ACA Capital Holdings Inc
Form 10-K
April 02, 2007

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

x	**ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
	For the fiscal year ended December 31, 2006
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 001-33111

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

(Address of principal executive officers, including zip code)

(212) 375-2000

(Registrant s telephone number, including area code)

Securities registered pursuant to Section 12(b) of the Act:

Title of each class	**Name of each exchange on which registered**
Common Stock, $0.10 per share	New York Stock Exchange, Inc.

Securities registered pursuant to Section 12(g) of the Act: None

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes o No x

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or 15(d) of the Act. Yes o No x

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 if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of Registrant s knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K 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 Act). Yes o No x

The Registrant completed the initial public offering of its common stock in November 2006. Accordingly, there was no public market for the Registrant s common stock as of June 30, 2006, the last day of the Registrant s most recently completed second fiscal quarter.

As of March 27, 2007, 37,038,756 shares of Common Stock, par value $0.10 per share, were outstanding.

Documents Incorporated By Reference

Part III incorporates certain information by reference from the Registrant s definitive proxy statement for the 2007 annual meeting of stockholders, which proxy will be filed no later than 120 days after the close of the Registrant s fiscal year ended December 31, 2006.

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CAUTIONARY STATEMENTS REGARDING FORWARD-LOOKING STATEMENTS

Some of the statements under Business, Risk Factors, Management s Discussion and Analysis of Financial Condition and Results of Operations and elsewhere in this Annual Report on Form 10-K may include statements that are not historical or current facts and may be considered forward-looking statements under the Private Securities Litigation Reform Act of 1995. The words believe , anticipate , project , plan , expec intend , may , will likely result , looking forward or will continue, and similar expressions identify forward-looking statements. Such statemen reflect management s current expectations or forecasts of future events based on its current views and assumptions regarding future events and economic performance.

Any or all of the forward-looking statements herein are subject to risks and uncertainties that may cause actual results to differ materially from those set forth in these statements. Among factors that could cause actual results to differ materially are: (1) difficulties with the execution of our business strategy; (2) changes in the economic, credit spread or interest rate environment in the United States and overseas; (3) the level of activity in the national and global debt markets; (4) market spreads and pricing on derivative products insured or issued by us; (5) significant credit losses in excess of expectations and the inability to obtain expected levels of reimbursement or recoveries; (6) ratings actions with respect to the financial strength rating assigned by Standard & Poor s Ratings Services, or S&P, to our insurance subsidiary, ACA Financial Guaranty Corporation, or a change in S&P s ratings criteria at any time; (7) prepayment speeds on insured asset-backed securities and other factors that may influence the maturity of collateralized debt obligations, or CDOs, and related management fees paid to us; (8) decreased demand for our insurance products or asset management services, or increased competition in our markets; (9) changes in accounting policies or practices that may impact our reported financial results; (10) the amount of reserves established for losses and loss expenses and the differences between our reserves and actual losses; (11) changes in regulation or tax laws applicable to us or those with which we do business; (12) governmental action; (13) loss of key personnel; (14) technological developments; (15) the effects of mergers, acquisitions and divestitures; (16) other risks and uncertainties that have not been identified at this time; (17) management s response to these factors; and (18) other risk factors identified under Part I, Item 1A of this report. We caution that forward-looking statements made by us speak only as of the date on which they are made, and, except as required by law, we do not undertake any obligation to update or revise such statements if management s expectations change or we become aware that any forward-looking statement is not likely to be achieved.

If one or more of these or other risks or uncertainties materialize, or if management s underlying assumptions prove to be incorrect, actual results may vary materially from what we projected. Any forward-looking statements you read in this report reflect management s current views with respect to future events and are subject to these and other risks, uncertainties and assumptions relating to our operations, results of operations, growth strategy and liquidity. All subsequent written and oral forward-looking statements attributable to us or to individuals acting on our behalf are expressly qualified in their entirety by this section.

PART I

Item 1. Business.

Overview

ACA Capital Holdings, Inc. (hereafter ACA , we , us , our or the Company) is a holding company, headquartered in New York City, that prov
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. Our business model seeks to combine the operational leverage of our core credit and asset management capabilities with the financial leverage provided by our A rated financial guaranty insurance platform.

Our core competency is selecting, analyzing, structuring and managing credit risk in a variety of fixed income financial asset classes, including investment grade and non-investment grade corporate obligations (including bonds and loans), asset-backed securities, or ABS (including mortgage-backed securities, or MBS, and other asset classes) and municipal and other public finance securities. Throughout our businesses we generally assume credit risk to the scheduled maturity of the underlying credit, including credit risks that are of low investment grade quality or high non-investment grade. We apply a rigorous underwriting and credit process to analyze each transaction and its incremental effect on our existing credit portfolio, and have adopted a risk management approach which is designed to ensure that the risk profile of a given credit or transaction meets our credit, profitability and loss tolerance standards.

Business Lines

We operate our businesses through three strategic business lines, which consist of our two financial guaranty insurance lines of business, Structured Credit and Public Finance, and our CDO Asset Management business. Each of these businesses relies on our core competencies of credit analysis, transaction structuring, risk management and surveillance. Applying these competencies across our platform allows us to create efficiencies in our operations and to deliver a wide range of services and product solutions for our institutional customers.

The following is an overview of each of our three business lines. For a more detailed discussion of each business line, see Structured Credit , Public Finance , and CDO Asset Management.

Financial Guaranty Insurance Lines of Business

Structured Credit: As a part of our financial guaranty insurance business, we apply our substantial experience in credit analysis to select, structure and sell credit protection, principally on highly rated exposures, through insured credit swaps in the institutional fixed income markets. We generate revenues in our Structured Credit business through the premiums paid to ACA Financial Guaranty to insure against the risk of default on the assets underlying our credit swaps. Although our A rating affords our Structured Credit business significant flexibility to offer credit protection on any portion of a given capital structure, currently our insured credit swap portfolio is constructed primarily of exposures attaching above the AAA rated level of subordination.

Additionally, we recently formed a Credit focused Absolute Return Fixed Income Fund, ACA Capital Partners I, or the Credit Fund, as a part of our Structured Credit line of business. As of December 31, 2006, our Credit Fund had net assets under management of $25.6 million. The Credit Fund was created to leverage our expertise in the capital and credit markets and as an asset manager. The Credit Fund is managed by ACA Management and invests primarily in fixed income securities.

Public Finance: We provide financial guaranty insurance on municipal and other public finance bonds that guarantee to the investor the timely payment of interest and ultimate payment of principal on such obligations. Through ACA Financial Guaranty, we target low investment grade, high non-investment grade and unrated sectors of the public finance market that, under our analysis, have strong credit profiles and security, or other enhancements. We also target markets that are underserved by reason of industry sector, credit characteristics or transaction size. We generate revenue in our Public Finance business through the receipt of premiums for the insurance we provide. ACA Financial Guaranty is licensed to provide financial guaranty insurance in all 50 states, the District of Columbia, Guam, Puerto Rico and the U.S. Virgin Islands.

Other Financial Services

CDO Asset Management: We apply our core competencies of evaluating and managing credit risk for fees in our CDO Asset Management line of business. Specifically, we serve as an asset manager of collateralized debt obligations, or CDOs, for the benefit of the third party investors in these CDOs. A CDO is a securitization of fixed income assets such as bonds, loans, MBS, ABS and credit swaps. CDO assets are funded by the issuance of various liabilities with credit profiles ranging from AAA rated debt to non-rated equity. Our CDOs have a diverse worldwide institutional investor base.

Our CDO Asset Management revenues consist of asset management fees and risk-based revenue in the form of return on our equity investments in our CDOs. In order to align our interests as a manager with those of our investors, we typically invest in some portion of the equity of our managed CDOs, currently targeting 10% of the total equity offered. ACA Management manages U.S. based assets and ACA Capital Management (U.K.) will manage European based assets.

Based on our knowledge of the market, we believe we are one of the largest global CDO managers as ranked by assets under management. Through our Structured Credit line of business, we have taken exposure at the most senior level in three of our CDOs. We do not credit enhance any portion of our CDO liabilities for investors.

Corporate Structure

ACA is a Delaware corporation. We began operations in September 1997 with a business strategy focused on providing A rated financial guaranty insurance to the municipal finance market. Beginning in 2002, we extended our financial guaranty insurance products to include our Structured Credit business and expanded our operations generally by establishing our CDO Asset Management business. In 2006, we opened offices in London and Singapore to further expand our operations into the European and Asian credit markets.

Our principal subsidiary through which we currently operate our business is ACA Financial Guaranty Corporation (ACA Financial Guaranty), our S&P A rated insurance subsidiary that is organized in the State of Maryland. As of December 31, 2006, approximately 85% of our assets on an unconsolidated basis represented our 100% indirect ownership interest in ACA Financial Guaranty. ACA Service L.L.C., a wholly-owned direct subsidiary of ACA Financial Guaranty, is a Delaware limited liability company and owns the majority of the special purpose entities through which we execute our insured credit swaps. ACA Financial Guaranty insures the obligations of the special purpose entities in our Structured Credit line of business. Our CDO Asset Management services are conducted through our subsidiaries ACA Management, L.L.C. (ACA Management), also a wholly-owned indirect subsidiary of ACA Financial Guaranty, and ACA Capital Management (U.K.) Pte. Limited, a wholly-owned indirect subsidiary of the Company. ACA Management, a Delaware limited liability company, is registered with the Securities and Exchange Commission (SEC) as an investment adviser. ACA Capital Management (U.K.), a United

Kingdom private limited company, became authorized and regulated by the Financial Services Authority (FSA) as an investment manager in January 2007.

Business Strategy

Our business strategy is to continue to leverage our credit management expertise to generate attractive risk-adjusted returns on our capital in our financial guaranty insurance lines of business through the insurance of targeted credit exposure and to grow our assets under management. We plan to achieve these objectives through the following strategies:

- Grow our insured credit exposure and assets under management, in terms of the number of transactions, size of transactions and types of asset classes that we insure and manage, both in the United States and internationally.

- Target attractive risk-adjusted returns in the credit markets.

- Expand our existing product lines into broader geographical areas, asset classes and credit profiles and develop new credit product areas.

- Expand counterparty and other key relationships for our insurance lines of business.

- Maintain a capital base in excess of S&P s requirements for A rated insurers so that we have excess rating agency capital to absorb unforeseen losses, while sustaining the operating flexibility of that A financial strength rating.

We maintain a website at www.aca.com. We are not including or incorporating by reference the information contained on our website into this report. We make available on our website, free of charge and as soon as reasonably practicable after we file with, or furnish to, the SEC, copies of our most recently filed Annual Report on Form 10-K, all Quarterly Reports on Form 10-Q and all Current Reports on Form 8-K, including all amendments to those reports. In addition, copies of our Corporate Governance Guidelines, Code of Conduct, Code of Ethics for Chief Executive Officer and Senior Financial Officers, Policy Regarding Director Independence Determinations and the governing charters for each Committee of our Board of Directors are available free of charge on our website, as well as in print to any stockholder upon request. The public may read and copy materials we file with the SEC in person at the public reference facility maintained by the SEC at its public reference room at 100 F Street, NE, Washington, DC 20549 and copies of all or any part thereof may be obtained from that office upon payment of the prescribed fees. You may call the SEC at 1-800-SEC-0330 for further information on the operation of the public reference room and you can request copies of the documents, upon payment of a duplicating fee, by writing to the SEC. In addition, the SEC maintains a web site at http://www.sec.gov that contains reports, proxy and information statements and other information regarding companies, including us, that file electronically with the SEC.

Structured Credit

General

We select, structure and sell credit protection through ACA Financial Guaranty, principally on highly rated liabilities of structured financings, including layers of risk of single tranche transactions and fully distributed CDOs, MBS and ABS transactions. Each liability or layer of risk that we insure generally references a diversified portfolio of corporate financial obligations such as bonds and loans, or structured finance securities. In addition, each layer of risk typically benefits from subordination, which means that we would not be required to make a payment until a pre-negotiated level of losses resulting from defaults on the referenced assets or a substitution of referenced assets has been reached. The pre-negotiated level of losses is referred to as an attachment point.

We generally assume credit risk in our Structured Credit business by entering into credit swaps with various counterparties, the required payments under which are insured by, and payable under, financial guaranty insurance policies. While generally we receive a fixed payment or premium for the sale of credit protection on a quarterly basis, in certain circumstances we receive a single premium that is paid up front at the time that we enter into such insured credit swap. Additionally, our insured credit swaps typically are secured by contingent collateral arrangements pursuant to which we agree to post collateral to secure our transactions, primarily in the event we experience a corporate credit event such as a downgrade of ACA Financial Guaranty to below an A- financial strength rating. Our willingness to provide such security, combined with our A-rated insurance platform, enhances counterparties willingness to do business with us and differentiates our business model from AAA rated financial guarantors and similar entities that are typically unable or unwilling to provide such collateral arrangements.

A large portion of our Structured Credit business consists of the insurance of single tranche transactions referencing a portfolio of corporate credits. In these transactions, which we refer to as Collateralized Synthetic Obligations (CSOs), we negotiate with dealers to construct a portfolio of reference entities, our attachment point and the size of our aggregate exposure that we will insure, each in accordance with the risk profile that we are willing to assume based on our risk adjusted return requirements.

For CDO, MBS and ABS transactions, we generally sell protection in the form of insured credit swaps that reference certain tranches of liabilities issued by those structures. Under our insured credit swaps we are obligated to make payments to a protection buyer in the event that the assets purchased in such structures have insufficient cash available to pay principal or interest on the referenced liability, or the assets underlying the referenced liability are written down beyond the enhancement afforded the class of securities insured.

As of December 31, 2006, over 99.7% of our insured credit swap portfolio was constructed of exposures attaching above the AAA rated level of subordination. However, beginning in 2005, we have assumed limited amounts of credit risk exposure that would be rated lower than AAA. We anticipate some growth in insuring credit exposure lower than AAA rated credit profiles when we believe such exposures will meet our risk-adjusted return requirements. We have also grown, and intend to continue to grow our Structured Credit business through the introduction of new asset classes and insurance products, including selling credit protection on single tranches referencing portfolios of MBS with various ratings, selling protection on single-name MBS (with various credit ratings), and executing credit swap transactions that reference the developing ABS indices.

Structured Credit Portfolio

The chart below shows the notional amounts of our insured Structured Credit portfolio as of the end of each quarter in 2006 and as of the end of each year since we closed our first Structured Credit transaction in 2002.

Historical Notional Amount of Structured Credit Portfolio
(Dollars in billions)

We executed our first Structured Credit transaction in July of 2002. As of December 31, 2006, we had completed 157 transactions with 151 of these outstanding as of December 31, 2006 and our insured Structured Credit portfolio totaled $39.4 billion (in aggregate insured credit swap notional amount). One way in which we manage risk in our insured credit swap portfolio is by means of diversification based on a variety of criteria, including reference rating quality, industry type and geographic location. As of December 31, 2006, our insured credit swaps written on CSO tranches include well over 1,000 reference entities spread across numerous ratings (primarily investment grade) and a wide range of industries and countries. Reference entities domiciled in the United States and outside of the United States comprised 53.7% and 46.3%, respectively, of our aggregate single tranche corporate credit portfolio as of December 31, 2006; of those domiciled outside of the United States, 61.8% constituted European reference entities and 24.6% constituted Asian reference entities. All of our insured credit swaps are denominated in United States dollars except for seven transactions denominated in Euros.

The chart below shows our insured Structured Credit portfolio by deal type as of December 31, 2006:

	Year Ended December 31,		**As of December 31,**	
	2006	**2005**	**2006**	
Deal Type	**Notional Written**	**Notional Written**	**Outstanding Notional Amount**	**Percentage of Portfolio**
CDO/CSO				
Corporate	$ 13,537	$ 9,009	$ 26,230	66.5 %
ABS/MBS	11,952	983	12,926	32.9 %
Multisector			202	0.5 %
Other		51	51	0.1 %
Total CDO/CSO	25,489	10,043	39,409	100.0 %
ABS/MBS		350	8	0.0 %
Total Structured Credit Portfolio	$ 25,489	$ 10,393	$ 39,417	100.0 %

Counterparties

As of December 31, 2006, we had 28 institutional counterparties in our Structured Credit business. Strengthening and expanding relationships with our counterparties is an important element of our business strategy. We enter into master agreements, standardized by the International Swaps and Derivatives Association, Inc. (ISDA) that govern the basic terms of our transactions with each of our counterparties, and a standard form financial guaranty insurance policy, which allows us to capitalize on market fluctuations and execute transactions in a timely and efficient manner.

Transaction Pricing and Loss Experience

The fixed payments that we receive in connection with our transactions are largely determined by the results of our quantitative modeling and credit swap market conditions, both generally and with respect to the particular reference entities included in a given portfolio. Our decision to enter into a particular transaction at a price is framed by our fundamental analysis of the underlying credits and by our proprietary model which considers numerous variables including the asset ratings and credit quality of the portfolio, portfolio industry and geographic concentrations, the explicit or implicit rating on the tranche, and the transaction terms and structural features, including the need for and terms of any potential collateral posting. We analyze our model s output and the market context of the subject transaction in light of our risk and economic return parameters.

Since establishing our Structured Credit business, we have made no payments in respect of defaults under our insured credit swaps.

Credit Fund

ACA Capital Partners I Master Fund Ltd. and ACA Capital Partners I Ltd. are private investment funds organized under the laws of the Cayman Islands, and collectively, are referred to as the Credit-focused Absolute Return Fixed Income Fund. 100% of ACA Capital Partners I Ltd. s investments are shares in ACA Capital Partners I Master Fund Ltd. The Credit Fund was created to leverage our expertise in the capital and credit markets and as an asset manager. The Credit Fund seeks to create value by investing in the structured finance, structured credit and corporate credit fixed income markets. As of December 31, 2006, ACA Capital Partners I Master Fund Ltd. had net assets under management of $25.6 million, of which ACA Financial Products, Inc., one of our wholly-owned indirect subsidiaries, owned $17.0 million. The balance of the $25.6 million was owned by outside investors through investments in ACA Capital Partners I Ltd. As of December 31, 2006, the Credit Fund had total assets under management of $264.6 million. The Credit Fund uses repurchase agreements to finance the acquisition of the majority of its assets. The Credit Fund is managed by ACA Management, which is paid a quarterly asset management fee for that portion of the assets managed for third parties. ACA Management is not paid a management fee for that portion of the Credit Fund s assets managed on our subsidiary s behalf. See Management s Discussion and Analysis of Financial Condition and Results of Operations Structured Credit.

Public Finance

General

We provide financial guaranty insurance through our subsidiary ACA Financial Guaranty, focusing on underserved segments of the public finance market and specific credits which we believe represent strong risk-adjusted value to the Company. Our financial guaranty insurance policies guarantee to investors the payment of the principal and interest on the insured obligation in accordance with the original payment schedule. ACA Financial Guaranty is licensed to write financial guaranty insurance in all 50 states, the District of Columbia, Guam, Puerto Rico and the U.S. Virgin Islands. As of December 31, 2006, we had $6.1 billion gross par outstanding.

Consistent with general market practice, we are typically paid our insurance policy premiums up front. Our premiums are negotiated to capture a portion of the difference in the borrowing cost, or spread, between our insured obligations and the same obligations if issued uninsured. ACA Financial Guaranty is the sole A rated financial guarantor.

From inception through December 31, 2006, we have paid $5.1 million of net losses and loss adjustment expenses which represent less than 1.7% of premiums written on our total Public Finance portfolio.

We generally execute our Public Finance transactions in the form of traditional financial guaranty insurance policies. In each of 2005 and 2006, however, we entered into an insured credit default swap referencing a single Public Finance obligation.

Target Public Finance Market

We target lower investment grade, high non-investment grade and non-rated transactions in the public finance market that we believe, by our analysis, have a strong credit profile and sufficient security to support our expectation of timely payment. Such additional security typically includes liens on the assets funded by the bond proceeds, mortgages on the underlying properties and revenue pledges amongst other forms of security as appropriate, all of which would be available to us in order to satisfy the principal and interest payments in the case of a default.

Our decision to insure a bond issue is only made following a detailed underwriting process. During this process, our underwriters perform quantitative and qualitative risk assessments that include stress testing the transaction to a remote-loss standard, a review of the economic rationale and the motivation of participants, an analysis of relative value and a legal review of the transaction structure. As part of the risk assessment process, the credit analysts also perform an economic analysis of each transaction, including a review of the proposed pricing relative to credit spreads for similar assets available in the market and the return on capital to us based on capital charges assessed by rating agencies. The ultimate decision to guarantee an issue is based upon such credit factors as the issuer s ability to repay the bonds, the bond s security features and the bond s structure. Further, for issues involving substantial construction, we typically require enhanced security, usually through a combination of third-party guarantees such as payment and performance bonds and builder s risk insurance, and liquidity reserve funds to cover completion and certain stabilization risks. As an A rated issuer we have greater flexibility from the rating agencies to select the credits we wish to insure as compared to other participants in the public finance market.

Prior to June 2004, we also participated in the secondary market for municipal bonds. In such cases, a holder of outstanding bonds in the secondary market will purchase financial guaranty insurance to facilitate the future sale of the bonds. Our current business strategy does not include any significant secondary market insurance participation; however, we do employ secondary market executions to supplement existing primary market exposures or in situations where we know the credit fundamentals of a particular issue of municipal bonds through primary underwriting. In the secondary market, the premium is generally payable in full at the time of policy issuance.

Public Finance Portfolio

We seek to maintain an insured portfolio that is designed to manage risk by means of diversification based on a variety of criteria including revenue source, issue size, type of asset, industry concentrations, type of bond and geographic area. As of December 31, 2006, we had 753 municipal policies outstanding relating to 379 unique obligors. Our insured portfolio of bonds is divided into the following major sector types:

Higher Education Bonds. Higher education bonds include bonds that are secured by revenue collected by either public or private colleges and universities. Such revenue can encompass all of an institution s revenue, including tuition and fees, or in other cases, can be specifically restricted to certain auxiliary sources of revenue. We also insure bonds issued for privatized student housing projects that benefit colleges and universities. These bonds are issued by not-for-profit entities that may or may not be affiliated with the college or university.

Health Care Revenue Bonds. Health care revenue bonds include bonds of healthcare facilities including community based hospitals and systems. To date, our primary focus in this area has been insuring bonds of acute care hospitals that are sole community providers in rural areas or specialty providers of essential services.

Tax-Backed (Non-General Obligation) Bonds. Tax-backed bonds include a variety of bonds that are supported, not by a general obligation, but instead by a specific tax source, and include tax-backed revenue bonds and general fund obligations of the issuer, such as lease revenue bonds. Tax-backed bonds may be secured by a lien on pledged tax revenues, such as revenues from special taxes, including retail sales and gasoline taxes, or from tax increments (or tax allocations) generated by growth in property values within a district.

Long-Term Care Bonds. Long-term care bonds that we insure consist primarily of long-term financings for capital construction or improvements of continuing care retirement communities, or CCRCs. CCRCs are organizations that offer a full range of housing, residential supportive services and healthcare to residents of retirement age. We typically insure the debt of CCRCs that have been operating with strong demand and stabilized occupancy or are being built to augment established operations.

General Obligation Bonds. General obligation or full faith and credit bonds are issued by states, their political subdivisions and other municipal issuers and are supported by the general obligation of the issuer to pay the bonds from available funds and by a pledge of the issuer to levy sufficient taxes to provide for the full payment of the bonds.

Transportation Revenue Bonds. Transportation revenue bonds include a wide variety of revenue-supported bonds, such as bonds for airports, ports, tunnels, municipal parking facilities, toll roads and toll bridges.

Housing Revenue Bonds. Housing revenue bonds include affordable multi-family housing bonds, with varying security structures based on the presence of underlying mortgages, reserve funds, and various other features.

Not-For-Profit Bonds. Not-for-profit bonds include bonds issued by not-for-profit organizations, including museums and other cultural institutions, the deal structures and security packages for which vary among transactions.

Municipal Utility Revenue Bonds. Municipal utility revenue bonds include obligations of all forms of municipal utilities, including electric, water and sewer utilities and resource recovery revenue bonds. Insurable utilities may be organized as municipal enterprise systems, authorities or joint-action agencies.

Investor-Owned Utilities Bonds. Pollution control bonds or industrial development bonds are issued to finance projects of investor-owned utilities. The bonds are secured by the senior credit or first mortgage obligations of an investor-owned utility, typically an electric distribution utility.

Other Public Bonds. Other types of public bonds insured by ACA Financial Guaranty include financings for Native American tribes, stadiums, government office buildings, recreation facilities, prison facilities and mobile home parks. These bond types are typically secured by a combination of project-related fee revenue, lease payments or other support of state or local governmental entities.

The following table shows the diversification by bond sector type of our gross par exposure insured for the year ended December 31, 2006 and our gross par exposure outstanding as of December 31, 2006:

Insured Public Finance Portfolio by Bond Type
(in millions)

Bond Type	Year Ended Insured December 31, 2006 Gross Par	Percentage	Outstanding Gross Par(1) December 31, 2006 Gross Par	Percentage
Higher Education	$ 160.5	25.9 %	$ 1,504.2	24.5 %
Health Care		0.0	843.9	13.8
Tax-Backed	51.1	8.3	778.0	12.7
Long Term Care	68.7	11.1	701.3	11.4
General Obligations	40.4	6.5	465.2	7.6
Transportation		0.0	384.8	6.3
Housing	42.7	6.9	277.8	4.5
Not For Profit	117.3	19.0	411.2	6.7
Utility	12.9	2.1	257.2	4.2
Other	125.0	20.2	505.8	8.3
Total Public Finance	$ 618.6	100.0 %	$ 6,129.4	100.0 %

(1) Debt service balances for the years ended December 31, 2006 and 2005 are $10.9 billion and $11.3 billion, respectively.

The table below sets forth the geographic distribution, by location of the obligor, of our outstanding gross par exposure by the ten largest jurisdictions as of December 31, 2006.

Public Finance Insured Portfolio by State or Territory
(in millions)

Location	Gross Par Exposure	Percent of Public Portfolio
California	$ 1,020.2	16.6 %
New York	642.8	10.5
Texas	374.2	6.1
Florida	333.9	5.4
Pennsylvania	279.0	4.6
Washington	278.0	4.5
Arizona	193.8	3.2
Massachusetts	190.7	3.1
Illinois	183.5	3.0
Colorado	183.3	3.0
Top 10 Public Finance	3,679.4	60.0
Other States or Territories	2,450.0	40.0
Total	$ 6,129.4	100.0 %

As of December 31, 2006, the gross par amount outstanding for our ten largest Public Finance credits, totaling $705.3 million, was 11.5% of our total gross par amount outstanding, with no one credit representing more than 1.7% of our total gross par amount outstanding.

We underwrite financial guaranty insurance on the assumption that the insurance will remain in force until maturity of the insured obligations.

CDO Asset Management

General

As an asset manager of CDOs we apply our core competencies in analyzing credit risk to construct and manage CDOs on behalf of third party investors for which we earn management fees. Increases in fee revenues generally correspond to increases in assets under management. To grow our assets under management, we sponsor CDOs that acquire pools of fixed income assets that we select and manage through our registered investment adviser subsidiary, ACA Management and, in the future, through ACA Capital Management (U.K.), our FSA regulated investment manager. We completed our first CDO in January 2002 and as of December 31, 2006, we had closed 22 CDO transactions and had grown our CDO assets under management from $2.4 billion as of year-end 2002 to $15.7 billion as of December 31, 2006. In the first quarter of 2007, ACA Capital Management (U.K.) obtained its license to manage CDOs in the United Kingdom and most of Europe. At December 31, 2006, our weighted average asset management fee was 0.23% on total CDO assets under our management. Based on our knowledge of the market, we believe that we are one of the largest global CDO managers as ranked by assets under management.

The chart below reflects assets under management as of December 31 of each year since we closed our first CDO in 2002.

CDO Assets Under Management
(in billions)

We receive multiple revenue streams in connection with our CDO products. We receive fees for structuring the CDOs, fees during the period the CDO assets are accumulated, which we call the warehouse phase, and fees for providing asset management services during the term of the CDO. In 2006, we invested in the equity of only four of our eight newly originated CDOs, ranging from 5% to 11% of the equity sold, which resulted in total equity investments of $8.6 million with respect to the $5.8 billion in CDO assets under management added. We view our equity investments as an opportunity to increase the marketability of our CDOs by aligning our interests as manager with those of our CDO investors. As an equity investor in our CDOs, we generally receive returns in respect of our equity investment from proceeds generated by the underlying collateral in excess of expenses and debt service, including principal payments currently payable on the liabilities issued by the CDO.

Each of our managed CDOs includes a diversified portfolio of financial obligations such as bonds, loans and/or credit swaps that reference individual bonds or loans. We currently sponsor and manage CDOs backed by non-investment grade and investment grade corporate financial obligations, ABS, MBS and other CDO securities, and non-investment grade leveraged loans and bonds. CDOs do not always own their underlying collateral outright but rather, in certain structures, achieve collateral exposure by entering into credit swaps, in which case we refer to the structures as synthetic CDOs. Our corporate credit CDOs and certain of our ABS CDOs are synthetic CDOs. In addition, many of our cash flow CDOs allow for some portion of the underlying exposures to be obtained synthetically through credit swaps.

At December 31, 2006, we managed over 2,500 credit positions across 52 industries in our CDOs, which are actively monitored by our credit analysts. We have an experienced staff of professionals with backgrounds in insurance, credit analysis, capital markets and risk assessment that services our CDO Asset Management business as well as a strong infrastructure of legal, accounting, information technology and other professionals.

The following tables provide certain information on our CDO assets under management as of December 31 2006:

CDO Assets Under Management

	Year Deal Closed	Collateral Type(1)	Current AUM (in millions)	Original Investment in Equity (in millions)	Retained Equity %	First Optional Call Date(2)	Maturity Date
Asset-Backed CDOs:							
ACA ABS 2002-1	2002	Investment Grade	$ 224	$ 18.0	100	8/2005	8/2037
ACA ABS 2003-1	2003	Investment Grade	403	18.0	100	6/2007	6/2038
Grenadier Funding	2003	High-Grade	1,485	22.5	100	8/2008	8/2038
ACA ABS 2003-2	2003	Investment Grade	725	33.5	100	12/2007	12/2038
ACA ABS 2004-1	2004	Investment Grade	411	10.0	61	7/2007	7/2039
Zenith Funding	2004	High-Grade	1,496	13.0	52	12/2009	12/2039
ACA ABS 2005-1	2005	Investment Grade	433	4.4	24	4/2008	4/2040
ACA ABS 2005-2	2005	Investment Grade	418	2.1	10	9/2009	12/2044
Khaleej II	2005	Investment Grade	750	4.5	14	9/2009	9/2040
Lancer Funding	2006	High-Grade	1,487	1.5	10	7/2010	4/2046
ACA Aquarius 2006-1	2006	Investment Grade	2,000			9/2010	9/2046
ACA ABS 2006-1	2006	Investment Grade	748	1.4	5	12/2009	6/2041
ACA ABS 2006-2	2006	Investment Grade	745	3.5	11	1/2011	1/2047
Total Asset-Backed CDOs			11,325	132.4			
Corporate Credit CDOs:							
ACA CDS 2001-1	2002	Investment Grade	975	22.5	100	N/A	4/2007
ACA CDS 2002-1	2002	Investment Grade	955	22.0	100	N/A	7/2007
ACA CDS 2002-2	2003	Investment Grade	990	25.0	100	N/A	3/2008
Argon 49	2005	Investment Grade	66 (3)				