ACA Capital Holdings Inc
Form 10-Q
August 14, 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 June 30, 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 August 10, 2007, 35,749,818 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 JUNE 30, 2007 AND DECEMBER 31, 2006

(Dollars in thousands)

	June 30, 2007	December 31, 2006
ASSETS		
Investments:		
Fixed-maturity securities available for sale at fair value, amortized cost of $4,843,922 and $5,043,239, respectively	$ 4,636,105	$ 5,026,276
Fixed-maturity securities trading at fair value, amortized cost of $408,627 and $251,884, respectively	406,432	251,825
Securities purchased under agreements to resell	3,408	10,248
Guaranteed investment contract	119,340	119,340
Total investments	5,165,285	5,407,689
Cash:		
Cash and cash equivalents	328,824	379,905
Restricted cash	46,155	67,061
Total cash	374,979	446,966
Accrued investment income	22,439	21,222
Derivative assets	232,267	19,730
Deferred policy acquisition costs, net	48,498	48,810
Deferred debt issuance costs, net	30,776	34,104
Receivable for securities sold	8,145	824
Prepaid reinsurance premiums	494	528
Deferred income taxes	126,363	
Other assets	82,996	58,321
Total assets	$ 6,092,242	$ 6,038,194
LIABILITIES, MINORITY INTEREST AND STOCKHOLDERS EQUITY		
LIABILITIES		
Unearned premiums	$ 195,667	$ 189,537
Reserve for losses and loss adjustment expenses	45,923	42,113
Short-term debt	2,779,513	2,677,828
Long-term debt	1,836,461	2,125,914
Related party debt	100,000	100,000
Securities sold under agreements to repurchase	372,936	232,227
Derivative liabilities	311,061	33,874
Accrued interest payable	15,797	17,900
Accrued expenses and other liabilities	76,058	61,855
Payable for securities purchased	2,110	9,628
Current income tax payable	15,765	7,056
Deferred income taxes		258
Total liabilities	5,751,291	5,498,190
MINORITY INTEREST	14,645	30,190
COMMITMENTS AND CONTINGENCIES		
STOCKHOLDERS EQUITY		
Common stock of 100,000,000 shares authorized at June 30, 2007 and December 31, 2006; 37,444,873 and 37,375,123 shares issued and outstanding at June 30, 2007 and December 31, 2006, respectively; par value of $0.10	3,744	3,737
Gross paid-in and contributed capital	441,545	438,935

Treasury stock at cost 851,847 shares at June 30, 2007 and December 31, 2006	(12,088)	(12,088)
Notes receivable from stockholders	(3,121)	(3,121)
Deferred compensation	(290)	(870)
Accumulated other comprehensive loss net of deferred income tax of $(57,420) and $(1,760) at June 30, 2007 and December 31, 2006, respectively	(106,594)	(3,308)
Retained earnings	3,110	86,529
Total stockholders equity	326,306	509,814
Total liabilities, minority interest and stockholders equity	$ 6,092,242	$ 6,038,194

See notes to unaudited condensed consolidated financial statements.

ACA CAPITAL HOLDINGS, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS (UNAUDITED)

FOR THE THREE AND SIX MONTHS ENDED JUNE 30, 2007 AND 2006

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

	Three Months Ended June 30, 2007	2006	Six Months Ended June 30, 2007	2006
REVENUES:				
Gross premiums written	$ 15,478	$ 15,727	$ 20,519	$ 20,515
Less premiums ceded	(630)	(61)	(761)	(186)
Net premiums written	14,848	15,666	19,758	20,329
Increase in unearned premium reserve - net	(6,403)	(7,191)	(6,164)	(6,972)
Premiums earned	8,445	8,475	13,594	13,357
Net insured credit swap revenue	(44,183)	7,931	(40,484)	22,111
Net investment income	90,627	82,452	180,547	160,164
Net realized and unrealized losses on investments	(110,142)	(1,256)	(113,850)	(3,223)
Net realized and unrealized gains on derivative instruments	3,256	2,497	5,336	6,139
Other net credit swap revenue	3,851	2,631	16,157	5,544
Fee income	7,596	6,955	13,928	11,073
Other income	299	53	355	104
Total revenues	(40,251)	109,738	75,583	215,269
EXPENSES:				
Loss and loss adjustment expenses	1,859	1,661	3,232	3,682
Policy acquisition costs	3,042	2,768	4,519	4,160
Other operating expenses	15,564	12,681	31,717	23,294
Interest expense	76,337	70,964	152,745	137,383
Depreciation and amortization	2,278	2,225	4,537	4,717
Total expenses	99,080	90,299	196,750	173,236
Income of minority interest	(1,265)	(1,074)	(2,144)	(2,229)
Income (loss) before income taxes	(140,596)	18,365	(123,311)	39,804
Provision for income tax expense (benefit)	(47,260)	6,323	(41,392)	13,615
Net income (loss)	$ (93,336)	$ 12,042	$ (81,919)	$ 26,189
Share and Per Share Data				
Earnings (loss) per share				
Basic	$ (2.55)	$ 0.53	$ (2.24)	$ 1.15
Diluted	$ (2.55)	$ 0.40	$ (2.24)	$ 0.87
Weighted average shares outstanding				
Basic	36,577	22,858	36,558	22,830
Diluted	36,577	30,085	36,558	29,846

See notes to unaudited condensed consolidated financial statements.

ACA CAPITAL HOLDINGS, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF STOCKHOLDERS EQUITY (UNAUDITED)

FOR THE SIX MONTHS ENDED JUNE 30, 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 (Loss)	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										26,189	26,189
Change in unrealized gain on investments, net of change in deferred income tax of $(1,528)									(3,999)		(3,999)
Change in derivative hedges, net of change in deferred income tax of $2,987									5,547		5,547
Total comprehensive income											27,737
Vesting of Series B senior conv. prf stock to CEO								580			580
Exercise of stock options by former executives			663,540	66	8,024						8,090
Common stock purchased from former executive						(6,588)					(6,588)
Stock based compensation-stock options					350						350
Issuance of note receivable from stockholder							(2,262)				(2,262)
Discharge of note receivable from stockholders							496				496
Senior convertible preferred stock dividend	25	1,957								(1,957)	
BALANCE June 30, 2006	2,786,882	$ 228,417	7,106,490	$ 710	$ 133,558	$ (12,088)	$ (3,121)	$ (1,450)	$ 12,680	$ 54,010	$ 412,716
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 loss:											
Net loss										(81,919)	(81,919)
Change in unrealized loss on investments, net of change in deferred income tax of $(56,453)									(104,841)		(104,841)
Change in derivative hedges, net of change in deferred income tax of $792									1,472		1,472
Foreign exchange unrealized gain									83		83
Total comprehensive loss											(185,205)
Vesting of CEO restricted common stock								580			580
Offering costs					63						63
Stock based compensation restricted stock					476						476
Stock based compensation stock options					1,349						1,349
Exercise of common stock options			69,750	7	722						729
BALANCE June 30, 2007		$	37,444,873	$ 3,744	$ 441,545	$ (12,088)	$ (3,121)	$ (290)	$ (106,594)	$ 3,110	$ 326,306

See notes to unaudited condensed consolidated financial statements.

ACA CAPITAL HOLDINGS, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)

FOR THE SIX MONTHS ENDED JUNE 30, 2007 AND 2006

(Dollars in thousands)

	2007	2006
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income (loss)	$ (81,919)	$ 26,189
Adjustments to reconcile net income (loss) to net cash provided by operating activities:		
Depreciation and amortization	4,537	4,717
Accrual of discount and amortization of premium on investment net	194	(208)
Income of minority interest	2,144	2,229
Net realized losses on fixed-maturity securities-available-for-sale	111,632	3,203
Net realized and unrealized losses on fixed-maturity securities- trading	2,219	20
Net realized and unrealized gains on derivative instruments	(5,336)	(6,139)
Net realized and unrealized (gains) losses on net insured credit swap revenue	82,846	(829)
Net realized and unrealized gains on other net credit swap revenue	(10,627)	(291)
Net foreign exchange loss	43	
Share based compensation expense	1,825	350
Discharge of note receivable from shareholders		496
Deferred compensation	580	580
Purchase of securities under agreement to resell	6,840	
Purchases of fixed-maturity securities-trading	(222,150)	
Proceeds from sales of fixed-maturity securities- trading	64,183	
Securities sold under agreement to repurchase	140,709	
Changes in assets and liabilities:		
Income taxes payable	8,709	343
Deferred income tax expense	(70,921)	2,967
Prepaid reinsurance premiums	34	228
Derivative liabilities	307	(1,905)
Accrued expenses and other liabilities	(7,298)	(2,591)
Deferred policy acquisition costs	312	(661)
Unearned premium reserve	6,130	6,743
Loss and loss adjustment expenses	3,810	2,938
Interest payable	(2,103)	632
Interest receivable	(1,217)	(2,052)
Other	5,472	1,272
Net cash provided by operating activities	40,955	38,231
CASH FLOWS FROM INVESTING ACTIVITIES:		
Net deposit of restricted cash	20,906	(3,881)
Purchases of fixed maturity securities available for sale	(538,170)	(519,582)
Proceeds from sales of fixed maturity securities available for sale	78,568	83,662
Proceeds from maturities of fixed maturity securities available for sale	533,395	524,052
Net purchase of property and equipment	(2,759)	(230)
Net cash provided by investing activities	91,940	84,021
CASH FLOWS FROM FINANCING ACTIVITIES:		
Paydown of commercial paper net	(361)	(393)
Paydown on long-term debt	(187,407)	(72,507)
Payment of issuance costs for debt		(308)
Proceeds from issuance of equity in Credit Fund	3,000	
Proceeds from exercise of common stock options	729	
Purchase of treasury stock		(759)
Offering costs	63	

Net cash used in financing activities	(183,976)	(73,967)
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	(51,081)	48,285
CASH AND CASH EQUIVALENTS beginning of period	379,905	174,420
CASH AND CASH EQUIVALENTS end of period	$ 328,824	$ 222,705
SUPPLEMENTAL CASH FLOW DISCLOSURES:		
Federal and local income taxes paid	$ 10,356	$ 11,049
Interest paid	$ 154,848	$ 136,752
SUPPLEMENTAL DISCLOSURES OF NON-CASH FINANCING ACTIVITIES:		
Common stock acquired in exchange for note receivable	$	$ 2,262

See notes to unaudited condensed consolidated financial statements.

ACA CAPITAL HOLDINGS, INC. AND SUBSIDIARIES

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

JUNE 30, 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 U.S.-based 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 or credit swaps), 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 and six months ended

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June 30, 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.

Valuation of Insured Credit Swap Transactions The Company values its insured credit swap transactions either by obtaining market quotes from dealers or through the application of the Company s valuation model. During the quarter ended June 30, 2007, the Company refined its valuation model to estimate fair value of its insured credit swap transactions. The change was implemented to be more consistent with models that the Company understands other market participants utilize, including many of ACA s insured credit swap counterparties. The relatively young market for credit swaps has continued to evolve over time and, while there is still substantial variance in valuation models among market participants, the trend is toward increasing convergence in this area. Under its refined model, the Company fully uses market spread data as a proxy for default probabilities in the determination of fair value. For transactions in which the underlying exposure is to corporate credits, the Company uses individual market spreads as proxies for defaults as they are readily available. For synthetic asset-backed transactions, the Company uses a current weighted average portfolio spread because individual spread information historically has not been consistently reliable and often has been unavailable. As the availability and quality of individual asset-backed spread data improves, the Company may make further refinements to its valuation model. The Company believes that its new model will inherently increase the volatility of these valuations, but provide a better estimate of the cost or benefit of unwinding the related transaction.

3. RELEVANT RECENT ACCOUNTING PRONOUNCEMENTS

On April 18, 2007, the Financial Accounting Standards Board (FASB) released an exposure draft entitled *Accounting for Financial Guarantee Insurance 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 15, 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 the Company s 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. The Company did not elect to early adopt FAS 159. 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).

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,

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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 05-1 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 June 30, 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
Abacus	2007	Unfunded	Investment Grade	192		No			6/2010	3/2038
ACA ABS 2007-2	2007	Partially funded	Investment Grade	750		No			7/2011	7/2045
Lancer II	2007	Partially funded	High-Grade	1,000		No			7/2011	7/2047
Total Asset-Backed CDOs				15,146			133.8			
Corporate Credit CDOs:										
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				1,556			25.0			
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
ACA CLO Euro 2007-1	2007	Funded	Non-Investment Grade	555	(2)	No	5.5	10	6/2010	6/2024
ACA CLO 2007-1	2007	Funded	Non-Investment Grade	350		No	2.7	10	6/2011	6/2022
Total Leveraged Loan CDOs				1,855			15.4			
Total				**$ 18,557**			**$ 174.2**			

Note: As of June 30, 2007, the Company s risk under corporate credit CDO ACA CDS 2002-1 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.

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(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. The original deal size for ACA CLO Euro 2007-1 was 400 million. For purposes of this chart, we have converted the amounts to U.S. dollars at the prevailing currency exchange rate on June 30, 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 on a specific date as negotiated, 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 the respective amounts to U.S. dollars at the prevailing currency exchange rates on June 30, 2007.

As of June 30, 2007 and December 31, 2006, consolidated liabilities include non-recourse debt from consolidated CDOs of $4,525.9 million and $4,711.8 million, respectively. Also, as of June 30, 2007 and December 31, 2006, consolidated assets include investments in CDO related fixed maturity securities and guaranteed investment contracts of $4,193.3 million and $4,656.0 million, respectively, and cash of $238.0 million 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 and six months ended June 30, 2007 and 2006:

	Three Months Ended June 30, 2007	**2006**	**Six Months Ended June 30, 2007**	**2006**
	(in thousands)			
Net insured credit swap revenue				
Insured credit swap premiums earned	$ 23,600	$ 11,218	$ 42,362	$ 21,282
Unrealized losses on insured credit swaps	(67,783)	(5,075)	(82,846)	(1,180)
Realized gains on insured credit swaps		1,788		2,009
Total net insured credit swap revenue	$ (44,183)	$ 7,931	$ (40,484)	$ 22,111

Of the $(67.8) million unrealized loss recorded in the three months ended June 30, 2007, $(67.5) million was related to valuation changes in the Company s Structured Credit transactions. The residential mortgage-backed securities (RMBS) portion of the Structured Credit portfolio incurred valuation losses of $253.0 million for the three months ended June 30, 2007. However, no realized or actual losses were incurred on this portfolio based on its very high credit quality, with over 99.8% of the portfolio constructed of exposures attaching above the AAA rated level of subordination. These valuation losses were precipitated by the severe level of delinquencies and defaults that have occurred in the residential mortgage market, particularly in the sub-prime and second lien segments, which constitute a significant portion of the assets underlying the RMBS included in the pools of assets referenced by certain of our Structured Credit transactions. Partially offsetting the valuation losses on the Structured Credit RMBS portfolio was an unrealized gain in the amount of $185.5 million on Structured Credit s corporate credit portfolio. The valuation gains on the corporate portfolio resulted from tighter spreads at June 30, 2007, on a portion of the portfolio, compared to spreads when the transactions were originated, and the refinement in the Company s valuation model to fully use market spread data as a proxy for default probabilities (see Note 2). In addition, pricing declined as more seasoned transactions reached maturity without experiencing losses, resulting in unrealized gains. As a result of the Company s intention to generally hold its insured credit swaps to term, absent credit losses, these unrealized amounts will revert to $0 at contract expiration.

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. As of June 30, 2007, the Company s risk to the partially funded CDS CDO and one of the synthetic equity participation had expired. 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 and six months ended June 30, 2007 and 2006:

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	Three Months Ended June 30, 2007 (in thousands)	2006	Six Months Ended June 30, 2007	2006
Other net credit swap revenue				
Credit swap fees earned	$ 1,643	$ 2,534	$ 5,811	$ 5,253
Unrealized gain on credit protection purchased	3,110		11,565	
Unrealized gains (losses) on credit swaps	(902)	97	(1,219)	291
Total other net credit swap revenue	$ 3,851	$ 2,631	$ 16,157	$ 5,544

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 for which the interest payable is 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 credit swaps, 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 and six months ended June 30, 2007 and 2006 (dollars in thousands):

	Three Months Ended June 30, 2007 Structured Credit	Public Finance	CDO Asset Management	Other	Consolidated Totals
REVENUES:					
Gross premiums written	$ 47	$ 15,371	$	$ 60	$ 15,478
Premiums earned	$ 47	$ 8,228	$	$ 170	$ 8,445
Net insured credit swap revenue	(44,628)	284	161		(44,183)
Net investment income	6,973	4,266	78,337	1,051	90,627
Net realized and unrealized gains (losses) on investments	(714)	2	(109,430)		(110,142)
Net realized and unrealized gains on derivative instruments	292		2,964		3,256
Other net credit swap revenue	(237)		4,088		3,851
Fee and other income	230	253	7,412		7,895
Total revenues	(38,037)	13,033	(16,468)	1,221	(40,251)
EXPENSES:					
Loss and loss adjustment expenses		1,614		245	1,859
Policy acquisition costs		2,841		201	3,042
Other operating expenses	6,408	2,832	6,322	2	15,564
Interest expense	4,475	391	71,378	93	76,337
Depreciation and amortization	159	132	1,987		2,278
Total expenses	11,042	7,810	79,687	541	99,080
Income of minority interest	(141)		(1,124)		(1,265)
Income (loss) before income taxes	(49,220)	5,223	(97,279)	680	(140,596)
Provision for income tax expense (benefit)	(16,520)	1,736	(32,702)	226	(47,260)
Net income (loss)	$ (32,700)	$ 3,487	$ (64,577)	$ 454	$ (93,336)
Segment Assets	$ 661,100	$ 598,761	$ 4,701,093	$ 131,288	$ 6,092,242

	Three Months Ended June 30, 2006 Structured Credit	Public Finance	CDO Asset Management	Other	Consolidated Totals
REVENUES:					
Gross premiums written	$ 192	$ 15,301	$	$ 234	$ 15,727
Premiums earned	$ 210	$ 7,575	$	$ 690	$ 8,475
Net insured credit swap revenue	7,699	(30)	262		7,931
Net investment income	882	4,133	76,482	955	82,452
Net realized and unrealized losses on investments	(35)	(81)	(1,120)	(20)	(1,256)
Net realized and unrealized gains on derivative instruments			2,497		2,497
Other net credit swap revenue	(11)		2,642		2,631
Fee and other income	153	54	6,801		7,008
Total revenues	8,898	11,651	87,564	1,625	109,738
EXPENSES:					
Loss and loss adjustment expenses		1,539		122	1,661
Policy acquisition costs		2,518		250	2,768
Other operating expenses	4,746	2,292	5,643		12,681
Interest expense	90	427	70,359	88	70,964
Depreciation and amortization	161	121	1,943		2,225
Total expenses	4,997	6,897	77,945	460	90,299
Income of minority interest	(7)		(1,067)		(1,074)
Income before income taxes	3,894	4,754	8,552	1,165	18,365

Provision for income tax expense	1,351	1,633	2,941	398	6,323
Net income	$ 2,543	$ 3,121	$ 5,611	$ 767	$ 12,042
Segment Assets	$ 56,390	$ 452,947	$ 5,139,289	$ 96,877	$ 5,745,503

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	Six Months Ended June 30, 2007 Structured Credit	Public Finance	CDO Asset Management	Other	Consolidated Totals
REVENUES:					
Gross premiums written	$ 134	$ 20,043	$	$ 342	$ 20,519
Premiums earned	$ 134	$ 13,106	$	$ 354	$ 13,594
Net insured credit swap revenue	(39,983)	1,430	(1,931)		(40,484)
Net investment income	12,718	8,543	157,183	2,103	180,547
Net realized and unrealized losses on investments	(2,226)	(27)	(111,590)	(7)	(113,850)
Net realized and unrealized gains on derivative instruments	288		5,048		5,336
Other net credit swap revenue	(274)		16,431		16,157
Fee and other income	345	344	13,594		14,283
Total revenues	(28,998)	23,396	78,735	2,450	75,583
EXPENSES:					
Loss and loss adjustment expenses		2,639		593	3,232
Policy acquisition costs		4,304		215	4,519
Other operating expenses	12,698	5,739	13,267	13	31,717
Interest expense	7,765	777	144,018	185	152,745
Depreciation and amortization	297	246	3,994		4,537
Total expenses	20,760	13,705	161,279	1,006	196,750
Income of minority interest	(58)		(2,086)		(2,144)
Income (loss) before income taxes	(49,816)	9,691	(84,630)	1,444	(123,311)
Provision for income tax expense (benefit)	(16,722)	3,253	(28,408)	485	(41,392)
Net income (loss)	$ (33,094)	$ 6,438	$ (56,222)	$ 959	$ (81,919)
Segment Assets	$ 661,100	$ 598,761	$ 4,701,093	$ 131,288	$ 6,092,242

	Six Months Ended June 30, 2006 Structured Credit	Public Finance	CDO Asset Management	Other	Consolidated Totals
REVENUES:					
Gross premiums written	$ 470	$ 19,383	$	$ 662	$ 20,515
Premiums earned	$ 506	$ 11,752	$	$ 1,099	$ 13,357
Net insured credit swap revenue	20,439	632	1,040		22,111
Net investment income	1,734	8,004	148,577	1,849	160,164
Net realized and unrealized losses on investments	(171)	(817)	(2,046)	(189)	(3,223)
Net realized and unrealized gains on derivative instruments			6,139		6,139
Other net credit swap revenue	(25)		5,569		5,544
Fee and other income	283	152	10,742		11,177
Total revenues	22,766	19,723	170,021	2,759	215,269
EXPENSES:					
Loss and loss adjustment expenses		2,915		767	3,682
Policy acquisition costs		3,790		370	4,160
Other operating expenses	8,663	4,404	10,227		23,294
Interest expense	173	830	136,207	173	137,383
Depreciation and amortization	367	309	4,041		4,717
Total expenses	9,203	12,248	150,475	1,310	173,236

Income of minority interest	(7)		(2,222)		(2,229)
Income before income taxes	13,556	7,475	17,324	1,449	39,804
Provision for income tax expense	4,637	2,558	5,925	495	13,615
Net income	$ 8,919	$ 4,917	$ 11,399	$ 954	$ 26,189
Segment Assets	$ 56,390	$ 452,947	$ 5,139,289	$ 96,877	$ 5,745,503

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 and 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 six months of 2007 and 2006, the vested portion of the restricted stock totaled $0.6 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 $0.7 million and $0.2 million for the three months ended June 30, 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 $0.2 million and $0.1 million for the three months ended June 30, 2007 and 2006, respectively. The Company recorded stock-based compensation expense of $1.8 million and $0.4 million for the six months ended June 30, 2007 and 2006, respectively, $0.3 million and $0 million of which, respectively, was deferred related to policy acquisition costs. The Company recorded a tax benefit of $0.6 million and $0.1 million for the six months ended June 30, 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.

	June 30, 2007		June 30, 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 six months of 2007 and 2006 was $5.19 and $4.45, respectively.

A summary of option activity for the six months ended June 30, 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	3,043,650		$	10.54
Granted	448,000		$	14.63	1,017,000		$	12.66
Exercised	(69,750	)	$	10.44	(663,540	)	$	10.23
Forfeited	(105,369	)	$	12.28	(51,402	)	$	10.52
Expired								
Outstanding, end of period	4,169,929		$	11.84	3,345,708		$	11.25
Options vested, end of period	2,237,946		$	11.02	1,526,922		$	10.70

As of June 30, 2007, there was $8.4 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 2.92 years.

During the first quarter of 2007, the Company granted 106,500 shares of restricted stock. As of June 30, 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 June 30, 2007 (dollars in thousands, except per share amounts):

Number of options vested	2,237,946	
Weighted average exercise price per share	$	11.02
Aggregate intrinsic value (excess market price over exercise price)	$	24,654
Weighted average remaining contractual term of options (in years)	5.33	

The following table summarizes information concerning outstanding and exercisable options at June 30, 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	1,827,916	5.31	$	10.33	1,522,639	$	10.32
$10.52-$12.01	96,000	7.62	$	11.63	55,453	$	11.63
$12.02-$13.51	1,811,013	7.92	$	12.70	659,854	$	12.58
$13.52-$15.01	435,000	9.63	$	14.63			
	4,169,929	6.95	$	11.84	2,237,946	$	11.02

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 six months ended June 30, 2007 and 2006, based on the fair value method under FAS 123 (dollars in thousands, except per share amounts).

	Six Months Ended June 30, 2007	Six Months Ended June 30, 2006
Net income (loss), as reported	$ (81,919)	$ 26,189
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	(152)	(212)
Pro forma net income (loss)	$ (82,071)	$ 25,977
Basic earnings (loss) per share		
As reported	$ (2.24)	$ 1.15
Pro forma	$ (2.24)	$ 1.14
Diluted earnings (loss) per share		
As reported	$ (2.24)	$ 0.87
Pro forma	$ (2.24)	$ 0.87

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 June 30, 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 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 June 30, 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	$ 38,304	$ (1,135)	$ 1,818	$ (77)	$ 40,122	$ (1,212)
Federal-agency securities	62,502	(1,501)	4,370	(180)	66,872	(1,681)
Obligations of states and political subdivisions	69,094	(986)	51,629	(1,461)	120,723	(2,447)
Corporate securities	24,993	(731)	54,821	(2,855)	79,814	(3,586)
Asset-backed securities	4,956	(43)	4,967	(111)	9,923	(154)
Mortgage-backed securities	49,819	(1,568)	90,859	(4,332)	140,678	(5,900)
Total non-VIE securities	249,668	(5,964)	208,464	(9,016)	458,132	(14,980)
Available for sale-VIE asset-backed securities	1,804,091	(160,467)	656,447	(45,918)	2,460,538	(206,385)
Total	$ 2,053,759	$ (166,431)	$ 864,911	$ (54,934)	$ 2,918,670	$ (221,365)

A substantial portion of the unrealized loss in CDO VIE asset-backed securities is related to RMBS, including both sub-prime and mid-prime quality mortgages. The last quarter of 2006 and first quarter of 2007 saw significant disruption in the sub-prime and second lien mortgage markets, with some mortgage originators being purchased or exiting the business. This severe disruption continued into the second quarter with other types of market participants (i.e., hedge funds, insurance companies) announcing significant losses in connection with their sub-prime and second lien mortgage exposure. This disruption further translated into decreased liquidity and wider spreads across the market, decreasing the market value of the portfolios. 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. During the second quarter of 2007, the Company determined that certain of its holdings in RMBS through its consolidated CDOs were other than temporarily impaired. As a result, write-offs relating primarily to those securities, aggregating $109.4 million were recorded as a reduction of net income during the quarter. The write-downs related to consolidated CDOs included approximately $46.9 million in excess of the Company s true economic exposure or its equity investment in the CDOs that was recorded in the Company s statement of operations. The Company has no right to use these CDO assets. Moreover, the CDO liabilities, which are non-recourse to the Company, can only be extinguished from the cash flows on these assets. The Company s maximum economic loss from a consolidated CDO is limited to its equity investment in the CDO. Under current rules governing consolidation accounting, the Company s consolidated income statement would reflect 100% of the CDOs realized losses and its balance sheet would reflect 100% of the CDOs unrealized losses despite the fact that its loss exposure is limited to its equity investment in the CDOs. Upon maturity, or the occurrence of a deconsolidation event, the equity and debt holders would absorb these losses and the Company would recognize a gain equal to all previous losses recognized in excess of its equity. The amount of realized and unrealized losses in excess of the Company s equity investment is $(46.9) million and $(72.8) million, respectively, as of June 30, 2007.

Regarding the unimpaired securities carried at an unrealized loss position as of June 30, 2007, the Company believed that it would be able to collect amounts due on these RMBS positions and has the ability and intent to hold these investments until a recovery of fair value, which may be at their maturities. The Company, therefore, did not consider these investments to be other-than-temporarily impaired at June 30, 2007.

For certain of the Company s consolidated CDOs, realized and unrealized losses exceed the amount of the Company s true economic exposure or equity investment in the CDO. This impairment in excess of the Company s equity investment is a result of the consolidation of CDO assets and liabilities on the Company s balance sheet in accordance with FIN 46(R).

The Company s accumulated other comprehensive loss of $(106.6) million at June 30, 2007, includes $(116.1) million related to unrealized losses on fixed maturity securities available for sale. Included in the $(116.1) million is $(72.8) million of unrealized losses in the consolidated CDOs mentioned above in excess of the Company s equity investment.

Included in the table above are 916 fixed maturity securities, 212 in the non-VIE portfolios, and 704 in the VIE portfolios. At June 30, 2007, there were 127 fixed maturity securities, all of which are in the VIE portfolios, whose fair value was less than 80% of its amortized cost. 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 June 30, 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 June 30, 2007, the Credit Fund had received capital contributions of $38.0 million, of which the Company had invested $26.4 million and third parties had invested $11.6 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 June 30, 2007 and its financial results are recorded in the Structured Credit line of business. As of June 30, 2007, the Credit Fund had total assets of $413.0 million, including investments in fixed-maturity securities trading of $406.4 million, and total liabilities and minority interest of $386.1 million, including securities sold under agreements to repurchase of $372.9 million, included in the Company s unaudited 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

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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. 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. LIQUIDITY FACILITY

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. The credit agreement contains certain financial covenants that require, among other things, the Company to maintain a minimum net worth and a maximum leverage ratio. The net worth covenant includes in its calculation the mark to market valuations recorded in the FAS 133 unrealized gains (losses) on derivatives in our statement of operations. While as of June 30, 2007, the Company was in compliance with these financial covenants, if credit spread widening continues beyond that which has occurred since June 30, 2007, the Company may violate the net worth covenant in the future. The Company intends to seek a waiver of or an amendment to this calculation. The Company may not, however, be able to obtain such waiver or amendment on a timely basis, or at all.

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 nor made any borrowing under the new credit facility as of June 30, 2007 and for the six month period then ended.

15. SUBSEQUENT EVENT-STOCK REPURCHASE PLAN

On July 24, 2007, the Company s Board of Directors authorized a $20 million stock repurchase program of the Company s outstanding common stock. As of August 9, 2007, the Company has repurchased 1,301,600 shares of common stock at a cost of $9.2 million in the aggregate.

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

The following discussion relates to our unaudited condensed 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 under Risk Factors below and 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 public 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 80% 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 June 30, 2007, we had credit exposure of $68.0 billion and our assets under management for third parties were $17.9 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. 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. 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, which is our intent, 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. See Critical Accounting Policies and Estimates and Net Insured Credit Swap Revenue.

In our Public Finance line of business, we primarily provide financial guaranty insurance policies guaranteeing the timely

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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 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 three and six months ended June 30, 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

$4.4 million and $3.3 million for the three months ended June 30, 2007 and 2006, respectively, and $5.0 million and $3.5 million for the comparable six months then ended.

On April 18, 2007, the FASB released an exposure draft entitled *Accounting for Financial Guarantee Insurance 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

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reserves and disclosures around such reserves. The Proposed Statement would be effective for financial statements issued for fiscal years beginning after December 15, 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.

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.

We value our insured credit swap transactions either by obtaining market quotes from dealers or through the application of our valuation model. During the quarter ended June 30, 2007, we refined our valuation model to estimate fair value of our insured credit swap transactions. The change was implemented to be more consistent with models that we understand other market participants utilize, including many of our insured credit swap counterparties. The relatively young market for credit swaps has continued to evolve over time and, while there is still substantial variance in valuation models among market participants, the trend is toward increasing convergence in this area. Under our refined model, we fully use market spread data as a proxy for default probabilities in the determination of fair value. For transactions in which the underlying exposure is to corporate credits, we use individual market spreads as proxies for defaults as they are readily available. For synthetic asset-backed transactions, we use a current weighted average portfolio spread because individual spread information historically has not been consistently reliable and often has been unavailable. As the availability and quality of individual asset-backed spread data improves, we may make further refinements to our valuation model. We believe that our new model will inherently increase the volatility of these valuations, but provide a better estimate of the cost or benefit of unwinding the related transaction.

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 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 ended June 18, 2007. No revised statement has yet been published. 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 $21.4 million and $20.2 million as of June 30, 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 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 June 30, 2007 plus future installment premium on closed transactions. This derived loss ratio is applied to total ever-to-date earned premiums as of June 30, 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 June 30, 2007 and December 31, 2006.

	As of June 30, 2007	**As of December 31, 2006**
	(in thousands)	
Case specific reserves	$ 21,421	$ 20,232
Non specific reserves	24,502	21,881
Total	$ 45,923	$ 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 of 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 June 30, 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 June 30, 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. Funded and partially funded CDOs are generally 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 CDO is consolidated, we do not have the right to use the assets of the CDO for general operations and the debt liabilities of the CDO are without recourse to any assets other than those of the CDO. 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 s equity, but are the primary beneficiary and thus consolidate the CDO, we establish minority interests for the unowned portion. As of June 30, 2007 and December 31, 2006, consolidated liabilities included non-recourse debt from consolidated CDOs of $4,525.9 million and $4,711.8 million, respectively. Also, as of June 30, 2007 and December 31, 2006, consolidated assets included investment in fixed maturity securities and guaranteed investment contracts of $4,193.3 million and $4,656.0 million, respectively, and cash of $238.0 million 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 six months of 2007, we closed eight CDOs and purchased an equity interest in three. During 2006, we closed eight CDOs and purchased an equity interest in four. During 2005, we closed five CDOs and purchased an equity interest in four. 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 June 30, 2007, the Credit Fund had received capital contributions of $38.0 million, of which the Company had invested $26.4 million and third parties had invested $11.6 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 U.S. GAAP accounting, 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 three months and the six months ended June 30, 2007 and 2006 and our financial condition as of June 30, 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 (loss) for the three months ended June 30, 2007 was $(93.3) million, or $(2.55) per diluted share, as compared to $12.0 million, or $0.40 per diluted share, for the three months ended June 30, 2006, a decrease of $105.3 million. The decrease in net income was principally related to after-tax other than temporary impairments of investments in our CDOs of $(71.1) million and after-tax net unrealized mark-to-market valuation losses on our portfolio of Structured Credit transactions of $(43.9) million.

The Company s consolidated net income (loss) for the six months ended June 30, 2007 was $(81.9) million, or $(2.24) per diluted share, as compared to $26.2 million, or $0.87 per diluted share, for the six months ended June 30, 2006, a decrease of $108.1 million, which were primarily the result of other than temporary impairments in our CDOs and unrealized mark-to-market valuation losses on our portfolio of Structured Credit transactions discussed above.

The following table summarizes the contribution of each line of business to net consolidated income (loss) for the three and six months ended June 30, 2007 and 2006:

Three Months Ended June 30,		Six Months Ended June 30,	
2007	2006	2007	2006