ACA Capital Holdings Inc
Form 10-Q
May 15, 2007

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, DC 20549

Form 10-Q

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

For the Quarter Ended March 31, 2007

or

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

For the transition period from to

Commission file number 1-33111

ACA Capital Holdings, Inc.

(Exact name of registrant as specified in its charter)

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

140 Broadway
New York, New York 10005
(212) 375-2000
(Address, including zip code, and telephone number, including area code, of registrant s principal executive offices)

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

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

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

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

As of May 14, 2007, 37,414,603 shares of Common Stock, par value $0.10 per share, were outstanding.

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PART I FINANCIAL INFORMATION

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

ACA CAPITAL HOLDINGS, INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED BALANCE SHEETS (UNAUDITED)
AS OF MARCH 31, 2007 AND DECEMBER 31, 2006
(Dollars in thousands)

	March 31, 2007	**December 31, 2006**
ASSETS		
Investments:		
Fixed-maturity securities available for sale at fair value, amortized cost of $5,004,901 and $5,043,239, respectively	$ 4,824,314	$ 5,026,276
Fixed-maturity securities trading at fair value, amortized cost of $309,529 and $251,884, respectively	308,012	251,825
Securities purchased under agreements to resell	3,679	10,248
Guaranteed investment contract	119,340	119,340
Total investments	5,255,345	5,407,689
Cash:		
Cash and cash equivalents	426,026	379,905
Restricted cash	70,221	67,061
Total cash	496,247	446,966
Accrued investment income	20,764	21,222
Derivative assets	23,784	19,730
Deferred policy acquisition costs, net	49,247	48,810
Deferred debt issuance costs, net	32,440	34,104
Receivable for securities sold	1,106	824
Prepaid reinsurance premiums	511	528
Deferred income taxes	55,171	
Other assets	73,840	58,321
Total assets	$ 6,008,455	$ 6,038,194
LIABILITIES, MINORITY INTEREST AND STOCKHOLDERS EQUITY		
LIABILITIES		
Unearned premiums	$ 189,281	$ 189,537
Reserve for losses and loss adjustment expenses	44,108	42,113
Short-term debt	2,678,982	2,677,828
Long-term debt	2,095,236	2,125,914
Related party debt	100,000	100,000
Securities sold under agreements to repurchase	277,701	232,227
Derivative liabilities	44,239	33,874
Accrued interest payable	16,264	17,900
Accrued expenses and other liabilities	59,110	61,855
Payable for securities purchased	50,813	9,628
Current income tax payable	8,856	7,056
Deferred income taxes		258
Total liabilities	5,564,590	5,498,190
MINORITY INTEREST	19,189	30,190
COMMITMENTS AND CONTINGENCIES		
STOCKHOLDERS EQUITY		
Common stock of 100,000,000 shares authorized at March 31, 2007 and December 31, 2006; 37,414,603 and 37,375,123 shares issued and outstanding at March 31, 2007 and December 31, 2006, respectively; par value of $0.10	3,741	3,737
Gross paid-in and contributed capital	440,266	438,935
Treasury stock at cost 851,847 shares at March 31, 2007 and December 31, 2006	(12,088)	(12,088)

Notes receivable from stockholders	(3,121)	(3,121)
Deferred compensation	(580)	(870)
Accumulated other comprehensive income net of deferred income tax of $(53,822) and $(1,760) at March 31, 2007 and December 31, 2006, respectively	(99,988)	(3,308)
Retained earnings	96,446	86,529
Total stockholders equity	424,676	509,814
Total liabilities, minority interest and stockholders equity	$ 6,008,455	$ 6,038,194

See notes to unaudited condensed consolidated financial statements.

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ACA CAPITAL HOLDINGS, INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS (UNAUDITED)
FOR THE THREE MONTHS ENDED MARCH 31, 2007 AND 2006
(Dollars and shares in thousands, except per share amounts)

	Three months ended March 31, 2007	2006
REVENUES:		
Gross premiums written	$ 5,041	$ 4,788
Less premiums ceded	(131)	(125)
Net premiums written	4,910	4,663
Decrease in unearned premium reserve - net	239	219
Premiums earned	5,149	4,882
Net insured credit swap revenue	3,699	14,180
Net investment income	89,920	77,712
Net realized and unrealized losses on investments	(3,708)	(1,967)
Net realized and unrealized gains on derivative instruments	2,080	3,642
Other net credit swap revenue	12,306	2,913
Fee income	6,332	4,118
Other income	56	51
Total revenues	115,834	105,531
EXPENSES:		
Loss and loss adjustment expenses	1,373	2,021
Policy acquisition costs	1,477	1,392
Other operating expenses	16,153	10,613
Interest expense	76,408	66,419
Depreciation and amortization	2,259	2,492
Total expenses	97,670	82,937
Income of minority interest	(879)	(1,155)
Income before income taxes	17,285	21,439
Provision for income tax expense	5,868	7,292
Net income	$ 11,417	$ 14,147
Share and Per Share Data		
Earnings per share		
Basic	$ 0.31	$ 0.62
Diluted	$ 0.31	$ 0.47
Weighted average shares outstanding		
Basic	36,540	22,806
Diluted	37,120	30,044

See notes to unaudited condensed consolidated financial statements.

ACA CAPITAL HOLDINGS, INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF STOCKHOLDERS EQUITY (UNAUDITED)
FOR THE THREE MONTHS ENDED MARCH 31, 2007 AND 2006
(Dollars in thousands, except for share amounts)

	Preferred Stock Shares	Preferred Stock Amount	Common Stock Shares	Common Stock Par Value	Gross Paid in and Contributed Capital	Treasury Stock	Notes Receivable from Stockholders	Deferred Compensation	Accumulated Other Comprehensive Income	Retained Earnings	Total Stockholders Equity
BALANCE January 1, 2006	2,786,857	$ 226,460	6,442,950	$ 644	$ 125,184	$ (5,500)	$ (1,355)	$ (2,030)	$ 11,132	$ 29,778	$ 384,313
Comprehensive income:											
Net income										14,147	14,147
Change in unrealized gain on investments, net of change in deferred income tax of $1,748									3,247		3,247
Change in derivative hedges, net of change in deferred income tax of $75									140		140
Total comprehensive income											17,534
Vesting of Series B senior conv. prf stock to CEO								290			290
Stock based compensation-stock options					226						226
Discharge of note receivable from stockholders							546				546
BALANCE March 31, 2006	2,786,857	$ 226,460	6,442,950	$ 644	$ 125,410	$ (5,500)	$ (809)	$ (1,740)	$ 14,519	$ 43,925	$ 402,909
BALANCE January 1, 2007		$	37,375,123	$ 3,737	$ 438,935	$ (12,088)	$ (3,121)	$ (870)	$ (3,308)	$ 86,529	$ 509,814
Effect of adoption of FIN 48										(1,500)	(1,500)
Comprehensive income:											
Net income										11,417	11,417
Change in unrealized loss on investments, net of change in deferred income tax of $(51,370)									(95,402)		(95,402)
Change in derivative hedges, net of change in deferred income tax of $(692)									(1,285)		(1,285)
Foreign exchange unrealized gain									7		7
Total comprehensive income											(85,263)
Vesting of CEO restricted common stock								290			290
Offering costs					(161)						(161)
Stock based compensation restricted stock					222						222
Stock based compensation stock options					863						863
Exercise of common stock options			39,480	4	407						411
BALANCE March 31, 2007		$	37,414,603	$ 3,741	$ 440,266	$ (12,088)	$ (3,121)	$ (580)	$ (99,988)	$ 96,446	$ 424,676

See notes to unaudited condensed consolidated financial statements.

ACA CAPITAL HOLDINGS, INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)
FOR THE THREE MONTHS ENDED MARCH 31, 2007 AND 2006

(Dollars in thousands)

	2007	2006
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income	$ 11,417	$ 14,147
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	1,947	2,492
Accrual of discount and amortization of premium on investment net	(33)	(70)
Income of minority interest	879	1,155
Net realized losses on fixed-maturity securities-available-for-sale	2,205	1,968
Net realized and unrealized losses on fixed-maturity securities- trading	1,504	
Net realized and unrealized gains on derivative instruments	(2,080)	(3,642)
Net realized and unrealized (gains) losses on net insured credit swap revenue	15,063	(4,116)
Net realized and unrealized gains on other net credit swap revenue	(8,138)	(194)
Share based compensation expense	1,085	226
Discharge of note receivable from shareholders		546
Deferred compensation	290	290
Purchase of securities under agreement to resell	6,569	
Purchases of fixed-maturity securities-trading	(86,369)	
Proceeds from sales of fixed-maturity securities- trading	28,416	
Securities sold under agreement to repurchase	45,474	
Changes in assets and liabilities:		
Income taxes payable	1,800	150
Deferred income tax expense	1,092	3,409
Prepaid reinsurance premiums	17	122
Derivative liabilities	(684)	16,674
Accrued expenses and other liabilities	(17,532)	(7,490)
Deferred policy acquisition costs	(437)	(693)
Unearned premium reserve	(256)	(23,954)
Loss and loss adjustment expenses	1,995	1,695
Interest payable	(1,636)	637
Interest receivable	458	(1,164)
Other	(1,422)	6,104
Net cash provided by operating activities	1,624	8,292
CASH FLOWS FROM INVESTING ACTIVITIES:		
Net deposit of restricted cash	(3,160)	(4,026)
Purchases of fixed maturity securities available for sale	(251,053)	(247,905)
Proceeds from sales of fixed maturity securities available for sale	57,140	59,226
Proceeds from maturities of fixed maturity securities available for sale	271,245	232,267
Net purchase of property and equipment	(401)	(197)
Net cash provided by investing activities	73,771	39,365
CASH FLOWS FROM FINANCING ACTIVITIES:		
Proceeds from issuance of commercial paper net	1,154	1,001
Paydown on long-term debt	(30,678)	(39,298)
Payment of issuance costs for debt		(154)
Proceeds from exercise of common stock	411	
Offering costs	(161)	
Net cash used in financing activities	(29,274)	(38,451)
NET INCREASE IN CASH AND CASH EQUIVALENTS	46,121	9,206
CASH AND CASH EQUIVALENTS beginning of period	379,905	174,420
CASH AND CASH EQUIVALENTS end of period	$ 426,026	$ 183,626

SUPPLEMENTAL CASH FLOW DISCLOSURES:				
Federal and local income taxes paid	$	3,076	$	3,108
Interest paid	$	78,043	$	65,782

See notes to unaudited condensed consolidated financial statements.

ACA CAPITAL HOLDINGS, INC. AND SUBSIDIARIES
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
MARCH 31, 2007

1. BUSINESS, ORGANIZATION AND OPERATIONS

ACA Capital Holdings, Inc. (ACA or the Company), is a Delaware domiciled holding company that provides financial guaranty insurance products to participants in the global credit derivatives markets, structured finance capital markets and public finance capital markets, as well as providing asset management services. The Company s principal activities include financial guaranty insurance of public finance obligations, structured credit risk assumption through insured credit derivatives and collateralized debt obligation asset management. ACA conducts its business through three principal wholly-owned indirect subsidiaries. Its financial guaranty insurance business is conducted through ACA Financial Guaranty Corporation (ACA Financial Guaranty), a Maryland domiciled insurance company. ACA Financial Guaranty is licensed to conduct financial guaranty insurance business, which provides credit enhancement on public finance and other debt obligations, in all 50 states, the District of Columbia, Guam, the U.S. Virgin Islands and Puerto Rico. Standard & Poor s Rating Services (S&P) has assigned a financial strength rating of A to ACA Financial Guaranty. ACA Financial Guaranty also provides the credit support for the Company s Structured Credit business activities. The Company conducts its CDO Asset Management business primarily through ACA Service L.L.C. and ACA Management, L.L.C. This business encompasses the origination (in collaboration with investment banks), structuring and management of collateralized debt obligations (including collateralized loan obligations and other similarly securitized asset classes, collectively CDOs). In January 2007, the Company s wholly-owned indirect subsidiary, ACA Capital Management (U.K.) Pte. Limited, became authorized and regulated by the Financial Services Authority as an investment manager to manage CDOs in the United Kingdom and most of Europe.

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

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

On November 9, 2006, the Company priced its initial public offering of 6,875,000 shares of newly issued common stock and 23,541 shares of existing common stock. The Company realized gross proceeds of $13 per share on the newly issued common stock, or $89.4 million. Net proceeds to the Company were $79.2 million, after issuance costs. On November 10, 2006, the Company s common stock commenced trading on the New York Stock Exchange under the symbol ACA. In conjunction with the initial public offering, the Company s senior convertible preferred stock, convertible preferred stock and series B senior convertible preferred stock all converted to common stock concurrently with the closing of our offering on November 15, 2006 at their conversion ratios of 6,000:1 shares, 6,000:1 shares and 6:1 shares, respectively.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

These unaudited condensed consolidated financial statements have been prepared pursuant to the rules and regulations of the Securities and Exchange Commission (SEC) regarding interim financial reporting. Accordingly, they do not include all of the information and footnotes required by accounting principles generally accepted in the United States of America (GAAP) for complete financial statements and should be read in conjunction with the Company s Annual Report on Form 10-K for the year ended December 31, 2006 (Form 10-K), filed with the SEC on April 2, 2007. These unaudited condensed consolidated financial statements include all adjustments, consisting only of normal recurring adjustments, that we consider necessary for the fair presentation of our financial position and results of operations for these periods. The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting periods. Actual results could differ from those estimates. Operating results for the three months ended March 31, 2007 are not necessarily indicative of the results that may be expected for the year ended December 31, 2007.

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

3. RELEVANT RECENT ACCOUNTING PRONOUNCEMENTS

On April 18, 2007, the Financial Accounting Standards Board (FASB) released an exposure draft entitled *Accounting for Financial Guarantee Contracts an interpretation of FASB Statement No. 60* (the Proposed Statement). While FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises*, sets out accounting standards for property and casualty and life insurance enterprises, it has historically not specifically considered financial guaranty insurance. This new interpretation is intended to address the specific attributes of this type of insurance. The principal items addressed in the exposure draft relate to revenue recognition, the establishment of claim reserves and disclosures around such reserves. The Proposed Statement would be effective for financial statements issued for fiscal years beginning after December 31, 2007. While certain provisions of the Proposed Statement are still being analyzed, management believes that the cumulative effect of initially applying the Proposed Statement could be material to our financial statements. Until the final interpretation is issued by the FASB, the Company continues to apply the accounting policies as disclosed in its Form 10-K.

In February 2007, the FASB issued Financial Accounting Standard (FAS) 159, *The Fair Value Option for Financial Assets and Financial Liabilities* (FAS 159). FAS 159 permits reporting entities to choose to remeasure many financial instruments and certain other items at fair value that are not currently required to be measured at fair value. The fair value option may be applied instrument by instrument, is irrevocable and is applied only to entire instruments and not to portions of instruments. FAS 159 also establishes presentation and disclosure requirements designed to facilitate comparisons between entities that choose different measurement attributes for similar types of assets and liabilities. FAS 159 is effective for fiscal years that begin after November 15, 2007. Early adoption is permitted as of the beginning of a fiscal year that begins on or before November 15, 2007 provided that the entity also elects to apply the provisions of FAS 157, which are described above. This early adoption election must be made within 120 days of the beginning of the fiscal year of adoption provided the entity has not yet issued interim period financial statements. Management is currently evaluating the potential impact, if any, which the adoption of FAS 159 will have on the Company s financial statements.

On January 1, 2007, the Company adopted FAS 155, *Accounting for Certain Hybrid Financial Instruments* (FAS 155), an amendment of FAS 133, *Accounting for Derivative Instruments and Certain Hedging Activities* (FAS 133) and FAS 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* (FAS 140). The implementation of this statement did not have a material impact on the Company s financial statements.

On January 1, 2007, the Company adopted FASB Interpretation No. (FIN) 48, *Accounting for Uncertainty in Income Taxes an Interpretation of FASB Statement No. 109* (FIN 48). The adoption of FIN 48 resulted in a decrease to stockholders equity as of January 1, 2007 of $1.5 million (see Note 6).

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

In September 2006, the SEC issued Staff Accounting Bulletin No. 108 (SAB 108), *Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements*, which provides interpretive guidance on how the effects of the carryover or reversal of prior year misstatements should be considered in quantifying a current year misstatement. The provisions of SAB 108 were put in effect at December 31, 2006. The adoption of this statement did not have a material impact on the Company s financial statements.

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

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

In September 2005, Statement of Position (SOP) 05-1, *Accounting by Insurance Enterprises for Deferred Acquisition Costs in Connection With Modifications or Exchanges of Insurance Contracts* , (SOP 05-1), was issued. This SOP provides guidance on accounting by insurance enterprises for deferred acquisition costs on internal replacement of insurance and investment contracts other than those specifically described in FAS No. 97, *Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments* . SOP 05-01 is effective for internal replacements occurring in fiscal years beginning after December 15, 2006. The adoption of this SOP did not have a material impact on the Company s financial statements.

4. CDO ASSET MANAGEMENT BUSINESS

One of the ways the Company participates in the structured finance market is through structuring and managing CDOs originated in collaboration with investment banks. CDOs can be issued in funded, unfunded or partially funded form. Funded CDOs issue debt instruments and purchase investment assets, while unfunded CDOs synthetically acquire assets and issue liabilities (i.e., assets and liabilities are in derivative form). Partially funded CDOs are a combination of these two forms. From an accounting perspective, funded and partially funded CDOs are determined to be VIEs. Each time such CDOs are formed, the Company performs an analysis to determine whether it is the primary beneficiary and thus required to consolidate the CDO under the provisions of FSP FIN 46(R)-6.

The following table lists each of the Company s CDOs outstanding as of March 31, 2007 (dollars in millions):

CDO name	Year Deal Closed	Transaction Type	Collateral Type (1)	Notional Deal Size (3)		Consolidated	Original Investment in Retained Equity	Retained Equity %	First Optional Call Date(4)	Maturity Date
Asset-Backed CDOs:										
ACA ABS 2002-1	2002	Funded	Investment Grade	$ 404		Yes	$ 18.0	100	8/2005	8/2037
ACA ABS 2003-1	2003	Funded	Investment Grade	400		Yes	18.0	100	6/2007	6/2038
Grenadier Funding	2003	Funded	High-Grade	1,500		Yes	22.5	100	8/2008	8/2038
ACA ABS 2003-2	2003	Funded	Investment Grade	725		Yes	33.5	100	12/2007	12/2038
ACA ABS 2004-1	2004	Funded	Investment Grade	450		Yes	10.0	61	7/2007	7/2039
Zenith Funding	2004	Funded	High-Grade	1,511		Yes	13.0	52	12/2009	12/2039
ACA ABS 2005-1	2005	Funded	Investment Grade	452		No	4.4	24	4/2008	4/2040
ACA ABS 2005-2	2005	Funded	Investment Grade	450		No	2.1	10	9/2009	12/2044
Khaleej II	2005	Partially funded	Investment Grade	750		No	4.5	14	9/2009	9/2040
Lancer Funding	2006	Funded	High-Grade	1,500		No	1.5	10	7/2010	4/2046
ACA Aquarius 2006-1	2006	Partially funded	Investment Grade	2,000		No			9/2010	9/2046
ACA ABS 2006-1	2006	Funded	Investment Grade	750		No	1.4	5	12/2009	6/2041
ACA ABS 2006-2	2006	Funded	Investment Grade	750		No	3.5	11	1/2011	1/2047
ACA ABS 2007-1	2007	Partially funded	Investment Grade	1,500		No	1.4	5	3/2010	5/2047
Millbrook	2007	Unfunded	Investment Grade	62		No			3/2010	10/2052
Total Asset-Backed CDOs				13,204			133.8			
Corporate Credit CDOs:										
ACA CDS 2002-1	2002	Partially funded	Investment Grade	1,000		Yes	22.0	100	N/A	7/2007
ACA CDS 2002-2	2003	Unfunded	Investment Grade	1,000		No	25.0	100	N/A	3/2008
Argon 49	2005	Funded	Investment Grade	67	(2)	No			N/A	6/2015
Argon 57	2006	Funded	Investment Grade	67	(2)	No			N/A	6/2013
Tribune	2006	Unfunded	Investment Grade	356	(5)	No			N/A	9/2016
Dolomite	2007	Unfunded	Investment Grade	66	(2)	No			N/A	7/2014
Total Corporate Credit CDOs				2,556			47.0			
Leveraged Loan CDOs:										
ACA CLO 2005-1	2005	Funded	Non-Investment Grade	300		No	5.0	21	10/2009	10/2017
ACA CLO 2006-1	2006	Funded	Non-Investment Grade	350		No			7/2009	7/2018
ACA CLO 2006-2	2006	Funded	Non-Investment Grade	300		No	2.2	10	1/2011	1/2021
Total Leveraged Loan CDOs				950			7.2			
Total				**$ 16,710**			**$ 188.0**			

Note: As of March 27, 2007, the Company s risk under corporate credit CDO ACA CDS 2001-1 expired.

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(1) Investment grade collateral is rated BBB- or better; however certain of our investment grade CDOs include the ability to invest a minority portion (20% or less) in non-investment grade assets. High-grade is A- or better.

(2) The original notional deal sizes for Argon 49 and Argon 57 were 50 million each, and that for Dolomite was 49 million and $1 million. For purposes of this chart, we have converted the amounts to U.S. dollars at the prevailing currency exchange rate on March 31, 2007.

(3) Notional deal size is defined as total liabilities at the deal s inception.

(4) Cash flow CDOs are generally callable once per quarter by a majority or greater vote of the equity holders following the conclusion of the reinvestment period, which is referred to as the First Optional Call Date.

(5) Tribune is comprised of 13 distinct trades some of which are denominated in Euros or Yen. For purposes of this chart, we have converted this amount to U.S. dollars at the prevailing currency exchange rates on March 31, 2007.

As of March 31, 2007 and December 31, 2006, consolidated liabilities include non-recourse debt from consolidated CDOs of $4,683.4 million and $4,711.8 million, respectively. Also, as of March 31, 2007 and December 31, 2006, investments include CDO related fixed maturity securities and guaranteed investment contracts of $4,447.5 million and $4,656.0 million, respectively, and cash of $333.9 and $265.0 million, respectively.

5. NET INSURED CREDIT SWAP REVENUE AND OTHER NET CREDIT SWAP REVENUE

Net insured credit swap revenue includes insured credit swap premiums received for credit protection the Company has sold under its insured credit swaps as well as realized and unrealized gains and losses related to those transactions. Realized losses arise upon the occurrence of credit events requiring payment by the Company under the related credit swap and, additionally, realized gains or losses could occur if a transaction is terminated in advance of its scheduled termination date. Unrealized gains and losses represent the adjustments for changes in fair value that are recorded in each reporting period, under FAS 133. The fair value of the Company s insured credit swaps are recorded as either a derivative liability or derivative asset in the consolidated balance sheets.

The following table disaggregates net insured credit swap revenue into its component parts for the three months ended March 31, 2007 and 2006:

	Three months ended March 31, 2007 (in thousands)	2006
Net insured credit swap revenue		
Insured credit swap premiums earned	$ 18,762	$ 10,064
Unrealized gains (losses) on insured credit swaps	(15,063)	3,895
Realized gains on insured credit swaps		221
Total net insured credit swap revenue	$ 3,699	$ 14,180

Other net credit swap revenue includes revenues received from a partially funded CDS CDO which sells credit protection under credit swaps for which it receives fixed quarterly fees as well as the residual returns on two synthetic equity participations. Other net credit swap revenue also includes net realized and unrealized gains and losses associated with these transactions, if any. These revenues are included in the Company s consolidated statement of operations.

The following table disaggregates other net credit swap revenue into its component parts for the three months ended March 31, 2007 and 2006:

	Three months ended March 31, 2007 (in thousands)	2006
Other net credit swap revenue		
Credit swap fees earned	$ 4,168	$ 2,719
Unrealized gains on credit swaps	8,138	194
Total other net credit swap revenue	$ 12,306	$ 2,913

6. INCOME TAXES

Effective January 1, 2007, the Company adopted the provisions of FIN 48. As a result of the implementation of FIN 48, the Company recorded a $1.5 million reserve for uncertain tax positions and a corresponding decrease to the 2007 opening retained earnings. The Company s effective tax rate would be increased if $1.5 million of unrecognized tax expense were recognized. It is unlikely that the unrecognized tax expense will significantly change in the next 12 months.

The Company files income tax returns in the U.S. federal jurisdiction, and various states and foreign jurisdictions. With few exceptions, the Company is no longer subject to U.S. federal, state and local, or non-U.S. income tax examinations by tax authorities for years before 2003.

The Company records interest and penalties related to unrecognized tax benefits in income taxes. $470,000 in accrued interest and penalties is included in the $1.5 million reserve for uncertain tax positions related to our adoption of FIN 48.

Our tax provision for interim periods is determined using an estimate of our annual effective tax rate. The 2007 effective tax rate is estimated to be lower than the 35% statutory rate primarily due to the Company s investment in securities exempt from federal income tax.

7. LITIGATION

In May 2006, the Company paid a judgment in the amount of $3.7 million in satisfaction of a damages award in connection with an employment contract dispute with a former executive of the Company plus accrued interest through the date of payment. Also in May 2006, the Company settled the former executive s attorney s fees at an additional amount of $0.6 million. The Company had recorded a reserve of $4.2 million to cover these costs in December 2005. A judicial satisfaction of the judgment has been filed and the Company has no additional liability with respect to this matter.

The Company is not aware of any pending or threatened litigation that it believes could reasonably be likely to result in a material adverse effect on the Company s financial position, results of operations or cash flows.

8. SEGMENT INFORMATION

The Company s reportable segments are as follows:

(1) Structured Credit, which structures and sells credit protection, principally in the form of insured CDS, against a variety of asset classes in the institutional fixed income markets;

(2) Public Finance, which provides insurance guaranteeing the timely payment of principal and interest on public finance and other debt obligations;

(3) CDO Asset Management, which originates, structures and manages assets, primarily corporate obligations or asset-backed securities, in funded, partially funded or synthetic CDOs; and

(4) Other, which primarily includes trade credit insurance business and financial guaranty insurance on certain other sectors, each of which the Company is no longer engaged in.

The Company s reportable segments are strategic business units that offer different products and services. They are managed separately since each business requires different marketing strategies, personnel skill sets and technology.

Where determinable, the Company specifically assigns assets to each segment, otherwise, the Company allocates assets based on estimates. In general, allocation percentages for assets are determined based on each line s estimated capital utilization from a rating agency perspective.

The accounting policies of the segments are the same as those described in the summary of significant accounting policies. The Company evaluates segment performance based on its income (loss) before income taxes. Reportable segment results are presented net of material inter-segment transactions. The following tables summarize the Company s operations and allocation of assets as of and for the three months ended March 31, 2007 and 2006 (dollars in thousands):

	Three months ended March 31, 2007				
	Structured Credit	**Public Finance**	**CDO Asset Management**	**Other**	**Consolidated Totals**
REVENUES:					
Gross premiums written	$ 87	$ 4,672	$	$ 282	$ 5,041
Premiums earned	$ 87	$ 4,878	$	$ 184	$ 5,149
Net insured credit swap revenue	4,645	1,146	(2,092)		3,699
Net investment income	5,745	4,277	78,846	1,052	89,920
Net realized and unrealized losses on investments	(1,512)	(29)	(2,160)	(7)	(3,708)
Net realized and unrealized gains on derivative instruments	(4)		2,084		2,080
Other net credit swap revenue	(37)		12,343		12,306
Fee and other income	115	91	6,182		6,388
Total revenues	9,039	10,363	95,203	1,229	115,834
EXPENSES:					
Loss and loss adjustment expenses		1,025		348	1,373
Policy acquisition costs		1,463		14	1,477
Other operating expenses	6,290	2,907	6,945	11	16,153
Interest expense	3,290	386	72,640	92	76,408
Depreciation and amortization	138	114	2,007		2,259
Total expenses	9,718	5,895	81,592	465	97,670
Income of minority interest	83		(962)		(879)
Income before income taxes	(596)	4,468	12,649	764	17,285
Provision for income tax expense	(202)	1,517	4,294	259	5,868
Net income	$ (394)	$ 2,951	$ 8,355	$ 505	$ 11,417
Segment Assets	$ 351,608	$ 552,466	$ 4,984,141	$ 120,240	$ 6,008,455

	Three months ended March 31, 2006				
	Structured Credit	**Public Finance**	**CDO Asset Management**	**Other**	**Consolidated Totals**
REVENUES:					
Gross premiums written	$ 278	$ 4,082	$	$ 428	$ 4,788
Premiums earned	$ 296	$ 4,177	$	$ 409	$ 4,882
Net insured credit swap revenue	12,740	662	778		14,180
Net investment income	852	3,871	72,095	894	77,712
Net realized and unrealized losses on investments	(136)	(736)	(926)	(169)	(1,967)
Net realized and unrealized gains on derivative instruments			3,642		3,642
Other net credit swap revenue	(14)		2,927		2,913
Fee and other income	130	98	3,941		4,169
Total revenues	13,868	8,072	82,457	1,134	105,531
EXPENSES:					
Loss and loss adjustment expenses		1,376		645	2,021
Policy acquisition costs		1,272		120	1,392
Other operating expenses	3,917	2,112	4,584		10,613
Interest expense	83	403	65,848	85	66,419
Depreciation and amortization	206	188	2,098		2,492

Total expenses	4,206	5,351	72,530	850	82,937
Income of minority interest			(1,155)		(1,155)
Income before income taxes	9,662	2,721	8,772	284	21,439
Provision for income tax expense	3,286	925	2,984	97	7,292
Net income	$ 6,376	$ 1,796	$ 5,788	$ 187	$ 14,147
Segment Assets	$ 43,914	$ 454,213	$ 5,167,487	$ 95,582	$ 5,761,196

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9. STOCK PLANS AND STOCK BASED COMPENSATION

In 2001, the Company adopted the American Capital Access Holdings, Incorporated Omnibus Incentive Compensation Plan (the Prior Plan) under which 2,188,584 shares of the Company s common shares were reserved for issuance to employees, directors and consultants. In 2003, the Company s Board of Directors approved the increase of the number of shares reserved for issuance by 72,954. In 2004, the Board of Directors approved the ACA Capital Holdings, Inc. Amended and Restated 2004 Stock Incentive Plan effective September 30, 2004 (as amended on October 4, 2004, the 2004 Plan) amending and restating the Prior Plan and increasing the total options available under the 2004 Plan (including those previously distributed under the Prior Plan) to 4,241,538. In August 2006, the Board of Directors approved the Amended and Restated 2006 Stock Incentive Plan, to become effective upon completion of the IPO (the 2006 Plan) which increased the total options available under the 2006 Plan, including all shares subject to existing awards thereunder pursuant to the Prior Plan and the 2004 Plan, to 6,327,972. The 2006 Plan became effective November 9, 2006. The 2006 Plan permits the grant of nonqualified and qualified stock options, incentive stock options, restricted stock, stock units, unrestricted stock, dividend equivalent and cash-based awards. The objectives of the 2006 Plan are to optimize the profitability and growth of the Company through annual long-term incentives that are consistent and linked with the Company s goals.

Unless otherwise provided by the Company, depending upon which version of plan the options were granted under, each option vests ratably either annually over 3 years or every 6 months over 3 1⁄2 years, beginning at the date of grant.

On September 30, 2004, the Company granted 335,214 restricted shares at a fair market value of $10.38 per share, to the Company s president and chief executive officer (the Executive). The total value at the grant date of the restricted stock totaled $3.5 million. The restricted stock vests one-third per year over a three-year period provided the Executive has been continuously employed by the Company or a subsidiary throughout the applicable vesting period. In both the first three months of 2007 and 2006, the vested portion of the restricted stock totaled $0.3 million, which was recognized in the Company s consolidated statement of operations.

In December 2004, the FASB issued FAS 123(R), *Shared Based Payments* (FAS 123(R)) that requires compensation cost related to share-based payment transactions to be recognized in an issuer s financial statements. The compensation cost, with limited exceptions, is measured based on the grant-date fair value of the equity or liability instrument issued. FAS 123(R) replaces FAS 123, *Accounting for Stock Based Compensation* (FAS 123) and supersedes Accounting Principles Board (APB) Opinion No. 25, *Accounting for Stock Issue to Employees* (APB 25).

Effective January 1, 2006, the Company adopted FAS 123(R) using the prospective application as permitted by FAS 123(R). Under this application, we are required to record compensation expense for all awards granted after the date of adoption. Awards granted prior to the date of adoption of FAS 123(R) continue to be accounted for under APB 25. Compensation cost is recognized over the periods that an employee provides service in exchange for the award. The Company recorded stock-based compensation expense of $1.1 million and $0.2 million for the three months ended March 31, 2007 and 2006, respectively, $0.1 million and $0 million of which, respectively, was deferred related to policy acquisition costs. The Company recorded a tax benefit of $0.4 million and $0.1 million for the three months ended March 31, 2007 and 2006, respectively.

The fair value of the stock options granted was estimated on the date of grant using a Black-Scholes option valuation model that uses the assumptions noted in the following table. The risk-free rate is based on the U.S. Treasury yield curve in effect at the time of grant. The expected term (estimated period of time outstanding) of the stock options granted was estimated using the simplified method, in which the expected term equals the average of the graded vesting term and the contractual term. Expected volatility was estimated based on the historical volatility of comparable public companies for a period equal to the stock option s expected term, ending on the day of grant, and calculated on a monthly basis.

	March 31, 2007	March 31, 2006
Expected life (years)	6.00	6.00
Risk free interest rate	4.71 %	4.55 %
Volatility	25.00 %	25.00 %
Dividend yield	0.00 %	0.00 %

Utilizing these assumptions, the weighted-average per-share fair value of stock options granted in the first three months of 2007 and 2006 was $5.19 and $4.45, respectively.

A summary of option activity for the three months ended March 31, 2007 and 2006 is as follows:

	2007		2006	
	Activity	Weighted Average Exercise Price Per Share	Activity	Weighted Average Exercise Price Per Share
Outstanding, beginning of period	3,897,048	$ 11.50	3,042,306	$ 10.53
Granted	448,000	$ 14.63	1,017,000	$ 12.66
Exercised	(39,480)	$ 10.41		
Forfeited	(98,226)	$ 12.16	(26,538)	$ 10.64
Expired				
Outstanding, end of period	4,207,342	$ 11.83	4,032,768	$ 11.07
Options vested, end of period	2,119,783	$ 11.05	2,031,336	$ 10.57

As of March 31, 2007, there was $9.1 million of total unrecognized compensation cost related to nonvested share-based compensation awards granted under our stock option plans. This cost is expected to be recognized over a weighted average period of 3.16 years.

During the first quarter of 2007, the Company granted 106,500 shares of restricted stock. As of March 31, 2007, the Company had 346,654 shares of unvested restricted stock outstanding under the 2006 Plan. With the exception of 6,154 shares of restricted stock granted to certain independent directors of the Company, which vest pro rata, annually over three years, these shares vest pro-rata, annually over 4 years, as long as the grantee is still with the Company.

The table summarizes information regarding fully vested share options as of March 31, 2007:

(Dollars in thousands, except per share amount)

Number of options vested	2,119,783
Weighted average exercise price per share	$ 11.05
Aggregate intrinsic value (excess market price over exercise price)	$ 23,430
Weighted average remaining contractual term of options (in years)	5.37

The following table summarizes information concerning outstanding and exercisable options at March 31, 2007:

	Options Outstanding			Options Exercisable	
Range of Exercise Prices	**Number Outstanding**	**Weighted Average Remaining Contractual Life (Years)**	**Weighted Average Exercise Price**	**Number Exercisable**	**Weighted Average Exercise Price**
$9.01-$10.51	1,856,815	5.48	$ 10.33	1,403,105	$ 10.31
$10.52-$12.01	96,000	7.87	$ 11.63	55,453	$ 11.63
$12.02-$13.51	1,814,527	8.16	$ 12.70	661,225	$ 12.58
$13.52-$15.01	440,000	9.77	$ 14.63		
	4,207,342	7.14	$ 11.83	2,119,783	$ 11.05

Prior to the adoption of FAS 123(R), the Company applied APB 25 to account for its stock-based compensation awards and provided the required pro forma disclosures of FAS 123. The following table illustrates the effect on net income and earnings per share had compensation expense for stock-based compensation awards been recorded in the three months ended March 31, 2007 and 2006, based on the fair value method under FAS 123.

(In thousands, except per share amounts)	**Three months ended March 31, 2007**	**Three months ended March 31, 2006**
Net income, as reported	$ 11,417	$ 14,147
Deduct: Stock-based compensation expense determined under fair value method for awards granted prior to the adoption of FAS 123(R), net of related tax effects	(76)	(106)
Pro forma net income	$ 11,341	$ 14,041
Basic earnings per share		
As reported	$ 0.31	$ 0.62
Pro forma	$ 0.31	$ 0.62
Diluted earnings per share		
As reported	$ 0.31	$ 0.47
Pro forma	$ 0.31	$ 0.47

10. INVESTMENTS

The Company accounts for its investments in fixed maturity securities in accordance with the FAS 115, *Accounting for Certain Investments in Debt and Equity Securities* (FAS 115) and Emerging Issues Task Force (EITF) Issue 99-20, *Recognition of Interest Income and Impairment on Purchased and Retained Beneficial Interests in Securitized Financial Assets.* Management determines the appropriate classification of securities at the time of purchase. As of March 31, 2007 and December 31, 2006, all investments in fixed maturity securities, with the exception of the Company s investments in its Credit-Focused Absolute Return Fixed Income Fund (the Credit Fund) (see Note 11), were designated as available-for-sale and were carried at fair value. Fixed maturity securities in the Company s Credit Fund are designated as trading securities and are also carried at fair value. The difference between fair value and amortized cost of available-for-sale securities is included in the accumulated other comprehensive income component of stockholders equity, net of applicable deferred income tax. Changes in fair value of trading securities are included in net income. The fair value of these securities is based on independent market quotations or, when such quotations are not readily available because the securities are infrequently traded in the public market, from internal valuation models. These models include estimates, made by management, which utilize current market information. The valuation results from these models could differ materially from amounts realizable in an open market sale or exchange.

The Company s process for identifying declines in the fair value of investments that are other than temporary involves consideration of several factors. These factors include (i) the duration of a significant decline in value, (ii) the liquidity, business prospects and overall financial condition of the issuer, (iii) the magnitude of the decline, (iv) the collateral structure and other credit support, as applicable, (v) the Company s intent and ability to hold the investment until the values recover, and (vi) for asset-backed securities, the estimated cash flows. When the analysis of the above factors results in a conclusion that a decline in fair value is other than temporary, the cost of the security is written down to fair value as of the reporting date and any previously unrealized loss is realized in the period such a determination is made.

The Company recognized $2.6 million and $0.9 million of other than temporary impairments within the CDO VIE portfolio during the three months ended March 31, 2007 and 2006, respectively.

The following table shows the gross unrealized losses and fair value of our fixed maturity securities available for sale with unrealized losses that are not deemed to be other-than-temporarily impaired, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position, at March 31, 2007.

	Less than 12 months		**12 months or more**		**Total**	
	Fair Value (in thousands)	**Unrealized Loss**	**Fair Value**	**Unrealized Loss**	**Fair Value**	**Unrealized Loss**
Available for sale-non-VIE:						
U.S. treasury securities	$ 30,937	$ (532)	$ 1,840	$ (55)	$ 32,777	$ (587)
Federal-agency securities	66,399	(558)	4,478	(69)	70,877	(627)
Obligations of states and political subdivisions	6,353	(46)	52,401	(886)	58,754	(932)
Corporate securities	15,000	(163)	55,770	(1,937)	70,770	(2,100)
Asset-backed securities	949		5,350	(61)	6,299	(61)
Mortgage-backed securities	28,058	(217)	96,021	(2,356)	124,079	(2,573)
Total non-VIE securities	147,696	(1,516)	215,860	(5,364)	363,556	(6,880)
Available for sale-VIE asset-backed securities	2,069,566	(178,262)	461,157	(15,960)	2,530,723	(194,222)
Total available for sale-non-VIE	$ 2,217,262	$ (179,778)	$ 677,017	$ (21,324)	$ 2,894,279	$ (201,102)

The unrealized losses on the non-VIE Company s investments were generally caused by interest rate increases. Because the decline in market value of these securities was attributable to changes in interest rates and not credit quality, and because the Company has the ability and intent to hold these investments until a recovery of fair value, which may be maturity, we do not consider these investments to be other-than-temporarily-impaired at March 31, 2007.

A substantial portion of the unrealized loss in VIE asset-backed securities is related to collateralized residential mortgage backed securities (RMBS), including both sub-prime and mid-prime quality mortgages. The last quarter of 2006 and first quarter of 2007 saw significant disruption and consolidation in the sub-prime mortgage market, with some mortgage originators being purchased or exiting the business. This disruption translated into decreased liquidity and wider spreads across the market, decreasing the market value of the portfolios. In particular, securities backed by mortgages from what are currently perceived as originators with weaker underwriting standards experienced a decrease in price in late 2006 and the first quarter of 2007, even when the credit performance of the securities had not suffered. An additional factor weighing on the market valuations for the Company s positions is the limited liquidity associated with the seasoned securities which have already received or are about to receive a significant return of principal. Since the Company, at March 31, 2007, believed that it would be able to collect amounts due on its RMBS positions and has the ability and intent to hold these investments until a recovery of fair value, which may be at their maturities, we did not consider these investments to be other-than-temporarily impaired at March 31, 2007.

Included above are 869 fixed maturity securities, 166 in the non-VIE portfolios, and 703 in the VIE portfolios. At March 31, 2007, there were 115 fixed maturity securities of whose amortized cost exceeded its respective fair value by greater than 20%. Over 99% of the securities in both the non-VIE portfolio and the VIE portfolios are rated investment grade. Management has assessed these and other factors and concluded that there were no other than temporarily impaired fixed maturity securities included in the above table as of March 31, 2007.

11. CREDIT-FOCUSED ABSOLUTE RETURN FIXED INCOME FUND

In May 2006, the Company launched the Credit Fund to leverage its expertise in the capital and credit markets and as an asset manager. The fund invests in fixed income securities, particularly in the asset-backed sector. Through March 31, 2007, the Credit Fund had received capital contributions of $35.0 million, of which the Company had invested $26.4 million and third parties had invested $8.6 million. In addition to receiving a return on its investment in the Credit Fund, the Company is paid a management fee to select and manage the assets of the fund for the Credit Fund s third party investors. For accounting purposes, the Credit Fund is consolidated in the Company s financial statements as of March 31, 2007 and its financial results are recorded in the Structured Credit line of business. As of March 31, 2007, the Credit Fund had total assets of $313.5 million, including investments in fixed-maturity securities trading of $308.0 million, and total liabilities and minority interest of $287.0 million, including securities sold under agreements to repurchase of $277.7 million, included in the Company s condensed consolidated balance sheet.

12. SENIOR CONVERTIBLE PREFERRED STOCK

In April 2006, the Company issued 25 shares of senior convertible preferred stock to its existing stockholders representing the 5% liquidation accretion premium earned from the date of issuance through September 30, 2004. The transaction was accounted for as a dividend. A value of $2.0 million, based on the March 31, 2006 book value, was re-classified from retained earnings to senior convertible preferred stock to record the dividend.

13. STOCK SPLIT

On August 3, 2006 the Company s Board of Directors authorized a dividend in order to effect a six-for-one stock split on the Company s outstanding shares of common stock and on each share of common stock to be issued upon conversion of the various classes of preferred stock of the Company. Each stockholder of record on August 3, 2006 received five additional shares of common stock for each share of common stock held by such stockholder on that date. Funds were reclassified from the additional paid in capital account to the common stock account in an amount equal to the par value of the incremental shares issued under the stock split. Upon the conversion of the various classes of the Company s preferred stock, each holder of convertible preferred stock, senior convertible preferred stock and series B senior convertible preferred stock was issued, in the case of convertible preferred stockholders and senior convertible preferred stockholders, 6,000 shares for each share of preferred stock held by such holder and, in the case of the series B senior convertible preferred stockholders, 6 shares of each share of preferred stock held by such holder. All earnings per share and related stock option information presented in these financial statements and accompanying footnotes have been retroactively adjusted to reflect the increased number of shares resulting from this action.

On November 9, 2006, ACA Capital priced its initial public offering of common stock. The Company sold 6,875,000 shares of common stock in the offering, at $13.00 per share, with net proceeds to ACA Capital of $79.2 million, including $0.2 million of offering costs recorded in the first three months of 2007. The transaction closed on November 15, 2006. ACA Capital is listed on the New York Stock Exchange under the symbol ACA. Upon the closing of its initial public offering of common stock, the Company converted 154 shares of senior convertible stock to 924,000 shares of common stock, 959 shares of convertible preferred stock converted to 5,754,000 shares of common stock and 2,785,769 shares of series B senior convertible preferred stock converted to 16,714,614 shares of common stock.

14. SUBSEQUENT EVENTS

The Company entered into a new credit agreement dated as of April 26, 2007 with a syndicate of banks. The new credit agreement provides for a three-year senior unsecured revolving credit facility in an aggregate principal amount of up to $150 million. The Company may borrow cash under the new credit facility bearing interest based on either (i) LIBOR plus an applicable margin depending on our leverage ratio (the ratio of debt to capital reflected in our then most current consolidated financial statements), or (ii) the greatest of the federal funds effective rate or prime rate in effect, plus 50 basis points. The Company pays a facility fee between 0.08% up to 0.15% per annum of the total commitments under the new credit facility depending on our leverage ratio. In addition, the Company also agreed to pay a utilization fee at a rate of 0.125% per annum on the average daily amount of the outstanding principal under the new credit facility, but only payable when such outstanding principal amount exceeds 50% of the commitments under the revolving credit facility.

This new revolving credit facility replaces the Company s prior 364-day $75 million senior unsecured revolving credit facility dated as of May 1, 2006. The Company had no amounts outstanding under the prior credit facility as of March 31, 2007.

Item 2. Management s Discussion and Analysis of Financial Condition and Results of Operations

The following discussion relates to our consolidated financial statements and should be read in conjunction with the financial statements and notes thereto appearing elsewhere in this report. Statements contained in this Management s Discussion and Analysis of Financial Condition and Results of Operations that are not historical facts may be considered forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995, and are subject to the safe harbor created by that Act. When used in filings with the SEC, in our press releases, investor presentations, and in oral statements made by or with the approval of one of our executive officers, the words or phrases like believe , anticipate , project , plan , expect , intend , may , will likely result , looking forward or will continue , or variations of such words and similar expressions are intended to identify such forward-looking statements. These forward-looking statements are not guarantees of future performance and are subject to risks, uncertainties and assumptions, including, among other things, information set forth in our periodic reports filed with the SEC. In making these statements, we are not undertaking to address or update these factors in future filings or communications regarding our business or results except as required by law. In light of these risks, uncertainties and assumptions, the forward-looking events discussed in this report might not occur. There may also be other risks that we are unable to predict at this time. Any of these risks and uncertainties may cause actual results to differ materially from the results discussed in the forward-looking statements.

Overview

We are a holding company that provides financial guaranty insurance products to participants in the global credit derivatives markets, structured finance capital markets and municipal finance capital markets. We also provide asset management services to specific segments of the structured finance capital markets. We participate in our target markets both as a provider of credit protection through the sale of financial guaranty insurance products, for risk-based revenues, and as an asset manager, for fee-based revenues. We conduct our financial guaranty insurance businesses through ACA Financial Guaranty Corporation, our A rated, regulated insurance subsidiary. Approximately 85% of our assets on an unconsolidated basis represent our 100% indirect ownership interest in ACA Financial Guaranty. ACA Financial Guaranty provides financial guaranty insurance policies for our Public Finance business, for the credit swaps in our Structured Credit business and for certain other transactions described in Other. We primarily conduct our asset management business through ACA Management, L.L.C., a wholly-owned indirect subsidiary of ACA Financial Guaranty. Additionally, in January 2007, we obtained a license from the FSA to conduct a European asset management business, which will be done through our wholly-owned indirect subsidiary ACA Capital Management (U.K.) Pte. Limited. As of March 31, 2007, we had credit exposure of $57.0 billion and our assets under management for third parties were $16.3 billion.

Our financial results include three principal operating lines of business: Structured Credit and Public Finance, which are both financial guaranty insurance lines of business, and our CDO Asset Management business. We have a fourth line of business, Other, which encompasses specified insurance transactions in areas in which we are no longer active, including industry loss warranty transactions, trade credit reinsurance and insurance of certain asset-backed securitizations, principally, manufactured housing. Our lines of business constitute segments for accounting purposes.

Through our Structured Credit line of business, we select, structure and sell credit protection, principally in the form of insured credit swaps, against a variety of asset classes in the institutional fixed income markets. At March 31, 2007, Structured Credit also included the consolidated results of the Credit Fund. The Credit Fund was created in 2006 to leverage our expertise in the capital and credit markets and as an asset manager. The fund primarily invests in fixed income securities, particularly in the asset-backed sector.

Within Structured Credit, our principal revenues are net insured credit swap revenue and net investment income, which includes amounts received from the Credit Fund and its allocated portion of corporate-wide investment income. Generally, we receive insured credit swap premiums in quarterly installments over the life of the related swaps which is typically in the range of 5 to 7 years. The principal expenses of this line of business are its allocated portion of corporate-wide operating expenses, interest expense and depreciation and amortization. It also incurs direct interest expense related to the financing of our consolidated Credit Fund s purchased investments. We enter into our insured credit swaps with intent that they remain outstanding for the entire term of the contract. These insured credit swaps are accounted for at fair value because they do not qualify for the financial guarantee scope exception under FAS No. 133, *Accounting for Derivative Instruments and Certain Hedging Activities*, as amended (FAS 133). Changes in the fair value of these contracts are required to be marked to market under the requirements of FAS 133 and are recorded, together with the related fixed quarterly premium payments payable to us under the insured credit swaps, under the caption net insured credit swap revenue. Since our insured credit swap transactions are generally not actively traded securities and have no observable market price, we utilize comprehensive internally developed models to estimate changes in fair value. We expect the fair values of these insured credit swaps to fluctuate primarily based on changes in credit spreads and the credit quality of the underlying referenced entities. When we hold these insured credit swaps for the entire term of the contract, the cumulative changes in fair value will net to zero at the end of the term, provided that we do not incur credit losses on the contract. In certain circumstances, we may agree with a counterparty to terminate an insured credit swap transaction prior to its maturity (such as on request of the counterparty or for risk management purposes, such as in connection with a deterioration of the underlying portfolio) and may experience realized gains or losses in connection with the early termination of such transactions.

In our Public Finance line of business, we primarily provide financial guaranty insurance policies guaranteeing the timely payment of principal and interest on public finance and other debt obligations. Our principal revenues in this line of business are premiums earned on our financial guaranty insurance policies and its allocated portion of corporate-wide investment income. The principal expenses of this line of business include its allocated portion of corporate-wide operating expenses, interest expense and depreciation and amortization. We also incur loss and loss adjustment expenses, related to the non-derivative exposure we insure, and policy acquisition costs, which are expenses that vary with and are directly attributable to the generation of insurance premiums and are deferred and recognized over the period in which the related premiums are earned. Typically, public finance premiums are received by us on an up front basis. However, under current accounting standards, they are recognized into income over the term of the underlying instrument.

In our CDO Asset Management line of business, we focus on CDO origination, structuring and asset management. Our principal revenues in this line of business are investment income, management fees, warehouse income, other credit swap revenue and premiums for credit swaps on insured equity tranches of unfunded synthetic CDOs. Also included is an allocated portion of corporate-wide investment income. The principal direct expenses are interest expense related to the CDO debt issued by us and the amortization of related capitalized debt issuance costs. This line of business also receives an allocated portion of corporate-wide operating expenses, interest expense and depreciation and amortization. Several of our CDOs are consolidated in our financial statements because we have been determined to be the primary beneficiary under FIN 46(R), *Consolidation of Variable Interest Entities an interpretation of ARB No. 51 analyses*. See Results of Operations CDO Asset Management Supplementary Information for a discussion on the accounting issues associated with consolidation.

Our Other line of business includes business in areas and markets in which we are no longer active. Principal direct items are premiums earned, loss and loss adjustment expenses and policy acquisition costs. This line of business also was allocated a portion of investment income and interest expense in the first quarters of 2007 and 2006.

We believe it is more meaningful to analyze our financial performance on an annual, rather than a quarterly, basis in order to give our lines of business flexibility to select only those opportunities that meet our risk-adjusted return expectations. We believe this maximizes our profitability and allows our lines of business to avoid unfavorable pricing, credit spreads and general market conditions that may occur in any particular quarter. Furthermore, during any given year we enter into a limited number of transactions in each of our lines of business and do not set corporate goals based on closing a specified number of transactions in any particular quarter or year. The transactions in which we participate are often highly negotiated and often take a significant period of time from start to finish, up to one year in Public Finance and up to nine months for a CDO. Accordingly, our financial performance can vary significantly from quarter to quarter and the operating results for any quarter are not indicative of results for any future period.

Additionally, management reviews our performance using a measure known as net economic income. Management believes that analyzing net economic income supplements the understanding of our results of operations by highlighting income attributable to our ongoing operating performance. See Net Economic Income.

Critical Accounting Policies and Estimates

We prepare our financial statements in accordance with accounting principles generally accepted in the United States of America (GAAP). The following accounting policies and estimates are viewed by us to be critical because they require significant judgment on our part. Financial results could be materially different if alternate methodologies were used or if we modified our assumptions.

Financial Guaranty Revenue Recognition

Premiums Earned Premiums on financial guaranty insurance products in the form of traditional insurance policies are typically received on an up front basis, although certain policies pay premium in periodic installments. The vast majority of our Public Finance business is conducted through the issuance of traditional policies. Traditional policies are those that meet the scope exception of the guidance of FAS 133, paragraph 10d, as amended by FAS 149, *Amendment of Statement 133 on Derivative Instruments and Hedging Activities* (FAS 149). The scope exception provides that financial guaranty contracts are not subject to FAS 133, if they meet certain specified criteria. Installment premiums are earned over each installment period, which is generally one year or less. Up front premiums are earned in proportion to the expiration of risk, which is par. Premium is allocated to each par maturity (*e.g.*, principal payment) included in an insured bond and earned on a straight-line basis for the period the related insured risk is outstanding. Unearned premiums represent that portion of premiums which is applicable to coverage of risk to be provided in the future on policies in-force. When an insured issue is retired or defeased prior to the end of the expected period of coverage, the remaining unearned premiums, less any amount credited to the refunding issue insured by us, are recognized as earned premium. The amounts earned from refundings were approximately $0.6 million and $0.2 million, for the quarters ended March 31, 2007 and 2006, respectively.

On April 18, 2007, the FASB released an exposure draft entitled *Accounting for Financial Guarantee Contracts an interpretation of FASB Statement No. 60* (the Proposed Statement). While FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises* , sets out accounting standards for property and casualty and life insurance enterprises, it has historically not specifically considered financial guaranty insurance. This new interpretation is intended to address the specific attributes of this type of insurance. The principal items addressed in the exposure draft relate to revenue recognition, the establishment of claim reserves and disclosures around such reserves. The Proposed Statement would be effective for financial statements issued for fiscal years beginning after December 31, 2007. While certain provisions of the Proposed Statement are still being analyzed, management believes that the cumulative effect of initially applying the Proposed Statement could be material to our financial statements. Until the final interpretation is issued and effective, we will continue to apply the accounting policies as disclosed in our audited financial statements as of December 31, 2006 and 2005 and for the years ended December 31, 2006, 2005 and 2004. The comment period for the exposure draft ends June 18, 2007.

Net Insured Credit Swap Revenue ACA Financial Guaranty insures the obligations of ACA s affiliated special purpose entities under insured credit swaps, pursuant to which we sell credit protection. The related insured credit swap premiums are included in net insured credit swap revenue and are generally received in quarterly fixed payments over the life of the related swaps. Obtaining the fair value (as such term is defined in FAS 133) for such instruments requires the use of management judgment. These instruments are valued using pricing models based on the net present value of expected future cash flows and observed prices for other transactions bearing similar risk characteristics. The fair value of these instruments is included in derivative assets or derivative liabilities. We do not believe that our insured credit swaps meet the scope exception of FAS 133, paragraph 10d, as amended by FAS 149, because there is no contractual requirement that the protection purchaser be exposed to the underlying risk.

Net insured credit swap revenue includes insured credit swap premiums received and realized and unrealized gains and losses on such credit swaps.

Derivative Contracts. All derivative instruments are recognized in our consolidated balance sheet as either assets or liabilities depending on the fair value to us as a credit protection seller as of the determination date. All derivative instruments are measured at estimated fair value. We value derivative contracts based on quoted market prices, when available. However, if quoted prices are not available, the fair value is estimated using valuation models specific to the type of credit protection. Valuation models

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include the use of management estimates and current market information. We utilize both proprietary and vendor based models (including rating agency models) and a variety of market data to provide the best estimate of fair value. Some of the more significant types of market data that influence our models include, but are not limited to, credit ratings, interest rates, credit spreads, default probabilities and recovery rates. If management s underlying assumptions for evaluating fair value prove to be inaccurate, there could be material changes in our consolidated operating results.

Policy Acquisition Costs. Policy acquisition costs include those expenses that relate primarily to and vary with premium production. Such costs are comprised primarily of premium taxes, personnel and personnel related expenses of individuals involved in underwriting, and certain rating-agency and legal fees for municipal and non-derivative structured finance business. Anticipated claims and claim adjustment expenses are considered in determining the recoverability of acquisition costs. Net acquisition costs are deferred and amortized over the period in which the related premiums are earned. In connection with its review of certain accounting standards for financial guaranty insurance contracts, the FASB is considering potential changes relating to deferred policy acquisition costs. See Critical Accounting Policies and Estimates Financial Guaranty Revenue Recognition Premiums Earned for further explanation of potential changes.

Loss and Loss Adjustment Expenses. Financial guaranty loss and loss adjustment expense reserves are established on our non-derivative exposure in an amount equal to our estimate of identified or case-specific reserves and non-specific reserves, including cost of settlement, on the obligations ACA Financial Guaranty has incurred. In determining our accounting policy for loss reserves, we rely primarily on FAS 60, *Accounting and Reporting by Insurance Enterprises* (FAS 60). However, FAS 60 was adopted when the financial guaranty industry was just beginning. As a result, FAS 60 did not contemplate the specific attributes of financial guaranty insurance as distinct from other forms of insurance. In particular, financial guaranty insurance is considered a short-duration insurance product; however, it has features that are more akin to long-duration contracts in that the term of some insured obligations can be as long as 30 years or more and the contracts are generally irrevocable. Under FAS 60, accounting for losses differs for short-duration and long-duration contracts. Because of this inconsistency, we also apply FAS 5, *Accounting for Contingencies* (FAS 5) in the determination of our loss reserves. Specifically, FAS 5 requires the establishment of reserves when it is probable that a liability has been incurred at the reporting date, but only to the extent the loss can be reasonably estimated. The Proposed Statement includes guidance on the establishment of claim reserves and disclosure around such reserves. Until the final interpretation is issued and effective, we will continue to apply the accounting policies as disclosed in our audited financial statements as of December 31, 2006 and 2005 and for the years ended December 31, 2006, 2005 and 2004. The comment period for the exposure draft ends June 18, 2007. See Critical Accounting Policies and Estimates Financial Guaranty Revenue Recognition Premiums Earned for further explanation of potential changes.

The financial guaranty insurance policies we issue insure scheduled payments of principal and interest due on various types of financial obligations against a payment default on such payments by the issuers of the obligations. Active surveillance of our insured portfolio tracks the performance of insured obligations from period to period. We establish loss and loss adjustment expenses, or LAE, reserves based on surveillance group reports, the latest available industry data, and analysis of historical default and recovery experience for the relevant sectors of the fixed-income market. Together the case reserves and non-specific reserves represent management s estimate of incurred losses on our non-derivative insured portfolio exposures.

Case specific reserves are reserves created on those obligations identified as currently or likely to be in default, and represent the present value, discounted at the U.S. Treasury Note rate applicable to the term of the underlying insured obligations, of the expected LAE payments, net of estimated recoveries (under salvage, subrogation or other recovery rights). Gross case-specific reserves, net of estimated recoveries, were $21.3 million and $20.2 million as of March 31, 2007 and December 31, 2006, respectively. We take into account a number of variables that depend primarily on the nature of the underlying insured obligation when we establish case specific reserves for individual policies. These variables include the nature and creditworthiness of the underlying issuer of the insured obligation, whether the obligation is secured or unsecured and the expected recovery rates on the insured obligation, the projected cash flow or market value of any assets that support the insured obligation and the historical and projected loss rates on such assets. The state of the economy, rates of inflation and the salvage values of specific collateral, among other factors, may affect the actual ultimate realized losses for any policy. Currently, we do not believe that

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changes to these factors would materially change the amount of our case specific loss reserves, with the exception of significant changes in salvage values of specific collateral. However, case specific reserves are regularly reviewed in order to incorporate relevant current facts and circumstances and changes to these factors may in the future materially change the amount of our case specific loss reserves.

Our non-specific reserve was derived from the calculation of expected loss, which we estimate using a Monte Carlo simulation. A Monte Carlo simulation is a technique that is commonly used to estimate the probability of certain mathematical outcomes. It randomly selects values to create scenarios of outcomes and this random selection process is repeated many times to create multiple scenarios. Each time a value is randomly selected, it forms one possible scenario and outcome. Together, these scenarios give a range of possible outcomes, some of which are more probable and some less probable. By definition, the average solution will give the most likely potential outcome. Our risk management team typically runs at least 100,000 trials in order to determine future expected losses. The model uses the current ratings and default frequency (net of recovery) applied to each transaction with outstanding exposure to determine the expected probability distribution of loss. Default frequency and recovery amounts are published periodically by each of the major rating agencies. From the model output, we can estimate a range of expected loss. The amount of non-specific reserve recorded in the financial statements is based on the loss ratio resulting from the calculation of total losses, including past incurred losses and expected future losses divided by premium. For this purpose, premium is defined as ever-to-date written premium as of March 31, 2007 plus future installment premium on closed transactions. This derived loss ratio is applied to total ever-to-date earned premiums as of March 31, 2007. Case specific reserves are subtracted from this amount to arrive at net non-specific reserves. The table below shows our case and non-specific reserves as of March 31, 2007 and 2006.

	As of March 31, 2007	**As of December 31, 2006**
	(in thousands)	
Case specific reserves	$ 21,251	$ 20,232
Non specific reserves	22,857	21,881
Total	$ 44,108	$ 42,113

Investment Portfolio. The primary components of our investment portfolio are the fixed maturity securities of ACA Financial Guaranty, our CDO investments and the investments in the Credit Fund. As per FAS 115, *Accounting for Certain Investments in Debt and Equity Securities* (FAS 115) management determines the appropriate classification of these securities at the time of purchase. As of March 31, 2007, all investments in fixed maturity securities except for those related to the Credit Fund were designated as available for sale and were carried at fair value. Unrealized gains and losses for available for sales securities are the difference between fair value and amortized cost included in the accumulated other comprehensive income component of stockholders equity, net of applicable deferred income tax. As of March 31, 2007, the investments of the Credit Fund were designated as trading securities and were also carried at fair value. Unrealized gains and losses for trading securities are included in net income. The fair values of our securities are based on independent market quotations or, when such quotations are not readily available because the securities are infrequently traded in the public market, from internal valuation models. The valuation results from these models could differ materially from amounts realizable in an open market sale or exchange.

Consolidation of Variable Interest Entities (VIEs) and Other Restricted Investments. From an accounting perspective, funded and partially funded CDOs are deemed to be issued out of VIEs. As such, each time a CDO is formed that includes the issuance of debt instruments to third parties and the purchase of investment assets, we perform an analysis to determine whether we are the primary beneficiary and thus required to consolidate the CDO under the provisions of Financial Interpretation 46(R), *Consolidation of Variable Interest Entities* (FIN 46(R)). Prior to 2005, we retained all or most of the equity position in our CDOs, and these CDOs are therefore consolidated in our financial statements (a total of seven CDOs are consolidated). Although the VIE is consolidated, we do not have the right to use the assets of the VIE for general operations and the debt liabilities of the VIE are without recourse to any assets other than those of the VIE. Our investment exposure to our CDOs is therefore limited to our equity investment, which is a first loss position of the CDO. In the instances that we own less than 100% of the CDO VIE s equity, but are the primary beneficiary and thus consolidate the CDO VIE, we establish minority interests for the

unowned portion. As of March 31, 2007 and December 31, 2006, consolidated liabilities included non-recourse debt from consolidated CDOs of $4,683.4 million and $4,711.8 million, respectively. Also, as of March 31, 2007 and December 31, 2006, consolidated assets included investment in fixed maturity securities of $4,447.5 million and $4,656.0 million, respectively, and cash of $333.9 and $265.0 million, respectively, related to CDOs.

Beginning in 2005, we have retained a lesser share of the equity position of our newly issued CDOs. Based on analyses under FIN 46(R), we are not deemed to be the primary beneficiary of these VIEs. As a result, these CDOs are not consolidated in our financial statements. Rather, our non-majority investment is recorded as an investment in a single fixed maturity security under the provisions of FAS 115 and Emerging Issues Task Force (EITF) Issue No. 99-20, *Recognition of Interest Income and Impairment on Purchased and Retained Beneficial Interests in Securitized Financial Assets* (EITF 99-20). During the first three months of 2007, we closed three CDOs and retained an equity interest in only one. During 2006, we closed eight CDOs and purchased an equity interest in four. During 2005, we closed five CDOs and purchased equity interests in four of the five CDOs. We were not determined to be the primary beneficiary in any of these CDOs and therefore do not consolidate them.

In May of 2006, we began managing our Credit Fund. The Credit Fund was created to leverage our expertise in the capital and credit markets and as an asset manager. The Credit Fund invests in fixed maturity securities, particularly in the asset-backed sector. Through March 31, 2007, the Credit Fund had received capital contributions of $35.0 million, of which the Company had invested $26.4 million and third parties had invested $8.6 million. In addition to receiving a return on our investment in the Credit Fund, we are paid a management fee to select and manage the assets for the Credit Fund s third party investors. Although the Credit Fund is consolidated pursuant to the requirements of FIN 46(R), we do not have the right to use the assets for general operations. See Results of Operations Structured Credit.

Results of Operations

Summary of Consolidated Results

The following describes our consolidated financial results for the quarters ended March 31, 2007, and 2006 and our financial condition as of March 31, 2007 and December 31, 2006. In order to understand our consolidated financial results, we perform a detailed segment by segment analysis for our lines of business and therefore, to augment the segments discussion, the following consolidated discussion has been prepared to describe (1) revenue and expense items that are allocated to our four lines of business and (2) the results of our lines of business: Structured Credit, Public Finance, CDO Asset Management and Other.

The accounting policies of our lines of business are the same as those described in the summary of Critical Accounting Policies and Estimates above and in our Form 10-K. Our two financial guaranty insurance lines of business, Structured Credit and Public Finance, are presented as separate lines of business. Items not directly attributable are allocated to each operating line of business. Allocated items consist of investment income from the corporate-wide investment portfolio of cash and investments, primarily from ACA Financial Guaranty, realized gains and losses on those investment portfolios, interest expense on the corporate debt at the holding company level, all operating expenses, non-CDO related depreciation and amortization expenses and income taxes. Income and expense items that are directly attributable to a business line are recorded as such.

The Company s consolidated net income for the three months ended March 31, 2007 was $11.4 million, or $0.31 per diluted share, as compared to $14.1 million, or $0.47 per diluted share, for the three months ended March 31, 2006, a decrease of $2.7 million. The decline in net income was principally related to unrealized mark-to-market valuation losses on our portfolio of Structured Credit transactions.

The following table summarizes the contribution of each line of business to net consolidated income for the quarters ended March 31, 2007 and 2006:

	Structured Credit (in thousands)	Public Finance	CDO Asset Management	Other	Consolidated Total
Net income (loss) by line of business					
March 31, 2007	$ (394)	$ 2,951	$ 8,355	$ 505	$ 11,417
March 31, 2006	$ 6,376	$ 1,796	$ 5,788	$ 187	$ 14,147

Structured Credit

For the three months ended March 31, 2007, a net loss of $0.4 million was recognized compared to net income of $6.4 million for the same period of 2006. The first quarter of 2007 included a net unrealized pre-tax loss in the amount of $12.9 million related to the mark to market valuation of insured credit swap transactions. This valuation loss was primarily related to insured credit swap transactions for which the underlying exposure is pools of sub-prime residential mortgage-backed securities and the associated widening of credit spreads on those assets that occurred during the quarter. The spread widening was in response to the pronounced increase in homeowner delinquencies with respect to sub-prime residential mortgages originated in 2006. Conversely, for the three months ended March 31, 2006, we recognized pre-tax net unrealized valuation gains in the amount of $3.7 million. Insured credit swap premiums earned from credit swap transactions increased to $17.5 million for the three months ended March 31, 2007 from $8.8 million for the same period of 2006. Other operating expenses increased in the three months ended March 31, 2007 compared to the same period in 2006. This increase was in connection with the additional expenses incurred due to our status as a public company as well as additional expenses incurred, mainly personnel related, in direct support of the Structured Credit business.

Public Finance

For the three months ended March 31, 2007, net income increased to $3.0 million from $1.8 million for the same period in 2006. Growth in net income was primarily related to increased premiums earned, mark to market valuation gains on two transactions that are in the form of insured credit swaps and higher net investment income based on increases in ACA Financial Guaranty s investment portfolio. The growth in net income was partially offset by higher operating expenses incurred due to our status as a public company and additional expenses incurred, namely personnel related, in direct support of the Public Finance business. Gross premiums written increased modestly to $4.7 million for the three months ended March 31, 2007 from $4.1 million for the same period of 2006.

CDO Asset Management

Net income increased to $8.4 million for the three months ended March 31, 2007 from $5.8 million for the same period in 2006. The growth in net income was primarily related to increased asset management fees. These increases were partially offset, however, by increased expenses related to our expansion of this line of business to the United Kingdom, where we opened a new office in 2006, the additional expenses incurred due to our status as a public company and additional expenses incurred, mainly personnel related, in direct support of the CDO Asset Management business.

Other

Other represented an immaterial portion of our reported results for the three months ended March 31, 2007 and 2006 and reflects the continued run-off of insurance contracts written in prior years in areas in which we are no longer active.

Items Allocated to Business Lines

Within our statement of operations, we have income and expense items that are directly attributable to our lines of business and items that are indirectly attributable. Examples of items that are directly attributable to lines of business are gross premiums written, premiums earned, insured credit swap revenue, net realized and unrealized gains, losses on derivatives, losses and loss adjustment expenses and

depreciation and amortization related to the consolidation of our CDOs. Certain operating expenses, including those related to personnel and other expenses dedicated to a line of business are allocated to that line of business. Remaining expenses are allocated to lines of business based on time and expense studies conducted annually. Due to its run-off status beginning in 2004, other operating expenses are not allocated to our Other line of business. Items allocated to lines of business include net investment income on the corporate-wide cash investment portfolios and other non-VIE entities within the consolidated group, net realized gains and losses on those portfolio, operating expenses, interest expense related to our corporate debt, depreciation and amortization and income taxes. The net investment income and net realized gains and losses on investments related to our CDO Asset Management and the Credit Fund are considered direct revenues. The following table summarizes the principal items in our consolidated statement of operations that are allocated for purposes of line of business reporting for the three months ended March 31, 2007 and 2006. All other revenue and expense items included in the consolidated statement of operations are directly attributable to a specific line of business.

	Three Months ended March 31, 2007 (in thousands)	**2006**
Net investment income		
Allocated	$ 7,505	$ 5,957
Direct to Business Lines	82,415	71,755
Total	$ 89,920	$ 77,712
Net realized and unrealized losses on investments		
Allocated	$ (51)	$ (1,132)
Direct to Business Lines	(3,657)	(835)
Total	$ (3,708)	$ (1,967)
Other operating expenses		
Allocated	$ 15,631	$ 10,076
Direct to Business Lines	522	537
Total	$ 16,153	$ 10,613
Interest expense		
Allocated	$ 1,840	$ 1,676
Direct to Business Lines	74,568	64,743
Total	$ 76,408	$ 66,419
Depreciation and amortization		
Allocated	$ 379	$ 613
Direct to Business Lines	1,880	1,879
Total	$ 2,259	$ 2,492
Provision for income tax expense		
Allocated	$ 5,868	$ 7,292
Direct to Business Lines		
Total	$ 5,868	$ 7,292

Net Investment Income. Allocated net investment income primarily represents the income recognized on the investment portfolio of ACA Financial Guaranty. To a much lesser degree, investment income from other non FIN 46(R) entities within the group is included to the extent it is not directly related to any of the lines of business. Investment income allocated to each line of business is based upon the estimated capital utilized by the line of business which is derived from our rating agency capital adequacy model. To the extent capital is outside of the insurance company, it is allocated based on an estimated utilization. For the three months ended March 31, 2007, allocated net investment income increased to $7.5 million from $6.0 million for the three months ended March 31, 2006. This increase was related to growth in the investment portfolio from $579.6 million at March 31, 2006 to $658.5 million at March 31, 2007. The growth in the investment portfolio between periods was primarily related to positive cash flows generated by our businesses and, from $79.2 million raised from the proceeds of our initial public offering in November 2006 (IPO).

Net Realized and Unrealized Gains and Losses on Investments. Allocated net unrealized and realized gains and losses on investments represent those gains and losses incurred on the investment portfolio discussed above and are similarly allocated to the lines of business. For the three months ended March 31, 2007, the net realized loss of $1.1 million was the result of a sector reallocation of bonds within the portfolio.

Other Operating Expenses. Allocated other operating expenses is comprised of all costs related to personnel, office leases and expenses, legal, accounting and rating agencies. Allocated other operating expenses does not include expenses related to the consolidation of our CDOs or the Credit Fund. Those expenses are treated as direct expenses of the CDO Asset Management line of business and the Credit Fund (part of the Structured Credit line of business), respectively, for this purpose. For the three months ended March 31, 2007, allocated other operating expenses increased to $15.6 million from $10.1 million for the three months ended March 31, 2006. The increase in expenses was attributable to additional personnel hired to support the businesses, of $3.8 million, and expenses in connection with the opening of our United Kingdom and Singapore offices in 2006.

Interest Expense. Allocated interest expense is related to our holding company debt. It is allocated to our lines of business based on capitalization of the respective lines of business as described above with respect to net investment income. The increase in allocated interest expense for the three month period ended March 31, 2007 from $1.7 million in 2006 to $1.8 million in 2007 was primarily related to the increase in LIBOR since this debt pays interest on a floating rate basis. No new debt was issued in the first quarter of 2007 or 2006.

Depreciation and Amortization. Allocated depreciation and amortization expense is related to furniture and computer equipment, leasehold improvements and any costs deferred in connection with the raising of corporate debt. Such expenses are allocated to line of business similarly to other operating expenses.

Income Taxes. Income taxes are generally allocated to line of business based upon the overall corporate effective tax rate applied to pre-tax income. The increase in income taxes over the three-year period is a direct result of our increased profitability.

Structured Credit

The following table summarizes the operations of our Structured Credit line of business for the three months ended March 31, 2007 and 2006:

	Three Months Ended March 31, 2007 (in thousands)	2006
REVENUES		
Gross premiums written	$ 87	$ 278
Premiums earned	$ 87	$ 296
Net insured credit swap revenue	4,645	12,740
Net investment income	5,745	852
Net realized and unrealized losses on investments	(1,512)	(136)
Net realized and unrealized gains (losses) on derivative instruments	(4)	
Other net credit swap revenue	(37)	(14)
Fee income	96	113
Other income	19	17
Total revenues	**9,039**	**13,868**
EXPENSES		
Other operating expenses	6,290	3,917
Interest expense	3,290	83
Depreciation and amortization	138	206
Total expenses	**9,718**	**4,206**
Loss of minority interest	**83**	
Income before income taxes	(596)	9.662
Provision for income tax expense (benefit)	(202)	3,286
Net income	**$ (394)**	**$ 6,376**

Gross Premiums Written. Gross premiums written within this line of business declined to $0.1 million for the three months ended March 31, 2007 from $0.3 million for the three months ended March 31, 2006. This decline occurred because transactions with respect to this line of business have been conducted in the form of insured credit swaps. No new traditional insurance contracts were written in 2007 for this line of business and the decline relates to the decreased premium for contracts that were written in previous years.

Premiums Earned. The change in premiums earned over the three month periods was directly related to the change in gross premiums written described above.

Net Insured Credit Swap Revenue. Net insured credit swap revenue declined to $4.6 million for the three months ended March 31, 2007 from $12.7 million for the same period in 2006. As set forth in the table below, insured credit swap revenue is the sum of premiums earned on our insured credit swap transactions, net realized gains (losses) which may result from time to time result from any termination or credit events related to such transactions and unrealized gains (losses) resulting from the changes in fair value of these transactions. The first quarter 2007 over first quarter 2006 decline in net insured credit swap revenue was directly related to $12.9 million net unrealized mark to market losses recorded during 2007. Conversely, in the first quarter 2006 unrealized mark to market gains were recorded. Valuation losses in the first quarter 2007 were principally related to the credit spreads associated with insured credit swap transactions for which the underlying exposure was to pools of sub-prime residential mortgage-backed securities. Premiums earned from our insured credit swap transactions increased to $17.5 million for the three months ended March 31, 2007 from $8.8 million for the three months ended March 31, 2006. The primary reason for the increase was the higher volume of transactions completed. As of March 31, 2007, the notional credit exposure in this line of business increased to $50.2 billion from $18.4 billion at March 31, 2006.

The following table shows the components of net insured credit swap revenue for the three months ended March 31, 2007 and 2006:

	Three Months Ended March 31, 2007 (in thousands)	2006
Insured credit swap premiums earned	$ 17,514	$ 8,846
Unrealized gains (losses) on insured credit swaps	(12,869)	3,673
Realized gains on insured credit swaps		221
Net insured credit swap revenue	$ 4,645	$ 12,740

Net Investment Income. Net investment income was $5.7 million for the three months ended March 31, 2007 compared to $0.9 million for the three months ended March 31, 2006. Of the total net investment income of $5.7 million in 2007, $4.5 million related to the Credit Fund and $1.2 million related to allocated investment income. In 2006, allocated investment income was $0.9 million. Allocated investment income increased due to growth within the overall allocated investment portfolio because of net positive cash flows from our businesses, which generated $46.3 million of operating cash flows during 2006, as well as the net proceeds from our IPO of $79.2 million. We also increased the allocation of investment income to this business in 2007 based upon our expected utilization of IPO proceeds across business lines.

	Three Months Ended March 31, 2007 (in thousands)	2006
Investment income from Credit Fund	$ 4,545	$
Allocated investment income	1,200	852
Total investment income	$ 5,745	$ 852

The Credit Fund had net assets under management of $35.0 million as of March 31, 2007. In addition to receiving a return on our investment in the Credit Fund, we are paid a management fee to select and manage the assets of the fund for third parties. As of March 31, 2007, the Credit Fund had total assets of $313.5 million, including investments in fixed-maturity securities trading of $308.0 million and total liabilities and minority interest of $287.0 million, including securities sold under agreements to repurchase of $277.7 million, all of which are included on our consolidated balance sheet.

Net Realized and Unrealized Gains (Losses) on Investments. Net realized gains (losses) are derived from our investment in the Credit Fund as well as allocated amounts related to our allocated investment portfolio. The following table shows the components of net realized losses for the three months ended March 31, 2007 and 2006:

	Three Months Ended March 31, 2007 (in thousands)	2006
Net unrealized and realized losses from Credit Fund	$ (1,504)	$
Allocated net realized losses	(8)	(136)
Net realized and unrealized losses on investments	$ (1,512)	$ (136)

Credit Fund losses were principally unrealized and related to the fair valuation of fixed income securities held in the portfolio. Such securities are designated as held for trading, and as a result mark to market valuation losses are recorded on our statement of operations.

Other Operating Expenses. Other operating expenses increased to $6.3 million for the three months ended March 31, 2007 from $3.9 million for the same period in 2006. The increase for the three months

ended March 31, 2007 compared to 2006 is related to the allocation of additional corporate and asset backed credit analysts in 2007 to this line of business in connection with its growth in transaction volume and the opening and staffing of our Singapore office, in late 2006.

Interest Expense. Interest expense results from debt costs at the Credit Fund as well as allocated interest costs associated with corporate debt at our holding company. The Credit Fund finances its asset purchases in part through the use of security repurchase agreements. Total interest expense related to the Credit Fund in the three months ended March 31, 2007 was $3.2 million. Allocated interest expense totaled $0.1 million in each of the three months ended March 31, 2007 and 2006.

Loss of Minority Interest. Loss of minority interest is related to our investment in the Credit Fund. While we consolidate the fund, we are not the sole equity investor in the fund. Loss related to the portion of the Credit Fund not owned by us in 2007 was $0.1 million.

Public Finance

The following table summarizes the operations of our Public Finance line of business for the three months ended March 31, 2007 and 2006:

	Three Months Ended March 31, 2007 (in thousands)	**2006**
REVENUES		
Gross premiums written	$ 4,672	$ 4,082
Premiums earned	$ 4,878	$ 4,177
Net insured credit swap revenue	1,146	662
Net investment income	4,277	3,871
Net realized and unrealized losses on investments	(29)	(736)
Fee income	74	98
Other income	17	
Total revenues	**10,363**	**8,072**
EXPENSES		
Loss and loss adjustment expenses	1,025	1,376
Policy acquisition costs	1,463	1,272
Other operating expenses	2,907	2,112
Interest expense	386	403
Depreciation and amortization	114	188
Total expenses	**5,895**	**5,351**
(Income) loss of minority interest		
Income before income taxes	4,468	2,721
Provision for income tax expense	1,517	925
Net income	**$ 2,951**	**$ 1,796**

Gross Premiums Written. Public Finance gross premiums written totaled $4.7 million for the three months ended March 31, 2007 compared to $4.1 million for the three months ended March 31, 2006. Overall, the tightening of credit spreads in our target market, which is the low investment grade and high non-investment grade segment of the municipal bond market that we experienced in 2006 continued to occur in the first quarter of 2007 and effect our volume of transactions closed. As spreads remain at historically tight levels, and in order to meet our risk-adjusted return expectations, we continue to be highly selective in our underwriting decisions. Because we are a net retainer of the risks we underwrite, gross premiums written approximate net premiums written.

Premiums Earned. Premiums earned were $4.9 million for the three months ended March 31, 2007 compared to $4.2 million for the same period in 2006. Premiums earned from refundings were $0.6 million and $0.2 million for the three months ended March 31, 2007 and 2006, respectively. Essentially, premiums

earned before refundings was flat when comparing the first quarter of 2007 to 2006. This is primarily due to the fact that gross par exposure has remained relatively flat at approximately $6.1 billion.

Net Insured Credit Swap Revenue. Net insured credit swap revenue was $1.1 million for the three months ended March 31, 2007 compared to $0.7 million for the same period in 2006. We closed two transactions in the Public Finance line of business that were in the form of insured credit swaps, one in 2006 and the other in 2005. Because these transactions are in the form of insured credit swaps, they are marked to market. The unrealized gains or losses resulting from the fair valuation of these transactions are included in net insured credit swap revenue. An unrealized gain of $1.0 million and $0.5 million was included in insured credit swap revenue for the three months ended March 31, 2007 and 2006, respectively.

Net Investment Income. Net investment income totaled $4.3 million for the three months ended March 31, 2007 and $3.9 million for the three months ended March 31, 2006. The entire amount of net investment income for the Public Finance line of business is derived from the allocation of investment income. Allocated investment income increased due to growth within the overall allocated investment portfolio because of net positive cash flows from our businesses, which generated $46.3 million of operating cash flows during 2006, as well as the net proceeds from our IPO of $79.2 million.

Net Realized Gains (Losses) on Investments. Net realized gains (losses) are derived entirely from allocated amounts.

Provision for Loss and Loss Adjustment Expenses. The provision for loss and loss adjustment expenses was $1.0 million for the three months ended March 31, 2007 compared to $1.4 million for the three months ended March 31, 2006. The following table shows the components of the provision for loss and loss adjustment expenses for the three months ended March 31, 2007 and 2006:

	Three Months Ended March 31, 2007	**2006**
	(in thousands)	
Incurred Losses Related To		
Case specific and LAE reserves	$ 49	$ 510
Non-specific reserves	976	866
Total provision for loss and loss adjustment expenses	$ 1,025	$ 1,376

The decline in incurred losses was primarily related to reduced loss adjustment expenses incurred in the first quarter of 2007. Loss adjustment expenses are costs associated with insured credits that are in varying stages of work-out. Non-specific reserves are based on the application of our reserving model and take into account transactional characteristics such as rating, sector and assumed recoveries. The decrease in non-specific reserves was a result of the increase in premiums earned and application of our non-specific reserve model.

Net Policy Acquisition Costs. Net policy acquisition costs totaled $1.5 million for the three months ended March 31, 2007 compared to $1.3 million for the same period in 2006. Generally, such costs vary in accordance with the changes in premiums earned during each period.

Other Operating Expenses. Other operating expenses were $2.9 million for the three months ended March 31, 2007 compared to $2.1 million for the three months ended March 31, 2006. These costs are non-policy acquisition related costs and are allocated. The increase of $0.8 million was primarily related to increased head count to support the business.

Interest Expense. Interest expense was $0.4 million for the each of three months ended March 31, 2007 and March 31, 2006. Interest expense results from the allocated interest cost associated with corporate debt at our holding company.

CDO Asset Management

The following table summarizes the operations of our CDO Asset Management line of business for the three months ended March 31, 2007 and 2006:

	Three Months Ended March 31, 2007 (in thousands)	2006
REVENUES		
Net insured credit swap revenue	$ (2,092)	$ 778
Net investment income	78,846	72,095
Net realized and unrealized losses on investments	(2,160)	(926)
Net realized and unrealized gains on derivative instruments	2,084	3,642
Other net credit swap revenue	12,343	2,927
Fee income	6,163	3,923
Other income	19	18
Total revenues	**95,203**	**82,457**
EXPENSES		
Other operating expenses	6,945	4,584
Interest expense	72,640	65,848
Depreciation and amortization	2,007	2,098
Total expenses	81,592	72,530
Income of minority interest	(962)	(1,155)
Income before income taxes	12,649	8,772
Provision for income tax expense	4,294	2,984
Net income	$ 8,355	$ 5,788
CDO assets under management (end of year, in millions)	$ 16,296	$ 11,362

Net Insured Credit Swap Revenue. Net insured credit swap revenue was $(2.1) million for the three months ended March 31, 2007 compared to $0.8 million for the three months ended March 31, 2006. As set forth in the table below, net insured credit swap revenue is the sum of premiums earned, net realized gains (losses), which may result from time to time from any termination or credit events related to such transactions and unrealized gains (losses) resulting from the changes in fair value of these transactions. We receive insured credit swap premiums from two synthetic CDOs we closed in 2003 and 2002 in which our insurance subsidiary, ACA Financial Guaranty, insured the equity tranche of each CDO. Because these were the only two transactions generating insured credit swap premiums over the two quarters, the amounts were similar. The following table shows the components of net insured credit swap revenue for the three months ended March 31, 2007 and 2006:

	Three Months Ended March 31, 2007 (in thousands)	2006
Insured credit swap premiums earned	$ 1,088	$ 1,086
Unrealized losses on insured credit swaps	(3,180)	(308)
Net insured credit swap revenue	$ (2,092)	$ 778

The unrealized loss recorded for the three months ended March 31, 2007 resulted from one of the credit swap transactions which expired as of the end of the quarter. As a result, the remaining unrealized valuation amount carried on our balance sheet was reversed to zero. The valuation or unrealized loss for the three months ended March 31, 2006 was also related to the fact that these transactions were in a net

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valuation gain position and as they approach maturity, those unrealized gains reverse, resulting in unrealized losses. Both transactions will expire by mid-2008.

Net Investment Income. Net investment income was $78.8 million for the three months ended March 31, 2007 compared to $72.1 million for the three months ended March 31, 2006. Net investment income includes income from assets of our consolidated CDO portfolios as well as allocated amounts. No new consolidated CDOs were added in the first quarter of 2007 or 2006. The portion of net investment income related to our consolidated CDO portfolio was $77.9 million for the three months ended March 31, 2007 compared to $71.6 million for the three months ended March 31, 2006. The increase in net investment income from 2006 to 2007 was principally related to the increase in short-term rates, namely one and three month LIBOR over the two quarters. The portion of net investment income allocated to the CDO Asset Management line of business was $1.0 million in the first quarter of 2007, compared to $0.5 million in the first quarter of 2006. Allocated investment income increased due to growth within the overall allocated investment portfolio because of net positive cash flows from our businesses, which generated $46.3 million of operating cash flows during 2006, as well as the net proceeds from our IPO of $79.2 million.

	Three Months Ended March 31, 2007 (in thousands)	**2006**
Investment Income from consolidated CDOs	$ 77,871	$ 71,618
Allocated net investment income	975	477
Total net investment income	$ 78,846	$ 72,095

Net Realized and Unrealized Gains (Losses) on Investments. Net realized gains (losses) are derived from our consolidated CDOs as well as allocated amounts. There are no unrealized gains or losses on investments for this line of business. The following table shows the components of net realized losses for the three months ended March 31, 2007 and 2006.

	Three Months Ended March 31, 2007 (in thousands)	**2006**
Net realized losses from CDOs	$ (2,155)	$ (835)
Allocated net realized losses	(5)	(91)
Net realized and unrealized losses on investments	$ (2,160)	$ (926)

Net realized losses from CDOs include losses from other than temporary impairments, or OTTI, in the amounts of $2.6 million for the three months ended March 31, 2007 compared to $0.9 million for the three months ended March 31, 2006. OTTI is recognized when the fair value of investments in fixed maturity securities is reported below amortized cost for stated periods of time. In the case of asset-backed securities, of which the vast majority of our CDO portfolio is comprised, the market value decline is also coupled with a decline in future expected cash flows. OTTI write-downs in each of the three month periods were associated with certain mortgage-backed securities which experienced declines in value and projected cash flows.

Net Realized and Unrealized Gains (Losses) on Derivative Instruments. The following table illustrates the type of derivative instruments reported in this line item:

	Three Months Ended March 31, 2007 (in thousands)	**2006**
Interest rate swaps	$ 1,670	$ 3,430
Interest rate caps	(189)	212
Trading derivatives	603	
Total net realized and unrealized gains on derivative instruments	$ 2,084	$ 3,642

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The most significant derivative instruments reported in this line item are interest rate swaps that are included in our consolidated CDOs. These CDOs have four such swaps and they pay fixed amounts and receive floating amounts based on three month LIBOR and pre-determined notional schedules. Unrealized valuation gains have been recognized on these four swaps as a result of a steady increase in short-term interest rates over the three year period. Interest rate caps are also used within consolidated CDOs to manage interest rate risk. We also recognized income in the amount of $0.6 million related to a leveraged loan trading program that began in December 2006 and is structured in the form of a total return swap. Changes in the values of the underlying leveraged loans represent unrealized gains or losses to us until such time that the loans may be sold. Income received under the total return swap is also included in net realized and unrealized gains on derivative instruments.

Other Net Credit Swap Revenue. Other net credit swap revenue was $12.3 million for the three months ended March 31, 2007 compared to $2.9 million for the three months ended March 31, 2006. As set forth in the table below, other net credit swap revenue is the sum of credit swap fees earned, net realized gains (losses) which may result from time to time result from any termination of such transactions and any credit events and unrealized gains (losses) resulting from the changes in fair value of these transactions. Most of this revenue resulted from credit swap fees from a partially funded consolidated synthetic CDO, in which the underlying instruments are credit swaps sold by the CDO to third parties. Also included as revenue in the first quarters of 2007 and 2006 are amounts of $2.3 million and $0.8 million, respectively, that represent distributions to us as equity holder of two synthetic CDOs. The following table shows the components of other net credit swap revenue for the three months ended March 31, 2007 and 2006:

	Three Months Ended March 31, 2007	**2006**
	(in thousands)	
Credit swap fees	$ 3,921	$ 2,733
Unrealized gains on credit swaps	8,422	194
Total other net credit swap revenue	$ 12,343	$ 2,927

Net unrealized gains related to changes in value were recorded for each period. The unrealized gain recorded for the three months ended March 31, 2007 was almost entirely related to the change in the value of two credit swap transactions we entered into in late 2006 whereby we purchased protection related to our exposure to subprime residential mortgage backed securities. We have exposure to certain classes of residential mortgaged backed securities, or RMBS, through equity we own in our CDOs. In particular, as of March 31, 2007 we have equity exposure of $59.5 million to RMBS backed by subprime mortgages originated in 2006 in six of our mezzanine asset-backed CDOs that invest in RMBS rated below A-/A3. In December 2006, we made the decision to purchase credit protection in the form of two credit swaps referencing representative market indices to moderate the impact to us of impairments related to 2006 vintage subprime residential mortgage exposure. We did this in light of the recent negative developments that we have noted in this asset class. Specifically, the relaxed underwriting standards of certain sub-prime originators in 2006 have led to significantly higher early stage delinquencies. Market participants have speculated that these RMBS may ultimately represent the worst performing sub-prime bonds on record to date. In light of the uncertainty in the market around this vintage of RMBS, we determined it prudent to purchase the credit swaps. The aggregate notional amount of credit protection purchased was $37.0 million. The annual cash expense for the protection is approximately $0.9 million and is also recorded in other net credit swap revenue. Additionally, we have equity exposure of $37.4 million to three CDOs which invest in RMBS that have some exposure to 2006 vintage subprime collateral rated at or above A-/A3.

Fee Income. Fee income is principally related to quarterly management fees, warehouse fees and structuring fees received in connection with our unconsolidated CDOs. Total fee income for CDO Asset Management was $6.2 million for the three months ended March 31, 2007 compared to $3.9 million for the three months ended March 31, 2006. The increase was the result of increased assets under management which grew to $16.3 billion at March 31, 2007 from $11.4 billion at March 31, 2006. During the first quarter of 2007, we revised our previous estimate of accrued warehouse fees as the result of a renegotiation of a deal s terms during the quarter. For the three months ended March 31, 2006, warehouse fees recorded were in connection with two transactions closing during that quarter. In general, structuring fees and warehouse fees are highly negotiated and vary from transaction to transaction. The following table shows the components of fee income for the three months ended March 31, 2007 and 2006: