG VIE assets and liabilities, (ii) the elimination of premiums and losses related to the FG VIE liabilities with recourse and (iii) the elimination of investment balances related to the Company's purchase of AGM insured FG VIE debt. Upon consolidation of a FG VIE, the related insurance and, if applicable, the related investment balances, are considered intercompany transactions and therefore eliminated. Such eliminations are included in the table below to present the full effect of consolidating FG VIEs.

**Effect of Consolidating FG VIEs on Net Income (Loss),
Cash Flows From Operating Activities and Shareholder's Equity**

	Year Ended December 31,	
	2017	2016
(in millions)		
Net earned premiums	\$ (13)	\$ (16)
Net investment income	(4)	(5)
Net realized investment gains (losses)	0	1
Fair value gains (losses) on FG VIEs	24	25
Loss and LAE	8	8
Effect on income before tax	15	13
Less: tax provision (benefit)	4	5
Effect on net income (loss)	<u>\$ 11</u>	<u>\$ 8</u>
Effect on cash flows from operating activities	<u>\$ 18</u>	<u>\$ 28</u>
	As of December 31, 2017	As of December 31, 2016
	(in millions)	
Effect on shareholder's equity (decrease) increase	<u>\$ 10</u>	<u>\$ (1)</u>

Fair value gains (losses) on FG VIEs represent the net change in fair value on the consolidated FG VIEs' assets and liabilities. In 2017, the Company recorded a pre-tax net fair value gain on consolidated FG VIEs of \$24 million. The primary driver of the 2017 gain in fair value of FG VIE assets and liabilities is price appreciation on the FG VIE assets resulting from improvement in the underlying collateral.

In 2016, the Company recorded a pre-tax net fair value gain on consolidated FG VIEs of \$25 million. The primary driver of the 2016 gain in fair value of FG VIE assets and liabilities was net mark-to-market gains due to price appreciation resulting from improvements in the underlying collateral of HELOC RMBS assets of the FG VIEs.

Non-Consolidated VIEs

As of December 31, 2017 and December 31, 2016, the Company had financial guaranty contracts outstanding for approximately 280 and 300 VIEs, respectively, that it did not consolidate, based on the Company's analyses which indicate that it is not the primary beneficiary of any other VIEs. The Company's exposure provided through its financial guaranties with respect to debt obligations of special purpose entities is included within net par outstanding in Note 4, Outstanding Exposure.

10. Investments and Cash

Accounting Policy

The vast majority of the Company's investment portfolio is composed of fixed-maturity and short-term investments, classified as available-for-sale at the time of purchase (approximately 94% based on fair value as of December 31, 2017), and therefore carried at fair value. Changes in fair value for other-than-temporarily-impaired (OTTI) securities are bifurcated between credit losses and non-credit changes in fair value. The credit loss on OTTI securities is recorded in the statement of operations and the non-credit component of the change in fair value of securities, whether OTTI or not, is recorded in OCI. For securities in an unrealized loss position where the Company has the intent to sell or it is more-likely-than-not that it will be required to sell the security before recovery, the entire impairment loss (i.e., the difference between the security's fair value and its amortized cost) is recorded in the combined statements of operations.

Credit losses reduce the amortized cost of impaired securities. The amortized cost basis is adjusted for accretion and amortization (using the effective interest method) with a corresponding entry recorded in net investment income.

Realized gains and losses on sales of investments are determined using the specific identification method. Realized loss includes amounts recorded for other-than-temporary impairments on debt securities and the declines in fair value of securities for which the Company has the intent to sell the security or inability to hold until recovery of amortized cost.

For mortgage-backed securities, and any other holdings for which there is prepayment risk, prepayment assumptions are evaluated and revised as necessary. Any necessary adjustments due to changes in effective yields and maturities are recognized in net investment income using the retrospective method.

Loss mitigation securities are generally purchased at a discount and are accounted for based on their underlying investment type, excluding the effects of the Company's insurance. Interest income on loss mitigation securities is recognized on a level yield basis over the remaining life of the security.

Short-term investments, which are those investments with a maturity of less than one year at time of purchase, are carried at fair value and include amounts deposited in money market funds.

Other invested assets primarily include:

- a surplus note issued by AGC to AGM (see Note 14, Related Party Transactions). The surplus note is being held to maturity,
- an investment in the limited partnership interest of a fund that invests in the equity of private equity managers and a minority interest in an independent investment advisory firm specializing in separately managed accounts, both of which are accounted for under the equity method, and
- preferred stocks, which are carried at fair value with changes in unrealized gains and losses recorded in OCI.

Cash consists of cash on hand and demand deposits. As a result of the lag in reporting FG VIEs, cash and short-term investments do not reflect cash outflow to the holders of the debt issued by the FG VIEs for claim payments made by the Company to the consolidated FG VIEs until the subsequent reporting period.

Assessment for Other-Than-Temporary Impairments

The Company has a formal review process to determine other-than-temporary-impairment for securities in its investment portfolio where there is no intent to sell and it is not more-likely-than-not that it will be required to sell the security before recovery. Factors considered when assessing impairment include:

- a decline in the market value of a security by 20% or more below amortized cost for a continuous period of at least six months;
- a decline in the market value of a security for a continuous period of 12 months;
- recent credit downgrades of the applicable security or the issuer by rating agencies;
- the financial condition of the applicable issuer;
- whether loss of investment principal is anticipated;
- the impact of foreign exchange rates; and
- whether scheduled interest payments are past due.

The Company assesses the ability to recover the amortized cost by comparing the net present value of projected future cash flows with the amortized cost of the security. If the security is in an unrealized loss position and its net present value is less than the amortized cost of the investment, an other-than-temporary impairment is recorded. The net present value is calculated by discounting the Company's estimate of projected future cash flows at the effective interest rate implicit in the debt security at the time of purchase. The Company's estimates of projected future cash flows are driven by assumptions regarding probability of default and estimates regarding timing and amount of recoveries associated with a default. The Company develops these estimates using information based on historical experience, credit analysis and market observable data, such as industry analyst reports and forecasts, sector credit ratings and other relevant data. For mortgage-backed and asset backed securities, cash flow estimates also include prepayment and other assumptions regarding the underlying collateral including default rates, recoveries and changes in value. The assumptions used in these projections require the use of significant management judgment.

The Company's assessment of a decline in value included management's current assessment of the factors noted above. The Company also seeks advice from its outside investment managers. If that assessment changes in the future, the Company may ultimately record a loss after having originally concluded that the decline in value was temporary.

Net Investment Income and Realized Gains (Losses)

Net investment income is a function of the yield that the Company earns on invested assets (which include a surplus note issued by AGC to the Company) and the size of the portfolio. The investment yield is a function of market interest rates at the time of investment as well as the type, credit quality and maturity of the invested assets. Accrued investment income, which is recorded in Other Assets, was \$59 million and \$57 million as of December 31, 2017 and December 31, 2016, respectively.

Net Investment Income

	Year Ended December 31,	
	2017	2016
	(in millions)	
Income from fixed-maturity securities managed by third parties	\$ 161	\$ 172
Income from internally managed securities:		
Fixed maturities	49	57
Other	17	18
Gross investment income	227	247
Investment expenses	(5)	(5)
Net investment income	<u>\$ 222</u>	<u>\$ 242</u>

Net Realized Investment Gains (Losses)

	Year Ended December 31,	
	2017	2016
	(in millions)	
Gross realized gains on available-for-sale securities	\$ 52	\$ 12
Gross realized losses on available-for-sale securities	(9)	(4)
Net realized gains (losses) on other invested assets	0	2
Other-than-temporary impairment	(37)	(45)
Net realized investment gains (losses)	<u>\$ 6</u>	<u>\$ (35)</u>

The following table presents the roll-forward of the credit losses of fixed-maturity securities for which the Company has recognized an other-than-temporary-impairment and where the portion of the fair value adjustment related to other factors was recognized in OCI.

Roll Forward of Credit Losses in the Investment Portfolio

	Year Ended December 31,	
	2017	2016
	(in millions)	
Balance, beginning of period	\$ 124	\$ 98
Additions for credit losses on securities for which an other-than-temporary-impairment was not previously recognized	13	3
Reductions for securities sold and other settlements	(4)	(4)
Additions for credit losses on securities for which an other-than-temporary-impairment was previously recognized	15	27
Balance, end of period	<u>\$ 148</u>	<u>\$ 124</u>

Investment Portfolio

**Fixed-Maturity Securities and Short-Term Investments
by Security Type
As of December 31, 2017**

Investment Category	Percent of Total (1)	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value	AOCI (2) Gain (Loss) on Securities with Other-Than- Temporary Impairment	Weighted Average Credit Rating (3)
(dollars in millions)							
Fixed-maturity securities:							
Obligations of state and political subdivisions	60%	\$ 3,473	\$ 149	\$ (7)	\$ 3,615	\$ (3)	AA
U.S. government and agencies	1	23	2	0	25	—	AA+
Corporate securities	16	916	40	(15)	941	(6)	A+
Mortgage-backed securities(4):							
RMBS	6	373	15	(14)	374	(1)	B+
CMBS	4	253	6	(2)	257	—	AAA
Asset-backed securities	2	126	16	0	142	9	BBB+
Foreign government securities	5	315	7	(17)	305	0	AA
Total fixed-maturity securities	94	5,479	235	(55)	5,659	(1)	AA-
Short-term investments	6	364	0	0	364	—	AAA
Total investment portfolio	100%	\$ 5,843	\$ 235	\$ (55)	\$ 6,023	\$ (1)	AA-

Fixed-Maturity Securities and Short-Term Investments
by Security Type
As of December 31, 2016

Investment Category	Percent of Total(1)	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value	AOCI (2) Gain (Loss) on Securities with Other-Than-Temporary Impairment	Weighted Average Credit Rating (3)
(dollars in millions)							
Fixed-maturity securities:							
Obligations of state and political subdivisions	62%	\$ 3,507	\$ 129	\$ (21)	\$ 3,615	\$ 1	AA
U.S. government and agencies	1	36	3	0	39	—	AA+
Corporate securities	11	633	12	(24)	621	(8)	BBB
Mortgage-backed securities(4):							
RMBS	8	452	12	(30)	434	(19)	BB
CMBS	4	254	7	(2)	259	—	AAA
Asset-backed securities	6	331	15	0	346	14	AA-
Foreign government securities	5	262	3	(32)	233	—	AA
Total fixed-maturity securities	97	5,475	181	(109)	5,547	(12)	A+
Short-term investments	3	165	0	0	165	—	AAA
Total investment portfolio	100%	\$ 5,640	\$ 181	\$ (109)	\$ 5,712	\$ (12)	A+

(1) Based on amortized cost.

(2) Also refer to Note 18, Other Comprehensive Income.

(3) Ratings in the tables above represent the lower of the Moody's and S&P Global Ratings, a division of Standard & Poor's Financial Services LLC (S&P) classifications except for bonds purchased for loss mitigation or risk management strategies, which use internal ratings classifications. The Company's portfolio consists primarily of high-quality, liquid instruments.

(4) Government-agency obligations were approximately 13% of mortgage backed securities as of December 31, 2017 and 17% as of December 31, 2016 based on fair value.

The Company's investment portfolio in tax-exempt and taxable municipal securities includes issuances by a wide number of municipal authorities across the U.S. and its territories.

The following tables present the fair value of the Company's available-for-sale portfolio of obligations of state and political subdivisions as of December 31, 2017 and December 31, 2016 by state.

**Fair Value of Available-for-Sale Portfolio of
Obligations of State and Political Subdivisions
As of December 31, 2017 (1)**

State	State General Obligation	Local General Obligation	Revenue Bonds	Fair Value	Amortized Cost	Average Credit Rating
(in millions)						
Fixed-maturity securities:						
New York	\$ 12	\$ 21	\$ 337	\$ 370	\$ 356	AA
Texas	4	120	207	331	319	AA
California	31	49	201	281	264	AA-
Washington	31	42	142	215	208	AA
Florida	6	12	185	203	193	AA-
Massachusetts	42	—	106	148	139	AA
Illinois	4	45	95	144	136	A
Michigan	—	—	98	98	93	A+
Ohio	16	13	66	95	93	AA
Georgia	—	8	85	93	87	A+
All others	117	149	688	954	925	AA-
Subtotal	<u>\$ 263</u>	<u>\$ 459</u>	<u>\$ 2,210</u>	<u>\$ 2,932</u>	<u>\$ 2,813</u>	AA-

**Fair Value of Available-for-Sale Portfolio of
Obligations of State and Political Subdivisions
As of December 31, 2016 (1)**

State	State General Obligation	Local General Obligation	Revenue Bonds	Fair Value	Amortized Cost	Average Credit Rating
(in millions)						
Fixed-maturity securities:						
New York	\$ 13	\$ 15	\$ 342	\$ 370	\$ 359	AA
Texas	4	95	206	305	297	AA
California	35	45	216	296	278	AA-
Florida	6	8	195	209	202	AA-
Washington	26	33	138	197	196	AA
Massachusetts	47	—	100	147	140	AA
Illinois	4	44	91	139	135	A
Michigan	—	—	95	95	92	A+
Georgia	—	7	87	94	90	A+
Ohio	16	7	60	83	82	AA-
All others	101	113	685	899	883	AA-
Subtotal	<u>\$ 252</u>	<u>\$ 367</u>	<u>\$ 2,215</u>	<u>\$ 2,834</u>	<u>\$ 2,754</u>	AA-

(1) Excludes \$683 million and \$781 million as of December 31, 2017 and 2016, respectively, of pre-refunded bonds, at fair value. The credit ratings are based on the underlying ratings and do not include any benefit from bond insurance.

The revenue bond portfolio is comprised primarily of essential service revenue bonds issued by transportation authorities and other utilities, water and sewer authorities, universities and healthcare providers.

**Revenue Bonds
Sources of Funds**

Type	As of December 31, 2017		As of December 31, 2016	
	Fair Value	Amortized Cost	Fair Value	Amortized Cost
(in millions)				
Fixed-maturity securities:				
Transportation	\$ 579	\$ 552	\$ 569	\$ 548
Water and sewer	415	397	331	322
Tax backed	363	345	377	367
Higher education	342	327	347	338
Municipal utilities	234	228	284	280
Healthcare	185	175	212	201
All others	92	90	95	94
Total	\$ 2,210	\$ 2,114	\$ 2,215	\$ 2,150

The following tables summarize, for all fixed-maturity securities in an unrealized loss position, the aggregate fair value and gross unrealized loss by length of time the amounts have continuously been in an unrealized loss position.

**Fixed-Maturity Securities
Gross Unrealized Loss by Length of Time
As of December 31, 2017**

	Less than 12 months		12 months or more		Total	
	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
(dollars in millions)						
Obligations of state and political subdivisions	\$ 96	\$ (2)	\$ 165	\$ (5)	\$ 261	\$ (7)
U.S. government and agencies	7	0	0	0	7	0
Corporate securities	47	0	167	(15)	214	(15)
Mortgage-backed securities:						
RMBS	123	(4)	111	(10)	234	(14)
CMBS	—	0	35	(2)	35	(2)
Asset-backed securities	9	0	—	—	9	0
Foreign government securities	19	0	140	(17)	159	(17)
Total	\$ 301	\$ (6)	\$ 618	\$ (49)	\$ 919	\$ (55)
Number of securities (1)		101		148		243
Number of securities with other-than-temporary impairment(1)		9		10		18

Fixed-Maturity Securities
Gross Unrealized Loss by Length of Time
As of December 31, 2016

	Less than 12 months		12 months or more		Total	
	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
	(dollars in millions)					
Obligations of state and political subdivisions	\$ 648	\$ (21)	\$ —	\$ —	\$ 648	\$ (21)
U.S. government and agencies	3	0	—	—	3	0
Corporate securities	93	(4)	118	(20)	211	(24)
Mortgage-backed securities:						
RMBS	189	(18)	86	(12)	275	(30)
CMBS	48	(2)	—	—	48	(2)
Asset-backed securities	1	0	—	—	1	0
Foreign government securities	45	(5)	113	(27)	158	(32)
Total	\$ 1,027	\$ (50)	\$ 317	\$ (59)	\$ 1,344	\$ (109)
Number of securities (1)		294		47		337
Number of securities with other-than-temporary impairment		5		7		12

- (1) The number of securities does not add across because lots consisting of the same securities have been purchased at different times and appear in both categories above (i.e., less than 12 months and 12 months or more). If a security appears in both categories, it is counted only once in the total column.

Of the securities in an unrealized loss position for 12 months or more as of December 31, 2017, 24 securities had unrealized losses greater than 10% of book value. The total unrealized loss for these securities as of December 31, 2017 was \$26 million. As of December 31, 2016, of the securities in an unrealized loss position for 12 months or more, 38 securities had unrealized losses greater than 10% of book value with an unrealized loss of \$56 million. The Company has determined that the unrealized losses recorded as of December 31, 2017 and December 31, 2016 were yield related and not the result of other-than-temporary-impairment.

The amortized cost and estimated fair value of available-for-sale fixed-maturity securities by contractual maturity as of December 31, 2017 are shown below. Expected maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

Distribution of Fixed-Maturity Securities
by Contractual Maturity
As of December 31, 2017

	Amortized Cost	Estimated Fair Value
	(in millions)	
Due within one year	\$ 152	\$ 154
Due after one year through five years	988	1,003
Due after five years through 10 years	1,248	1,292
Due after 10 years	2,465	2,579
Mortgage-backed securities:		
RMBS	373	374
CMBS	253	257
Total	\$ 5,479	\$ 5,659

Based on fair value, investments and restricted cash that are either held in trust for the benefit of third party ceding insurers in accordance with statutory requirements, placed on deposit to fulfill state licensing requirements, or otherwise restricted total \$10 million and \$16 million, as of December 31, 2017 and December 31, 2016, respectively. In addition, the total collateral required to be funded into a reinsurance trust account by AGM for the benefit of AGE as of December 31, 2017 and December 31, 2016 was approximately \$199 million and \$208 million, respectively, based on fair value.

No material investments of the Company were non-income producing for years ended December 31, 2017 and 2016, respectively.

Externally Managed Portfolio

As of December 31, 2017, the majority of the investment portfolio is managed by six outside managers (including Wasmer, Schroeder & Company LLC, in which the Company has a minority interest as indicated below), and a seventh outside manager was added in January 2018. The Company has established detailed guidelines regarding credit quality, exposure to a particular sector and exposure to a particular obligor within a sector. The Company's investment guidelines generally do not permit its outside managers to purchase securities rated lower than A- by S&P or A3 by Moody's, excluding a minimal allocation to corporate securities not rated lower than BBB by S&P or Baa2 by Moody's.

Internally Managed Portfolio

The investment portfolio tables shown above include both assets managed externally and internally. In the table below, more detailed information is provided for the component of the total investment portfolio that is internally managed (excluding short-term investments and surplus note from affiliate). The internally managed portfolio (other than short term investments and surplus note from affiliate) represents approximately 8% and 16% of the investment portfolio, on a fair value basis as of December 31, 2017 and December 31, 2016, respectively. The internally managed portfolio consists primarily of the Company's investments in securities for (i) loss mitigation purposes, (ii) other risk management purposes and (iii) where the Company believes a particular security presents an attractive investment opportunity.

One of the Company's strategies for mitigating losses has been to purchase loss mitigation securities, at discounted prices. In addition, the Company holds other invested assets that were obtained or purchased as part of negotiated settlements with insured counterparties or under the terms of the financial guaranties (other risk management assets).

Alternative investments include various funds investing in both equity and debt securities and catastrophe bonds as well as investments in investment managers. In February 2017 the Company agreed to purchase up to \$100 million of limited partnership interests in a fund that invests in the equity of private equity managers. Separately, in September 2017 the Company acquired a minority interest in Wasmer, Schroeder & Company LLC, an independent investment advisory firm specializing in separately managed accounts (SMAs).

Internally Managed Portfolio Carrying Value

	<u>As of</u> <u>December 31, 2017</u>	<u>As of</u> <u>December 31, 2016</u>
	(in millions)	
Assets purchased for loss mitigation and other risk management purposes:		
Fixed maturity securities, at fair value	\$ 458	\$ 897
Other invested assets	8	9
Alternative investments	69	48
Total	\$ 535	\$ 954

Cash and Restricted Cash

The following table provides a reconciliation of the cash reported on the balance sheets and the cash and restricted cash reported in the statements of cash flows.

Cash and Restricted Cash

	As of December 31,		
	2017	2016	2015
		(in millions)	
Cash	\$ 36	\$ 32	\$ 23
Restricted cash (1)	—	8	—
Total cash and restricted cash	\$ 36	\$ 40	\$ 23

(1) Amounts relate to cash held in trust accounts and are reported in other assets in the balance sheets. See Note 13, Reinsurance and Other Monoline Exposures, for more information.

11. Insurance Company Regulatory Requirements

Basis of Regulatory Financial Reporting

United States

AGM's and MAC's ability to pay dividends depends, among other things, upon their financial condition, results of operations, cash requirements, compliance with rating agency requirements, and is also subject to restrictions contained in the insurance laws and related regulations of their state of domicile and other states. Financial statements prepared in accordance with accounting practices prescribed or permitted by local insurance regulatory authorities differ in certain respects from GAAP.

AGM and MAC prepare statutory financial statements in accordance with accounting practices prescribed or permitted by the National Association of Insurance Commissioners (NAIC) and NYDFS. Prescribed statutory accounting practices are set forth in the NAIC Accounting Practices and Procedures Manual. AGM and MAC have no permitted accounting practices on a statutory basis.

GAAP differs in certain significant respects from U.S. insurance companies' statutory accounting practices prescribed or permitted by insurance regulatory authorities. The principal differences result from the following statutory accounting practices:

- upfront premiums are earned when related principal and interest have expired rather than earned over the expected period of coverage;
- acquisition costs are charged to expense as incurred rather than over the period that related premiums are earned;
- a contingency reserve is computed based on statutory requirements, whereas no such reserve is required under GAAP;
- certain assets designated as “non-admitted assets” are charged directly to statutory surplus, rather than reflected as assets under GAAP;
- investments in subsidiaries are carried on the balance sheet on the equity basis, to the extent admissible, rather than consolidated with the parent;
- the amount of deferred tax assets that may be admitted is subject to an adjusted surplus threshold and is generally limited to the lesser of those assets the Company expects to realize within three years of the balance sheet date or fifteen percent of the Company's adjusted surplus. This realization period and surplus percentage is subject to change based on the amount of adjusted surplus. Under GAAP there is no non-admitted asset determination,

rather a valuation allowance is recorded to reduce the deferred tax asset to an amount that is more likely than not to be realized;

- insured credit derivatives are accounted for as insurance contracts rather than as derivative contracts measured at fair value;
- bonds are generally carried at amortized cost rather than fair value;
- insured obligations of VIEs and refinancing vehicles debt, where the Company is deemed the primary beneficiary, are accounted for as insurance contracts. Under GAAP, such VIEs and refinancing vehicles are consolidated and any transactions with the Company are eliminated;
- surplus notes are recognized as surplus and each payment of principal and interest is recorded only upon approval of the insurance regulator rather than liabilities with periodic accrual of interest;
- acquisitions are accounted for as either statutory purchases or statutory mergers, rather than the purchase method under GAAP;
- losses are discounted at the tax equivalent yield of the Company's investment portfolio, recorded when the loss is deemed probable and without consideration of the deferred premium revenue. Under GAAP, expected losses are discounted at the risk free rate at the end of each reporting period and are recorded only to the extent they exceed deferred premium revenue;
- the present value of installment premiums and commissions are not recorded on the balance sheet as they are under GAAP; and
- mergers of acquired companies are treated as statutory mergers at historical balances and financial statements are retroactively revised assuming the merger occurred at the beginning of the prior year, rather than prospectively beginning with the date of acquisition at fair value under GAAP.

Contingency Reserves

From time to time, AGM has obtained approval to release contingency reserves based on losses or because the accumulated reserve is deemed excessive in relation to the insurer's outstanding insured obligations. In 2017, on the latter basis, AGM obtained the NYDFS's approval for a contingency reserve release of approximately \$246 million. In 2016, AGM obtained the NYDFS's approval for a contingency reserve release of approximately \$175 million. In addition, MAC also released approximately \$62 million and \$53 million of contingency reserves in 2017 and 2016, respectively, which consisted of the assumed contingency reserves maintained by MAC, as reinsurer of AGM, in respect of the same obligations that were the subject of AGM's \$246 million and \$175 million releases in 2017 and 2016, respectively.

With respect to the regular, quarterly contributions to contingency reserves required by New York laws and regulations, such laws and regulations permit the discontinuation of such quarterly contributions to a company's contingency reserves when such company's aggregate contingency reserves for a particular line of business (i.e., municipal or non-municipal) exceed the sum of the company's outstanding principal for each specified category of obligations within the particular line of business multiplied by the specified contingency reserve factor for each such category. In accordance with such laws and regulations, and with the approval of the NYDFS, AGM ceased making quarterly contributions to its contingency reserves for non-municipal business, beginning in the fourth quarter of 2014. Such cessations are expected to continue for as long as AGM satisfies the foregoing condition for its applicable line of business.

The following table summarizes the equity and income amounts reported to local regulatory bodies in the U.S. by AGM and its indirect subsidiary, MAC. The discussion that follows describes the basis of accounting and differences to U.S. GAAP.

Insurance Regulatory Amounts Reported

	Policyholders' Surplus		Net Income	
	As of December 31,		Year Ended December 31,	
	2017	2016	2017	2016
	(in millions)			
U.S. statutory companies:				
AGM(1) (2)	\$ 2,254	\$ 2,321	\$ 152	\$ 191
MAC	270	487	32	142

- (1) Policyholders' surplus of AGM includes its indirect ownership share of MAC. AGM owns approximately 61% of the outstanding stock of MAC Holdings, which owns 100% of the outstanding common stock of MAC.
- (2) The acquisition of the European Subsidiaries was accounted for as a statutory purchase, which does not require a combined presentation for prior year amounts.

United Kingdom

AGE prepares its solvency and condition report based on PRA and Solvency II Regulations (Solvency II). AGE adopted the full framework required by Solvency II on January 1, 2016, which is the date they became effective. In calculating its Own Funds (regulatory capital resources under Solvency II), AGE starts with its UK GAAP Balance Sheet and makes the adjustments required by Solvency II. The significant adjustments relate to reinsurance recoverable, future premiums and reinsurance commissions receivable, provision for unearned premiums and unexpired risks provisions, technical provision, future reinsurance premiums payable, and reinsurance commissions deferred. As of December 31, 2017 and December 31, 2016, AGE's Own Funds were in excess of its Solvency Capital Requirement.

Dividend Restrictions and Capital Requirements

Dividends and Return of Capital By Insurance Company

	Year Ended December 31,	
	2017	2016
	(in millions)	
Dividends paid by AGM to AGMH	\$ 196	\$ 247
Dividends paid by MAC to MAC Holdings (1)	36	—
Repurchase of common stock by AGM from AGMH (2)	101	300
Repurchase of common stock by MAC from MAC Holdings (1)	250	—
Repayment of surplus note by MAC to AGM	—	100
Repayment of surplus note by MAC to MAC Holdings (1)	—	300

- (1) MAC Holdings distributed nearly the entire amounts to AGM and AGC, in proportion to their ownership percentages.
- (2) Represents repurchase of 42 and 125 of AGM's shares in 2017 and 2016, respectively. Pursuant to AGM's Charter, the par value of AGM's remaining shares of common stock issued and outstanding increased automatically in order to maintain MAC's total paid-in capital at \$15 million.

United States

Under New York insurance law, AGM and MAC may only pay dividends out of "earned surplus," which is the portion of the company's surplus that represents the net earnings, gains or profits (after deduction of all losses) that have not been distributed to shareholders as dividends, transferred to stated capital or capital surplus, or applied to other purposes permitted by law, but does not include unrealized appreciation of assets. AGM and MAC may each pay dividends without the prior

approval of the New York Superintendent of Financial Services (New York Superintendent) that, together with all dividends declared or distributed by it during the preceding 12 months, do not exceed the lesser of 10% of its policyholders' surplus (as of its last annual or quarterly statement filed with the New York Superintendent) or 100% of its adjusted net investment income during that period.

The maximum amount available during 2018 for AGM to distribute as dividends without regulatory approval is estimated to be approximately \$190 million. Of such \$190 million, approximately \$73 million is available for distribution in the first quarter of 2018. The maximum amount available during 2018 for MAC to distribute as dividends to MAC Holdings, which is owned by AGM and AGC, without regulatory approval is estimated to be approximately \$27 million, of which approximately \$3 million is available for distribution in the first quarter of 2018.

United Kingdom

U.K. company law prohibits each of AGE, AGLN and AGUK from declaring a dividend to its shareholders unless it has "profits available for distribution." The determination of whether a company has profits available for distribution is based on its accumulated realized profits less its accumulated realized losses. While the U.K. insurance regulatory laws impose no statutory restrictions on a general insurer's ability to declare a dividend, the PRA's capital requirements may in practice act as a restriction on dividends. In addition, AGLN currently must confirm that the PRA does not object to the payment of any dividend to its parent company before AGLN makes any dividend payment.

12. Income Taxes

Accounting Policy

The provision for income taxes consists of an amount for taxes currently payable and an amount for deferred taxes. Deferred income taxes are provided for temporary differences between the financial statement carrying amounts and tax bases of assets and liabilities, using enacted rates in effect for the year in which the differences are expected to reverse. A valuation allowance is recorded to reduce the deferred tax asset to an amount that is more likely than not to be realized.

Non-interest-bearing tax and loss bonds are purchased in the amount of the tax benefit that results from deducting contingency reserves as provided under Internal Revenue Code Section 832(e). The Company records the purchase of tax and loss bonds in deferred taxes.

The Company recognizes tax benefits only if a tax position is "more likely than not" to prevail.

Overview

The Company files its U.S. federal tax return as a part of the consolidated group for AGUS, an indirect parent holding company. Each member of the AGUS consolidated tax group is part of a tax sharing agreement and pays or receives its proportionate share of the consolidated regular federal tax liability for the group as if each company filed on a separate return basis. On June 26, 2017, AGM purchased the European Subsidiaries, from AGC; see Note 1, Business and Basis of Presentation and Note 2, Common Control Acquisition for additional information.

For the year ending December 31, 2017, AGM is taxed at the U.S. corporate income tax rate of 35% and its foreign subsidiaries, AGE, AGUK and AGLN, are taxed at the blended marginal corporate tax rate of 19.25% in U.K. and CIFGE is taxed at 33.33% in France. For periods subsequent to April 1, 2017, the U.K. tax rate has been reduced to 19%. For the periods between April 1, 2015 and March 31, 2017 the U.K. corporation tax rate was 20%. AGE, the Company's U.K. subsidiary, had previously elected under U.S. Internal Revenue Code Section 953(d) to be taxed as a U.S. company. In January 2017, AGE filed a request with the U.S. Internal Revenue Service (IRS) to revoke the election, which was approved in May 2017. As a result of the revocation of the Section 953(d) election, AGE will no longer be liable to pay future U.S. taxes beginning in 2017.

Effect of the Tax Act

On December 22, 2017, the Tax Act was signed into law. The Tax Act changed many items of U.S. corporate income taxation, including a reduction of the corporate income tax rate from 35% to 21%, implementation of a territorial tax system and imposition of a tax on deemed repatriated earnings of non-U.S. subsidiaries. At December 31, 2017, the Company had not completed accounting for the tax effects of the Tax Act; however, the Company made a reasonable estimate of the effects on the existing deferred tax balances and the one-time transition tax. The Company recognized a provisional amount of \$44 million, which is included as a component of income tax expense from continuing operations. The Company will continue to assess its provision for income taxes as future guidance is issued. Any adjustments, if necessary, during the measurement period guidance outlined in Staff Accounting Bulletin No. 118 will be included in net earnings from continuing operations as an adjustment to income tax expense in the reporting period when such adjustments are determined.

Provisional Amounts

Deferred Tax Assets and Liabilities

The Company remeasured certain deferred tax assets and liabilities based on the rates at which they are expected to reverse in the future, which is generally 21%. However, the Company is still analyzing certain aspects of the Tax Act and refining its calculations, which could potentially affect the measurement of these balances or potentially give rise to new deferred tax amounts. The provisional amount recorded related to the remeasurement of its deferred tax balance was \$16 million.

Foreign Tax Effects

The one-time transition tax is based on total post-1986 earnings and profits (E&P) for which the Company had previously deferred U.S. income taxes. The Company recorded a provisional amount for its one-time transition tax liability on non-U.S. subsidiaries less realizable foreign tax credits (FTCs) and a write off of deferred tax liabilities on unremitted earnings, resulting in an increase in income tax expense of \$28 million. The Company has not yet completed its calculation of the total post-1986 foreign E&P for these non-U.S. subsidiaries. Further, the transition tax is based in part on the amount of those earnings held in cash and other specified assets. This amount may change when the Company finalizes the calculation of post-1986 foreign E&P previously deferred from U.S. federal taxation.

The table below summarizes the impact of the Tax Act on the statements of operations.

Summary of the Tax Act Effect

	Year Ended December 31, 2017
	(in millions)
Transition tax	\$ 91
Foreign tax credit realized	(25)
Write down of unremitted earnings	(38)
Net impact of repatriation	28
Write down of deferred tax asset due to tax rate change	16
Net impact of Tax Act	<u>\$ 44</u>

Provision for Income Taxes

The effective tax rates reflect the proportion of income recognized by AGM and its insurance subsidiaries, with U.S. subsidiaries taxed at the U.S. marginal corporate income tax rate of 35%, and U.K. subsidiaries taxed at the U.K. blended marginal corporate tax rate of 19.25% unless taxed as a U.S. controlled foreign corporation. For periods subsequent to April 1, 2017, the U.K. corporation tax rate has been reduced to 19%. For the periods between April 1, 2015 and March 31, 2017, the U.K. corporation tax rate was 20%. The Company's overall effective tax rate fluctuates based on the distribution of income across jurisdictions.

A reconciliation of the difference between the provision for income taxes and the expected tax provision at statutory rates in taxable jurisdictions is presented below.

Effective Tax Rate Reconciliation

	Year Ended December 31,	
	2017	2016
	(in millions)	
Expected tax provision (benefit) at statutory rate	\$ 225	\$ 149
Tax-exempt interest	(33)	(37)
Change in liability for uncertain tax positions	(4)	6
Effect of provision to tax return filing adjustments	(6)	(4)
Effect of Tax Act	44	—
Other	(9)	(5)
Total provision (benefit) for income taxes	<u>\$ 217</u>	<u>\$ 109</u>
Effective tax rate	33.7%	25.6%

The change in liability for uncertain tax positions for 2017 is driven by the closure of the 2009 - 2012 IRS Audit, see "Audits" below for further discussion.

The expected tax provision at statutory rates in taxable jurisdictions is calculated as the sum of pretax income in each jurisdiction multiplied by the statutory tax rate of the jurisdiction by which it will be taxed. Pretax income of the Company's subsidiaries which are not U.S. or U.K. domiciled but are subject to U.S. as controlled foreign corporations, are included at the U.S. or U.K. statutory tax rate. Where there is a pretax loss in one jurisdiction and pretax income in another, the total combined expected tax rate may be higher or lower than any of the individual statutory rates.

Components of Net Deferred Tax Assets

	As of December 31,	
	2017	2016
	(in millions)	
Deferred tax assets:		
Unrealized losses on credit derivative financial instruments, net	\$ 1	\$ 25
Unearned premium reserves, net	50	50
Loss and LAE reserve	1	66
Tax and loss bonds	—	50
Foreign tax credit	31	—
Deferred ceding commission	—	27
Investment basis difference	46	48
Deferred compensation	1	13
FG VIE	9	23
Other	2	6
Total deferred income tax assets	<u>141</u>	<u>308</u>
Deferred tax liabilities:		
Contingency reserves	—	82
Unrealized appreciation on investments	35	23
Unrealized appreciation on committed capital securities	6	10
Market discount	26	14
Deferred ceding commission	12	—
Deferred balances related to non-U.S. affiliates	16	7
Other	4	6
Total deferred income tax liabilities	<u>99</u>	<u>142</u>
Less: Valuation allowance	31	—
Net deferred income tax asset	<u>\$ 11</u>	<u>\$ 166</u>

During 2017 the Company generated \$31 million of FTC to carry forward as a result of the Tax Act's deemed repatriation of previously untaxed unremitted foreign earnings. The Company has established a full valuation allowance against the entire FTC balance. See the valuation allowance discussion below.

Valuation Allowance

The Company has \$31 million of FTC due to the Tax Act for use against regular tax in future years. FTCs will expire by 2027. In analyzing the future realizability of FTCs, the Company notes limitations on future foreign source income due to overall foreign losses as negative evidence. After reviewing positive and negative evidence, the Company came to the conclusion that it is more likely than not that the FTC will not be utilized, and therefore, recorded a valuation allowance with respect to this tax attribute.

The Company came to the conclusion that it is more likely than not that the remaining net deferred tax asset will be fully realized after weighing all positive and negative evidence available as required under GAAP. The positive evidence that was considered included the cumulative income the Company has earned over the last three years, and the significant unearned premium income to be included in taxable income. The positive evidence outweighs any negative evidence that exists. As such, the Company believes that no valuation allowance is necessary in connection with this deferred tax asset. The Company will continue to analyze the need for a valuation allowance on a quarterly basis.

Audits

As of December 31, 2017, AGUS had open tax years with the IRS for 2013 to present. In December 2016, the IRS issued a Revenue Agent Report (RAR) which did not identify any material adjustments that were not already accounted for in the prior periods. In April 2017, AGUS received a final letter from the IRS to close the audit for tax years 2009-2012 with no additional findings or changes, and as a result the Company released previously recorded uncertain tax position reserves and accrued interest of approximately \$11.5 million in the second quarter of 2017. The Company's U.K. subsidiaries are not currently under examination and have open tax years of 2015 forward. The Company's French subsidiary, CIFGE, is under examination for the period January 1, 2015 through December 31, 2016, and has open tax years of 2014 to present.

Uncertain Tax Positions

The following table provides a reconciliation of the beginning and ending balances of the total liability for unrecognized tax positions.

	2017	2016
	(in millions)	
Balance as of January 1,	\$ 23	\$ 18
Effect of provision to tax return filing adjustments	7	3
Increase in unrecognized tax positions as a result of position taken during the current year	0	2
Decrease in unrecognized tax positions as a result of settlement of positions taken during the prior period	(9)	—
Balance as of December 31,	<u>\$ 21</u>	<u>\$ 23</u>

The Company's policy is to recognize interest related to uncertain tax positions in income tax expense and has accrued \$1 million for 2017 and \$0.8 million for 2016. As of December 31, 2017 and December 31, 2016, the Company has accrued \$2.5 million and \$3.6 million of interest, respectively.

The total amount of reserves for unrecognized tax positions, including accrued interest, as of December 31, 2017 would affect the effective tax rate, if recognized. The reduction in reserves is driven by the closure of the 2009- 2012 IRS Audit.

13. Reinsurance and Other Monoline Exposures

The Company assumes exposure (Assumed Business) and may cede portions of exposure it has insured (Ceded Business) in exchange for premiums, net of ceding commissions. The Company historically entered into ceded reinsurance contracts in order to obtain greater business diversification and reduce the net potential loss from large risks. More recently, the Company has commuted several of those previously ceded portfolios.

Accounting Policy

For business assumed and ceded, the accounting model of the underlying direct financial guaranty contract dictates the accounting model used for the reinsurance contract (except for those eliminated as FG VIEs). For any assumed or ceded financial guaranty insurance premiums and losses, the accounting models described in Note 6, Contracts Accounted for as Insurance are followed. For any ceded credit derivative contracts, the accounting model in Note 8, Contracts Accounted for as Credit Derivatives is followed.

Ceded and Assumed Business

The Company has ceded financial guaranty business to affiliated and non-affiliated companies to limit its exposure to risk. Under these relationships, the Company ceded a portion of its insured risk to the reinsurer in exchange for the reinsurer receiving a share of the Company's premiums for the insured risk (typically, net of a ceding commission). The Company remains primarily liable for all risks it directly underwrites and is required to pay all gross claims. It then seeks reimbursement from the reinsurer for its proportionate share of claims. The Company may be exposed to risk for this exposure if it were required to pay the gross claims and not be able to collect ceded claims from an assuming company experiencing financial

distress. A number of the financial guaranty insurers to which the Company has ceded par have experienced financial distress and been downgraded by the rating agencies as a result. In addition, state insurance regulators have intervened with respect to some of these insurers. The Company's ceded contracts generally allow the Company to recapture ceded financial guaranty business after certain triggering events, such as reinsurer downgrades.

AGM is also party to reinsurance agreements as a reinsurer to its affiliated financial guaranty insurance companies. In 2013, MAC assumed a book of U.S. public finance business from AGM and AGC.

The Company has assumed business primarily from its affiliate, AGC. Under this relationship, the Company assumes a portion of the ceding company's insured risk in exchange for a premium. The Company may be exposed to risk in this portfolio in that the Company may be required to pay losses without a corresponding premium in circumstances where the ceding company is experiencing financial distress and is unable to pay premiums. The Company's agreement with AGC is generally subject to termination at the option of the ceding company if the Company fails to meet certain financial and regulatory criteria or to maintain a specified minimum financial strength rating. Upon termination under these conditions, the Company may be required to return to the ceding company unearned premiums and loss reserves calculated on a statutory basis of accounting, attributable to the reinsurance assumed, after which the Company would be released from liability with respect to the Assumed Business. Upon the occurrence of the conditions set forth above, whether or not an agreement is terminated, the Company may be obligated to increase the level of ceding commission paid.

The following table presents the components of premiums and losses reported in the statements of operations and the contribution of the Company's Assumed and Ceded Businesses.

Effect of Reinsurance on Statement of Operations

	Year Ended December 31,	
	2017	2016
	(in millions)	
Premiums Written:		
Direct	\$ 301	\$ 163
Assumed	0	(1)
Ceded	(81)	(83)
Net	<u>\$ 220</u>	<u>\$ 79</u>
Premiums Earned:		
Direct	\$ 433	\$ 547
Assumed	42	52
Ceded	(122)	(153)
Net	<u>\$ 353</u>	<u>\$ 446</u>
Loss and LAE:		
Direct	\$ 304	\$ 270
Assumed	1	0
Ceded	(48)	(72)
Net	<u>\$ 257</u>	<u>\$ 198</u>

In addition to the items presented in the table above, the Company records in the statements of operations the effect of ceded credit derivative exposures. These amounts were losses of \$3 million in 2017 and of \$54 million in 2016. The Company has no assumed credit derivative exposures.

Exposure to Reinsurers (1)

	As of December 31, 2017		As of December 31, 2016	
	Affiliated Reinsurers	Non-Affiliated Reinsurers	Affiliated Reinsurers	Non-Affiliated Reinsurers
	(in millions)			
Due (To) From:				
Assumed premium, net of commissions	\$ 1	\$ 10	\$ 1	\$ 12
Ceded premium, net of commissions	(103)	(24)	(76)	(43)
Assumed expected loss to be paid	—	—	—	—
Ceded expected loss to be paid	157	29	246	87
Par Outstanding:				
Ceded par outstanding (2)	56,200	3,974	57,447	10,496
Assumed par outstanding (3)	13,994	380	16,923	492
Second-to-pay insured par outstanding (4)	151	3,662	167	6,226

- (1) The total collateral posted by all affiliated and non-affiliated reinsurers required to post, or that had agreed to post, collateral as of December 31, 2017 and December 31, 2016 was approximately \$1.3 billion and \$1.2 billion, respectively. The collateral excludes amounts posted by AGM for the benefit of AGE.
- (2) Of the total ceded par to unrated or BIG rated reinsurers, \$296 million and \$340 million is rated BIG as of December 31, 2017 and December 31, 2016, respectively.
- (3) Assumed par outstanding includes \$13,994 million and \$16,894 million assumed by MAC from AGC as of December 31, 2017 and December 31, 2016, respectively.
- (4) The par on second-to-pay exposure where the primary insurer and underlying transaction rating are both BIG and/or not rated is \$65 million and \$344 million as of December 31, 2017 and December 31, 2016, respectively. Second-to-pay insured par outstanding represents transactions the Company has insured that were previously insured by such other monoline financial guaranty insurers. The Company underwrites such transactions based on the underlying insured obligation without regard to the primary insurer.

In accordance with U.S. statutory accounting requirements and U.S. insurance laws and regulations, in order for the Company to receive credit for liabilities ceded to reinsurers domiciled outside of the U.S., such reinsurers must secure their liabilities to the Company. These reinsurers are required to post collateral for the benefit of the Company in an amount at least equal to the sum of their ceded unearned premium reserve, loss reserves and contingency reserves all calculated on a statutory basis of accounting. In addition, certain authorized reinsurers post collateral on terms negotiated with the Company.

Commutations

During the first quarter of 2017, the Company entered into a commutation agreement to reassume the entire portfolio previously ceded to one of its unaffiliated reinsurers, consisting predominantly (over 97%) of U.S. public finance and international public and project finance exposures. During the third quarter of 2017, the Company entered into a commutation agreement where it reassumed the entire portfolio previously ceded to one of its unaffiliated reinsurers under quota share reinsurance, consisting predominantly of U.S. public finance and international public and project finance exposures. The table below summarizes the effect of commutations.

Commutations of Ceded Reinsurance Contracts

	Year Ended December 31,	
	2017	2016
	(in millions)	
Increase (decrease) in net unearned premium reserve	\$ 80	\$ —
Increase (decrease) in net par outstanding	4,672	56
Commutation gains (losses)	324	13

Excess of Loss Reinsurance Facility

Effective January 1, 2018, AGC, AGM and MAC entered into a \$400 million aggregate excess of loss reinsurance facility of which \$180 million was placed with an unaffiliated reinsurer. This facility replaces a similar \$400 million aggregate excess of loss reinsurance facility, of which \$360 million was placed with unaffiliated reinsurers, that AGC, AGM and MAC had entered into effective January 1, 2016 and which terminated on December 31, 2017. The new facility covers losses occurring either from January 1, 2018 through December 31, 2024, or January 1, 2019 through December 31, 2025, at the option of AGC, AGM and MAC. It terminates on January 1, 2020, unless AGC, AGM and MAC choose to extend it. The new facility covers certain U.S. public finance exposures insured or reinsured by AGC, AGM and MAC as of September 30, 2017, excluding exposures that were rated non-investment grade as of December 31, 2017 by Moody's or S&P or internally by AGC, AGM or MAC and is subject to certain per credit limits. Among the exposures excluded are those associated with the Commonwealth of Puerto Rico and its related authorities and public corporations. The new facility attaches when AGC's, AGM's and MAC's net losses (net of AGC's and AGM's reinsurance (including from affiliates) and net of recoveries) exceed \$0.8 billion in the aggregate. The new facility covers a portion of the next \$400 million of losses, with the reinsurer assuming \$180 million of the \$400 million of losses and AGC, AGM and MAC jointly retaining the remaining \$220 million. The reinsurer is required to be rated at least AA- or to post collateral sufficient to provide AGM, AGC and MAC with the same reinsurance credit as reinsurers rated AA-. AGM, AGC and MAC are obligated to pay the reinsurer its share of recoveries relating to losses during the coverage period in the covered portfolio. AGC, AGM and MAC paid approximately \$3.2 million of premiums in 2018 (of which AGM and MAC paid approximately \$2.8 million) for the term January 1, 2018 through December 31, 2018 and deposited approximately \$3.2 million in cash into a trust account (of which AGM and MAC deposited approximately \$2.8 million) for the benefit of the reinsurer to be used to pay the premiums for 2019. The main differences between the new facility and the prior facility that terminated on December 31, 2017 are the reinsurance attachment point (\$0.8 billion versus \$1.25 billion), the total reinsurance coverage (\$180 million part of \$400 million versus \$360 million part of \$400 million) and the annual premium (\$3.2 million versus \$9 million).

Reinsurance of SGI's Insured Portfolio

On February 2, 2018, AGC entered into an agreement with Syncora Guarantee Inc. (SGI) to reinsure, generally on a 100% quota share basis, substantially all of SGI's insured portfolio. The transaction also includes the commutation of a substantial portion of a small book of business ceded to SGI by AGM. At December 31, 2017, such business to be commuted totaled approximately \$1.2 billion principal outstanding. As consideration for the reinsurance and commutation transactions, at closing, SGI will pay \$360 million and assign installment premiums estimated to total \$55 million in present value to Assured Guaranty. The consideration paid to AGM for the commutation is expected to be approximately \$20 million of the total \$360 million paid by SGI. The transaction is subject to regulatory approval and other closing conditions, and is expected to close by the end of the second quarter of 2018.

Other Monoline Exposure

As of December 31, 2017, based on fair value, the Company had fixed-maturity securities in its investment portfolio consisting of \$65 million insured by National Public Finance Guarantee Corporation, \$68 million insured by Ambac, \$48 million insured by AGC and \$8 million insured by other guarantors.

14. Related Party Transactions

Guarantees or Contingencies for Related Parties

AGM currently provides support to AGE, through a quota share and excess of loss reinsurance agreement (the Reinsurance Agreement) and a net worth maintenance agreement (the AGE Net Worth Agreement). For transactions closed prior to 2011, AGE typically guaranteed all of the guaranteed obligations directly and AGM reinsured under the quota share cover of the Reinsurance Agreement approximately 92% of AGE's retention after cessions to other reinsurers. In 2011, AGE and AGM implemented a co-guarantee structure pursuant to which (i) AGE directly guarantees a portion of the guaranteed obligations in an amount equal to what would have been AGE's pro rata retention percentage under the quota share cover, (ii) AGM directly guarantees the balance of the guaranteed obligations, and (iii) AGM also provides a second-to-pay guarantee for AGE's portion of the guaranteed obligations. AGM's ability to provide such direct guaranties outside of the U.K. is uncertain.

Under the excess of loss cover of the Reinsurance Agreement, AGM pays AGE quarterly the amount by which (i) the sum of (a) AGE's incurred losses calculated in accordance with U.K. GAAP as reported by AGE in its financial returns filed with the PRA and (b) AGE's paid losses and LAE, in both cases net of all other performing reinsurance, including the reinsurance provided by the Company under the quota share cover of the Reinsurance Agreement, exceeds (ii) an amount equal to (a) AGE's capital resources under U.K. law minus (b) 110% of the greatest of the amounts as may be required by the PRA as a condition for AGE to maintain its authorization to carry on a financial guarantee business in the U.K. The Reinsurance Agreement permits AGE to terminate the Reinsurance Agreement upon the following events: a downgrade of AGM's ratings by Moody's below Aa3 or by S&P below AA- if AGM fails to restore its rating(s) to the required level within a prescribed period of time; AGM's insolvency; failure by AGM to maintain the minimum capital required by its domiciliary jurisdiction; or AGM filing a petition in bankruptcy, going into liquidation or rehabilitation or having a receiver appointed.

The quota share and excess loss covers each exclude transactions guaranteed by AGE on or after July 1, 2009 that are not municipal, utility, project finance or infrastructure risks or similar types of risks.

The Reinsurance Agreement also contemplates the establishment of collateral by AGM to support AGM's reinsurance obligations to AGE. In December 2014, to satisfy the PRA's collateral requirements, AGM and AGE entered into a trust agreement pursuant to which AGM established and deposited assets into a reinsurance trust account for the benefit of AGE. AGM's collateral requirement was measured during 2015, as of the end of each calendar quarter, by (i) using the PRA's FG Benchmark Model to calculate at the 99.5% confidence interval the losses expected to be borne collectively by AGE's three affiliated reinsurers, AGM, Assured Guaranty Re Ltd. (AG Re) and Assured Guaranty Re Overseas Ltd. (AGRO); (ii) deducting from such calculation AGE's capital resources under such model; and (iii) requiring AGM, AG Re and AGRO collectively to maintain collateral equal to fifty percent (50%) of such difference, i.e., the excess of AGM's, AG Re's and AGRO's assumed modeled losses over AGE's capital resources. As of January 1, 2016, the PRA agreed to allow AGM's collateral requirement to be determined using AGE's internal capital requirement model instead of the FG Benchmark Model under the same formula described above. This change in the calculation of AGM's required collateral was reflected in an amendment to the Reinsurance Agreement approved by the NYDFS and made effective in April 2016.

Pursuant to the AGE Net Worth Agreement, AGM is obligated to cause AGE to maintain capital resources equal to 110% of the greatest of the amounts as may be required by the PRA as a condition for AGE to maintain its authorization to carry on a financial guarantee business in the U.K., provided that AGM's contributions (a) do not exceed 35% of AGM's policyholders' surplus on an accumulated basis as determined by the laws of the State of New York, and (b) are in compliance with Section 1505 of the New York Insurance Law. AGM has never been required to make any contributions to AGE's capital under the AGE Net Worth Agreement or the prior net worth maintenance agreement. With the approval of the NYDFS, AGE and AGM amended the AGE Net Worth Agreement effective in April 2016 to provide for use of the internal capital requirement model.

In addition, the Company's affiliate, AGC, currently provides support to AGUK through a Further Amended and Restated quota share reinsurance agreement (the Quota Share Agreement), a Further Amended and Restated excess of loss reinsurance agreement (the XOL Agreement), and a Further Amended and Restated net worth maintenance agreement (the AGUK Net Worth Agreement). Pursuant to the Quota Share Agreement, AGUK cedes 90% of its financial guaranty insurance and reinsurance exposure to AGC. Pursuant to the XOL Agreement, AGC indemnifies AGUK for 100% of losses (net of the quota share reinsurance agreement discussed above) incurred by AGUK in excess of an amount equal to (a) AGUK's capital resources minus (b) 110% of the greatest of the amounts as may be required by the PRA as a condition for AGUK maintaining its authorization to carry on a financial guarantee business in the U.K. Pursuant to the AGUK Net Worth Agreement, if AGUK's net worth falls below 110% of the minimum level of capital required by the PRA, AGC must invest additional funds in order to bring the capital of AGUK back into compliance with the required amount.

In 2016, AGC and AGUK reached an agreement with the PRA that, in order for AGC to secure its outstanding reinsurance of AGUK under the Quota Share Agreement and XOL Agreement, AGC shall post as collateral its share of AGUK-guaranteed triple-X insurance bonds that have been purchased by AGC for loss mitigation and an additional amount to be determined by (i) using AGUK's internal capital requirement model to calculate at the 99.5% confidence interval the losses expected to be borne by AGC for the exposures it has assumed from AGUK that do not have loss reserves (non-reserve exposures); (ii) adding the amount of loss reserves ceded by AGUK to AGC under U.K. GAAP; (iii) subtracting from such sum AGUK's capital resources under its internal capital requirement model (the result of clauses (i) through (iii) being referred to as the resulting amount); and then (iv) reducing the resulting amount by 50% of the portion of the resulting amount that was contributed by the non-reserve exposures. Accordingly, AGC and AGUK entered into a trust agreement pursuant to which AGC established a reinsurance trust account for the benefit of AGUK and deposits therein sufficient assets to satisfy the above-described collateral requirement agreed with the PRA. This new collateral requirement is reflected in the Quota Share Agreement and XOL Agreement, which were approved by the MIA and made effective in July 2016.

Letter of Support

AGC is a party to the letter of support dated December 6, 2001 issued to CIFGE. Pursuant to such letter of support, AGC agrees to maintain CIFGE's statutory capital and surplus to policyholders under French law and regulation in an amount not less than €20 million for so long as CIFGE carries on business. As of December 31, 2017, CIFGE's statutory capital and surplus to policyholders was approximately €34 million. No capital contributions were made to CIFGE by AGC pursuant the letter of support since AGC succeeded CIFGNA as the parent of CIFGE in July 2016.

Certain of these reinsurance, net worth maintenance agreements and letter of support will be amended or terminated to address requests from the PRA in connection with the proposed European business combination, including that the collateral requirement be calculated using a different methodology, which may materially increase the amount of collateral that AGM and AGC will be required to post in support of their respective reinsurance obligations to AGE and AGUK. The amendments are still being discussed with the PRA and will require the approval of the NYDFS and the MIA before being implemented.

Management, Service Contracts or Cost Sharing Arrangements

Until December 31, 2016, the Company and various of its affiliates were parties to the Amended and Restated Service Agreement, effective as April 1, 2015 (the Group Service Agreement). Under the Group Service Agreement, the Company's Maryland affiliate, AGC, was the payroll company for, and employer of, the U.S. employees of the Assured Guaranty group. AGC's employees made available to its Bermuda, U.S. and U.K. affiliates, as applicable, equipment, insurance, reinsurance and such other services, including actuarial, marketing, underwriting, claims handling, surveillance, legal, corporate secretarial, information technology, human resources, accounting, tax, financial reporting and investment planning services. In addition, under the Group Service Agreement the Company made available to AGC and the other affiliates the use of certain equipment and office space leased by the Company. Expenses under the Group Service Agreement were allocated directly where appropriate and, where not appropriate, based upon an allocation of employee time and corresponding office overhead. The agreement provided for quarterly settlements and an express right of offset with regard to amounts owing between parties under the Group Service Agreement and other agreements between such parties.

In the first quarter of 2017, the Company's indirect parent, AG US Holdings, formed and capitalized AG US Group Services Inc. (AG Services), a Delaware corporation, to act as the payroll company and employer for all U.S. personnel and the central, dedicated service provider within the Assured Guaranty group in place of AGC. This structure is consistent with the way in which numerous other insurance holding companies provide inter-company staff and services. Accordingly, effective January 1, 2017, (i) AGC transferred the employees and the employee benefit, retirement and health plans relating to such employees to AG Services; and (ii) the Group Service Agreement was amended and restated to replace AGC with AG Services as the payroll company and service provider under the agreement. Such amended and restated agreement is substantially identical to the Group Service Agreement except for a few changes primarily related to operational matters, including pre-funding by affiliates who are the largest consumers of group services and inter-company allocation of expenses.

See Note 17, Employee Benefit Plans for expenses related to Long-Term Compensation Plans of AGL which are allocated to AGM.

The following table summarizes the allocated expenses from (to) affiliate companies under the expense sharing agreements.

Expenses Allocated From (To) Affiliated Companies

	Year Ended December 31,	
	2017	2016
	(in millions)	
Affiliated companies:		
AG Services	\$ 93	\$ —
AGC	—	79
Assured Guaranty Finance Overseas Ltd.	8	4
AGL	6	6
Assured Guaranty (UK) Services Limited	4	6
Total	<u>\$ 111</u>	<u>\$ 95</u>

The following table summarizes the amounts due (to) from affiliate companies under the expense sharing agreements.

Amounts Due (To) From Affiliated Companies

	As of December 31,	
	2017	2016
	(in millions)	
Affiliated companies:		
AG Services	\$ (48)	\$ —
AGC	(7)	(48)
AGL	(6)	(4)
Assured Guaranty Finance Overseas Ltd.	(6)	(1)
Other	(1)	(3)
Total	<u>\$ (68)</u>	<u>\$ (56)</u>

Reinsurance Agreements

The Company cedes to and assumes from affiliated entities under certain reinsurance agreements. See below for material balance sheet and statement of operations items related to insurance transactions.

The following table summarizes the affiliated components of each balance sheet item, where applicable.

	As of December 31,	
	2017	2016
	(in millions)	
Assets:		
Premium receivable		
AGC	\$ 1	\$ 1
Ceded unearned premium reserve		
AG Re	584	544
AGC	78	84
Reinsurance recoverable on unpaid losses		
AG Re	117	79
AGC	66	151
Reinsurance recoverable on paid losses (1)		
AG Re	1	0
AGC	1	0
Profit commission receivable (1)		
AG Re	—	1
Net credit derivative assets		
AG Re	0	2
AGC	0	0
Liabilities:		
Unearned premium reserve		
AGC	82	121
Ceded premium payable, net of ceding commission (2)		
AG Re	76	50
AGC	27	26
Ceded salvage and subrogation recoverable (2)		
AG Re	16	7
AGC	35	9
Ceded funds held (3)		
AG Re	27	15
AGC	12	12
Deferred ceding commissions (3)		
AG Re	141	119
AGC	9	8
Other information:		
Exposure		
Assumed par outstanding		
AGC	13,994	16,923
Ceded par outstanding		
AG Re	51,771	53,414
AGC	4,429	4,033

(1) Included in other assets on the combined balance sheets.

(2) Included in reinsurance balances payable, net on the combined balance sheets.

(3) Included in other liabilities on the combined balance sheets.

The following table summarizes the affiliated components of each statement of operations item, where applicable.

	Year Ended December 31,	
	2017	2016
(in millions)		
Revenues:		
Net earned premiums		
AG Re	(83)	\$ (91)
AGC	27	37
Profit commission income		
AG Re	—	1
Realized gains and other settlements on credit derivatives		
AG Re	0	0
AGC	0	0
Net unrealized gains (losses) on credit derivatives		
AG Re	(1)	(1)
Expenses:		
Loss and loss adjustment expenses (recoveries)		
AG Re	(72)	(39)
AGC	52	(1)
Commissions incurred (earned)		
AG Re	(19)	(17)
AGC	(1)	(1)

Other Invested Assets

Surplus Note from AGC

On December 18, 2009, AGC issued a surplus note with a principal amount of \$300 million to AGM. This note carries a simple interest rate of 5.0% per annum and matures on December 31, 2029. Principal is payable at the option of AGC prior to the final maturity of the note in 2029 and interest is payable on the note annually in arrears as of December 31 of each year, commencing December 31, 2010. Payments of principal and interest are subject to AGC having policyholders' surplus in excess of statutory minimum requirements after such payment and to prior written approval by the MIA. On April 11, 2016, the surplus note agreement was amended to reduce the simple interest rate to 3.5% per annum effective January 1, 2016. AGM recognized \$11 million and \$11 million of interest income in each of the years ended December 31, 2017 and 2016. AGM also received \$11 million and \$11 million of interest from AGC in each of the years ended December 31, 2017 and 2016. There was no principal paydown on the surplus note by AGC.

15. Commitments and Contingencies

Leases

AGM and AGE are party to various lease agreements accounted for as operating leases. The Company leases and occupies approximately 103,500 square feet in New York City through 2032. Subject to certain conditions, the Company has an option to renew the lease for five years at a fair market rent. In addition, AGM and AGE lease additional office space in various locations under non-cancelable operating leases which expire at various dates through 2029. Rent expense allocated to the Company for all premises was \$4.5 million in 2017 and \$7.4 million in 2016.

The future minimum rental payments as of December 31, 2017 are as follows:

Future Minimum Rental Payments

Year	(in millions)
2018	\$ 7
2019	8
2020	9
2021	9
2022	9
Thereafter	79
Total	<u>\$ 121</u>

Legal Proceedings

Lawsuits arise in the ordinary course of the Company's business. It is the opinion of the Company's management, based upon the information available, that the expected outcome of litigation against the Company, individually or in the aggregate, will not have a material adverse effect on the Company's financial position or liquidity, although an adverse resolution of litigation against the Company in a fiscal quarter or year could have a material adverse effect on the Company's results of operations in a particular quarter or year.

In addition, in the ordinary course of their respective businesses, the Company and its affiliates assert claims in legal proceedings against third parties to recover losses paid in prior periods or prevent losses in the future. For example, the Company has commenced a number of legal actions in the U.S. District Court for the District of Puerto Rico to enforce its rights with respect to the obligations it insures of Puerto Rico and various of its related authorities and public corporations. See the "Exposure to Puerto Rico" section of Note 4, Outstanding Exposure, for a description of such actions. Also refer to the "Recovery Litigation" section of Note 5, Expected Loss to be Paid, for a description of recovery litigation unrelated to Puerto Rico. The amounts, if any, the Company will recover in these and other proceedings to recover losses are uncertain, and recoveries, or failure to obtain recoveries, in any one or more of these proceedings during any quarter or year could be material to the Company's results of operations in that particular quarter or year.

AGM also receives subpoenas *duces tecum* and interrogatories from regulators from time to time.

Accounting Policy

The Company establishes accruals for litigation and regulatory matters to the extent it is probable that a loss has been incurred and the amount of that loss can be reasonably estimated. For litigation and regulatory matters where a loss may be reasonably possible, but not probable, or is probable but not reasonably estimable, no accrual is established, but if the matter is material, it is disclosed, including matters discussed below. The Company reviews relevant information with respect to its litigation and regulatory matters on a quarterly basis and updates its accruals, disclosures and estimates of reasonably possible loss based on such reviews.

16. Credit Facilities

Committed Capital Securities

AGM has entered into put agreements with four separate custodial trusts allowing AGM to issue an aggregate of \$200 million of non-cumulative redeemable perpetual preferred securities to the trusts in exchange for cash. The custodial trusts were created for the primary purpose of issuing \$50 million face amount of AGM CPS, investing the proceeds in high-quality assets and entering into put options with AGM. The Company does not consider itself to be the primary beneficiary of the trusts and the trusts are not consolidated in the Company's financial statements.

The trusts provide AGM access to new equity capital at its sole discretion through the exercise of the put options. Upon AGM's exercise of its put option, the relevant trust will liquidate its portfolio of eligible assets and use the proceeds to purchase the AGM preferred stock. AGM may use the proceeds from its sale of preferred stock to the trusts for any purpose,

including the payment of claims. The put agreements have no scheduled termination date or maturity. However, each put agreement will terminate if (subject to certain grace periods) specified events occur. AGM continues to have the ability to exercise its put options and cause the related trusts to purchase its preferred stock.

Prior to 2007, the amounts paid on the AGM CPS were established through an auction process. All of those auctions failed in 2007, and the rates paid on the AGM CPS increased to its maximum. The annualized rate on the AGM CPS is one-month LIBOR plus 200 basis points.

See Note 7, Fair Value Measurement, –Other Assets–Committed Capital Securities, for a fair value measurement discussion.

17. Employee Benefit Plans

Accounting Policy

AGM participates in AGL's long term incentive plans. AGL follows the fair value recognition provisions for share based compensation expense. The Company is allocated its proportionate share of all compensation expense based on time studies conducted annually, in accordance with the Group Service Agreement. See Note 14, Related Party Transactions for additional information.

Assured Guaranty Ltd. 2004 Long-Term Incentive Plan

Under the Assured Guaranty Ltd. 2004 Long-Term Incentive Plan, as amended (the Incentive Plan), the number of AGL common shares that may be delivered under the Incentive Plan may not exceed 18,670,000. In the event of certain transactions affecting AGL's common shares, the number or type of shares subject to the Incentive Plan, the number and type of shares subject to outstanding awards under the Incentive Plan, and the exercise price of awards under the Incentive Plan, may be adjusted.

The Incentive Plan authorizes the grant of incentive stock options, non-qualified stock options, stock appreciation rights, and full value awards that are based on AGL's common shares. The grant of full value awards may be in return for a participant's previously performed services, or in return for the participant surrendering other compensation that may be due, or may be contingent on the achievement of performance or other objectives during a specified period, or may be subject to a risk of forfeiture or other restrictions that will lapse upon the achievement of one or more goals relating to completion of service by the participant, or achievement of performance or other objectives. Awards under the Incentive Plan may accelerate and become vested upon a change in control of AGL.

The Incentive Plan is administered by the Compensation Committee of the Board of Directors of AGL, except as otherwise determined by the Board. The Board may amend or terminate the Incentive Plan. As of December 31, 2017, 10,034,895 common shares of AGL were available for grant under the Incentive Plan.

The Company recognized expenses of \$7 million and \$5 million for the years ended December 31, 2017 and 2016, respectively, under the Incentive Plan.

Time Vested Stock Options

Stock options are generally granted once a year with exercise prices equal to the closing price on the date of grant. To date, AGL has only issued non-qualified stock options. All stock options, except for performance stock options, granted to employees vest in equal annual installments over a three-year period and expire seven years or ten years from the date of grant. None of AGL's options, except for performance stock options, have a performance or market condition.

Performance Stock Options

Assured Guaranty grants performance stock options under the Incentive Plan. These awards are non-qualified stock options with exercise prices equal to the closing price of an AGL common share on the applicable date of grant. These awards vest 35%, 50% or 100%, if the price of AGL's common shares using the highest 40-day average share price during the relevant three-year performance period reaches certain hurdles. If the share price is between the specified levels, the vesting level will be interpolated accordingly. These awards expire seven years from the date of grant.

Restricted Stock Awards

Restricted stock awards are valued based on the closing price of the underlying shares at the date of grant. Restricted stock awards to employees generally vest in equal annual installments over a four-year period.

Restricted Stock Units

Restricted stock units are valued based on the closing price of the underlying shares at the date of grant. Restricted stock units generally vest in equal annual installments over a four-year period or fully vest after a three-year period.

Performance Restricted Stock Units

Assured Guaranty has granted performance restricted stock units under the Incentive Plan. These awards vest 35%, 50%, 100%, or 200%, if the price of AGL's common shares using the highest 40-day average share price during the relevant three-year performance period reaches certain hurdles. If the share price is between the specified levels, the vesting level will be interpolated accordingly.

Employee Stock Purchase Plan

Assured Guaranty established the AGL Employee Stock Purchase Plan (Stock Purchase Plan) in accordance with Internal Revenue Code Section 423, and participation is available to all eligible employees. Maximum annual purchases by participants are limited to the number of whole shares that can be purchased by an amount equal to 10% of the participant's compensation or, if less, shares having a value of \$25,000. Participants may purchase shares at a purchase price equal to 85% of the lesser of the fair market value of the stock on the first day or the last day of the subscription period. The Company recorded \$0.1 million and \$0.1 million in share-based compensation, after the effects of DAC, under the Stock Purchase Plan during the years ended December 31, 2017 and 2016, respectively.

Defined Contribution Plan

Employees receive employer contributions into the AGC Employee Retirement Plan (AGC ERP) based on a fixed percentage of the employee's compensation and are eligible to make employee contributions and to receive matching employer contributions based on a percentage of compensation up to limits prescribed by Internal Revenue Code Section 401(k). Effective January 1, 2017, the plan's name has changed to AG US Group Services Inc. Employee Retirement Plan (AGS ERP). Any amounts over the IRS limits are contributed to a nonqualified supplemental executive retirement plan. The Company recognized defined contribution expenses of \$6 million and \$5 million for the years ended December 31, 2017 and 2016, respectively.

Cash-Based Compensation Plans

Assured Guaranty Ltd. maintains a Performance Retention Plan (PRP) (that is part of the Incentive Plan) that permits the grant of deferred cash based awards to selected employees. Generally, each PRP award is divided into three installments that vest over four years. The cash payment depends on growth in certain measures of intrinsic value and financial return defined in each PRP award agreement. The Company recognized performance retention plan expenses of \$6 million and \$6 million for the years ended December 31, 2017 and 2016, respectively, representing its proportionate share of the Assured Guaranty expense.

Assured Guaranty's executive officers are eligible to receive compensation under a non-equity incentive plan. The amount of compensation payable is subject to a performance goal being met. AGL's Compensation Committee then uses discretion to determine the actual amount of cash incentive compensation payable to each executive officer for such performance year based on factors and criteria as determined by the Compensation Committee of AGL, provided that such discretion cannot be used to increase the amount that was determined to be payable to each executive officer. For an applicable performance year, the Compensation Committee of AGL establishes target financial performance measures for AGL and individual non-financial objectives for the executive officers. Most employees other than executive officers are eligible to receive discretionary bonuses.

18. Other Comprehensive Income (Loss)

The following tables present the changes in each component of AOCI and the effect of reclassifications out of AOCI on the respective line items in net income.

Changes in Accumulated Other Comprehensive Income by Component Year Ended December 31, 2017

	Net Unrealized Gains (Losses) on Investments with no Other-Than- Temporary Impairment	Net Unrealized Gains (Losses) on Investments with Other-Than- Temporary Impairment	Cumulative Translation Adjustment	Total Accumulated Other Comprehensive Income
	(in millions)			
Balance, December 31, 2016	\$ 49	\$ (8)	\$ (29)	\$ 12
Reclassification of stranded tax effects (see Note 1)	22	0	(3)	19
Other comprehensive income (loss) attributable to AGM before reclassifications	84	(8)	16	92
Amounts reclassified from AOCI to:				
Net realized investment gains (losses)	(30)	24	—	(6)
Net investment income	—	(1)	—	(1)
Tax (provision) benefit	10	(8)	—	2
Total amount reclassified from AOCI, net of tax	(20)	15	—	(5)
Net current period other comprehensive income (loss) attributable to AGM	64	7	16	87
Balance, December 31, 2017	\$ 135	\$ (1)	\$ (16)	\$ 118

Changes in Accumulated Other Comprehensive Income by Component Year Ended December 31, 2016

	Net Unrealized Gains (Losses) on Investments with no Other-Than- Temporary Impairment	Net Unrealized Gains (Losses) on Investments with Other-Than- Temporary Impairment	Cumulative Translation Adjustment	Total Accumulated Other Comprehensive Income
	(in millions)			
Balance, December 31, 2015	\$ 137	\$ (23)	\$ (8)	\$ 106
Other comprehensive income (loss) attributable to AGM before reclassifications	(81)	(13)	(21)	(115)
Amounts reclassified from AOCI to:				
Net realized investment gains (losses)	(8)	43	—	35
Net investment income	(3)	—	—	(3)
Tax (provision) benefit	4	(15)	—	(11)
Total amount reclassified from AOCI, net of tax	(7)	28	—	21
Net current period other comprehensive income (loss) attributable to AGM	(88)	15	(21)	(94)
Balance, December 31, 2016	\$ 49	\$ (8)	\$ (29)	\$ 12

19. Subsequent Events

Subsequent events have been considered through March 20, 2018, the date on which these financial statements were issued.