ANNUAL REPORT 1998

Ambac

FINANCIAL PEACE OF MIND

Ambac Financial Group, Inc., headquartered in New York City, is a holding company whose subsidiaries provide financial guarantee insurance and financial services to clients in both the public and private sectors around the world. The principal operating subsidiary, Ambac Assurance Corporation, a leading insurer of municipal and structured finance obligations, has been assigned triple-A ratings, the highest ratings available from Moody's Investors Services, Inc., Standard & Poor's Ratings Group, Fitch IBCA, Inc. and Japan Ratings and Investment Information, Inc. Ambac Financial Group, Inc., through its subsidiaries, also provides investment agreements, interest rate swaps and investment advisory and cash management services primarily to states, municipalities and municipal authorities. Ambac Financial Group, Inc. common stock is listed on the New York Stock Exchange (ticker symbol ABK).

In this Annual Report, we may make statements about our future results that are considered "forward-looking statements" under the Private Securities Litigation Reform Act of 1995. See "Management's Discussion and Analysis of Financial Condition and Results of Operations" of this Annual Report for further information regarding forward-looking statements, including factors that could cause materially different results.

Ambac

...COMES FINANCIAL PEACE OF MIND

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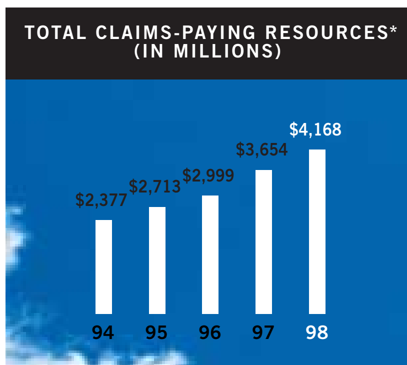
AMBAC AT A GLANCE

Infrastructure Ambac Assurance helps structure and provides insurance for public finance bond issues in the U.S. and abroad. Financial guarantee insurance is available for virtually all types of municipal bonds.

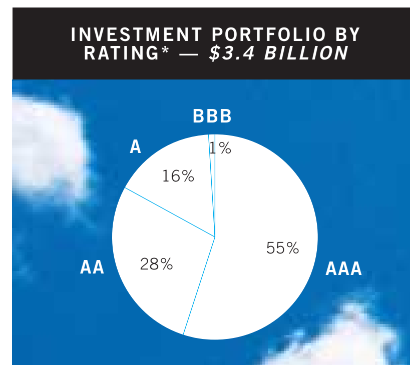
Healthcare Ambac Assurance financial guarantee insurance is used by hospitals and not-for-profit healthcare entities to help lower their financing costs through the added strength of its triple-A ratings.

Housing Public housing authorities utilize Ambac Assurance financial guarantee insurance to bolster their financing activities. In addition, Ambac Assurance actively works with issuers of mortgage-backed securities to improve the strength and marketability of their mortgage-backed and home equity loan securitizations.

Utilities Financing needs are broad and ongoing in the public and investor-owned utility sectors. Ambac Assurance works with utilities throughout the U.S. and in overseas markets, providing credit enhancement through financial guarantee insurance.



* Includes qualified statutory capital, unearned premiums, claims expenses and reserves, the present value of installment premiums and third party capital support.



* Based upon Standard & Poor's ratings.

Ambac, working through one or more of its various subsidiaries, provides financial guarantee insurance, risk management, cash management and other financial products to states, municipalities, local government authorities, school districts and corporate clients.

Ambac Assurance Corporation, a financial guarantee insurance subsidiary, is a leading insurer of municipal bonds throughout the United States. Ambac Assurance, rated triple-A by all the major rating agencies, also guarantees structured and asset-backed securities in the U.S. and around the world. Ambac Assurance founded the municipal bond insurance industry in 1971 and continues to be an industry leader in innovation and client service.

Another subsidiary, Cadre Financial Services, helps nearly 3,000 clients, primarily school districts, in 17 states manage

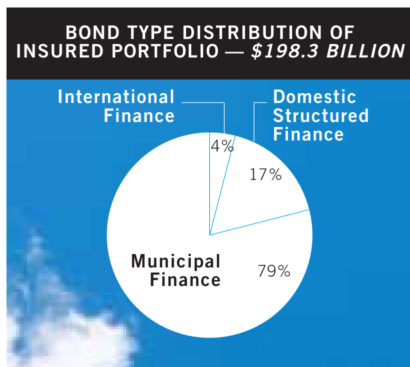
Education In addition to extensive financial guarantee insurance capabilities for student loan securitization and school infrastructure needs, Cadre Financial Services helps school districts in 17 states better manage their short-term financial and cash flow needs.

Asset/Liability Management Ambac Financial Group, Inc.'s subsidiaries use their product and market acumen to offer additional services, including interest rate swaps, investment agreements and portfolio management, to help clients lower the cost of financing and meet their often complex financial needs.

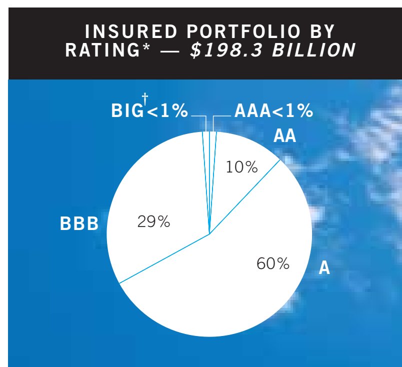
International Corporations and governments in Europe, Australia, Japan and Latin America are capitalizing on the benefits of financial guarantee insurance as Ambac Assurance broadens its capabilities to include service to markets outside the U.S. through its MBIA•AMBAC International joint venture.

Structured & Asset-Backed Ambac Assurance financial guarantee insurance is used increasingly by issuers of structured and asset-backed securities in the U.S. and around the world including banks, asset-backed commercial paper conduits and corporate issuers.

BOND TYPE DISTRIBUTION OF INSURED PORTFOLIO — *$198.3 BILLION*



INSURED PORTFOLIO BY RATING* — *$198.3 BILLION*



* Based upon Ambac internal ratings.
† Below Investment Grade

their short-term financial needs with innovative and flexible cash management programs, combining safety and liquidity with competitive yields.

The full range of products and services offered by Ambac Financial Group, Inc.'s subsidiaries are designed to add value while mitigating risk: in a bond offering, through an investment agreement, with an interest rate swap, or as part of an ongoing cash management program. We add value with a combination of extensive credit analysis skills and a thorough understanding of financial instruments and trading markets. The programs and services we provide, frequently tailored to meet specific needs, are often enhanced by Ambac Assurance's triple-A rating to help clients better meet their financing objectives.

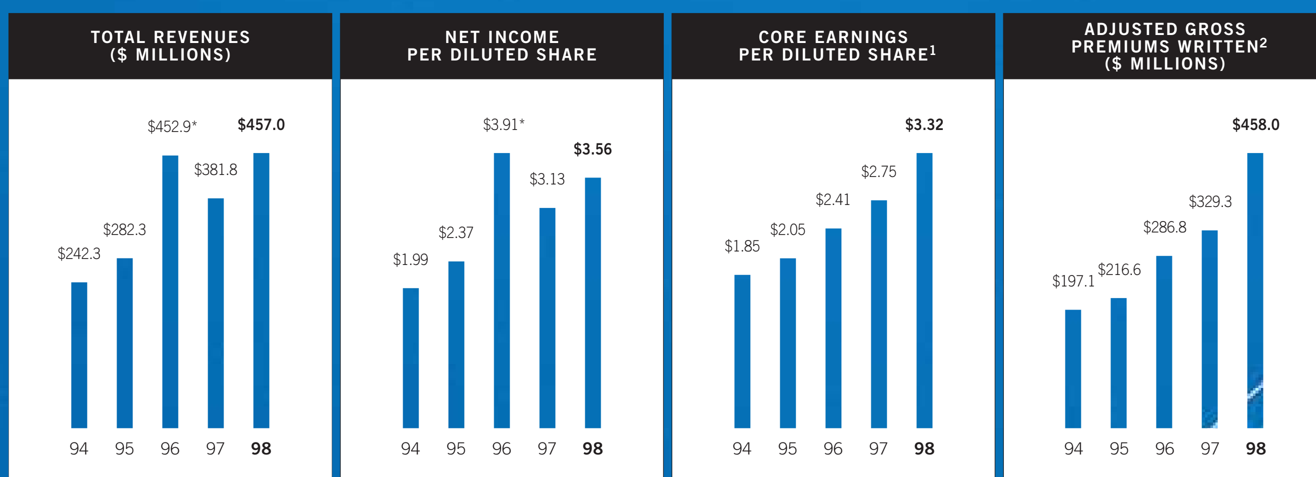
FINANCIAL HIGHLIGHTS

Ambac Financial Group, Inc. and Subsidiaries	Years Ended December 31,				
(Dollars in millions, except per share amounts)	**1998**	1997	1996*	1995	1994
STATEMENT OF OPERATIONS HIGHLIGHTS					
Gross premiums written	**$361.0**	$286.2	$247.2	$193.3	$189.9
Net premiums earned	**212.7**	154.0	136.6	111.8	117.5
Net investment income	**186.2**	159.7	144.9	131.0	117.1
Financial management services revenue	**49.5**	35.2	22.0	13.1	15.9
Total revenues	**457.0**	381.8	452.9	282.3	242.3
Losses and loss adjustment expenses	**6.0**	2.9	3.8	3.4	2.6
Financial guarantee insurance underwriting and operating expenses	**46.7**	40.7	37.2	34.5	32.8
Financial management services expenses	**35.5**	28.0	12.0	7.8	6.1
Interest expense	**32.8**	21.3	20.9	20.9	18.8
Net income	**254.0**	223.0	276.3	167.6	141.1
Net income per share	**3.63**	3.19	3.95	2.39	2.00
Net income per diluted share	**3.56**	3.13	3.91	2.37	1.99
Return on equity	**12.8%**	12.8%	18.3%	13.8%	13.2%

Ambac Financial Group, Inc. and Subsidiaries	As of December 31,				
(Dollars in millions)	**1998**	1997	1996	1995	1994
BALANCE SHEET HIGHLIGHTS					
Total investments, at fair value	**$ 8,748.4**	$6,915.1	$5,200.5	$4,441.6	$3,764.2
Prepaid reinsurance	**199.9**	183.5	168.8	153.4	139.9
Total assets	**11,212.3**	8,291.7	5,876.4	5,309.3	4,287.0
Unearned premiums	**1,294.2**	1,179.0	991.2	903.0	836.6
Losses and loss adjustment expenses	**115.8**	103.3	60.6	66.0	65.7
Obligations under investment agreements, investment repurchase agreements and payment agreements	**5,956.8**	4,321.0	2,754.6	2,426.9	2,025.3
Debentures	**423.9**	223.9	223.8	223.7	223.7
Total stockholders' equity	**2,096.1**	1,872.5	1,615.0	1,404.0	1,033.5

*1996 includes a one-time gain from the sale of a subsidiary equal to $155.6 million pre-tax and $100.6 million after-tax.

FIVE YEAR
HIGHLIGHTS



1 Core earnings is not a substitute for net income computed in accordance with Generally Accepted Accounting Principles (GAAP). It excludes the effect on net income from net realized gains and losses, net insurance premiums earned from refundings and calls and certain non-recurring items. The definition of core earnings used by Ambac Financial Group, Inc. may differ from definitions of core earnings used by other public holding companies of financial guarantee insurers.

2 Adjusted gross premiums written is not promulgated under GAAP. It includes gross up-front premiums written plus the present value of estimated future installment premiums written in the period. The definition of adjusted gross premiums written used by Ambac Financial Group, Inc. may differ from definitions of adjusted gross premiums written used by other public holding companies of financial guarantee insurers.

* 1996 includes a one-time gain from the sale of a subsidiary equal to $155.6 million pre-tax and $100.6 million after-tax.

LETTER TO STOCKHOLDERS

DEAR FELLOW STOCKHOLDERS:

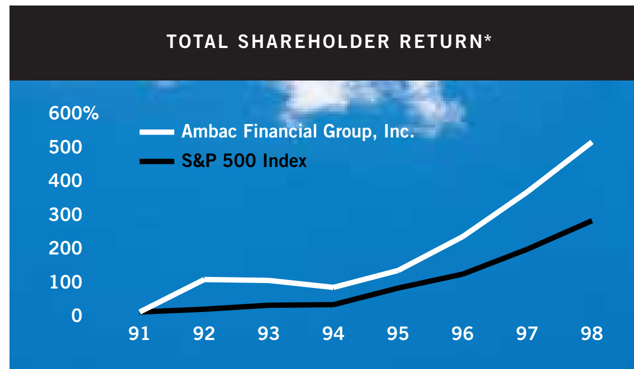
Ambac Financial Group, Inc. recorded significant accomplishments in 1998, most notably outstanding financial results, double-digit earnings growth and superior shareholder returns. We exceeded every target set for the year and began to realize the exciting potential for Ambac in our newer areas. These areas include providing financial guarantees for structured and asset-backed securities, expanding the range of financing tools offered to clients, and capitalizing on the tremendous opportunity to provide credit enhancement in markets outside the United States. In addition, the overall quality of our insured portfolio has never been better.

Expanding our breadth of activity while we engender meaningful partnerships with clients enables us to continue to provide consistent financial returns. Total return on an investment in Ambac's common stock for the full year was 32 percent as compared to 29 percent for the S&P 500. Since our initial public offering in 1991, total return on Ambac's stock has been 512 percent, as compared to a 279 percent total return for the S&P 500 for the same period.

FINANCIAL RESULTS

Ambac's superior financial performance in 1998 included growth in core earnings and adjusted gross premiums written of 21 percent and 39 percent, respectively. Core earnings is an important tool we use to gauge the underlying momentum of our business. Core earnings begins with net income and excludes the less predictable elements of income such as refundings of bonds in our insured portfolio and capital gains and losses in our investment portfolio. Adjusted gross premiums is significant because it quantifies today the total premiums expected to be

From left to right: Frank J. Bivona – *Executive Vice President and Chief Financial Officer*; Robert J. Genader – *Vice Chairman, Specialized Finance Group*; Phillip B. Lassiter – *Chairman, President and Chief Executive Officer*; David L. Boyle – *Vice Chairman, Municipal Financial Services Group*



*Includes common stock price appreciation and impact of reinvested dividends.

earned in the future. Adjusted gross premiums written includes both gross up-front premiums written and the present value of estimated future installment premiums written during the period.

LEVERAGING STRENGTHS, GENERATING RESULTS

Our outstanding financial results for 1998 validate the wisdom of our strategy: leveraging core skills to broaden the range of products and services we offer to clients through meaningful relationships. To continue successful execution of this strategy, we will remain a leading force in financial guarantee insurance with superior credit analysis, risk management and transaction structuring expertise, backed by a triple-A rated claims-paying base.

State and local clients benefited from the advantages of our triple-A guarantee on a wide range of municipal issues covering virtually all types of bonds in 1998. Our partnership approach fosters long-term relationships with clients and enables us to develop innovative solutions to their financing needs.

> "BROADENING THE RANGE OF SOLUTIONS WE BRING TO CLIENTS IS AN IMPORTANT COMPONENT IN OUR ABILITY TO BUILD SUBSTANTIVE RELATIONSHIPS."

Total municipal bond insurance market penetration remained strong in 1998 at 51 percent and no significant change is expected in the coming year. Ambac's total share of the par guaranteed in the municipal market declined in 1998, but our share of premiums written remained relatively stable at 25 percent. Our strategy is to maintain balance in our portfolio while we seek adequate returns on our capital. We believe that we can deliver attractive growth in our municipal financial guarantee business without sacrificing margins.

The structured and asset-backed securities markets provided continued opportunities for rapid growth of financial guarantee insurance in 1998. The mortgage-backed sector, including home equity loan securitizations, was particularly active and we took advantage of Ambac's strong market and financial position to provide reliable execution during market instability in the fourth quarter.

CAPITALIZING ON INTERNATIONAL OPPORTUNITIES

International markets proved to be especially fertile territory for Ambac in 1998. We serve clients abroad primarily through our joint venture, MBIA•AMBAC International – an exceptionally effective combination in financial guarantee insurance. Working together, we bring our international clients nearly $12 billion in combined claims-paying resources as well as a superior reservoir of financing knowledge and structuring talent. Three years after its formation, the joint venture is delivering outstanding results, working with clients in Japan, Australia, Latin America and Europe.

Monetary union and changes throughout Europe are fostering expansion of a more developed corporate bond market in the region. Credit enhancement is a valuable lubricant in bringing issuers and investors together in this dynamic environment.

Other international markets hold promise for growth as well. Japan is moving toward a far broader and deeper market for debt securities. Here, as in Europe, credit enhancement will be a valuable catalyst in broadening issuers' access to capital and in attracting investors to the market. We have the expertise in place to capture the growing opportunities in this market.

INNOVATIVE SOLUTIONS, USEFUL FINANCIAL TOOLS

Our international activities are bringing us more than superior financial returns, however. Working on complex international issues, particularly privatization transactions, provides opportunities to share expertise and bring innovative transaction structures to clients in the U.S.

Increasingly, state and municipal financing authorities are turning to the private sector – mimicking its successful

> "OUR OUTLOOK FOR THE FUTURE IS BRIGHT: WE ENTERED 1999 IN A STRONG FINANCIAL AND COMPETITIVE POSITION, EXECUTING A SOLID BUSINESS STRATEGY TO FURTHER BUILD OUR ROBUST BOOK OF BUSINESS."

techniques and structures, or seeking outright partnerships for project development. Ambac's burgeoning expertise in structured finance qualifies us to help state and local governments and their agencies navigate the often complex territory where private interests intersect with public need.

> "AMBAC'S PEOPLE ARE UNDOUBTEDLY THE KEY TO OUR SUCCESS."

Broadening the range of solutions we bring to clients is an important component in our ability to build substantive relationships. Investment agreements, to help clients earn competitive financial returns on bond proceeds, and interest rate swaps, to achieve cost savings in borrowings, are two critical capabilities we offer. In 1998, clients turned to us for these services in greater numbers as we worked with them to determine how best to reach their financial objectives. With a continued favorable interest rate environment and accelerating momentum, we anticipate further growth in these areas in 1999.

Cash management is a service we offer through our Cadre Financial Services subsidiary. Cadre now manages or administers more than $6.8 billion in assets for nearly 3,000 clients, mostly school districts, in 17 states. During the year, we improved Cadre's technology infrastructure and focused on expanding Cadre's reach. That expansion included the successful launch of Liquid Asset Fund, Cadre's primary cash management vehicle, in New York State in mid-1998.

Late in the fourth quarter we decided to discontinue development of our electronic commerce services business, Ambac Connect, Inc. While electronic commerce applications for the municipal marketplace remain an intriguing opportunity, the extended timeframe for generating acceptable financial returns did not meet our requirements for prudent use of shareholder capital. This decision resulted in a $9.5 million charge against fourth quarter results.

STRENGTH FOR TODAY AND TOMORROW

Our outlook for the future is bright. We enter 1999 in a strong financial and competitive position, executing a solid business strategy to further build our robust book of business. We will continue to deploy and commit capital prudently to benefit issuers, bondholders and Ambac stockholders.

Ambac's people are undoubtedly the key to our success. Our experienced and talented professionals continue to set new standards of excellence in underwriting, credit analysis, transaction structuring and client service. During the year, we further strengthened our reservoir of talent by welcoming several experienced professionals who bring additional skills and highly specialized knowledge to our organization.

Risk management and monitoring is an essential ongoing focus for Ambac. Our Portfolio Risk Management Committee, comprised of our most senior professionals contributing expertise across a broad spectrum of risk, constantly monitors the risk exposure of each individual business as well as Ambac as a whole. We firmly believe that keeping Ambac strong, using the Ambac Assurance guarantee judiciously and providing clients with innovative, yet realistic financial solutions is the best way to continue to build our business and create shareholder value.

Thank you for your continued confidence. We look forward to delivering the growth and returns Ambac shareholders have come to expect from our quality organization.

Sincerely,

Phillip B. Lassiter
Chairman, President and Chief Executive Officer

BEFORE THE FIRST TOUCHDOWN...

Ambac works with state and local agencies to access the financing needed to build today's modern stadiums. Having a sports franchise is increasingly critical for a community's vibrancy and civic pride. Yet the economics of today's professional sports significantly increase the potential financial burden to the cities. Ambac is a leader in the growing trend to finance stadiums in close partnership with private sector interests, tapping the future revenue streams of the facilities and their sports franchises. Bridging the gap between public and private constituents, Ambac's funding solutions enable stadium projects to proceed while allowing a community continued access to the capital markets.

Each stadium project is unique, and Ambac's partnership approach to client relationships results in customized solutions. Ambac draws on recent experience with major stadium projects, as well as on techniques utilized in privatization transactions overseas. By analyzing and valuing each aspect of a sports franchise and facility, Ambac enables financing clients to prudently access the future revenue streams of sports facilities, thereby providing the capital needed to give the home team, its fans and the community an economically viable stadium.

From left to right: Steve Dymant, Asset/Liability Management Services; Mike Kelly, Asset/Liability Management Services; Mark Spinelli, Public Finance – South; Kate McDonough, Public Finance – West

... Ambac WAS THERE

BEFORE THE FIRST DELIVERY...

...Ambac WAS THERE

Ambac partners with non-profit hospitals, hospital systems, and health maintenance organizations to help them raise the capital necessary to provide much-needed patient service. Through bond insurance, lease guarantees and interest rate swaps, Ambac's experienced professionals help health care clients reduce borrowing costs while maintaining critical credit ratings.

Continuing industry change and increasing competition create significant financing challenges for health care institutions. Ambac lifts clients over the capital access hurdle with innovative structures and solutions tailored to meet their needs. An insured synthetic lease, for example, enables a health care organization to monetize the value of an important asset while still maintaining control over that asset. Structured appropriately, this type of financing raises funds without inhibiting further access to the capital markets.

With a strong presence in the market, a high quality portfolio and superior underwriting and surveillance expertise, Ambac sets the standard for knowledgeable, reliable health care financing support.

From left to right: Eleanor Matthews, Health Care Finance; Ruben Selles, Health Care Finance; Steven Renn, Specialized Finance Risk Management

BEFORE THE FIRST

RENOVATION...

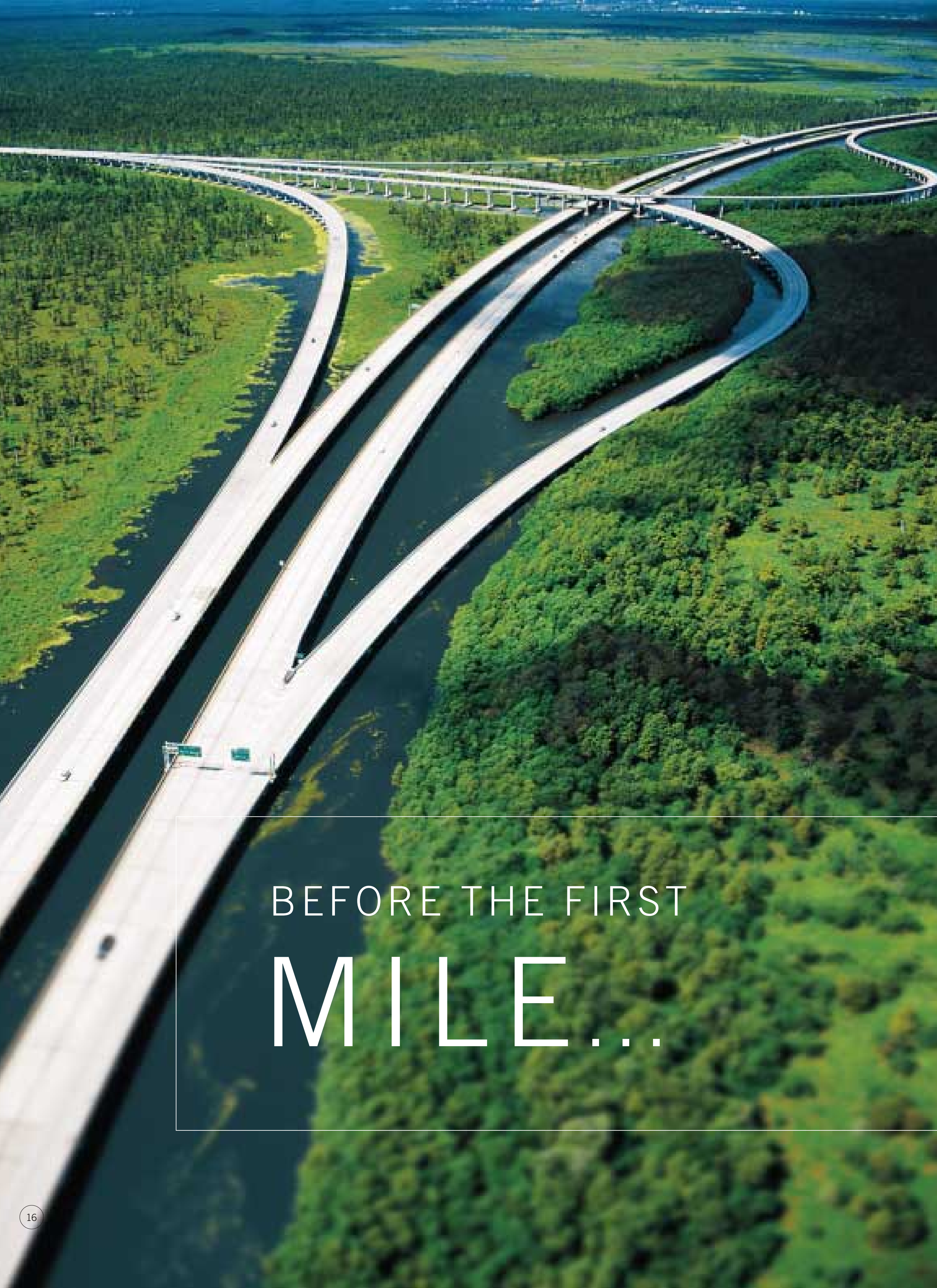
...Ambac WAS THERE

Ambac is active in providing financial guarantees for mortgage- and asset-backed securities – including the growing securitization of home equity loan portfolios. Continued vigor of the mortgage securitization market ensures capital access for home buyers and home owners, by helping financial institutions better manage their capital and lending resources.

Technical proficiency, exhaustive market knowledge and rapid, skillful execution make Ambac a vital partner for its mortgage-issuing clients. This strength was particularly valuable to clients in late 1998 when mortgage-market events constrained liquidity for some mortgage issuers. Well prepared for the risks and opportunities inherent in securitization, Ambac provided clients continued access to cost-effective capital during this difficult time.

The securitization market's increasing complexity demands skill, experience and innovation. Ambac's depth of market knowledge, financial structuring expertise and ability to develop unique solutions to address client needs add critical value to securitization transactions. As clients create new lending products for their customers, Ambac will continue to devise innovative structures and financial guarantees for effective securitization.

From left to right: Warren Tong, Thomas Adams, Iain Bruce, Jeffrey Nabi, Donna Troia, Structured Finance – Mortgage-Backed Securities



BEFORE THE FIRST MILE...

Ambac helps state and local governments access the money they need for infrastructure projects that foster local economic health. Building, expanding and renewing infrastructure requires extensive financing support and Ambac is creating innovative transaction structures tailored to meet the specific funding needs of its clients. To finance highway projects, for example, Ambac participated in the first bond issue that monetized future Federal highway grants expected by a state. By accessing future revenue streams, local governments can aggressively pursue needed improvements and expansion to spur continued economic growth and job creation.

Ambac's willingness to help clients achieve fiscal goals extends well beyond successful transaction execution. For example, our investment agreements, guaranteed by Ambac Assurance, enable issuers to invest proceeds of a bond issue to meet specific criteria for rate of return and use of funds. It's a further demonstration of Ambac's commitment to work in partnership with clients on all aspects of a financing to ensure needs are fully satisfied.

From left to right: Howard Pfeffer, Public Finance; Robert Shoback, Public Finance – North; Dennis Santo, Leasing and Product Development; Carl Dincesen, Credit Risk Management; Thea Okin, Leasing and Product Development

...Ambac WAS THERE

BEFORE THE FIRST CLASS BELL...

Ambac provides the support and financial strength for issuers raising funds for construction of educational facilities or ongoing capital needs. Client engagements span the gamut from straightforward general obligations for government education authorities to complex financings enabling private colleges and institutions to solve specific financing challenges with innovative tax-exempt bond solutions. The range of services offered by Ambac through its subsidiaries helps clients, including educational authorities and institutions, better utilize resources with innovative techniques such as interest rate swaps provided by Ambac Financial Services, L.P. Swaps can lower present and future borrowing costs for issuers and provide a valuable means to manage interest rate risk.

Ambac also serves schools with reliable short-term cash management services administered by its subsidiary, Cadre Financial Services. Cadre's Liquid Asset Funds provide safety, liquidity and competitive yields for nearly 3,000 school districts in 17 states.

...Ambac WAS THERE

From left to right: Bill Sullivan, Cadre Financial Services; Jud Hennessy, Portfolio Management; Robert Selvaggio, Market Risk Management; Lori Miller, Asset/Liability Management Services

BEFORE THE FIRST EURO...

Ambac, through its joint venture, MBIA•AMBAC International, brings financial strength, structuring expertise and an ability to get deals done to issuers in markets outside the United States. International issuers are increasingly embracing the financial guarantees as well as the financial engineering skills Ambac brings to the market. During 1998, the joint venture provided insurance for a wide range of clients throughout Europe, Latin America, Japan and Australia. Transaction types spanned a wide gamut, including infrastructure financings; securitization transactions; university, housing and hospital deals; and a number of collateralized bond and loan obligations. We have demonstrated our ability to add significant value in a client relationship through involvement in numerous United Kingdom Private Finance Initiative (PFI) transactions. These complex, fast-changing deals require creativity, flexibility and depth of knowledge across a spectrum of sectors. By combining the expertise and resources of Ambac and MBIA Insurance Company, the joint venture brings clients an unmatched level of talent and experience, as well as nearly $12 billion in combined claims-paying ability.

Impending European economic union creates further opportunity to expand our solid joint venture business. As the European corporate fixed income market grows and develops, investors will be widening their horizons, looking at unfamiliar credits and less well-known issuers. Financial guarantees will become increasingly important in helping investors evaluate potential credits. In addition to providing the important triple-A imprimatur, our involvement in a transaction brings investors underwriting expertise and ongoing surveillance that add significant value to the marketplace. In markets outside Europe, we will leverage these capabilities and our ability to help issuers get complex deals to market on a timely, cost-effective basis to realize further opportunities for growth.

From left to right: John Uhlein, International; Michael Maguire, MBIA representative to MBIA•AMBAC International; Michael Schozer, Financial Institutions; John Bryan, Structured Asset-Backed Securities; Tim Travers, Utilities; Lori Evangel, MBIA representative to MBIA•AMBAC International

...Ambac WAS THERE

FINANCIAL REVIEW

From left to right: Kevin Doyle, Specialized Finance – Legal; Jeffrey Fried, Public Finance – Legal; William McKinnon, Specialized Finance – Credit Risk Management; Narayan Nair, Internal Audit; Joseph Salzano, General Counsel; Stephen Cooke, General Counsel – Ambac Assurance; Janice Reals Ellig, Corporate Marketing; Gregg Bienstock, Human Resources; Brian Moore, Investor Relations; Kenneth Plotzker, Technology; Robert Starr, Finance; Thomas Gandolfo, Finance

GENERAL

Ambac Financial Group, Inc. ("AFGI"), headquartered in New York City, is a holding company whose subsidiaries provide financial guarantee insurance and financial management services to clients in both the public and private sectors in the United States and abroad.

The following paragraphs describe the consolidated results of operations of AFGI and its subsidiaries (collectively referred to as the "Company") for 1998, 1997 and 1996, and its financial condition as of December 31, 1998 and 1997. These results are presented for the Company's two reportable segments: Financial Guarantee Insurance and Financial Management Services. This discussion should be read in conjunction with the consolidated financial statements included elsewhere in this report.

In this Annual Report, we may make statements about our future results that are considered "forward-looking statements" under the Private Securities Litigation Reform Act of 1995. These statements are based on our current expectations and the current economic environment. We caution you that these statements are not guarantees of future performance. They involve a number of risks and uncertainties that are difficult to predict. Our actual results could differ materially from those expressed or implied in the forward-looking statements. Among the factors that could cause actual results to differ materially are: (1) changes in the economic, credit, or interest rate environment in the United States and abroad; (2) the level of activity within the national and worldwide debt markets; (3) competitive conditions and pricing levels; (4) legislative and regulatory developments; (5) changes in tax laws; and (6) other risks and uncertainties that have not been identified at this time. We undertake no obligation to publicly correct or update any forward-looking statement if we later become aware that it is not likely to be achieved.

RESULTS OF OPERATIONS

CONSOLIDATED NET INCOME. The Company's net income in 1998 was $254.0 million or $3.56 per diluted share, an increase of 14% from $223.0 million or $3.13 per diluted share in 1997. This increase was primarily attributable to the growth in both Financial Guarantee Insurance and Financial Management Services revenues, partially offset by lower net realized gains and higher net realized losses in the Financial Guarantee Insurance segment and the Financial Management Services segment, respectively, in 1998. The Company's net income in 1997 decreased 19% from $276.3 million or $3.91 per diluted share in 1996. This decrease was primarily the result of a net realized gain in 1996 of $155.6 million (which had a net income per diluted share effect of $1.42) from the Company's sale of its former subsidiary, HCIA Inc. ("HCIA"). Excluding the effect of this one-time gain, 1997 net income increased 27% over 1996 primarily due to higher net income in the Financial Guarantee Insurance segment, partially offset by lower net income in the Financial Management Services segment.

FINANCIAL GUARANTEE INSURANCE

The Company provides financial guarantee insurance through its principal operating subsidiary, Ambac Assurance Corporation ("Ambac Assurance"), which is a leading insurer of municipal and structured finance obligations both in the United States and abroad.

In December 1997, Ambac Assurance acquired Connie Lee Holdings, Inc. and its triple-A rated financial guarantee insurance subsidiary, Connie Lee Insurance Company ("Connie Lee"). No new business was written by Connie Lee in 1998.

GROSS PAR VALUE WRITTEN. Ambac Assurance insured $61.5 billion of par value bonds during 1998, an increase of 35% from $45.5 billion in 1997. Par value

written in 1997 represented an increase of 27% from $35.7 billion in 1996. Par value written in 1998 comprised $33.9 billion from the insurance of domestic municipal bond obligations, $22.6 billion from domestic structured finance obligations and $5.0 billion from international obligations, versus $29.4 billion, $12.9 billion and $3.2 billion, respectively, in 1997 and $26.8 billion, $6.4 billion and $2.5 billion, respectively, in 1996. The 1998 increase in insured domestic municipal bond obligations resulted primarily from a 30% increase in market issuance and an increase in insured penetration, partially offset by lower market share. The 1998 increase in insured domestic structured finance obligations was attributable to increased market issuance, higher market penetration and a higher market share in the home equity loan and mortgage-backed sectors, as well as increased market presence in the commercial asset-backed sector. The 1998 increase in insured international obligations resulted from greater acceptance of financial guarantee insurance, primarily in Europe, Japan and Latin America.

Management believes, based on growth experienced in the last few years, that in the foreseeable future, domestic structured finance and international markets will grow more rapidly than the domestic municipal market. Domestic structured finance and international insured par may see large quarterly variances, primarily due to the developmental nature of these markets.

Ambac Assurance serves clients in international markets through its wholly-owned subsidiary Ambac Insurance UK Limited and through an arrangement with MBIA Insurance Company ("MBIA") to participate in MBIA•AMBAC International, an unincorporated joint venture with MBIA (the "JV Arrangement"). See Note 5 of Notes to Consolidated Financial Statements for further discussion about the JV Arrangement.

GROSS PREMIUMS WRITTEN. Gross premiums written in 1998 were $361.0 million, an increase of 26% from $286.2 million in 1997. This increase was primarily driven by a 28% increase in new issue municipal finance premiums and a 46% increase in international premiums. Gross premiums written in 1997 increased 16% from $247.2 million in 1996. This increase was primarily due to higher new issue municipal finance premiums written. The following table sets forth the amounts of gross premiums written and related gross par written by type:

(Dollars in millions)	**1998**		1997		1996	
	Gross Premiums Written	**Gross Par Written**	Gross Premiums Written	Gross Par Written	Gross Premiums Written	Gross Par Written
Domestic:						
Municipal finance:						
Up-front:						
New issue	**$228.2**	**$29,616**	$178.9	$25,889	$182.9	$23,735
Secondary market	**14.6**	**1,400**	19.6	1,530	20.4	1,362
Sub-total up-front	**242.8**	**31,016**	198.5	27,419	203.3	25,097
Installment	**17.7**	**2,899**	13.5	2,024	13.0	1,641
Total municipal finance	**260.5**	**33,915**	212.0	29,443	216.3	26,738
Structured finance:						
Up-front	**1.4**	**1,985**	11.1	922	1.2	156
Installment	**35.7**	**20,581**	19.6	11,952	8.8	6,255
Total structured finance	**37.1**	**22,566**	30.7	12,874	10.0	6,411
Total domestic	**297.6**	**56,481**	242.7	42,317	226.3	33,149
International:						
Up-front	**52.8**	**2,463**	37.6	1,566	18.0	690
Installment	**10.6**	**2,553**	5.9	1,575	2.9	1,839
Total international	**63.4**	**5,016**	43.5	3,141	20.9	2,529
Total	**$361.0**	**$61,497**	$286.2	$45,458	$247.2	$35,678
Total up-front	**$297.0**	**$35,464**	$247.2	$29,907	$222.5	$25,943
Total installment	**64.0**	**26,033**	39.0	15,551	24.7	9,735
Total	**$361.0**	**$61,497**	$286.2	$45,458	$247.2	$35,678

ADJUSTED GROSS PREMIUMS.[1] While the majority of Ambac Assurance's premiums written are collected up front at policy issuance, a growing portion of premiums are collected on an installment basis. Adjusted gross premiums written, which are defined as up-front premiums written plus the present value of estimated future installment premiums written in the period, were $458.0 million in 1998, up 39% from $329.3 million in 1997. The increase in 1998 was primarily due to increased up-front premiums written in all markets, combined with the increase in the present value of international installment policies. Adjusted gross premiums written in 1997 increased 15% from $286.8 million in 1996. The present value of estimated future installment premiums written in 1998 was $173.4 million, an increase of 94% from $89.3 million in 1997. The present value of estimated future installment premiums written in 1997 increased 27% from $70.3 million in 1996. The aggregate net present value of estimated future installment premiums was $308.4 million, $210.8 million, and $157.7 million as of December 31, 1998, 1997 and 1996, respectively.

CEDED PREMIUMS WRITTEN. Ceded premiums written in 1998 were $49.6 million, up 53% from $32.5 million in 1997. The increase in ceded premiums written is primarily due to the cession of $11.6 million of premiums related to Connie Lee's insured portfolio. In 1997, Ambac Assurance began using only facultative reinsurance to reduce its risk and manage its insurance portfolio. Ceded premiums written in 1996 were $37.8 million. The 14% decrease from 1996 to 1997 is primarily due to the non-renewal of automatic treaty reinsurance, partially offset by higher ceded premiums for international business pursuant to the JV Arrangement. Ceded premiums written were 14%, 11%, and 15% of gross premiums written in 1998, 1997 and 1996, respectively.

NET PREMIUMS EARNED. Net premiums earned during 1998 were $212.7 million, an increase of 38% from $154.0 million in 1997. This increase was primarily the result of higher premiums earned from the growth of the book of business and increased premiums earned from refundings, calls and other accelerations (collectively referred to as "refundings") during the year.

When an issue insured by Ambac Assurance has been refunded or called, the remaining unearned premium (net of refunding credits, if any) is generally earned at that time. Refunding levels vary depending upon a number of conditions, primarily the relationship between current interest rates and interest rates on outstanding debt. Net premiums earned in 1998 included $46.9 million (net income per diluted share effect of $0.37) from refundings. Net premiums earned in 1997 included $28.0 million (net income per diluted share effect of $0.22) from refundings. Excluding the effect of accelerated earnings related to refundings, net premiums earned in 1998 were $165.8 million, an increase of 32% from $126.0 million in 1997.

Net premiums earned during 1997 increased 13% from $136.6 million in 1996. This increase was primarily the result of higher premiums earned from the growth of the book of business during the year, partially offset by a decline in premiums earned from refundings in 1997. Net premiums earned in 1996 included $31.3 million (net income per diluted share effect of $0.25) from refundings. Excluding the effect of accelerated earnings related to refundings, net premiums earned in 1997 increased 20% from $105.3 million in 1996.

NET INVESTMENT INCOME. Net investment income in 1998 was $186.2 million, an increase of 17% from $159.7 million in 1997. This increase was primarily attributable to the growth of the investment portfolio from ongoing operations and the net increase in the investment portfolio from the acquisition of Connie Lee, partially offset by lower yields. Investments in tax-exempt securities amounted to 74% of the total market value of the portfolio as of December 31, 1998, versus 75% and 79% as of December 31, 1997 and 1996, respectively. The average pre-tax yield-to-maturity on the investment portfolio was 6.17% as of December 31, 1998 compared with 6.40% and 6.47% for December 31, 1997 and 1996, respectively. Net investment income in 1997 increased 10% from $144.9 million in 1996. This increase was primarily attributable to the growth of the investment portfolio, partially offset by lower yields.

NET REALIZED GAINS (LOSSES). Net realized gains in 1998 were $3.7 million, compared to $21.1 million in net realized gains in 1997. The 1998 and 1997 net realized gains were generated as a result of the ongoing management of the investment portfolio. Net realized losses of $20.5 million in 1996 were realized for tax planning purposes to partially offset the realized gain from the sale of HCIA.

LOSSES AND LOSS ADJUSTMENT EXPENSES. Losses and loss adjustment expenses in 1998 were $6.0 million, versus $2.9 million in 1997 and $3.8 million in 1996. Losses and loss adjustment expenses are based upon estimates of the ultimate aggregate losses inherent in the insured portfolio. The liability for losses and loss adjustment expenses consists of the active credit reserve ("ACR"), which represents an estimate of unidentified losses, and case basis loss reserves for obligations in monetary default, or, in the judgement of management, for which default is imminent. The Company regularly reviews its outstanding obligations to determine an appropriate reserve for losses and loss adjustment expenses. The following table summarizes the Company's loss reserves split between case basis loss reserves and ACR at December 31, 1998 and 1997:

(Dollars in millions)	**1998**	1997
Net loss and loss adjustment expense reserves:		
Case basis*	**$ 33.9**	$50.9
ACR	**78.2**	48.2
Total	**$112.1**	$99.1

*After netting reinsurance recoverable amounting to $3.6 million and $4.2 million in 1998 and 1997, respectively.

Paid losses, net of salvage received, were ($7.0) million, $2.5 million and $9.6 million in 1998, 1997 and 1996, respectively.

UNDERWRITING AND OPERATING EXPENSES. Underwriting and operating expenses were $46.7 million in 1998, an increase of 15% from $40.7 million in 1997. Underwriting and operating expenses in 1997 increased 9% from $37.2 million in 1996. Underwriting and operating expenses consist of gross underwriting and operating expenses, less the deferral to future periods of expenses and reinsurance commissions related to the acquisition of new insurance contracts, plus the amortization of previously deferred expenses and reinsurance commissions. During 1998, gross underwriting and operating expenses were $67.8 million, an increase of 15% from $59.2 million in 1997. During 1997, gross underwriting and operating expenses increased 5% from $56.4 million in 1996. The increase in gross underwriting and operating expenses in both 1998 and 1997 reflects the overall increased business activity in those years. Underwriting and operating expenses deferred were $38.2 million,

$32.8 million, and $32.3 million in 1998, 1997 and 1996, respectively. The amortization of previously deferred expenses and reinsurance commissions was $18.2 million, $14.2 million, and $12.5 million in 1998, 1997 and 1996, respectively.

FINANCIAL MANAGEMENT SERVICES

Through its financial management services subsidiaries, the Company provides investment agreements, interest rate swaps, investment advisory and cash management services, principally to states, municipalities and their authorities, school districts, and hospitals and health organizations. In the fourth quarter of 1998, the Company discontinued development of electronic commerce applications for the municipal marketplace. This effort had been underway as a pilot operation through a subsidiary, Ambac Connect, Inc. ("Ambac Connect"). The decision resulted in an after-tax charge of $9.5 million, or $0.13 in net income per diluted share. This charge did not affect operating or core earnings.(2)

Revenues in 1998 were $49.5 million (excludes $17.1 million in net realized losses), versus $35.2 million (excludes $0.6 million in net realized losses) in 1997. This increase is primarily due to higher revenues on interest rate swaps and investment agreements primarily due to increased volume. In 1998, realized gains on fixed-income securities in the investment agreement business of $10.1 million were offset by a realized loss of $11.5 million, representing the write-off of the Company's entire investment in Ambac Connect (this write-off is included in the $9.5 million after-tax charge discussed above), and a $15.7 million loss in a trading position. This trading position, which represented a small portion of the Company's assets, contained high quality municipal bonds hedged with treasury futures. The loss was due to a change in the relationship between municipal and treasury interest rates. This trading position was closed during the fourth quarter of 1998. Revenues in 1997 reflected a 60% increase from $22.0 million (excludes $0.4 million in net realized gains) in 1996. The increase was primarily due to revenues of Cadre Financial Services, Inc. ("Cadre"), acquired at the end of 1996, which provides investment advisory and cash management services primarily to school districts, and higher revenues from investment agreements, due to higher volume.

Expenses in 1998 were $32.5 million (excluding a $3.0 million restructuring charge for Ambac Connect), versus $24.5 million (excluding a $3.5 million restructuring charge for consolidating certain operations in New York) in 1997. This increase results from higher compensation expenses in the investment agreement and swap businesses, as well as increased expenditures to develop the money management and electronic commerce businesses. Expenses in 1997 increased 104% (excluding the $3.5 million 1997 restructuring charge for consolidating certain operations in New York) from $12.0 million in 1996. This increase reflects expenses for Cadre and start-up expenses for Ambac Connect.

CORPORATE ITEMS

INTEREST EXPENSE. Interest expense in 1998 was $32.8 million, an increase of 54% from $21.3 million in 1997. The increase is attributable to AFGI's issuance of $200 million in debentures in April 1998. Interest expense in 1996 was $20.9 million.

OTHER INCOME. Other income includes investment income of AFGI. Other income increased to $13.7 million in 1998 from $7.2 million in 1997, primarily due to higher investment income generated from investing the proceeds of AFGI's $200 million in debentures. Other income decreased in 1997 from $7.9 million in 1996.

OTHER NET REALIZED GAINS. The other net realized gain in 1996 resulted primarily from the sale of the Company's remaining holdings in HCIA in a secondary public offering yielding net proceeds of $202.6 million. The sale resulted in a net realized gain of $155.6 million pre-tax, $100.6 million after-tax (net income per diluted share effect of $1.42).

OTHER EXPENSES. Other expenses include the operating expenses of AFGI. Other expenses were $7.1 million in 1998, $2.9 million in 1997, and $3.5 million in 1996. Other expenses were higher in 1998 compared to 1997 primarily due to increased compensation costs.

INCOME TAXES. Income taxes for 1998 were at an effective rate of 22.8%, compared to 22.0% and 26.4% for 1997 and 1996, respectively. The 1996 effective tax rate was higher compared to 1998 and 1997 due to the realized gain of the sale of HCIA as discussed above.

SUPPLEMENTAL ANALYTICAL FINANCIAL DATA

CORE EARNINGS.(2) In 1998 core earnings were $236.5 million, an increase of 21% from $195.8 million in 1997. This increase was primarily the result of continued higher premiums earned from the growth in the insurance book of business and higher net investment income from insurance operations, as well as higher revenues from the investment agreement and swap businesses in the Financial Management Services segment. In 1997 core earnings increased 15% from $170.5 million in 1996. The increase was primarily the result of continued higher premiums earned from the growth in the insurance book of business and higher net investment income from insurance operations. Core earnings, which the Company reports as analytical data, exclude the effect on consolidated net income from net realized gains and losses, net insurance premiums earned from refundings and certain non-recurring items.

OPERATING EARNINGS.(2) Operating earnings in 1998 were $263.3 million, an increase of 24% from $211.8 million in 1997. Operating earnings in 1997 increased 12% from $188.3 million in 1996. The Company defines operating earnings as net income, less the effect of net realized gains and losses and certain non-recurring items.

Following is a table reconciling net income computed in accordance with U.S. Generally Accepted Accounting

Principles ("GAAP") to operating earnings and core earnings for the years ended December 31, 1998, 1997 and 1996:

(Dollars in Millions)	**1998**	1997	1996
Net income	**$254.0**	$223.0	$276.3
Net realized losses (gains), after tax	**7.1**	(13.3)	(88.0)
Non-recurring item, after tax	**2.2**	2.1	–
Operating earnings	**263.3**	211.8	188.3
Premiums earned from refundings, after tax	**(26.8)**	(16.0)	(17.8)
Core earnings	**$236.5**	$195.8	$170.5

LIQUIDITY AND CAPITAL RESOURCES

AFGI LIQUIDITY. AFGI's liquidity, both on a short-term basis (for the next twelve months) and a long-term basis (beyond the next twelve months), is largely dependent upon: (i) Ambac Assurance's ability to pay dividends or make payments to AFGI; and (ii) external financings. Pursuant to Wisconsin insurance laws, Ambac Assurance may declare dividends, provided that, after giving effect to the distribution, it would not violate certain statutory equity, solvency and asset tests. During 1998, Ambac Assurance paid dividends of $48.0 million on its common stock to AFGI. For further discussion, see Note 8 of Notes to Consolidated Financial Statements.

AFGI's principal uses of liquidity are for the payment of its operating expenses, interest on its debt, dividends on its shares of common stock, and capital investments in its subsidiaries. Based on the amount of dividends that Ambac Assurance expects to pay during 1999 and the income it expects to receive from its investment portfolio, management believes AFGI will have sufficient liquidity to satisfy its liquidity needs over the next twelve months, including the payment of dividends on the common stock in accordance with its dividend policy. Beyond the next twelve months, Ambac Assurance's ability to declare and pay dividends to AFGI may be influenced by a variety of factors, including adverse market changes, insurance regulatory changes and changes in general economic conditions. Consequently, although management believes that AFGI will continue to have sufficient liquidity to meet its debt service and other obligations over the long term, no guarantee can be given that Ambac Assurance will be permitted to dividend amounts sufficient to pay all of AFGI's operating expenses, debt service obligations and dividends on its common stock.

On April 1, 1998, AFGI issued $200.0 million in principal amount of its 7.08% debentures due on March 31, 2098. AFGI may not redeem the debentures prior to March 31, 2003. On or after March 31, 2003, AFGI may redeem the debentures, in whole at any time or in part from time to time, at 100% of their principal amount, plus accrued interest to the date of redemption. Use of the net proceeds received from the sale of the debentures will be for general corporate purposes, which include additions to working capital of subsidiaries, acquisitions, and repurchases of common stock.

AMBAC ASSURANCE LIQUIDITY. The principal uses of Ambac Assurance's liquidity are the payment of operating expenses, reinsurance premiums, income taxes, and dividends to AFGI. Management believes that Ambac Assurance's operating liquidity needs can be funded exclusively from its operating cash flow. The principal sources of Ambac Assurance's liquidity are gross premiums written, scheduled investment maturities and net investment income. The majority of premiums for Ambac Assurance's financial guarantee insurance policies are payable in full at the outset of the term of the policy, even though premiums are earned over the life of such policies for financial accounting purposes.

FINANCIAL MANAGEMENT SERVICES LIQUIDITY. The principal uses of liquidity by Financial Management Services subsidiaries are the payment of investment agreement obligations pursuant to defined terms, net obligations under interest rate swaps and related hedges, operating expenses, and income taxes. Management believes that its Financial Management Services liquidity needs can be funded primarily from its operating cash flow and the maturity of its invested assets. The principal sources of this segment's liquidity are proceeds from issuance of investment agreements, net investment income, maturities of securities from its investment portfolio which are invested with the objective of matching the duration of its obligations under the investment agreements, net receipts from interest rate swaps and related hedges, and fees for investment management services. Additionally, from time to time, liquidity needs are satisfied by short-term intercompany loans from AFGI. The investment objectives with respect to investment agreements are to achieve the highest after-tax total return, subject to a minimum average quality rating of Aa/AA on invested assets, and to maintain cash flow matching of invested assets to funded liabilities to minimize interest rate and liquidity exposure. A portion of Financial Management Services assets are maintained in short-term investments and repurchase agreements in order to meet unexpected liquidity needs.

CREDIT FACILITIES. AFGI and Ambac Assurance have a revolving credit facility with three major international banks for $150 million, which expires in August 1999 and provides a two-year term loan provision. The facility is available for general corporate purposes, including the payment of claims. As of December 31, 1998 and 1997, no amounts were outstanding under this credit facility.

Ambac Assurance maintains third party capital support in the form of a seven-year irrevocable limited recourse credit facility from a group of highly-rated international banks. This credit facility provides liquidity to Ambac Assurance in the event claims from municipal obligations in its covered portfolio exceed specified levels. Repayment of amounts drawn under the credit facility are limited primarily to the amount of any recoveries of losses related to policy obligations. During 1998, total third party capital support was increased from $500 million to $555 million and its expiration reset to

December 2, 2005. As of December 31, 1998 and 1997, no amounts were outstanding under this facility.

STOCK REPURCHASE PROGRAM. The Board of Directors of AFGI has authorized the establishment of a stock repurchase program that permits the purchase of up to 6,000,000 shares of AFGI's common stock. During 1998, AFGI acquired approximately 976,000 treasury shares for an aggregate amount of $52.7 million. Since inception of the Stock Repurchase Program, AFGI has acquired approximately 4,248,000 shares for an aggregate amount of $142.7 million.

ADJUSTED BOOK VALUE.[3] Adjusted Book Value ("ABV") per share increased 15% to $41.98 at December 31, 1998 from $36.59 at December 31, 1997.

The following table reconciles book value per share to ABV per share as of December 31, 1998 and 1997:

	1998	1997
Book value per share	**$29.97**	$26.77
After-tax value of:		
Net unearned premium reserve	**10.17**	9.25
Deferred acquisition costs	**(1.12)**	(0.99)
Present value of installment premiums	**2.86**	1.96
Unrealized gain (loss) on investment agreements	**0.10**	(0.40)
Adjusted book value per share	**$41.98**	$36.59

BALANCE SHEET. Total assets as of December 31, 1998 were $11.21 billion, an increase of 35% over $8.29 billion at December 31, 1997. The increase was primarily due to the increased volume in investment agreements and positive net cash flow from the Financial Guarantee Insurance segment. Stockholders' equity as of December 31, 1998 was $2.10 billion, an increase of 12% from $1.87 billion at year-end 1997. This increase was primarily due to net income for the year and higher net unrealized gains in the investment portfolio, partially offset by dividends to shareholders and stock option exercises.

CASH FLOWS. Net cash provided by operating activities was $337.7 million, $324.5 million and $190.6 million during 1998, 1997 and 1996, respectively. These cash flows were primarily provided by the Financial Guarantee Insurance operations. Net cash provided by financing activities was $1,723.0 million, $1,564.3 million and $463.2 million during 1998, 1997 and 1996, respectively. This activity included $1,391.9 million, $1,096.5 million and $499.2 million in investment agreements issued (net of draws paid) in 1998, 1997 and 1996, respectively. The total cash provided by operating and financing activities was $2,060.7 million, $1,888.8 million and $653.8 million during 1998, 1997 and 1996, respectively. From these totals, $2,061.7 million, $1,887.3 million and $658.2 million was used in investing activities, principally net purchases of investment securities, during 1998, 1997 and 1996, respectively.

MATERIAL COMMITMENTS. The Company has made no commitments for material capital expenditures within the next twelve months.

RISK MANAGEMENT

In the ordinary course of business, the Company, through its subsidiaries, manages a variety of risks, principally market, credit, liquidity, operational and legal. These risks are identified, measured and monitored through a variety of control mechanisms, which are in place at different levels throughout the organization.

Market risk represents the potential for losses that may result from changes in the market value of a financial instrument as a result of changes in market conditions. The Company has financial instruments held for purposes other than trading and for trading purposes. The principal market risk for the Company's financial instruments held for purposes other than trading is interest rate risk. An independent market risk management group is involved in setting and monitoring risk limits and the application of risk measurement methodologies. The estimation of potential losses arising from adverse changes in market conditions is a key element in managing market risk. The Company utilizes various models and stress test scenarios to monitor and manage interest rate risk. This process includes frequent analyses of both parallel and non-parallel shifts in the yield curve. These models include estimates, made by management, which utilize current and historical market information. The valuation results from these models could differ materially from amounts that would actually be realized in the market. Financial instruments held for purposes other than trading which may be adversely affected by changes in interest rates consist primarily of investment securities, investment agreement liabilities, debentures, and related derivative contracts (primarily interest rate swaps and financial futures) used for hedging purposes.

The following table summarizes the estimated change in fair value (based primarily on the valuation models discussed above) on the net balance of financial instruments held for purposes other than trading assuming immediate changes in interest rates at specified levels at December 31, 1998 and 1997:

(Dollars in Millions)

Change in interest rates	Estimated fair value of net financial instruments held for purposes other than trading	Estimated change in fair value
1998:		
300 basis point rise	$2,172	$(757)
200 basis point rise	2,401	(529)
100 basis point rise	2,655	(275)
Base Scenario	2,930	–
100 basis point decline	3,215	285
200 basis point decline	3,500	570
300 basis point decline	3,802	872
1997:		
300 basis point rise	$2,071	$(560)
200 basis point rise	2,264	(367)
100 basis point rise	2,489	(142)
Base Scenario	2,631	–
100 basis point decline	2,801	170
200 basis point decline	2,965	334
300 basis point decline	3,136	505

The Company, through its subsidiary Ambac Financial Services, L.P. ("AFSLP"), is a provider of interest rate swaps to states, municipalities and their authorities and other entities in connection with their financings. AFSLP manages its business with the goal of being market neutral to changes in overall interest rates, while seeking to profit from retaining some basis risk. If actual or projected floating tax-exempt interest rates change in relation to floating taxable interest rates, the Company will experience an unrealized mark-to-market gain or loss. The AFSLP swap portfolio is considered held for trading purposes. Since late 1995, most municipal interest rate swaps transacted by AFSLP contain provisions which are designed to protect the Company against certain forms of tax reform, thus mitigating its basis risk. An independent market risk management group monitors trading risk limits and, together with senior management, is involved in the application of risk measurement methodologies.

The estimation of potential losses arising from adverse changes in market relationships, known as "value-at-risk," is a key element in managing market risk for financial instruments held for trading purposes. The Company has developed a value-at-risk methodology to estimate potential losses over a specified holding period and based on certain probabilistic assessments. The Company's methodology estimates value-at-risk using a 300 day historical "look back" period. This means that changes in market values are simulated using market inputs from the past 300-days. For the years ended December 31, 1998 and 1997, the Company's value-at-risk, for financial instruments considered held for trading purposes, calculated at a ninety-nine percent confidence level, averaged approximately $1.0 million and $0.6 million, respectively. The Company's value-at-risk ranged from a high of $1.1 million to a low of $0.7 million in 1998, and from a high of $1.1 million to a low of $0.3 million in 1997. Since no single measure can capture all dimensions of market risk, the Company supplements its value-at-risk methodology by performing daily analyses of parallel and non-parallel shifts in yield curves and stress test scenarios which measure the potential impact of normal market conditions, which might cause abnormal volatility swings or disruptions of market relationships.

Credit risk arises from the potential inability of issuers of bond obligations in Ambac Assurance's insured portfolio and other counterparties to perform on an obligation in accordance with the terms of the contract. The Company is exposed to credit risk in various capacities including as an issuer of a financial guarantee policy, as counterparty to financial contracts and as a holder of investment securities. The Company has established various procedures and controls to monitor and manage credit risk. These include the initial credit review and approval process, minimum credit rating requirements, single credit concentration limits and the continuous monitoring of credit exposures.

Liquidity risk relates to the possible inability to satisfy contractual obligations when due. This risk is present in financial guarantee insurance, investment agreements, interest rate swaps and futures contracts. Ambac Assurance manages its liquidity risk by maintaining a comprehensive daily analysis of projected cash flows. Additionally, Ambac Assurance maintains a minimum level of cash and short-term investments at all times. See additional discussion in "Liquidity and Capital Resources" section. The investment agreement business manages liquidity risk by matching the effective duration of its invested assets, including hedges, with the effective duration of its investment agreement liabilities. Additionally, the Company's policy is to maintain a minimum level of cash and short-term investments equivalent to a specified percentage of its investment agreement liabilities outstanding. AFSLP maintains cash and cash equivalents, closely matching the dates swap payments are made and received, and limiting the amount of risk hedged with futures contracts.

Operational risk relates to the potential for loss caused by a breakdown in information, communication and settlement systems. The Company mitigates operational risk by maintaining systems and procedures to monitor transactions and positions, documentation and confirmation of transactions and ensuring compliance with regulations.

Legal risk relates to the uncertainty of the enforceability, through legal or judicial processes, of the obligations that Ambac Assurance insures or obligations of the Company's counterparties, including contractual provisions intended to reduce exposure by providing for the offsetting or netting of mutual obligations. The Company seeks to remove or minimize such uncertainties through continuous consultation with internal and external legal advisers to analyze and understand the nature of legal risk, to improve documentation and to strengthen transaction structure.

OTHER MATTERS

YEAR 2000. The Company is addressing the issue of computer programs' and embedded computer chips' ability to distinguish between the year 1900 and the year 2000, commonly known as the Y2K problem ("Y2K"). The Company is assessing the risks to its businesses related to the functionality of its own computer systems and those of third parties. This is a high priority undertaking and crucial to the operation of the Company's businesses.

The Company has established a Y2K Steering Committee comprised of members of senior management. The committee has full responsibility and authority to establish methodologies and budgets and to allocate necessary resources. The committee is responsible for the coordination of internal and external resources with the goal of evaluating and remediating, if necessary, critical technology systems. The Company has also contracted with an outside consultant to support its Y2K initiative.

In connection with this initiative, the Company embarked on a three phase process. Phase I is an inventory analysis and impact assessment. Inventory included:

(a) those information technology systems which were deemed critical to running the businesses; (b) non-information technology systems such as fire systems, elevators and the like; (c) material third parties such as electronic data interchange ("EDI") partners; (d) hardware and software vendors; and (e) business user spreadsheets. Phase II is the testing phase during which: (a) all critical systems are tested; (b) transactions are run through critical systems by applying various permutations and combinations of Y2K sensitive dates; and (c) results are reviewed independently by each business unit. In Phase III, the extent of code repair is determined and remediated.

Phase I, the inventory analysis and impact assessment, is 100% complete. Phase II, the testing phase, is 100% complete for all aspects of the business except for the investment advisory and cash management services business (Cadre). Phase II is approximately 80% complete for Cadre, and is expected to be 100% complete by March 31, 1999. Phase III, code repair, is 100% complete for all aspects of the business except for Cadre. Code repair, if necessary for Cadre, is targeted for completion by March 31, 1999.

The cost of identifying, testing and remediating critical systems is estimated to be approximately $1.1 million, $0.7 million of which was incurred in 1998.

The Company's principal Y2K risks can be grouped into four categories. The first is the risk that the Company does not successfully ready its operations for the next century. The second is the risk of disruption of Company operations due to operational failures of third parties. The third is the risk of business interruption among obligors of Ambac-insured obligations such that the scheduled payment of debt service does not occur, thus triggering a claim under its insurance policy. The fourth is financial institution risk. These risks are further described below.

COMPANY'S INTERNAL SYSTEMS RISK. The Company, like other financial institutions, is heavily dependent upon its computer systems. Y2K problems in the Company's internal systems could result in an interruption in, or failure of, certain normal business activities or operations. Such failures could adversely affect the Company's operations.

THIRD PARTY RISK. Computer failure of third parties may also jeopardize Company operations, but how seriously depends on the nature and duration of such failures. Such third parties could include suppliers of telecommunications, electric power suppliers, and services provided by governmental agencies. Although the Company's inquiries are under way, the Company does not yet have the information to estimate the likelihood of significant disruptions among its suppliers.

ISSUER RISK. A potential exposure to the Company is the failure by any insured issuer to make debt service payments due to an issuer's systems failure. An issuer's failure to make debt service payments due to Y2K related systems failures may result in a claim under an Ambac Assurance insurance policy. In such event, the Company would utilize its sources of liquidity to pay claims. The Company would expect full recovery of such claims.

FINANCIAL INSTITUTION RISK. Financial institution risk includes trustees or paying agents on transactions insured by the Company. The Company relies on the operating systems of such trustees to identify the correct interest payment dates, calculate the correct payments and, through various payment systems, to move the funds to the bondholders. This risk is mitigated by the fact that Ambac Assurance's obligation to pay claims is related to the creditworthiness of the issuer and not the trustee. However, to minimize payment disruption and identify potential future problems, the Company has requested compliance statements from certain trustees or paying agents of its insured transactions, reviewed the appropriate publicly available disclosures and monitored the activities of the banking regulatory agencies for Y2K developments. Additionally, financial institution risk relates to custodians of securities held for its own account and the accounts of others. The procedures outlined above have been applied to such custodians as well.

With respect to the Company's internal operations, preliminary findings do not give any indications that these systems will be non-compliant, management is in the process of developing contingent procedures in the event its critical systems should fail. With respect to third parties, the Company's inquiries are underway, and the Company does not expect significant disruptions among vendors, EDI partners, issuers and financial institutions.

FOOTNOTES

(1) Adjusted gross premiums written, which is not promulgated under GAAP, is used by management, equity analysts and investors to measure the financial results of the Company. Adjusted gross premiums written, which the Company reports as analytical data, is defined as gross up-front premiums written plus the present value of estimated future installment premiums written in the period. The definition of adjusted gross premiums written used by the Company may differ from definitions of adjusted gross premiums written used by other public holding companies of financial guarantee insurers.

The definition of adjusted gross premiums written, and all current and historical figures, have been revised to better reflect the Company's international joint venture arrangement with MBIA. Under the revision, all reinsurance cessions to MBIA under the joint venture reinsurance arrangement reduce adjusted gross premiums written. Consequently, the revised adjusted gross premiums written recorded by the Company includes only the net retention on business written under the joint venture arrangement.

(2) Core earnings and operating earnings are not substitutes for net income computed in accordance with GAAP, but are important measures used by management, equity analysts and investors to measure the financial results of the Company. The definition of core earnings and operating earnings used by the Company may differ from definitions of core earnings and operating earnings used by other public holding companies of financial guarantee insurers.

(3) Adjusted book value ("ABV"), which is not promulgated under GAAP, is used by management, equity analysts and investors as a measurement of the Company's intrinsic value with no benefit given for ongoing business activity. Management derives ABV by beginning with stockholders' equity (book value) and adding or subtracting the after-tax value of: the net unearned premium reserve, deferred acquisition costs, the present value of estimated net future installment premiums, and the unrealized gain or loss on investment agreement liabilities. The definition of ABV used by the Company may differ from definitions of ABV used by other public holding companies of financial guarantee insurers. The adjustments to book value described above will not be realized until future periods and may differ materially from the amounts used in determining ABV.

The management of Ambac Financial Group, Inc. is responsible for the integrity and objectivity of the financial statements and all other financial information presented in this Annual Report and for assuring that such information fairly presents the consolidated financial position and operating results of Ambac Financial Group, Inc. The accompanying consolidated financial statements have been prepared in conformity with generally accepted accounting principles using management's best estimates and judgment. The financial information presented elsewhere in this Annual Report is consistent with that in the consolidated financial statements.

Ambac Financial Group, Inc. maintains a system of internal accounting controls designed to provide reasonable assurance that assets are safeguarded against loss or unauthorized use and that the financial records are reliable for use in preparing financial statements and maintaining accountability of assets. Qualified and professional financial personnel maintain and monitor these internal controls on a continuous basis. The concept of reasonable assurance is based on the recognition that the cost of a system of internal control should not exceed the related benefits.

Ambac Financial Group, Inc.'s consolidated financial statements have been audited by KPMG LLP, independent auditors, whose audits were made in accordance with generally accepted auditing standards and included a review of internal accounting controls to the extent necessary to express an opinion on the fairness of the consolidated financial statements.

The Audit Committee of the Board of Directors, comprised solely of outside directors, meets regularly with financial management, the independent auditors and the internal auditors to review the work and procedures of each. The independent auditors and the internal auditors have free access to the Audit Committee, without the presence of management, to discuss the results of their work and their considerations of Ambac and its subsidiaries and the quality of Ambac Financial Group, Inc.'s financial reporting. The Board of Directors, upon recommendation of the Audit Committee, appoints the independent auditors, subject to stockholder approval.

PHILLIP B. LASSITER
Chairman, President and Chief Executive Officer

FRANK J. BIVONA
Executive Vice President and Chief Financial Officer

January 27, 1999

INDEPENDENT AUDITORS' REPORT

To the Board of Directors and Stockholders
Ambac Financial Group, Inc.

We have audited the accompanying consolidated balance sheets of Ambac Financial Group, Inc. and subsidiaries as of December 31, 1998 and 1997, and the related consolidated statements of operations, stockholders' equity and cash flows for each of the years in the three-year period ended December 31, 1998. These consolidated financial statements are the responsibility of Ambac Financial Group, Inc.'s management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Ambac Financial Group, Inc. and subsidiaries as of December 31, 1998 and 1997, and the results of their operations and their cash flows for each of the years in the three-year period ended December 31, 1998 in conformity with generally accepted accounting principles.

KPMG LLP
New York, New York

January 27, 1999

(Dollars in thousands, except per share amounts) December 31,	1998	1997
ASSETS:		
Investments:		
Fixed income securities, at fair value (amortized cost of $8,307,046 in 1998 and $6,525,650 in 1997)	**$ 8,622,282**	$6,773,844
Short-term investments, at cost (approximates fair value)	**119,528**	136,278
Other, at cost	**6,567**	5,000
Total investments	**8,748,377**	6,915,122
Cash	**8,239**	9,256
Securities purchased under agreements to resell	**252,295**	85,466
Receivable for investment agreements	**73,142**	–
Receivable for securities sold	**16,233**	106,246
Investment income due and accrued	**125,929**	78,690
Reinsurance recoverable	**3,638**	4,219
Prepaid reinsurance	**199,920**	183,492
Deferred acquisition costs	**120,619**	105,996
Loans	**673,930**	503,192
Receivable from brokers and dealers	**750,000**	183,041
Other assets	**239,989**	116,985
Total assets	**$11,212,311**	$8,291,705
LIABILITIES AND STOCKHOLDERS' EQUITY:		
Liabilities:		
Unearned premiums	**$ 1,294,214**	$1,178,990
Losses and loss adjustment expenses	**115,794**	103,345
Ceded reinsurance balances payable	**6,576**	9,258
Obligations under investment and payment agreements	**4,774,953**	3,230,052
Obligations under investment repurchase agreements	**1,181,810**	1,090,912
Deferred income taxes	**145,782**	135,228
Current income taxes	**6,949**	9,016
Debentures	**423,929**	223,864
Accrued interest payable	**89,615**	46,017
Accounts payable and other liabilities	**262,423**	117,153
Payable to brokers and dealers	**750,000**	–
Payable for securities purchased	**64,176**	275,388
Total liabilities	**9,116,221**	6,419,223
Stockholders' equity:		
Preferred stock, par value $0.01 per share; authorized shares – 4,000,000; issued and outstanding shares – none	**–**	–
Common stock, par value $0.01 per share; authorized shares – 200,000,000 at December 31, 1998 and 100,000,000 at December 31, 1997; issued shares – 70,680,384 at December 31, 1998 and December 31, 1997	**707**	707
Additional paid-in capital	**519,305**	500,107
Accumulated other comprehensive income	**159,313**	135,223
Retained earnings	**1,449,832**	1,262,740
Common stock held in treasury at cost, 738,381 shares at December 31, 1998 and 732,947 at December 31, 1997	**(33,067)**	(26,295)
Total stockholders' equity	**2,096,090**	1,872,482
Total liabilities and stockholders' equity	**$11,212,311**	$8,291,705

See accompanying Notes to Consolidated Financial Statements

(Dollars in thousands, except per share amounts) Years Ended December 31,	**1998**	1997	1996
REVENUES:			
Financial Guarantee Insurance:			
Gross premiums written	**$361,011**	$286,163	$247,208
Ceded premiums written	**(49,563)**	(32,452)	(37,793)
Net premiums written	**311,448**	253,711	209,415
Increase in unearned premiums	**(98,764)**	(99,711)	(72,786)
Net premiums earned	**212,684**	154,000	136,629
Net investment income	**186,190**	159,709	144,941
Net realized gains (losses)	**3,735**	21,084	(20,531)
Other income	**5,781**	4,402	5,261
Financial Management Services:			
Revenue	**49,510**	35,249	21,973
Net realized (losses) gains	**(17,096)**	(637)	393
Other:			
Revenue	**13,725**	7,207	7,929
Net realized gains	**2,507**	748	156,313
Total revenues	**457,036**	381,762	452,908
EXPENSES:			
Financial Guarantee Insurance:			
Losses and loss adjustment expenses	**6,000**	2,854	3,778
Underwriting and operating expenses	**46,720**	40,672	37,182
Financial Management Services	**35,540**	27,993	12,040
Interest	**32,761**	21,346	20,925
Other	**7,103**	2,901	3,477
Total expenses	**128,124**	95,766	77,402
Income before income taxes	**328,912**	285,996	375,506
Provision for income taxes	**74,918**	62,966	99,189
Net income	**$253,994**	$223,030	$276,317
Net income per share	**$ 3.63**	$ 3.19	$ 3.95
Net income per diluted share	**$ 3.56**	$ 3.13	$ 3.91
Weighted average number of shares outstanding	**69,939,710**	69,988,497	69,929,628
Weighted average number of diluted shares outstanding	**71,330,053**	71,227,347	70,748,470

See accompanying Notes to Consolidated Financial Statements

(Dollars in thousands) Years Ended December 31,	**1998**		1997		1996	
RETAINED EARNINGS:						
Balance at January 1	**$1,262,740**		$1,072,418		$ 819,479	
Net income	**253,994**	**$253,994**	223,030	$223,030	276,317	$276,317
Dividends declared – common stock	**(26,571)**		(24,165)		(21,500)	
Exercise of stock options	**(40,331)**		(8,543)		(1,878)	
Balance at December 31	**$1,449,832**		$1,262,740		$1,072,418	
ACCUMULATED OTHER COMPREHENSIVE INCOME:						
Balance at January 1	**$ 135,223**		$ 58,911		$ 102,470	
Unrealized gains (losses) on securities, ($36,476, $121,347, and ($71,667), pre-tax, in 1998, 1997 and 1996, respectively)(1)		**23,889**		76,155		(43,559)
Foreign currency gain		**201**		157		–
Other comprehensive income	**24,090**	**24,090**	76,312	76,312	(43,559)	(43,559)
Total comprehensive income		**$278,084**		$299,342		$232,758
Balance at December 31	**$ 159,313**		$ 135,223		$ 58,911	
PREFERRED STOCK:						
Balance at January 1 and December 31	**$ –**		$ –		$ –	
COMMON STOCK:						
Balance at January 1	**$ 707**		$ 353		$ 353	
Stock split effected as dividend	**–**		354		–	
Balance at December 31	**$ 707**		$ 707		$ 353	
ADDITIONAL PAID-IN CAPITAL:						
Balance at January 1	**$ 500,107**		$ 498,401		$ 492,495	
Issuance of stock	**–**		(3,506)		3,624	
Exercise of stock options	**19,198**		5,566		2,282	
Stock split effected as dividend	**–**		(354)		–	
Balance at December 31	**$ 519,305**		$ 500,107		$ 498,401	
COMMON STOCK HELD IN TREASURY AT COST:						
Balance at January 1	**$ (26,295)**		$ (15,067)		$ (10,809)	
Cost of shares acquired	**(52,738)**		(40,397)		(31,751)	
Shares issued under equity plans	**45,966**		29,169		17,211	
Issued to acquire subsidiary	**–**		–		10,282	
Balance at December 31	**$ (33,067)**		$ (26,295)		$ (15,067)	
TOTAL STOCKHOLDERS' EQUITY AT DECEMBER 31	**$2,096,090**		$1,872,482		$1,615,016	

(1) Disclosure of reclassification amount:	**1998**	1997	1996
Unrealized holding gains (losses) arising during period	**$34,526**	$88,744	$(56,195)
Less: reclassification adjustment for net gains (losses) included in net income	**10,637**	12,589	(12,636)
Net unrealized gains (losses) on securities	**$23,889**	$76,155	$(43,559)

See accompanying Notes to Consolidated Financial Statements.

(Dollars in thousands) Years Ended December 31,	1998	1997	1996
CASH FLOWS FROM OPERATING ACTIVITIES:			
Net income	**$ 253,994**	$ 223,030	$ 276,317
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation and amortization	**2,460**	1,925	1,986
Amortization of bond premium and discount	**(4,942)**	(3,257)	(1,603)
Current income taxes	**(2,067)**	9,978	1,413
Deferred income taxes	**(2,034)**	12,015	4,497
Deferred acquisition costs	**(14,623)**	(11,784)	(11,592)
Unearned premiums, net	**98,796**	99,706	72,786
Losses and loss adjustment expenses	**13,030**	408	(5,776)
Ceded reinsurance balances payable	**(2,682)**	1,303	(7,216)
Investment income due and accrued	**(47,239)**	(9,415)	(9,550)
Accrued interest payable	**43,598**	16,059	4,464
Loss (gain) on sales of investments and affiliates	**10,854**	(21,195)	(136,175)
Other, net	**(11,488)**	5,744	1,079
Net cash provided by operating activities	**337,657**	324,517	190,630
CASH FLOWS FROM INVESTING ACTIVITIES:			
Proceeds from sales of bonds	**2,020,463**	1,718,174	1,911,909
Proceeds from matured bonds	**1,034,511**	1,080,338	959,527
Purchases of bonds	**(4,746,366)**	(4,135,404)	(3,825,803)
Change in short-term investments	**16,750**	(23,767)	64,178
Securities purchased under agreements to resell	**(166,829)**	115,703	39,111
Loans	**(170,738)**	(503,192)	–
Purchase of affiliate, net of cash acquired	**–**	(120,006)	–
Proceeds from sale of affiliate	**–**	–	202,609
Other, net	**(49,478)**	(19,121)	(9,783)
Net cash used in investing activities	**(2,061,687)**	(1,887,275)	(658,252)
CASH FLOWS FROM FINANCING ACTIVITIES:			
Dividends paid	**(26,571)**	(24,165)	(21,500)
Proceeds from issuance of investment agreements	**3,628,266**	2,805,256	1,696,813
Payments for investment agreement draws	**(2,236,348)**	(1,708,775)	(1,197,584)
Proceeds from issuance of debentures	**193,700**	–	–
Payment agreements	**170,738**	503,192	–
Purchases of treasury stock	**(52,738)**	(40,397)	(31,751)
Proceeds from sale of treasury stock	**45,966**	29,169	17,211
Net cash provided by financing activities	**1,723,013**	1,564,280	463,189
NET CASH FLOW	**(1,017)**	1,522	(4,433)
Cash at January 1	**9,256**	7,734	12,167
Cash at December 31	**$ 8,239**	$ 9,256	$ 7,734
SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION:			
Cash paid during the year for:			
Income taxes	**$ 66,853**	$ 34,163	$ 90,649
Interest expense on debt	**$ 33,056**	$ 21,799	$ 21,675
Interest expense on investment agreements	**$ 252,713**	$ 169,875	$ 148,526

See accompanying Notes to Consolidated Financial Statements.

1 BACKGROUND

Ambac Financial Group, Inc. ("AFGI") is a holding company whose subsidiaries provide financial guarantee insurance and financial management services to clients in both the public and private sectors in the United States and abroad. AFGI's principal operating subsidiary, Ambac Assurance Corporation ("Ambac Assurance"), a leading insurer of municipal and structured finance obligations, has earned triple-A ratings, the highest ratings available from Moody's Investors Service, Inc., Standard & Poor's Ratings Group, Fitch IBCA, Inc., and Japan Rating and Investment Information, Inc. AFGI's Financial Management Services segment provides investment agreements, interest rate swaps, and investment advisory and cash management services, principally to states, municipalities and their authorities, school districts, and hospitals and health organizations.

2 SIGNIFICANT ACCOUNTING POLICIES

The accompanying Consolidated Financial Statements of AFGI and subsidiaries (the "Company") have been prepared on the basis of U.S. Generally Accepted Accounting Principles ("GAAP"). 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 disclosures of contingent assets and liabilities at the date of the financial statements and the reported revenues and expenses during the reporting period. Actual results could differ from those estimates. The significant accounting policies of the Company are described below:

CONSOLIDATION:

The consolidated financial statements include the accounts of AFGI and its subsidiaries. All significant intercompany balances have been eliminated.

NET INCOME PER SHARE AND NET INCOME PER DILUTED SHARE:

Net income per share is based on the weighted average number of shares outstanding during the year, retroactively adjusted to reflect a two-for-one stock split in 1997. Net income per diluted share reflects the potential dilution that would occur if securities, such as employee stock options, were exercised.

INVESTMENTS:

The Company's investment portfolio is accounted for on a trade-date basis and consists primarily of investments in fixed income securities that are considered available-for-sale and are carried at fair value. Fair value is based on quotes obtained by the Company from independent market sources. Short-term investments are carried at cost, which approximates fair value. Unrealized gains and losses, net of deferred income taxes, are included as a component of "Accumulated Other Comprehensive Income" in stockholders' equity and are computed using amortized cost as the basis. For purposes of computing amortized cost, premiums and discounts are accounted for using the interest method. For bonds purchased at a price below par value, discounts are accreted over the remaining term of the securities. For bonds purchased at a price above par value which have call features, premiums are amortized to the most likely call dates as determined by management. For premium bonds that do not have call features, such premiums are amortized over the remaining terms of the securities. Premiums and discounts on mortgage-backed and asset-backed securities are adjusted for the effects of actual and anticipated prepayments. Realized gains and losses on the sale of investments are determined on the basis of specific identification.

SECURITIES PURCHASED UNDER AGREEMENTS TO RESELL:

Securities purchased under agreements to resell are collateralized financing transactions, and are recorded at their contracted resale amounts, plus accrued interest. The Company takes possession of the collateral underlying those agreements and monitors its market value on a daily basis and, when necessary, requires prompt transfer of additional collateral to reflect current market value.

LOANS:

Loans are reported at their outstanding unpaid principal balances, net of any deferred fees. Interest income is accrued on the unpaid principal balance. Deferred fees are amortized to interest income over the contractual life of the loan using the interest method or the straight-line method if not materially different.

OBLIGATIONS UNDER INVESTMENT AND PAYMENT AGREEMENTS:

Obligations under investment and payment agreements and investment repurchase agreements are recorded as liabilities on the Consolidated Balance Sheets at the face value of the agreement, adjusted for draws paid and interest credited to the account. Unsettled agreements are accrued on a trade-date basis on the Consolidated Balance Sheets at the time of commitment. Interest expense is computed based upon daily outstanding settled liability balances at rates and periods specified in the agreements. Net interest income relating to investment agreements and investment repurchase agreements is included as a component of Financial Management Services revenue.

PREMIUM REVENUE RECOGNITION:

Premiums can be structured in two ways: (1) computed as a percentage of principal and interest insured, typically collected in a single payment at policy inception date, and earned pro-rata over the period of risk; and (2) computed as a percentage of either principal or principal and interest insured, collected periodically (i.e., monthly, quarterly or annually), and reflected in income pro-rata over the period covered by the premium payment.

When a new or secondary market issue insured by Ambac Assurance has been refunded or called, the remaining unearned premium (net of refunding credits, if any) is generally earned at that time.

LOSSES AND LOSS ADJUSTMENT EXPENSES:

The liability for losses and loss adjustment expenses consists of the active credit reserve ("ACR") and case basis loss and loss adjustment expense reserves. The development of the ACR is based upon estimates of the expected annual levels of debt service defaults resulting from credit failures on currently insured issues that are not presently or imminently in default. When losses occur (actual monetary defaults or defaults which are imminent on insured obligations), case basis loss reserves are established in an amount that is sufficient to cover the present value of the anticipated defaulted debt service payments over the expected period of default and estimated expenses associated with settling the claims, less estimated recoveries under salvage or subrogation rights. During 1998, 1997 and 1996, paid losses, net of salvage received, were ($7,030), $2,474 and $9,554, respectively. All or part of case basis loss reserves are allocated from any ACR available.

Ambac Assurance's management believes that the reserves for losses and loss adjustment expenses are adequate to cover the ultimate net cost of claims, but the reserves are necessarily based on estimates and there can be no assurance that the ultimate liability will not exceed such estimates.

DEFERRED ACQUISITION COSTS:

Certain costs incurred that vary with, and are primarily related to, the production of business have been deferred. These costs include direct and indirect expenses related to underwriting, marketing and policy issuance, rating agency fees and premium taxes, net of reinsurance ceding commissions. The deferred acquisition costs are being amortized over the periods in which the related premiums are earned, and such amortization amounted to $18,248, $14,213 and $12,553 for 1998, 1997 and 1996, respectively. Deferred acquisition costs, net of such amortization, amounted to $14,623, $11,784 and $11,592 for 1998, 1997 and 1996, respectively.

DEPRECIATION AND AMORTIZATION:

Depreciation of furniture and fixtures and electronic data processing equipment is provided over the estimated useful lives of the respective assets, ranging from three to five years, using the straight-line method. Amortization of leasehold improvements and intangibles, including certain computer software licenses, is provided over the estimated useful lives of the respective assets, ranging from three to 10 years, using the straight-line method.

DERIVATIVE CONTRACTS:

DERIVATIVE CONTRACTS HELD FOR PURPOSES OTHER THAN TRADING:

The Company uses derivative contracts (primarily interest rate swaps and futures contracts) for hedging purposes as part of its overall interest rate risk management.

The Company accounts for its futures contracts in accordance with the provisions of FAS Statement 80, "Accounting for Futures Contracts" ("FAS 80"). FAS 80 permits hedge accounting for futures contracts when the item to be hedged exposes the Company to price or interest rate risk, and the futures contract effectively reduces that exposure and is designated as a hedge. Futures contracts held for purposes other than trading are used primarily to hedge interest sensitive assets and liabilities. Futures contracts are designated at inception as a hedge to specific assets and liabilities. Gains and losses on futures and options contracts that qualify as accounting hedges of existing assets or liabilities are included as a component of "Accumulated Other Comprehensive Income" in stockholders' equity, net of deferred tax, and amortized over the remaining lives of the assets and liabilities as an adjustment to interest income or expense. When the hedged asset is sold, or the hedged liability is settled, the unamortized gain or loss on the related hedge is recognized in income.

Interest rate swaps that are linked with existing liabilities are accounted for as a hedge of those liabilities, using the accrual method as an adjustment to interest expense. Interest rate swaps that are linked with existing assets classified as available for sale are accounted for as hedges of those assets, using the accrual method as an adjustment to interest income, with unrealized gains and losses included as a component of "Accumulated Other Comprehensive Income" in stockholders' equity, net of deferred tax. Interest rate risk is managed through the linkage of the interest rate swaps, which synthetically changes the nature of the underlying asset or liability (for example, from a fixed to floating interest rate obligation).

Gains and losses on futures contracts, purchased options or interest rate swaps that do not qualify as accounting hedges are recognized immediately in current period income.

DERIVATIVE CONTRACTS HELD FOR TRADING PURPOSES:

The Company, through its subsidiary Ambac Financial Services, L.P. ("AFSLP"), a provider of interest rate swaps to states, municipalities and their authorities, and other entities in connection with their financings, uses derivative contracts which are classified as held for trading purposes. Derivative contracts are recorded on trade date at fair value. Changes in fair value are recorded as a component of Financial Management Services segment income. The fair value of interest rate swaps is determined through the use of valuation models. Interest rate swaps are recorded on the balance sheet on a gross basis; assets and liabilities are netted by customer only when a legal right of set-off exists.

INCOME TAXES:

AFGI files a consolidated federal income tax return with its subsidiaries. Deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in

tax rates is recognized in the period that includes the enactment date.

The Internal Revenue Code permits financial guarantee insurance companies to deduct from taxable income, subject to certain limitations, the amounts added to the statutory mandatory contingency reserve for municipal obligations during the year. The deduction taken is allowed only to the extent that U.S. Treasury noninterest-bearing tax and loss bonds are purchased at their par value prior to the original due date of the Company's consolidated federal tax return and held in an amount equal to the tax benefit attributable to such deductions. The amounts deducted must be included in taxable income when the contingency reserve is released, at which time the Company may redeem the tax and loss bonds to satisfy the additional tax liability. The purchases of tax and loss bonds are recorded as payments of federal income taxes.

POSTRETIREMENT AND POSTEMPLOYMENT BENEFITS:

The Company provides various postretirement and postemployment benefits, including pension, and health and life benefits covering substantially all employees who meet certain age and service requirements. The Company accounts for these benefits under the accrual method of accounting. Amounts related to the defined benefit pension plan and postretirement health benefits are charged based on actuarial determinations.

STOCK COMPENSATION PLANS:

In 1997, the Company adopted the Ambac 1997 Equity Plan. Under this plan, awards are granted to eligible employees of the Company in the form of incentive stock options or other stock-based awards. The Company accounts for its incentive stock options and stock-based awards under FAS Statement 123, "Accounting for Stock-Based Compensation" ("FAS 123"). FAS 123 permits a company to choose either the fair value based method of accounting as defined in the Statement or the intrinsic value based method of accounting as prescribed by APB Opinion No. 25, "Accounting for Stock Issued to Employees" ("APB 25"), for its stock-based compensation plans. Companies electing the accounting requirements under APB 25 must also make pro-forma disclosures of net income, earnings per share and earnings per diluted share as if the fair value based method of accounting had been applied. The Company has elected to account for its plans under APB 25.

ACCOUNTING STANDARDS:

During 1998, the Company adopted the following new standards: FAS Statement 130, "Reporting Comprehensive Income" ("FAS 130"); FAS Statement 131, "Disclosures about Segments of an Enterprise and Related Information" ("FAS 131"); and FAS Statement 132, "Employers' Disclosures about Pensions and Other Postretirement Benefits" ("FAS 132").

FAS 130 establishes standards for the reporting and presentation of comprehensive income and its components in a full set of financial statements. Comprehensive income encompasses all changes in stockholders' equity (except those arising from transactions with stockholders) and includes net income, net unrealized capital gains or losses on available-for-sale securities and foreign currency translation adjustments. Comprehensive income is disclosed in the Consolidated Statement of Stockholders' Equity. FAS 131 redefines how reportable segments are determined and requires disclosure of certain financial and descriptive information about a company's reportable segments. Disclosures regarding the Company's two reportable segments, Financial Guarantee Insurance and Financial Management Services are included in Note 17. FAS 132 alters disclosure requirements regarding pensions and other postretirement benefits in the financial statements of employers who sponsor such benefit plans. The revised disclosure requirements are designed to provide additional information to assist readers in evaluating future costs related to such plans. The required pension disclosures are included in Note 10. As each of these new standards only requires additional disclosure information in the consolidated financial statements, they do not affect the Company's consolidated financial position or results of operations.

In June 1998, the Financial Accounting Standards Board issued FAS Statement 133, "Accounting for Derivative Instruments and Hedging Activities" ("FAS 133"). FAS 133 establishes accounting and reporting standards for derivative instruments and hedging activities. The statement requires all derivatives to be recorded on the balance sheet at fair value and establishes special accounting for the following three different types of hedges: (1) hedges of changes in the fair value of assets, liabilities or firm commitments (referred to as fair value hedges); (2) hedges of the variable cash flows of forecasted transactions (cash flow hedges); and (3) hedges of foreign currency exposures of net investments in foreign operations. Though the accounting treatment and criteria for each of the three types of hedges is unique, they all result in recognizing offsetting changes in value or cash flow of both the hedge and the hedged item in earnings in the same period. Changes in the fair value of derivatives that do not meet the criteria of one of these three categories of hedges are included in earnings in the period of the change with no related offset. FAS 133 is effective for years beginning after June 15, 1999, but companies may adopt early. The Company will adopt FAS 133 effective January 1, 2000. Management is assessing the impact of FAS 133 on the Company's consolidated financial position and results of operations.

RECLASSIFICATIONS:

Certain reclassifications have been made to prior years' amounts to conform to the current year's presentation.

3 INVESTMENTS

The amortized cost and estimated fair value of investments in fixed income securities and short-term investments at December 31, 1998 and 1997 were as follows:

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
1998				
Municipal obligations	**$2,632,276**	**$172,960**	**$3,912**	**$2,801,324**
Corporate obligations	**1,335,749**	**103,030**	**3,352**	**1,435,427**
U.S. Government obligations	**114,385**	**8,511**	**–**	**122,896**
Mortgage- and asset-backed securities (includes U.S. Government Agency obligations)	**4,224,636**	**41,994**	**3,995**	**4,262,635**
Other	**119,528**	**–**	**–**	**119,528**
Total	**$8,426,574**	**$326,495**	**$11,259**	**$8,741,810**
1997				
Municipal obligations	$2,146,137	$152,971	$ 112	$2,298,996
Corporate obligations	1,022,995	71,520	928	1,093,587
U.S. Government obligations	136,771	2,855	28	139,598
Mortgage- and asset-backed securities (includes U.S. Government Agency obligations)	3,200,262	25,511	3,017	3,222,756
Other	155,763	91	669	155,185
Total	$6,661,928	$252,948	$ 4,754	$6,910,122

The amortized cost and estimated fair value of fixed income securities and short-term investments at December 31, 1998, by contractual maturity, were as follows:

	Amortized Cost	Estimated Fair Value
Due in one year or less	$ 250,741	$ 252,235
Due after one year through five years	222,466	232,054
Due after five years through ten years	399,846	423,355
Due after ten years	3,328,885	3,571,531
	4,201,938	4,479,175
Mortgage- and asset-backed securities	4,224,636	4,262,635
	$8,426,574	$8,741,810

Expected maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

Securities carried at $6,191 and $8,415 at December 31, 1998 and 1997, respectively, were deposited by the Company with governmental authorities or designated custodian banks as required by laws affecting insurance companies.

Net investment income from the Financial Guarantee Insurance segment comprised the following:

	1998	1997	1996
Fixed income securities	**$181,437**	$155,810	$139,410
Short-term investments	**8,139**	6,506	7,999
Total investment income	**189,576**	162,316	147,409
Investment expense	**(3,386)**	(2,607)	(2,468)
Net investment income	**$186,190**	$159,709	$144,941

The Financial Guarantee Insurance segment had gross realized gains of $14,219, $25,641 and $19,236 for 1998, 1997 and 1996, respectively, and gross realized losses of $10,484, $4,557 and $39,767 for 1998, 1997 and 1996, respectively.

The Financial Management Services segment had gross realized gains of $22,592, $3,766 and $3,406 for 1998, 1997 and 1996, respectively, and gross realized losses of $39,688, $4,403 and $3,013 for 1998, 1997 and 1996, respectively. Gross realized gains and losses includes amounts related to a trading position, which represented a small portion of the Company's assets, containing high quality municipal bonds hedged with treasury futures. These gains were $2,967, $1,309 and $0 for 1998, 1997 and 1996, respectively, and losses of $18,638, $3,578 and $0 for 1998, 1997 and 1996, respectively. Gross realized losses also include the Company's $11,548 write-off of its investment in Ambac Connect, Inc. in 1998.

Net investment income related to the investment agreement business comprises gross investment income less related interest expense, and is a component of Financial Management Services revenue. For 1998, 1997 and 1996, gross investment income from investment agreements was $281,904, $200,337 and $165,196, respectively, and the related interest expense was $263,586, $186,678 and $154,484, respectively.

As of December 31, 1998 and 1997, the Company held securities subject to agreements to resell for $252,295 and $85,466, respectively. These securities were held as collateral by the Company under agreements that had terms of less than 30 days.

As of December 31, 1998 and 1997, the Company had pledged (or sold under agreements to repurchase) securities purchased under agreements to resell and investment securities to certain municipalities, with a fair value of $3,636,519 and $2,714,719, respectively, in connection with certain investment agreements (including agreements structured as investment repurchase agreements).

During 1998, the Company entered into security borrowing agreements, the purpose of which was to limit the Company's cost of collateralizing certain investment agreements (including agreements structured as investment repurchase agreements) by reducing the use of securities purchased under agreements to resell. The security borrowing agreements allow the Company to borrow securities with a maximum market value of $1,000,000. The borrowings are secured by Company-owned investment securities. As of December 31, 1998, the Company had $750,000 in outstanding securities borrowed. The borrowings and related pledged securities are classified as "Payable to brokers and dealers" and "Receivable from brokers and dealers," respectively, on the Consolidated Balance Sheets.

4 LOANS

In the normal course of business, the Company has extended loans to customers participating in certain structured municipal transactions. The loans are collateralized with cash that the customers have deposited with a payment custodian in amounts adequate to repay the loan balance and interest thereon. Equipment and other assets underlying the transactions serve as additional collateral for the loans. The Company may act as the payment custodian and hold the funds posted as collateral.

As of December 31, 1998 and 1997, the interest rates on these loans ranged from 6.25% to 8.42%.

5 REINSURANCE

In the ordinary course of business, Ambac Assurance cedes exposures under various reinsurance contracts primarily designed to minimize losses from large risks and to protect capital and surplus. The effect of reinsurance on premiums written and earned was as follows:

Years Ended December 31,	1998		1997		1996	
	Written	**Earned**	Written	Earned	Written	Earned
Direct	**$333,652**	**$238,452**	$277,814	$176,009	$240,544	$155,883
Assumed	**27,359**	**7,367**	8,349	3,614	6,664	3,126
Ceded	**(49,563)**	**(33,135)**	(32,452)	(25,623)	(37,793)	(22,380)
Net premiums	**$311,448**	**$212,684**	$253,711	$154,000	$209,415	$136,629

The reinsurance of risk does not relieve the ceding insurer of its original liability to its policyholders. In the event that all or any of the reinsurers are unable to meet their obligations to Ambac Assurance under the existing reinsurance agreements, Ambac Assurance would be liable for such defaulted amounts. To minimize its exposure to significant losses from reinsurer insolvencies, Ambac Assurance evaluates the financial condition of its reinsurers and monitors concentrations of credit risk. There were no reinsurance recoverables on paid losses as of December 31, 1998 and 1997. As of December 31, 1998, prepaid reinsurance of approximately $159,361 was associated with Ambac Assurance's three largest reinsurers. As of December 31, 1998, Ambac Assurance held letters of credit and collateral amounting to approximately $198,957 from its reinsurers to cover liabilities ceded under the aforementioned reinsurance contracts.

Ambac Assurance and MBIA Insurance Corporation ("MBIA") formed an unincorporated joint venture, MBIA•AMBAC International, in 1995. The joint venture was formed with the goal of bringing the combined capital and human resources of the two companies together to more efficiently serve the international market. Under the joint venture arrangement, financial guarantee policies are issued separately by each of the companies. Premiums assumed from MBIA were $18,715, $8,009 and $4,674 in 1998, 1997 and 1996, respectively. Premiums ceded to MBIA were $15,505, $8,874 and $6,532 in 1998, 1997 and 1996, respectively.

6 STOCKHOLDERS' EQUITY

The Company is authorized to issue 200,000,000 shares of common stock, par value $0.01 per share, of which 70,680,384 were issued as of December 31, 1998. The Company is also authorized to issue 4,000,000 shares of preferred stock, $0.01 par value per share, none of which was issued and outstanding as of December 31, 1998.

Dividends declared per share amounted to $0.38, $0.345 and $0.3075 in 1998, 1997 and 1996, respectively.

The Board of Directors of the Company (the "Board") has authorized the establishment of a stock repurchase program that permits the repurchase of up to 6,000,000 shares of the Company's common stock. As of December 31, 1998, approximately 4,248,000 shares had been repurchased under this program for an aggregate amount of $142,700.

STOCKHOLDER RIGHTS PLAN:

The Company adopted a Stockholder Rights Plan under which stockholders received (after giving effect to a stock split since adoption of the Plan) one Right for each two shares of common stock owned. Each Right entitles the registered holder to purchase from the Company one one-hundredth of a share of Series A Junior Participating Preferred Stock, par value $0.01 per share, at a purchase price of $190 per share. The Rights generally detach and become exercisable when any person or group acquires 20% or more (or announces a tender offer for 20% or more) of the Company's common stock, at which time each Right (other than those held by the acquiring company) will entitle the holder to receive that number of shares of common stock of the Company with a value of two times the exercise price of the Right. If the Company is acquired in a merger or other business combination transaction in which the Company is not the surviving corporation or 50% or more of the Company's assets, cash flow or earning power is sold or transferred, each Right will entitle the holder to receive that number of shares of stock of the acquiring company having a value equal to two times the exercise price of the Right. The Rights, which expire on January 31, 2006, are redeemable in whole, but not in part, by action of the Board at a price of $0.01 per Right at any time prior to their becoming exercisable.

7 COMMITMENTS AND CONTINGENCIES

The Company is responsible for leases on the rental of office space. The lease agreements, which expire periodically through September 2019, contain provisions for scheduled periodic rent increases and are accounted for as operating leases. An estimate of future net minimum lease payments in each of the next five years ending December 31, and the periods thereafter, is as follows:

	Amount
1999	$ 7,067
2000	7,076
2001	6,174
2002	6,115
2003	6,091
All later years	88,369
	$120,892

Rent expense for the aforementioned leases amounted to $5,537, $5,048 and $3,862 for the years ended December 31, 1998, 1997 and 1996, respectively. Total rentals to be received under future sublease agreements is estimated at $5,125.

8 INSURANCE REGULATORY RESTRICTIONS

Ambac Assurance is subject to insurance regulatory requirements of the States of Wisconsin and New York,

and the other jurisdictions in which it is licensed to conduct business.

Ambac Assurance's ability to pay dividends is generally restricted by law and subject to approval by the Office of the Commissioner of Insurance of the State of Wisconsin (the "Wisconsin Commissioner"). Wisconsin insurance law restricts the payment of dividends in any 12-month period without regulatory approval to the lesser of (a) 10% of policyholders' surplus as of the preceding December 31 and (b) the greater of (i) statutory net income for the calendar year preceding the date of dividend, minus realized capital gains for that calendar year and (ii) the aggregate of statutory net income for three calendar years preceding the date of the dividend, minus realized capital gains for those calendar years and minus dividends paid or credited within the first two of the three preceding calendar years. Ambac Assurance paid cash dividends of $48,000, $44,000 and $40,000 on its common stock in 1998, 1997 and 1996, respectively. In addition, on April 30, 1996, Ambac Assurance, in conjunction with the sale of the Company's remaining holdings in HCIA, Inc. ("HCIA") common stock, delivered to the Company (in the form of an extraordinary dividend) its 2,378,672 shares of HCIA common stock, at fair value. The Wisconsin Commissioner approved such dividend. Based upon these restrictions, at December 31, 1998, the maximum amount that will be available during 1999 for payment of dividends by Ambac Assurance is approximately $116,200.

The New York Financial Guarantee Insurance Law establishes single risk limits applicable to all obligations issued by a single entity and backed by a single revenue source. Under the limit applicable to municipal bonds, the insured average annual debt service for a single risk, net of reinsurance and collateral, may not exceed 10% of qualified statutory capital, which is defined as the sum of insurer's policyholders' surplus and contingency reserves. In addition, insured principal of municipal bonds attributable to any single risk, net of reinsurance and collateral, is limited to 75% of Ambac Assurance's qualified statutory capital. Additional single risk limits, which generally are more restrictive than the municipal bond single risk limit, are also specified for several other categories of insured obligations.

Statutory capital and surplus was $1,162,639 and $1,006,829 at December 31, 1998 and 1997, respectively. Qualified statutory capital was $1,920,298 and $1,655,554 at December 31, 1998 and 1997, respectively. Statutory net income for Ambac Assurance was $271,808, $198,615 and $222,810 for 1998, 1997 and 1996, respectively. Statutory capital and surplus differs from stockholders' equity determined under GAAP principally due to statutory accounting rules that treat loss reserves, premiums earned, policy acquisition costs, and deferred income taxes differently.

9 INCOME TAXES

The Company's provision for income taxes is comprised of the following:

	1998	1997	1996
Current taxes	**$72,608**	$51,036	$94,392
Deferred taxes	**2,310**	11,930	4,797
	$74,918	$62,966	$99,189

The total effect of income taxes on income and stockholders' equity for the years ended December 31, 1998 and 1997 was as follows:

	1998	1997
Total income taxes charged to income	**$ 74,918**	$ 62,966
Income taxes (credited) charged to stockholders' equity:		
Unrealized gains on bonds	**12,587**	45,192
Exercise of stock options	**(19,144)**	(5,566)
Total (credited) charged to stockholders' equity	**(6,557)**	39,626
Total effect of income taxes	**$ 68,361**	$102,592

The tax provisions in the accompanying consolidated statements of operations reflect effective tax rates differing from prevailing federal corporate income tax rates. The following is a reconciliation of these differences:

	1998	%	1997	%	1996	%
Computed expected tax at statutory rate	**$115,119**	35.0%	$100,099	35.0%	$131,427	35.0%
Reductions in expected tax resulting from:						
Tax-exempt interest	**(38,926)**	(11.8)	(35,682)	(12.5)	(30,760)	(8.2)
Other, net	**(1,275)**	(0.4)	(1,451)	(0.5)	(1,478)	(0.4)
Income tax expense	**$ 74,918**	22.8%	$ 62,966	22.0%	$ 99,189	26.4%

The tax effects of temporary differences that give rise to significant portions of the deferred tax liabilities and deferred tax assets at December 31, 1998 and 1997 are presented below:

	1998	1997
Deferred tax liabilities:		
Contingency reserve	**$119,150**	$115,360
Unrealized gains on bonds	**87,930**	75,342
Deferred acquisition costs	**42,583**	38,030
Unearned premiums	**36,728**	35,679
Investments	**2,442**	1,491
Other	**1,189**	2,026
Total deferred tax liabilities	**290,022**	267,928
Deferred tax assets:		
Tax and loss bonds	**88,471**	87,951
Loss reserves	**27,918**	17,182
Alternative minimum tax carryforward	**7,001**	14,049
Amortization and depreciation	**5,406**	6,032
Compensation	**12,009**	4,030
Other	**3,435**	3,456
Sub-total deferred tax assets	**144,240**	132,700
Valuation allowance	**–**	–
Total deferred tax assets	**144,240**	132,700
Net deferred tax liabilities	**$145,782**	$135,228

The Company believes that no valuation allowance is necessary in connection with the deferred tax assets.

10 EMPLOYEE BENEFITS

PENSIONS:
The Company has a defined benefit pension plan covering substantially all employees of the Company. The benefits are based on years of service and the employee's compensation during the last five years of employment. The Company's funding policy is to contribute annually the maximum amount that can be deducted for Federal income tax purposes. Contributions are intended to provide not only for benefits attributed to service-to-date, but also for those expected to be earned in the future.

The table below sets forth a reconciliation of the beginning and ending projected benefit obligation, beginning and ending balances of the fair value of plan assets, and the funded status of the plan as of December 31, 1998 and 1997.

	1998	1997
Change in Projected Benefit Obligation:		
Projected benefit obligation at beginning of year	**$ 9,374**	$ 8,189
Service cost	**691**	723
Interest cost	**684**	601
Amendments	**116**	–
Actuarial loss	**1,843**	114
Benefits paid	**(275)**	(253)
Projected benefit obligation at end of year	**$12,433**	$ 9,374
Change in Plan Assets:		
Fair value of plan assets at beginning of year	**$ 9,644**	$ 8,153
Actual return on plan assets	**1,595**	1,635
Company contributions	**–**	138
Benefits paid	**(275)**	(253)
Expenses paid	**(30)**	(29)
Fair value of plan assets at end of year	**$10,934**	$ 9,644
Funded status	**$ (1,499)**	$270
Unrecognized net loss	**1,118**	62
Unrecognized prior service cost	**(1,289)**	(1,454)
Unrecognized net transition asset	**(4)**	(7)
Pension liability included in other liabilities	**$ (1,674)**	$(1,129)

Net pension costs for 1998, 1997 and 1996 included the following components:

	1998	1997	1996
Service cost	**$ 807**	$ 723	$ 674
Interest cost on expected benefit obligation	**684**	601	539
Expected return on plan assets	**(793)**	(701)	(613)
Amortization of unrecognized transition asset	**(3)**	(3)	(3)
Amortization of prior service cost	**(165)**	(165)	(165)
Recognized net actuarial loss	**15**	33	87
Net periodic pension cost	**$ 545**	$ 488	$ 519

The discount rate used in the determination of the actuarial present value for the projected benefit obligation was 6.50% and 7.25% for 1998 and 1997, respectively. The expected long-term rate of return on assets was 9.25% for both 1998 and 1997. The rate of increase in future compensation levels used in determining the actuarial present value of the projected benefit obligation was 5.0 % and 4.8% for 1998 and 1997, respectively.

Substantially all employees of the Company are covered by a defined contribution plan (the "Savings Incentive Plan"), for which contributions and costs are determined as 6% of each eligible employee's base salary, plus a matching company contribution of 50% on contributions up to 6% of base salary made by eligible employees to the plan. The total cost of the Savings Incentive Plan was $2,063, $1,806 and $1,680 in 1998, 1997 and 1996, respectively.

ANNUAL INCENTIVE PROGRAM:
The Company has an annual incentive program that provides for awards to key officers and employees based upon predetermined criteria. The cost of the program in 1998, 1997 and 1996 amounted to $16,095, $12,038 and $10,822, respectively.

POSTRETIREMENT HEALTH CARE AND OTHER BENEFITS:
Ambac Assurance provides certain medical and life insurance benefits for retired employees and eligible dependents. All plans are contributory. None of the plans are currently funded.

Postretirement benefits expense was $316, $262 and $220 in 1998, 1997 and 1996, respectively. The unfunded accumulated postretirement benefit obligation was $3,121 and the related accrued postretirement liability was $1,956 as of December 31, 1998.

The assumed health care cost trend rates range from 8.0% in 1999, decreasing ratably to 5.5% in 2003, and remaining at that level thereafter. Increasing the assumed health care cost trend rate by one percentage point in each future year would increase the accumulated postretirement benefit obligation at December 31, 1998 by $554 and the 1998 benefit expense by $79. The weighted average discount rate used to measure the accumulated postretirement benefit obligation and 1998 expense was 6.50%.

11 INSURANCE IN FORCE

The par amount of bonds insured, net of reinsurance, was $198,274,000 and $165,601,000 at December 31, 1998 and 1997, respectively. As of December 31, 1998 and 1997, the insured portfolio was diversified by type of insured bond as shown in the following table:

(Dollars in millions)	Net Par Amount Outstanding 1998	1997
Domestic:		
Municipal finance:		
General obligation	**$ 37,502**	$ 36,324
Lease and tax-backed revenue	**36,929**	30,980
Utility revenue	**27,014**	24,913
Health care revenue	**20,071**	18,545
Investor-owned utilities	**8,013**	6,255
Transportation revenue	**7,831**	7,370
Higher education	**7,720**	6,852
Housing revenue	**6,445**	6,064
Student loans	**4,528**	3,516
Other	**873**	597
Total municipal finance	**156,926**	141,416
Structured finance:		
Mortgage-backed and home equity	**19,478**	11,620
Commercial asset-backed	**10,015**	4,538
Other consumer asset-backed	**2,132**	1,514
Banks/financial institutions	**671**	524
Other	**567**	439
Total structured finance	**32,863**	18,635
Total domestic	**189,789**	160,051
International finance:		
Commercial asset-backed	**3,180**	2,600
Banks/financial institutions	**1,514**	283
Utilities	**1,073**	456
Sovereign/sub-sovereign	**1,027**	981
Mortgage-backed and home equity	**607**	496
Other	**1,084**	734
Total international finance	**8,485**	5,550
	$198,274	$165,601

As of December 31, 1998 and 1997, the international insured portfolio is shown in the following table by location of risk:

(Dollars in millions)	Net Par Amount Outstanding 1998	1997
United Kingdom	**$2,289**	$ 865
Australia	**779**	63
France	**692**	1,032
Japan	**675**	879
Italy	**571**	555
Internationally diversified [1]	**1,621**	899
Other international	**1,858**	1,257
Total International	**$8,485**	$5,550

(1) Internationally diversified represents insured policies with multiple locations of risk.

Direct insurance in force (principal and interest) was $367,801,000 and $321,104,000 at December 31, 1998 and 1997, respectively. Net insurance in force (after giving effect to reinsurance) was $317,668,000 and $275,931,000 as of December 31, 1998 and 1997, respectively.

12 FINANCIAL INSTRUMENTS HELD FOR PURPOSES OTHER THAN TRADING

DERIVATIVE FINANCIAL INSTRUMENTS:

In the normal course of business, the Company becomes a party to various financial instruments to reduce its exposure to fluctuations in interest rates. These financial instruments include interest rate swaps, exchange traded futures contracts and purchased interest rate options. The notional amounts of these financial instruments were as follows:

As of December 31,	1998	1997
Derivative financial instruments with off-balance sheet risk:		
Interest rate futures contracts	**$5,836,700**	$3,689,100
Interest rate swaps	**590,468**	712,206
Other:		
Purchased interest rate options	**15,000**	85,500

Notional principal amounts are often used to express the volume of these transactions and do not reflect the extent to which positions may offset one another. These amounts do not represent the much smaller amounts potentially subject to risk.

As discussed in Note 2, interest rate futures and purchased option contracts held for purposes other than trading are used primarily to hedge interest rate risk inherent in the portfolio of interest-sensitive assets and liabilities. Interest rate swaps held for purposes other than trading are used to manage interest rate risk by synthetically changing the nature of specific assets or liabilities.

Futures contracts are purchased to hedge interest rate risk inherent in fixed rate liabilities. Futures contracts are sold to hedge interest rate risk inherent in fixed rate investment securities. Interest rate option contracts are purchased to hedge interest rate risk inherent in fixed rate assets and liabilities. At December 31, 1998 and 1997, futures and purchased option contracts with an outstanding notional of $360,700 and $627,000, respectively, were designated as hedges of fixed rate liabilities. Additionally, at December 31, 1998 and 1997, futures and purchased option contracts with an outstanding notional of $5,491,000 and $3,147,600, respectively, were designated as hedges of fixed rate investment securities.

Interest rate swaps that require the Company to pay a fixed rate are used primarily to hedge fixed rate investment securities. Interest rate swaps that require the Company to receive a fixed rate are used primarily to hedge fixed rate liabilities. The table below summarizes, for each major type of swap, the weighted average fixed rate paid or received on the respective notional amounts outstanding. Notional amounts are used to calculate the contractual payments to be exchanged.

	Pay fixed swaps:		Receive fixed swaps:		
Maturing After December 31,	Notional amount	Weighted average fixed rate	Notional amount	Weighted average fixed rate	Range of implied floating interest rates
1999	$299,775	6.98%	$12,922	6.46%	4.98% to 5.16%
2000	202,368	7.02%	12,271	6.46%	5.08% to 5.25%
2001	161,145	6.93%	11,602	6.46%	5.23% to 5.35%
2002	173,144	6.93%	10,913	6.46%	5.32% to 5.45%
2003	182,783	6.93%	10,205	6.46%	5.45% to 5.52%
Thereafter	53,924	7.08%	20,354	7.07%	

The floating rate side of the Company's interest rate swaps is based on several indices, primarily one-month, three-month and six-month LIBOR. The floating rates shown above reflect the range of the implied forward LIBOR yield curve for those indices, as of December 31, 1998.

FAIR VALUES OF FINANCIAL INSTRUMENTS HELD FOR PURPOSES OTHER THAN TRADING:
Fair value amounts are determined by using independent market information when available, and appropriate valuation methodologies when market quotes were not available. In cases where specific market quotes are unavailable, interpreting market data and estimating market values require considerable judgment by management. Accordingly, the estimates presented are not necessarily indicative of the amount the Company could realize in a current market exchange.

The following methods and assumptions were used to estimate the fair value of each class of financial instruments for which it is practicable to estimate that value:

INVESTMENTS: The fair values of fixed income investments are based on quoted market prices received from a nationally recognized pricing service or dealer quotes.

SHORT-TERM INVESTMENTS AND CASH: The fair values of short-term investments and cash are assumed to equal amortized cost.

OTHER: The fair value of other investments, primarily preferred stock, is based on an evaluation of the underlying company and recent transactions in such preferred stock.

SECURITIES PURCHASED UNDER AGREEMENTS TO RESELL: The fair value of securities purchased under agreements to resell is assumed to approximate carrying value.

LOANS: The fair value of loans is assumed to approximate carrying value.

RECEIVABLE/PAYABLE TO BROKERS AND DEALERS: The fair value of receivable/payable to brokers and dealers, representing securities borrowed from various counterparties secured by Company-owned securities, are assumed to approximate carrying value.

DEBENTURES: The fair value of the debentures is based on the quoted market prices and dealer quotes.

OBLIGATIONS UNDER INVESTMENT, REPURCHASE AND PAYMENT AGREEMENTS (INCLUDING ACCRUED INTEREST): The fair value of the liability for investment agreements and repurchase agreements (including accrued interest) is estimated based upon valuation models using rates currently offered for contracts of similar remaining maturities. The fair value of payment agreements is assumed to approximate carrying value.

DERIVATIVE CONTRACTS: Fair values of derivative contracts (futures, swaps and interest rate options) are based on quoted market and dealer prices, current settlement values, or pricing models.

LIABILITY FOR NET FINANCIAL GUARANTEES WRITTEN: The fair value of the liability for those financial guarantees written related to new issue and secondary market exposures is based on the estimated cost to reinsure those exposures at current market rates, which amount consists of the current unearned premium reserve, less an estimated ceding commission thereon.

Certain other financial guarantee insurance policies have been written on an installment basis, where the future premiums to be received by the Company are determined based on the outstanding exposure at the time the premiums are due. The fair value of Ambac Assurance's liability under its installment premium policies is measured using the present value of estimated future installment premiums, less an estimated ceding commission. The estimate of the amounts and timing of the future installment premiums is based on contractual premium rates, debt service schedules and expected run-off scenarios. This measure is used as an estimate of the cost to reinsure Ambac Assurance's liability under these policies.

The carrying amount and estimated fair value of financial instruments held for purposes other than trading are presented below:

As of December 31,	**1998**		1997	
(Dollars in Millions)	**Carrying Amount**	**Estimated Fair Value**	Carrying Amount	Estimated Fair Value
Financial assets:				
Fixed income securities	**$8,622**	**$8,622**	$6,774	$6,774
Short-term investments	**120**	**120**	136	136
Other investments	**7**	**7**	5	5
Cash	**8**	**8**	9	9
Securities purchased under agreements to resell	**252**	**252**	85	85
Loans	**674**	**674**	503	503
Receivable from brokers and dealers	**750**	**750**	–	–
Financial liabilities:				
Debentures	**424**	**476**	224	269
Obligations under investment, repurchase and payment agreements (including accrued interest)	**6,046**	**5,959**	4,367	4,405
Payable to brokers and dealers	**750**	**750**	–	–
Derivative financial instruments:				
Interest rate futures contracts	**(4)**	**–**	(2)	–
Interest rate swaps	**(22)**	**(20)**	(9)	(7)
Purchased interest rate option contracts	**–**	**–**	–	–
Liability for financial guarantees written:				
Gross	**1,294**	**906**	1,179	855
Net of reinsurance	**1,094**	**766**	995	722
Net installment premiums	**–**	**216**	–	153

13 FINANCIAL INSTRUMENTS HELD FOR TRADING PURPOSES

AFSLP is a provider of interest rate swaps to states, municipalities and their authorities and other entities in connection with their financings. AFSLP is subject to basis risk (the relationship between tax-exempt and taxable interest rates). If actual or projected tax-exempt interest rates change in relation to taxable rates, the Company will experience an unrealized mark-to-market gain or loss. The AFSLP swap portfolio is considered held for trading purposes.

The following table summarizes information about the Company's financial instruments held for trading purposes as of December 31, 1998 and 1997:

	Net Estimated Fair Value		Average Net Fair Value		Notional Amount
	Assets	Liabilities	Assets	Liabilities	
1998:					
Derivative financial instruments:					
Interest rate swaps	**$200,454**	**$163,043**	**$130,984**	**$103,414**	**$5,357,450**
Futures contracts	**–**	**–**	**–**	**–**	**706,700**
Other financial instruments	**–**	**–**	**183,682**	**181,698**	**–**
1997:					
Derivative financial instruments:					
Interest rate swaps	$ 67,743	$ 49,265	$ 43,748	$ 33,954	$3,347,190
Futures contracts	–	–	–	–	514,900
Other financial instruments	183,041	181,732	160,251	159,213	–

Financial instruments held for trading purposes are carried at estimated fair value. The aggregate amount of net trading income recognized from derivative financial instruments held for trading purposes was $705, $7,454 and $10,579 for 1998, 1997 and 1996, respectively. Other financial instruments held for trading purposes consists of fixed income securities held in 1997 and sold during 1998. The aggregate amount of net trading income recognized from other financial instruments was $2,967, $1,309 and $0 in 1998, 1997 and 1996, respectively. Average net fair values were calculated based on average monthly net fair values. Notional principal amounts are often used to express the volume of these transactions and do not reflect the extent to which positions may offset one another. These amounts do not represent the much smaller amounts potentially subject to risk.

14 LONG-TERM DEBT AND LINES OF CREDIT

The carrying value of long-term debt was as follows:

As of December 31,	1998	1997
9 3/8% Debentures, due 2011	**$149,434**	$149,389
7 1/2% Debentures, due 2023	**74,495**	74,475
7.08% Debentures, due 2098	**200,000**	–
	$423,929	$223,864

The debentures due on August 1, 2011 were issued on August 8, 1991 in the principal amount of $150,000 and bear interest of 9 3/8%, payable on February 1 and August 1 of each year and are non-callable.

The debentures due on May 1, 2023 were issued on May 11, 1993 in the principal amount of $75,000 and bear interest of 7 1/2%, payable on May 1 and November 1 of each year and are non-callable.

The debentures due on March 31, 2098 were issued on April 1, 1998 in the principal amount of $200,000 and bear interest of 7.08%, payable on March 31, June 30, September 30 and December 31 of each year. The debentures may not be redeemed prior to March 31, 2003 and were sold at 100% of their principal amount. On or after March 31, 2003, the Company may redeem the debentures, in whole at any time or in part from time to time, at 100% of their principal amount, plus accrued interest to the date of redemption.

AFGI and Ambac Assurance have a revolving credit facility with three major international banks for $150,000, which expires in August 1999 and provides a two-year term loan provision. The facility is available for general corporate purposes, including the payment of claims. As of December 31, 1998 and 1997, no amounts were outstanding under this credit facility.

Ambac Assurance maintains third party capital support in the form of a seven-year irrevocable limited recourse credit facility from a group of highly-rated international banks. This credit facility provides liquidity to Ambac Assurance in the event claims from municipal obligations in its insured portfolio exceed specified levels. Repayment of amounts drawn under the credit facility are limited primarily to the amount of any recoveries of losses related to policy obligations. During 1998, total third party capital support was increased from $500,000 to $555,000 and its expiration reset to December 2005. As of December 31, 1998 and 1997, no amounts were outstanding under this facility.

15 OBLIGATIONS UNDER INVESTMENT AGREEMENTS AND PAYMENT AGREEMENTS

Obligations under investment agreements, including those structured in the form of repurchase contracts, are recorded on a trade-date basis. Certain obligations may be called at various times prior to maturity at the option of the counterparty. As of December 31, 1998 and 1997, the interest rates on these agreements ranged from 4.00% to 8.14% and 4.23% to 8.14%, respectively. As of December 31, 1998 and 1997, the average yield on these agreements was 5.70% and 5.85%, respectively. Obligations under investment agreements and investment repurchase agreements as of December 31, 1998 and 1997 were as follows:

As of December 31,	1998	1997
Settled	**$5,209,690**	$3,817,772
Unsettled	**73,142**	–
	$5,282,832	$3,817,772

Net payments due under settled investment agreements in each of the next five years ending December 31, and the periods thereafter, based on expected draw dates, are as follows:

	Principal Amount
1999	$2,308,820
2000	1,237,441
2001	554,655
2002	190,338
2003	29,481
All later years	888,955
	$5,209,690

Obligations under payment agreements represent funds received by the Company from certain municipal customers. These funds serve as collateral for loans extended by the Company in connection with certain structured municipal transactions. In connection with these transactions, the Company is obligated to make periodic agreed upon payments. As of December 31, 1998 and 1997, the interest rates on these obligations ranged from 6.25% to 8.42%. Net (deposits)/payments due under payment agreements in each of the next five years ending December 31, and the periods thereafter, based on contractual payment dates, are as follows:

	Principal Amount
1999	$ (11,558)
2000	(6,971)
2001	2,840
2002	8,493
2003	16,248
All later years	664,879
	$673,931

16 COMMON STOCK INCENTIVES

The Ambac 1997 Equity Plan (the "Equity Plan") provides for the granting of stock options, stock appreciation rights, restricted stock units, performance units and other awards that are valued or determined by reference to the common stock. Stock options awarded to employees are exercisable and expire as specified at the time of grant. Additionally, such options generally may not have a per share exercise price less than the fair market value of a share of common stock on the date of grant or have a term in excess of ten years from the date of the grant. The Company also maintains the Ambac 1997 Non-Employee Directors Equity Plan (the "Directors Plan"), which provides awards of stock options and restricted stock units to non-employee members of the Company's Board of Directors. The number of options and their exercise price, and the number of restricted stock units, awarded to each non-employee director under the Directors Plan are determined by formula. As of December 31, 1998, approximately 6,070,000 shares were available for future grant under the Equity Plan and the Directors Plan. A summary of option activity is as follows:

	1998		1997		1996	
	Shares	**Weighted Average Exercise Price**	Shares	Weighted Average Exercise Price	Shares	Weighted Average Exercise Price
Outstanding at beginning of year	**3,917,693**	**$22.15**	4,248,642	$19.37	4,140,824	$18.17
Granted	**969,698**	**$47.66**	859,800	$33.59	964,150	$24.25
Exercised	**(1,332,729)**	**$15.78**	(898,942)	$19.05	(721,724)	$18.53
Forfeited	**(165,298)**	**$34.46**	(291,807)	$24.99	(134,608)	$21.87
Outstanding at end of year	**3,389,364**	**$31.34**	3,917,693	$22.15	4,248,642	$19.37
Exercisable	**1,941,601**		2,392,853		2,407,838	

	Options Outstanding			Options Exercisable	
Range of Exercise Prices	Number Outstanding at December 31, 1998	Weighted Average Remaining Contract Life	Weighted Average Exercise Price	Number Exercisable at December 31, 1998	Weighted Average Exercise Price
$10 to 24	1,780,468	4.7	$22.02	1,584,390	$21.74
$25 to 44	696,446	5.1	$33.56	235,482	$33.52
$45 to 61	912,450	5.6	$47.84	121,729	$53.42
	3,389,364			1,941,601	

The Company applies APB 25 and related interpretations in accounting for its plans. Accordingly, since the fair value of the options at grant date equals the exercise price, no compensation cost has been recognized for its fixed stock option plan. Had compensation cost for the Company's stock-based compensation plan been determined consistent with FAS 123, the Company's net income, earnings per share and earnings per diluted share for the years ended December 31, 1998, 1997 and 1996, would have been reduced to the pro-forma amounts indicated below:

	1998	1997	1996
Net Income:			
As reported	**$253,994**	$223,030	$276,317
Pro-forma	**$248,089**	$218,852	$273,528
Earnings per share:			
As reported	**$3.63**	$3.19	$3.95
Pro-forma	**$3.55**	$3.13	$3.91
Earnings per diluted share:			
As reported	**$3.56**	$3.13	$3.91
Pro-forma	**$3.48**	$3.07	$3.87

The weighted-average fair value (determined as of the date of the grants) of options granted in 1998, 1997 and 1996 was $13.09 per share, $9.85 per share, and $6.19 per share, respectively. The fair value of each option grant issued was estimated as of the date of the grant using the Black-Scholes option-pricing model, with the following weighted-average assumptions used for grants in 1998, 1997 and 1996, respectively: (i) dividend yield of 0.85%, 1.08% and 1.24%; (ii) expected volatility of 20.5%, 19.4% and 16.5%; (iii) risk-free interest rates of 5.5%, 6.4% and 6.2%; and (iv) expected lives of 5 years, 6 years and 5 years. The pro-forma amounts disclosed above are not likely to be representative of the effects of reported pro-forma net income for future years because options vest over several years and additional awards are granted each year.

17 SEGMENT INFORMATION

The Company has two reportable segments, as follows: (1) Financial Guarantee Insurance, which provides insurance of municipal and structured finance obligations; and (2) Financial Management Services, which provides investment agreements, interest rate swaps, and investment advisory and cash management services. During the fourth quarter of 1998, the Company discontinued its operations relating to electronic commerce applications for the municipal marketplace. Balances relating to the electronic commerce business are included in the Financial Management Services segment below. Total losses before income taxes for the electronic commerce business was $6,946, $3,557 and $617 for the years ended December 31, 1998, 1997 and 1996, respectively. Also included below for both revenues and income before income taxes for the Financial Management Services segment is a $11,548 charge representing the write-off of the investment in Ambac Connect.

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

The accounting policies of the segments are the same as those described in Note 2, "Significant Accounting Policies." Pursuant to insurance and indemnity agreements, Ambac Assurance guarantees the swap and investment agreement obligations of those financial management services subsidiaries. Intersegment revenues include the premiums earned under those agreements. Such premiums are accounted for as if they were premiums to third parties, that is, at current market prices.

Information provided below for "Corporate and Other" relates to AFGI corporate activities. Revenue from unaffiliated customers of $16,232 and $7,955 consists primarily of interest income from investment securities for the years ended December 31, 1998 and 1997, respectively. Revenue from unaffiliated customers in 1996 of $164,242 includes a one-time gain from the sale of a subsidiary of approximately $155,600.

The following table is a summary of the financial information by reportable segment for the years ended December 31, 1998, 1997 and 1996:

	Financial Guarantee Insurance	Financial Management Services	Corporate and Other	Intersegment Eliminations	Total Consolidated
1998:					
Revenues:					
Unaffiliated customers	**$ 408,390**	**$ 32,414**	**$ 16,232**	**$ –**	**$ 457,036**
Intersegment	**2,761**	**(2,819)**	**48,610**	**(48,552)**	**–**
Total revenues	**$ 411,151**	**$ 29,595**	**$ 64,842**	**$ (48,552)**	**$ 457,036**
Income before income taxes:					
Unaffiliated customers	**$ 355,670**	**$ (3,126)**	**$ (23,632)**	**$ –**	**$ 328,912**
Intersegment	**2,761**	**(4,891)**	**48,610**	**(46,480)**	**–**
Total income before income taxes	**$ 358,431**	**$ (8,017)**	**$ 24,978**	**$ (46,480)**	**$ 328,912**
Identifiable assets	**$3,825,411**	**$7,128,350**	**$258,550**	**$ –**	**$11,212,311**
1997:					
Revenues:					
Unaffiliated customers	$ 339,195	$ 34,612	$ 7,955	$ –	$ 381,762
Intersegment	1,857	(194)	44,068	(45,731)	–
Total revenues	$ 341,052	$ 34,418	$ 52,023	$ (45,731)	$ 381,762
Income before income taxes:					
Unaffiliated customers	$ 295,669	$ 6,619	$ (16,292)	$ –	$ 285,996
Intersegment	1,736	(1,031)	44,068	(44,773)	–
Total income before income taxes	$ 297,405	$ 5,588	$ 27,776	$ (44,773)	$ 285,996
Identifiable assets	$3,392,333	$4,805,517	$ 93,855	$ –	$ 8,291,705
1996:					
Revenues:					
Unaffiliated customers	$ 266,300	$ 22,366	$164,242	$ –	$ 452,908
Intersegment	1,728	(810)	159,883	(160,801)	–
Total revenues	$ 268,028	$ 21,556	$324,125	$(160,801)	$ 452,908
Income before income taxes:					
Unaffiliated customers	$ 225,340	$ 10,326	$139,840	$ –	$ 375,506
Intersegment	1,728	(980)	159,883	(160,631)	–
Total income before income taxes	$ 227,068	$ 9,346	$299,723	$(160,631)	$ 375,506
Identifiable assets	$2,886,657	$2,861,527	$128,174	$ –	$ 5,876,358

The following table summarizes gross premiums written and net premiums earned included in the financial guarantee segment, by location of risk.

	Gross Premiums Written	Net Premiums Earned
1998:		
United States	$297,565	$198,904
United Kingdom	30,337	1,754
Australia	16,166	686
France	1,318	1,745
Japan	3,970	1,941
Italy	–	974
Internationally diversified[1]	4,436	3,654
Other international	7,219	3,026
Total	$361,011	$212,684
1997:		
United States	$242,727	$145,988
United Kingdom	16,144	903
Australia	–	114
France	2,911	2,048
Japan	2,349	1,175
Italy	4,731	841
Internationally diversified[1]	1,831	1,409
Other international	15,470	1,522
Total	$286,163	$154,000

	Gross Premiums Written	Net Premiums Earned
1996:		
United States	$226,276	$131,638
United Kingdom	11,624	751
Australia	1,624	81
France	2,515	1,959
Japan	472	338
Italy	–	617
Internationally diversified[1]	392	662
Other international	4,305	583
Total	$247,208	$136,629

(1) Internationally diversified represents insured policies with multiple locations of risk.

In the United States, California was the state with the highest aggregate net par amount in force, accounting for 11.4% of the total at December 31, 1998, and no other state accounted for more than ten percent. The highest single insured risk represented less than 1% of aggregate net par amount insured. All revenues of the Financial Management Services segment are from operations in the United States.

18 QUARTERLY FINANCIAL INFORMATION (UNAUDITED)

	First	Second	Third	Fourth	Full Year
1998:					
Gross premiums written	**$77,487**	**$88,042**	**$88,731**	**$106,751**	**$361,011**
Net premiums written	**51,400**	**77,994**	**83,967**	**98,087**	**311,448**
Net premiums earned	**53,184**	**53,318**	**50,143**	**56,039**	**212,684**
Net investment income	**45,040**	**45,872**	**47,436**	**47,842**	**186,190**
Financial management services income	**12,754**	**12,732**	**13,541**	**10,483**	**49,510**
Losses and loss adjustment expenses	**1,577**	**1,423**	**1,500**	**1,500**	**6,000**
Financial guarantee underwriting and operating expenses	**12,018**	**11,190**	**11,844**	**11,668**	**46,720**
Financial management services expenses	**7,443**	**8,603**	**8,237**	**11,257**	**35,540**
Income before income taxes	**86,197**	**78,513**	**85,199**	**79,003**	**328,912**
Net income	**65,658**	**60,796**	**65,382**	**62,158**	**253,994**
Net income per share	**0.94**	**0.87**	**0.94**	**0.89**	**3.63**
Net income per diluted share	**$ 0.92**	**$ 0.85**	**$ 0.92**	**$ 0.87**	**$ 3.56**
1997:					
Gross premiums written	$51,792	$73,740	$52,371	$108,260	$286,163
Net premiums written	46,360	66,545	45,876	94,930	253,711
Net premiums earned	37,033	36,386	35,672	44,909	154,000
Net investment income	38,447	39,258	40,109	41,895	159,709
Financial management services income	7,222	6,150	9,062	12,815	35,249
Losses and loss adjustment expenses	728	664	730	732	2,854
Financial guarantee underwriting and operating expenses	9,092	9,732	10,173	11,675	40,672
Financial management services expenses	8,980	5,474	5,751	7,788	27,993
Income before income taxes	62,396	67,836	79,637	76,127	285,996
Net income	49,738	53,613	60,795	58,884	223,030
Net income per share[1]	0.71	0.77	0.87	0.84	3.19
Net income per diluted share	$ 0.70	$ 0.75	$ 0.85	$ 0.83	$ 3.13

(1) Net income per share has been retroactively adjusted to reflect the two-for-one stock split which occurred in September 1997.

BOARD OF DIRECTORS

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Chief Executive Officer
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Argus Associates
(Financial Consulting)

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RICHARD DULUDE*†‡
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Hoenemeyer, Inc.
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† Member Compensation and Organization Committee
‡ Member Nominating Committee

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and Chief Financial Officer

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WEST REGION
KATHLEEN A. McDONOUGH
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Managing Director

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JUSTIN D. HENNESSY
Managing Director

MARKET RISK MANAGEMENT
ROBERT D. SELVAGGIO
Managing Director

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JEFFREY R. FRIED
Managing Director

INVESTMENT ADVISORY AND FUNDS ADMINISTRATION

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WILLIAM T. SULLIVAN, JR.
Chairman and Chief
Executive Officer

FRANCIS X. SULLIVAN
President and Chief
Operating Officer

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STRUCTURED FINANCE/ MORTGAGE-BACKED SECURITIES
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Managing Director

ASSET-BACKED SECURITIES
JOHN H. BRYAN III
Managing Director

HEALTH CARE
RUBEN SELLES
Managing Director

UTILITIES
TIMOTHY S. TRAVERS
Managing Director

FINANCIAL INSTITUTIONS
MICHAEL J. SCHOZER
Managing Director

INTERNATIONAL
JOHN W. UHLEIN III
Managing Director

CREDIT RISK MANAGEMENT
STEVEN C. RENN
Managing Director

CREDIT MANAGEMENT
WILLIAM T. McKINNON
Managing Director

LEGAL
KEVIN J. DOYLE
Managing Director

CORPORATE

STEPHEN D. COOKE
Senior Vice President,
General Counsel and
Secretary, Ambac
Assurance Corporation

JANICE REALS ELLIG
Senior Vice President,
Corporate Marketing

NARAYAN NAIR
Senior Vice President,
Internal Audit

GREGG L. BIENSTOCK
Managing Director
Human Resources and
Employment Counsel

THOMAS J. GANDOLFO
Managing Director and
Financial Controller

BRIAN S. MOORE
Managing Director,
External Relations

KENNETH S. PLOTZKER
Managing Director and
Chief Information Officer

ANNE G. GILL
Corporate Secretary

ROBERT W. STARR
Treasurer

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8135 403 4625

ANNUAL MEETING OF STOCKHOLDERS
The Annual Meeting of Stockholders of Ambac Financial Group, Inc. will be held on Wednesday, May 12, 1999, at 11:30 a.m. in New York City. Detailed information about the meeting is contained in the Notice of Annual Meeting and Proxy Statement to be sent to each stockholder of record as of March 22, 1999. The Company estimates that it has approximately 34,000 stockholders.

FORM 10-K
A copy of the Company's 1998 Annual Report on Form 10-K for the year ended December 31, 1998, as filed with the Securities and Exchange Commission, may be obtained without charge by writing to:
Ambac Financial Group, Inc.,
Attn: Investor Relations
One State Street Plaza
New York, New York 10004

TRANSFER AGENT, REGISTRAR AND DIVIDEND PAYING AGENT
Citibank, N.A.
111 Wall Street, 5th Floor
New York, New York 10043
212-657-5997

INDEPENDENT AUDITORS
KPMG LLP
New York, New York

STOCK LISTING
Ambac Financial Group, Inc. common stock is listed on the New York Stock Exchange under the ticker symbol ABK.

INVESTOR RELATIONS
Frank J. Bivona
Executive Vice President
and Chief Financial Officer

Brian S. Moore
Managing Director
212-208-3333
1-800-221-1854
bmoore@ambac.com

COMMON STOCK DATA

The table below shows the high and low price per share for each quarter of 1998 and 1997, as adjusted for the two-for-one common stock split, which occurred in September 1997.

	1998 Market Price				1997 Market Price			
Three Months Ended	**High**	**Low**	**Close**	**Dividends Per Share**	High	Low	Close	Dividends Per Share
March 31	**$58 9/16**	**$44 3/8**	**$58 7/16**	**$0.0900**	$37	$31 5/8	$32 1/4	$0.0825
June 30	**61**	**53 1/2**	**58 1/2**	**0.0900**	42 1/4	31	38 3/16	0.0825
September 30	**65 15/16**	**45 9/16**	**48**	**0.1000**	42 15/16	38 1/4	40 11/16	0.0900
December 31	**62 3/8**	**40 7/8**	**60 3/16**	**0.1000**	47 9/16	40	46	0.0900

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PREMIER

VALUES

PEOPLE Our greatest asset is the individuals who serve our constituencies. We demonstrate by our behavior and actions that our people, their skills, development and motivation "make the difference" to give us a competitive advantage in the marketplace.

REPUTATION We maintain an environment where integrity and honesty are fundamental principles of conduct. We know that our reputation is a franchise that must never be compromised.

EXCELLENCE We understand that success means earning client respect and exceeding client expectations. We strive to achieve excellence in every task.

MERITOCRACY We seek out and retain the best talent, providing our people with opportunities to grow and share in our success.

INNOVATION We welcome new insights, new ideas, fresh perspectives – we value strategic thinking and are not afraid of change, recognizing that innovation is an essential success element for all companies in all industries.

EARNINGS/RETURNS We understand that long-term earnings growth and attractive returns on capital are of vital importance to our stockholders and other constituents.

RISK MANAGEMENT We recognize that excellence in managing risk is central to our business and evidence that commitment through exacting standards and professionalism in all aspects of the risk management process.

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