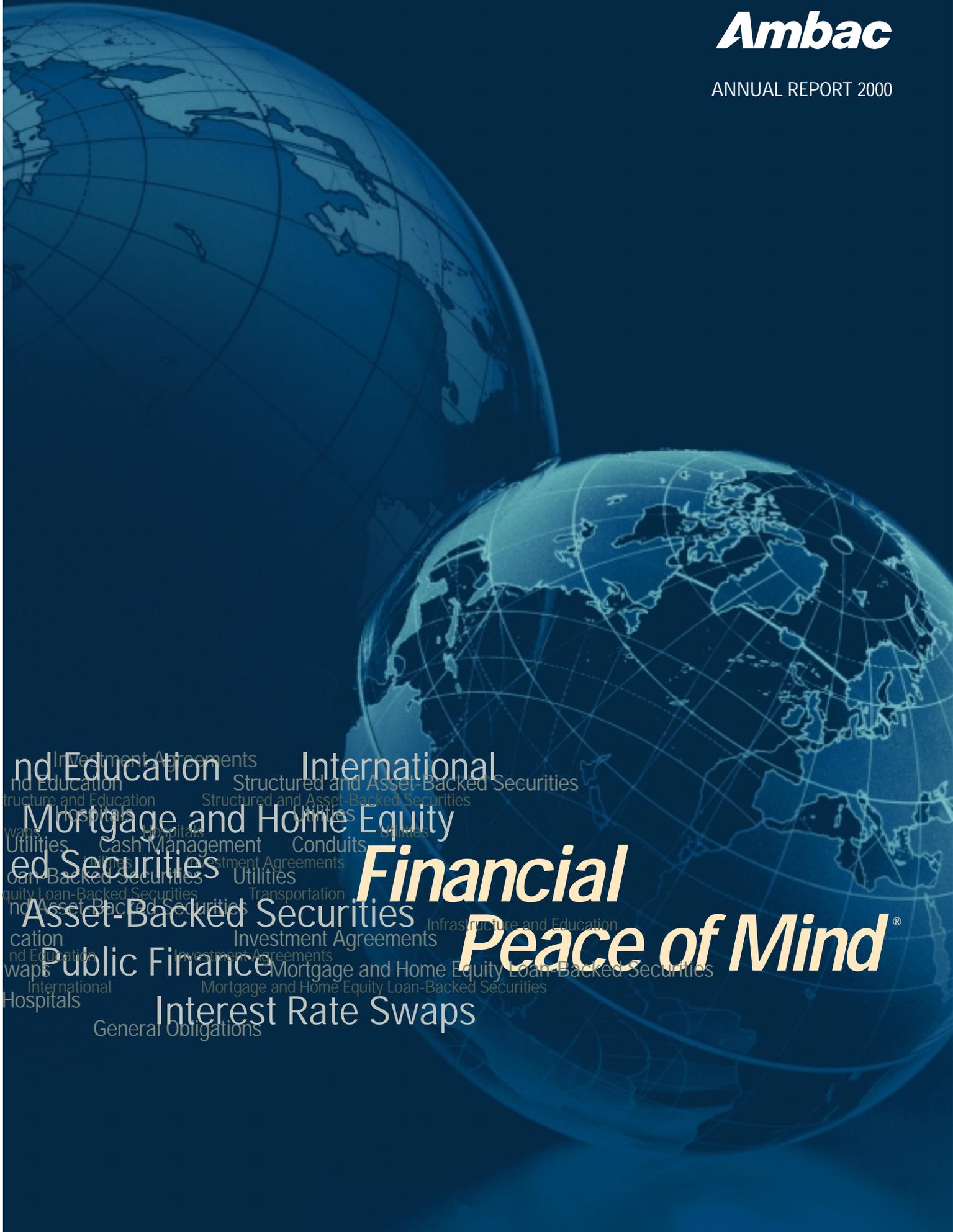


Ambac

ANNUAL REPORT 2000



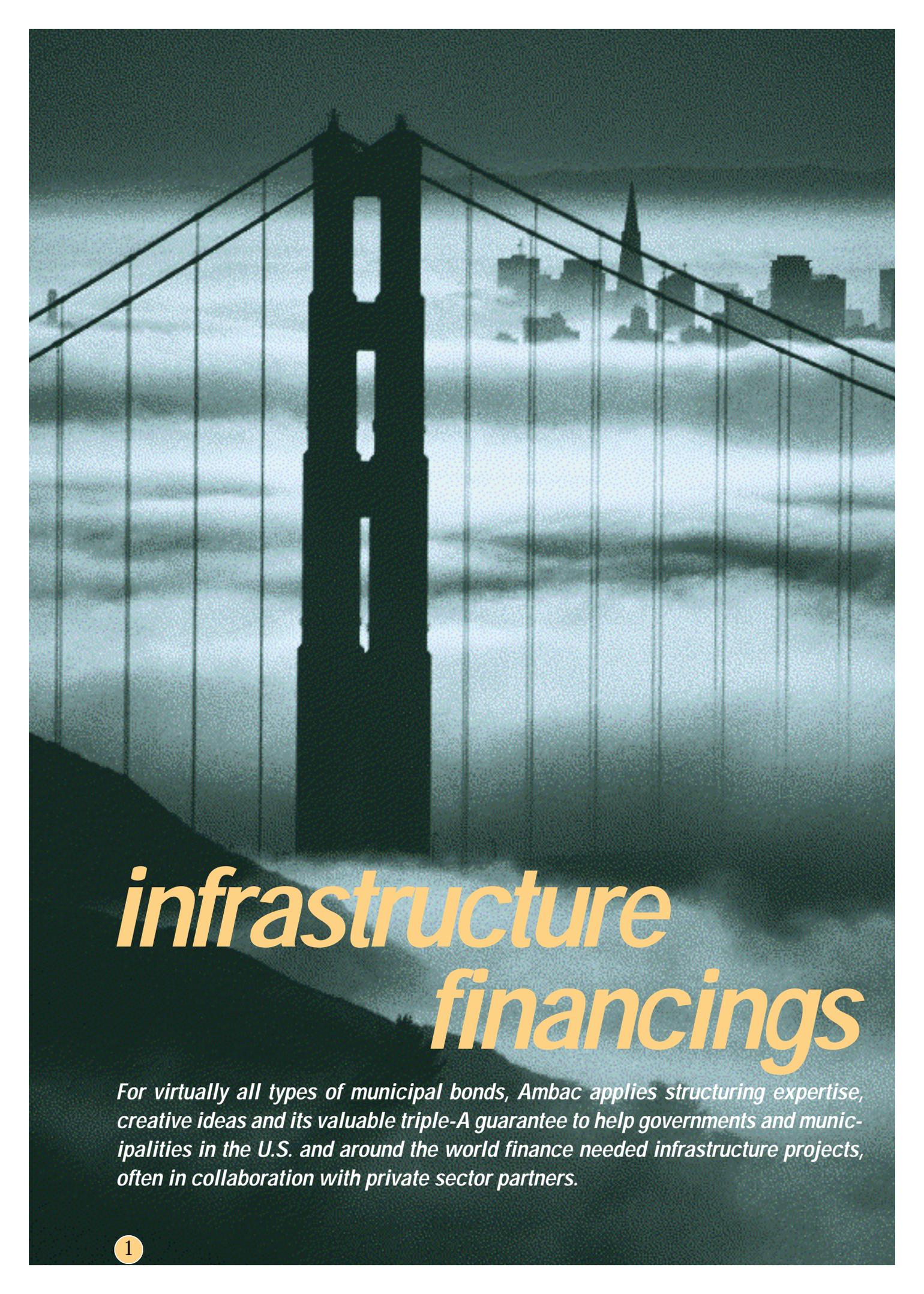
nd Education International
nd Education Structured and Asset-Backed Securities
Structure and Education Structured and Asset-Backed Securities
Mortgage and Home Equity
Hospitals Utilities
Utilities Cash Management Conduits
ed Securities Investment Agreements
Loan-Backed Securities Utilities
Equity Loan-Backed Securities Transportation
nd Asset-Backed Securities
Asset-Backed Securities Infrastructure and Education
Investment Agreements
Public Finance Mortgage and Home Equity Loan-Backed Securities
Investment Agreements
International Mortgage and Home Equity Loan-Backed Securities
Hospitals
Interest Rate Swaps
General Obligations

**Financial
Peace of Mind[®]**

Corporate Overview	1
Financial Highlights	6
Letter to Shareholders	7
5-Year Performance	12
Premier Values	14
Case Studies	15
Ambac's Management Team	22
Financial Review	24
Directors and Officers	55
Stockholder Information	56

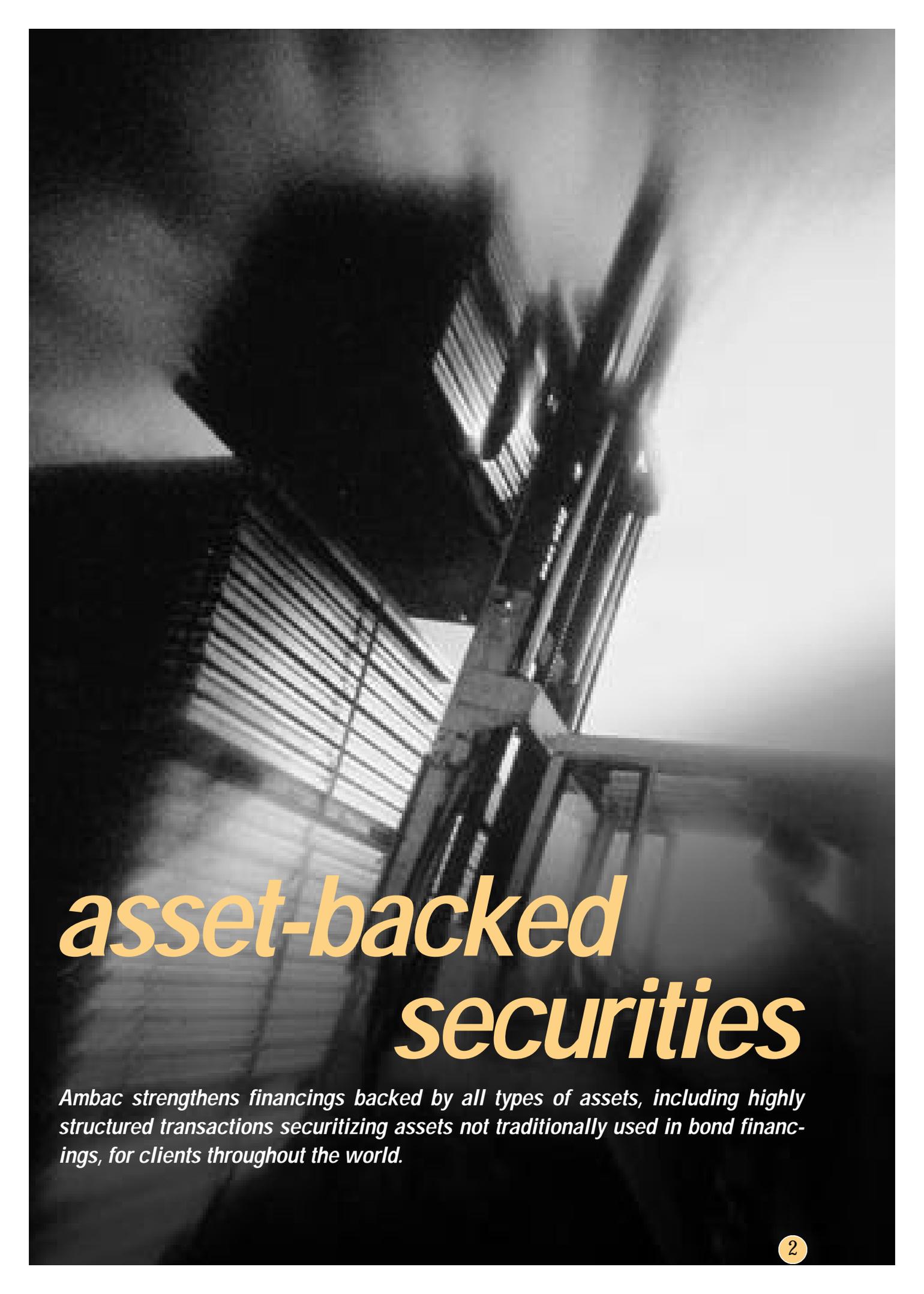
Ambacked. *Ambac's triple-A-rated guarantee insures the timely payment of principal and interest due on bonds, strengthening financings and improving the marketability of all types of fixed income securities in markets throughout the world. Broad experience and innovative thinking enable Ambac to create financing structures that satisfy clients' unique requirements and needs.*

global



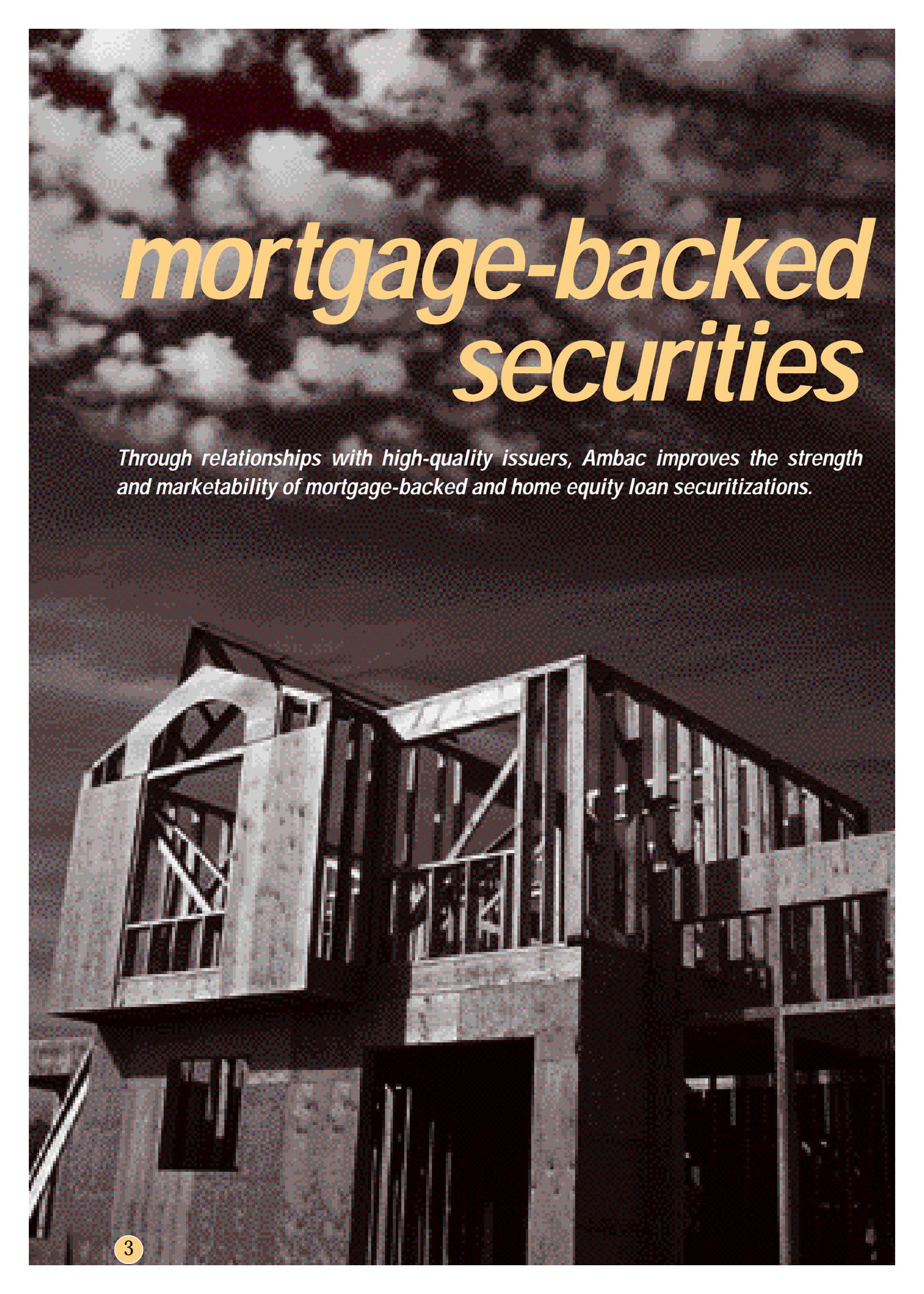
infrastructure financings

For virtually all types of municipal bonds, Ambac applies structuring expertise, creative ideas and its valuable triple-A guarantee to help governments and municipalities in the U.S. and around the world finance needed infrastructure projects, often in collaboration with private sector partners.



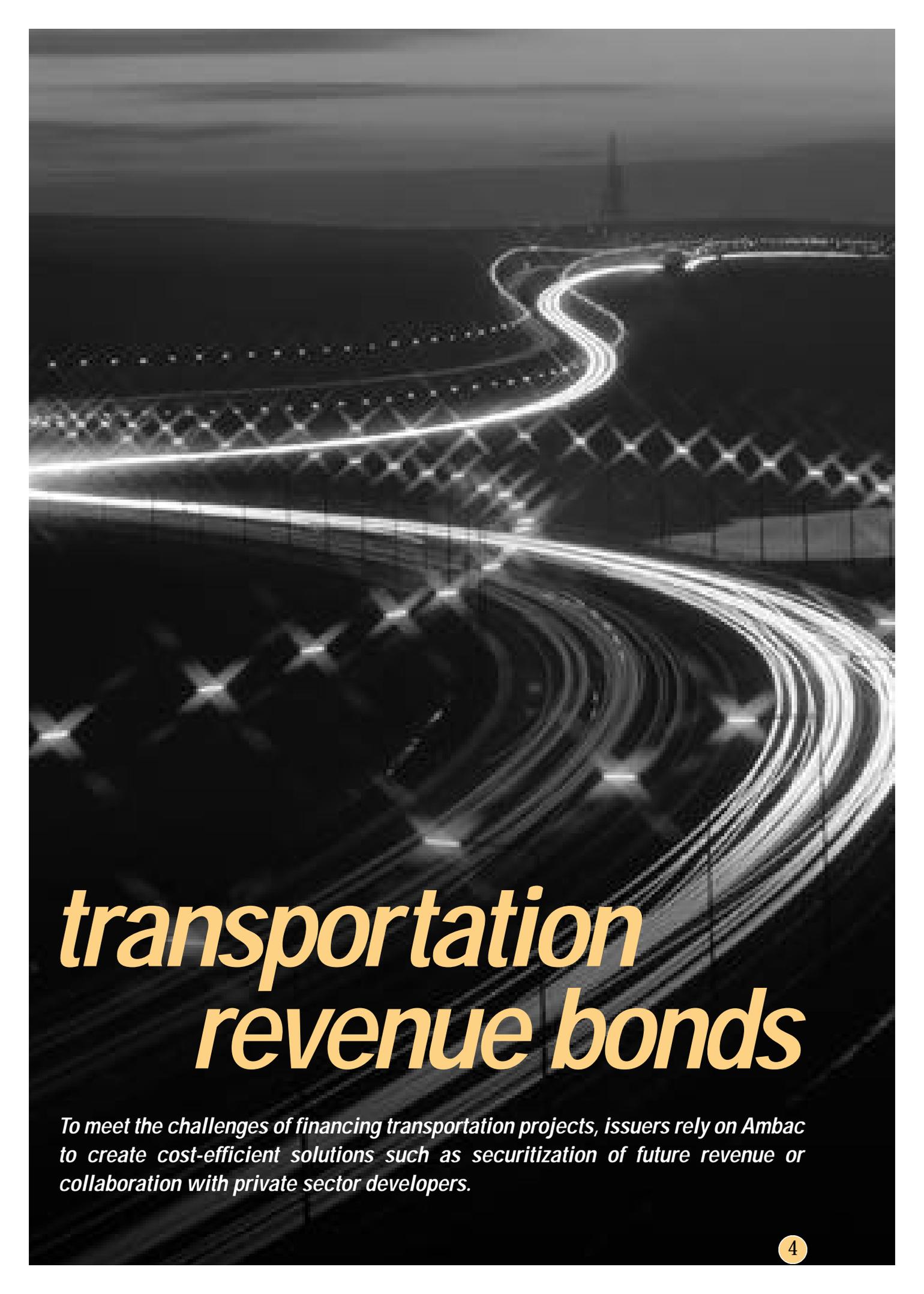
asset-backed securities

Ambac strengthens financings backed by all types of assets, including highly structured transactions securitizing assets not traditionally used in bond financings, for clients throughout the world.



mortgage-backed securities

Through relationships with high-quality issuers, Ambac improves the strength and marketability of mortgage-backed and home equity loan securitizations.



transportation revenue bonds

To meet the challenges of financing transportation projects, issuers rely on Ambac to create cost-efficient solutions such as securitization of future revenue or collaboration with private sector developers.

risk management

Ambac's experienced risk management professionals rigorously employ modern analytical tools to constantly assess, measure, report and manage the company's risks across diverse sectors.

FINANCIAL HIGHLIGHTS

Ambac Financial Group, Inc. and Subsidiaries

(Dollars in millions, except per share amounts)

	2000	1999	1998	1997	1996 ⁽¹⁾
STATEMENT OF OPERATIONS HIGHLIGHTS					
Gross premiums written	\$ 483.1	\$ 445.2	\$ 361.0	\$ 286.2	\$ 247.2
Net premiums earned	311.3	264.4	212.7	154.0	136.6
Net investment income	241.0	209.3	186.2	159.7	144.9
Financial services net revenue	62.7	51.6	49.5	35.2	22.0
Total revenue	621.3	533.3	457.0	381.8	452.9
Losses and loss adjustment expenses	15.0	11.0	6.0	2.9	3.8
Financial guarantee underwriting and operating expenses	55.2	48.8	46.7	40.7	37.2
Financial services expenses	24.8	25.8	35.5	28.0	12.0
Interest expense	37.5	36.5	32.8	21.3	20.9
Net income	366.2	307.9	254.0	223.0	276.3
Net income per share: ⁽²⁾					
Basic	3.49	2.94	2.42	2.12	2.63
Diluted	3.41	2.88	2.37	2.09	2.60
Return on equity	15.9%	15.0%	12.8%	12.8%	18.3%
Cash dividends declared per common share ⁽²⁾	0.307	0.280	0.253	0.230	0.205

BALANCE SHEET HIGHLIGHTS

Total investments, at fair value	\$ 8,323.9	\$ 8,962.5	\$ 8,748.4	\$ 6,915.1	\$ 5,200.5
Prepaid reinsurance	242.6	218.0	199.9	183.5	168.8
Total assets	10,120.3	11,345.1	11,212.3	8,291.7	5,876.4
Unearned premiums	1,546.3	1,431.1	1,294.2	1,179.0	991.2
Losses and loss adjustment expense reserve	132.4	121.5	115.8	103.3	60.6
Obligations under investment agreements, investment repurchase agreements and payment agreements	4,892.9	6,140.3	5,956.8	4,321.0	2,754.6
Debentures	424.1	424.0	423.9	223.9	223.8
Total stockholders' equity	2,596.1	2,018.5	2,096.1	1,872.5	1,615.0

(1) 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.

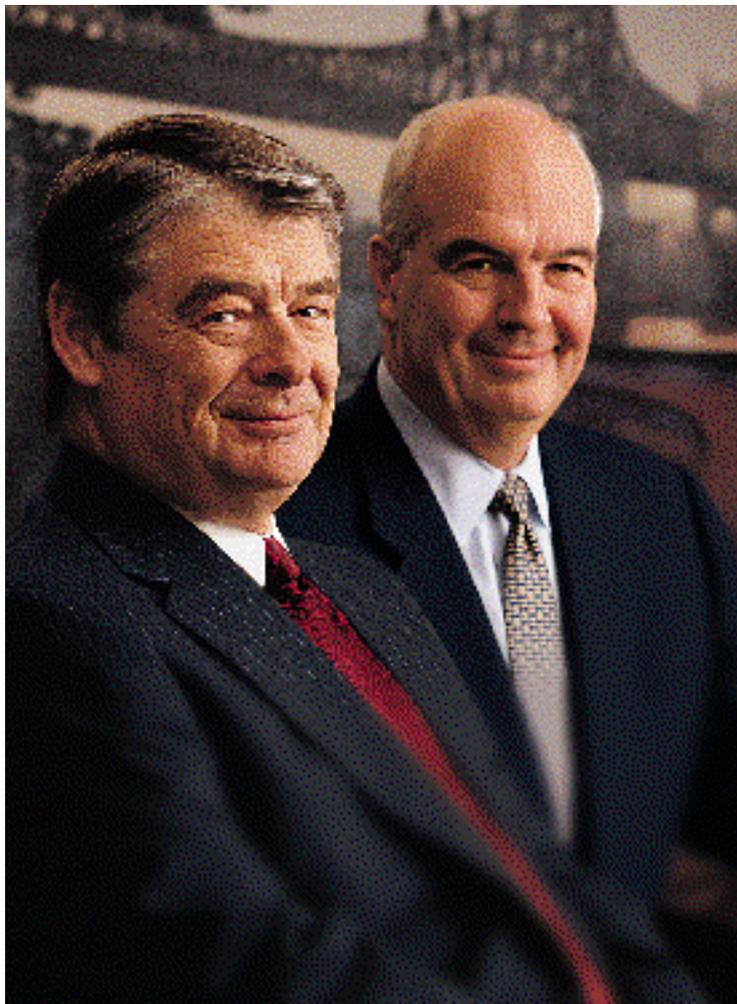
(2) Per share amounts have been retroactively adjusted to reflect a three-for-two stock split in 2000 and a two-for-one stock split in 1997.

DEAR FELLOW STOCKHOLDERS

Once again, we are pleased to report another superb year for our company. Bolstered by strong growth in our international and structured finance businesses, Ambac met or exceeded all financial targets in 2000. Our stated business strategy of leveraging our credit analysis and financial guarantee skills to broaden the range of client relationships and markets we serve continues to produce superior results.

For the third year in a row, Ambac achieved core earnings growth of 20% or more over the prior year. We reported growth in core earnings and adjusted gross premiums written of 23% and 11%, respectively, for 2000. Core earnings is an important tool we use to gauge the fundamental 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 written is significant because it quantifies today the value of premiums expected to be earned in the future. In addition, our strong financial performance enabled us to post an industry-leading return on equity of 15.9% in 2000.

This year, the price of Ambac's stock better reflected our performance and earnings growth potential: total return on Ambac's stock for 2000 was 69%, compared with -9% for the S&P 500. In fact, since our initial public offering in 1991, Ambac's total return to shareholders equalled 804% compared with 317% for the broader market index during that same period. We are pleased with these results and confident that Ambac will continue to build on this record of achievement for our shareholders' benefit.



Left:
Phillip B. Lassiter,
Chairman and Chief Executive Officer

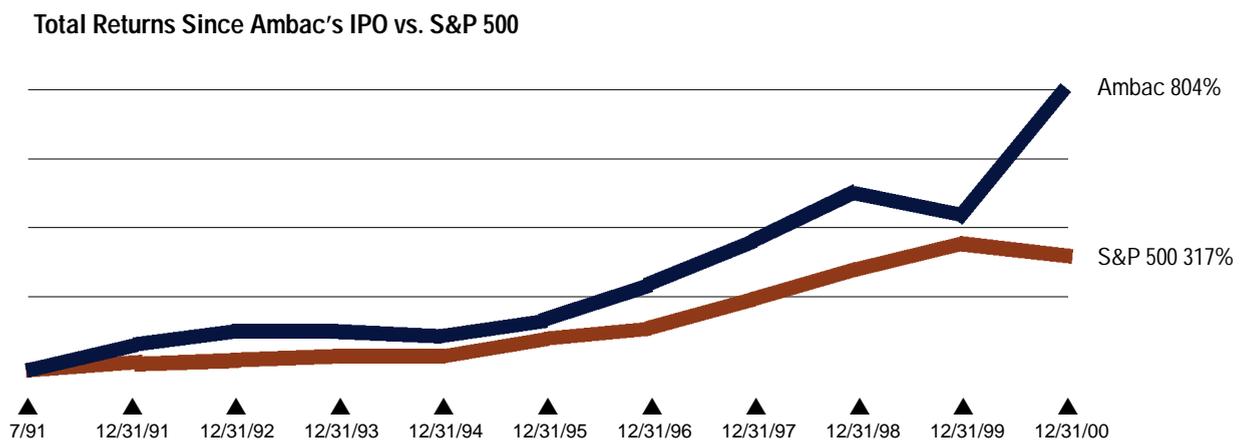
Right:
Robert J. Genader,
President and Chief Operating Officer

The market provided additional recognition of Ambac's continued growth when our stock was added to the S&P 500 Index late in the year. We are delighted to be among this leading group of companies.

Broadened Revenue Streams – Our strong financial performance in 2000 also marked an important milestone in the ongoing evolution of our company: almost 50% of our earned premium for the year was derived through sources outside the U.S. municipal finance market. Since the mid-1990s we have systematically expanded the range of markets and clients we serve with our financial guarantee competency to include structured and asset-backed securities issuers in the U.S. and abroad. We now apply our structuring capabilities and triple-A-rated financial guarantee to a wide range of transaction types, including collateralized bond and loan obligations, international future flow transactions and complex securitizations, among others. We have also broadened the types of assets underlying many of these obligations, always with keen attention to the impact on the risk profile of Ambac's total insured portfolio.

Early in 2000, we restructured our international operations as a result of the mutual decision to effectively dissolve our joint venture with MBIA. The rapid acceptance of financial guarantee products in Europe and other international markets, as well as the abundance of potential new business abroad, spurred this decision. Since the transition, growth in our international business continues to exceed expectations. In addition, we have bolstered our capabilities to serve a global clientele, opening further opportunities for Ambac in markets outside the U.S.

A Commitment to Municipal Finance – The broadened expertise gained from this range of international and structured finance activity benefits our municipal finance business as well. The U.S. municipal finance market is and will remain a vital part of Ambac’s overall business. Our top-drawer professionals, the engine that powers our success, consistently share ideas and techniques across markets and transaction types. This enables Ambac to apply innovative approaches and structures to municipal finance challenges, opening new ways for government-affiliated issuers to source needed capital. Examples of this activity, as well as other transaction types, are detailed in the following pages of this report.



Although the U.S. municipal market is relatively mature, we envision attractive growth for our public finance business. The outlook for interest rates favors stable to increasing refunding activity and solid new money issuance growth. Combining our triple-A-rated guarantee with our ability to add value to financings through insightful ideas, new structuring techniques and efficient execution will help us realize increased revenue from our municipal financing activity.

We also continue to serve our municipal clients with financial products that further enhance their financing strategies. Interest rate swaps, guaranteed investment contracts and cash management services underscore our commitment to helping clients utilize financial resources efficiently and effectively.

A Vigilant Eye on Risk – Ambac moves into this new century well-positioned for continuing growth and success. Our competencies and financing services are often more valuable to clients in a less robust economic environment and interest rates, as mentioned earlier, should continue to trend favorably.

Within our industry, pricing trends continue to show improvement, with greater focus on return on capital as a measure of financial strength. Ambac's long-standing commitment to consistently improve returns through disciplined underwriting and active risk management has clearly been successful. Given the attractive array of opportunities for financial guarantee providers, I expect that risk and pricing discipline will continue to be an industry mantra for the year ahead.

We serve our clients and all our constituents best by emphasizing our risk management excellence. Ongoing investments in people and systems enable us to confidently analyze, assess and manage individual credit risk as well as the correlation of risks across Ambac's total portfolio. As the

complexity of our portfolio expands, so does the depth and breadth of our risk management expertise. We will continue to emphasize this vital core competency.

Building on Superior Talent – Our disciplined and rigorous risk management process functions well because of the highly capable and motivated people who comprise our organization. Ambac professionals bring diverse and extensive credit experience to every assignment. Their ability to create new ideas, enhance transaction structures and get deals done makes Ambac a truly valued financing partner. We take great pride in our work on behalf of clients; I wish to personally thank all of the members of the Ambac family for their continued dedication and contributions to building our franchise.

In particular, I want to acknowledge Bob Genader for his highly successful effort over the past six years in expanding Ambac's franchise into new markets. In January of this year, Bob was promoted to President and Chief Operating Officer and became a member of our board of directors.

Our distinguished board deserves my thanks as well for their support, assistance and sage counsel over the years. In March of 2000, we were delighted to welcome Jill Considine, Chairman and CEO of Depository Trust and Clearing Corp., to our board.

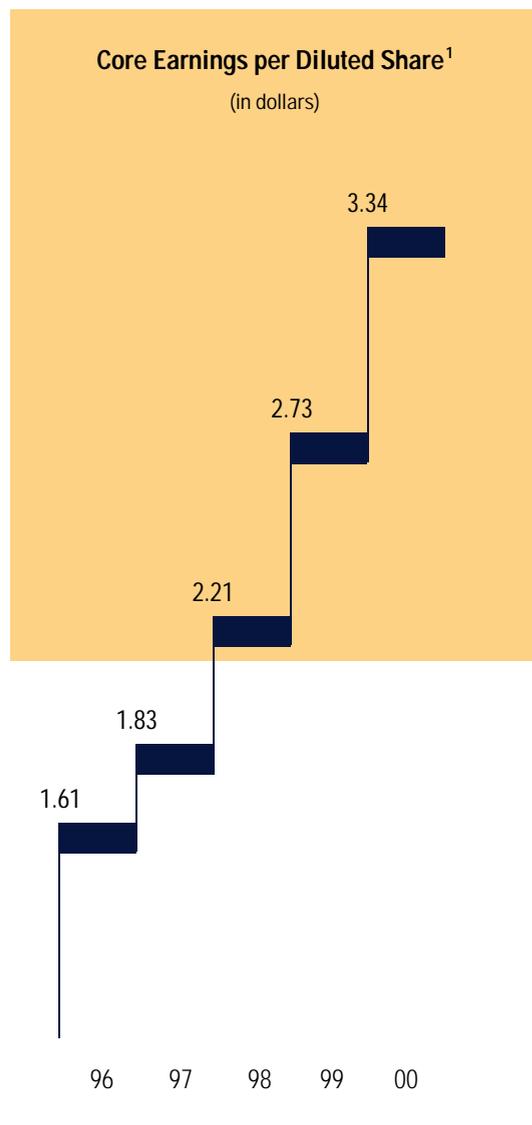
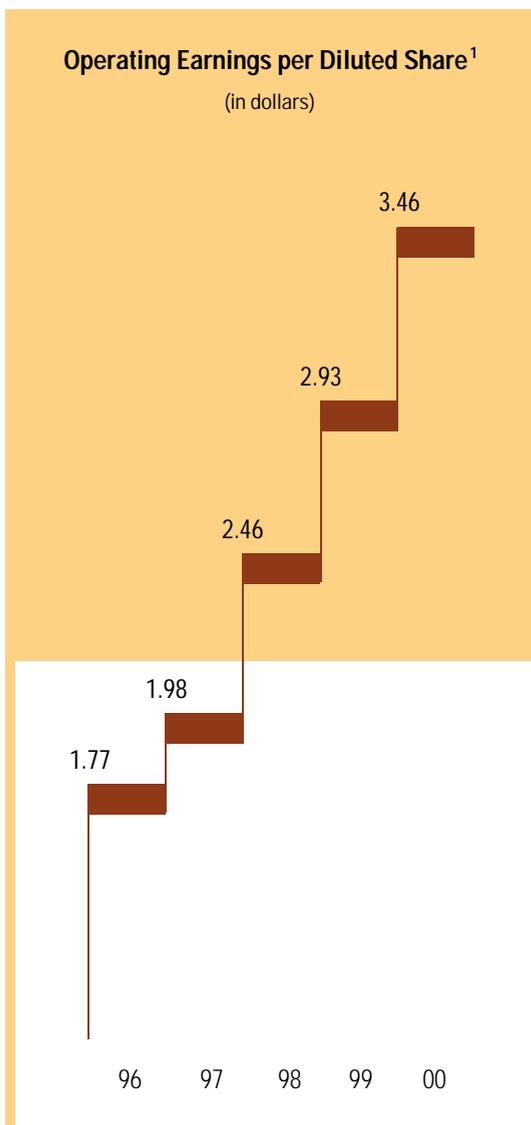
I look forward to our future with optimism, confident in the knowledge that Ambac is extraordinarily well-positioned to take advantage of the abundant and expanding market opportunities for our services.

Sincerely,

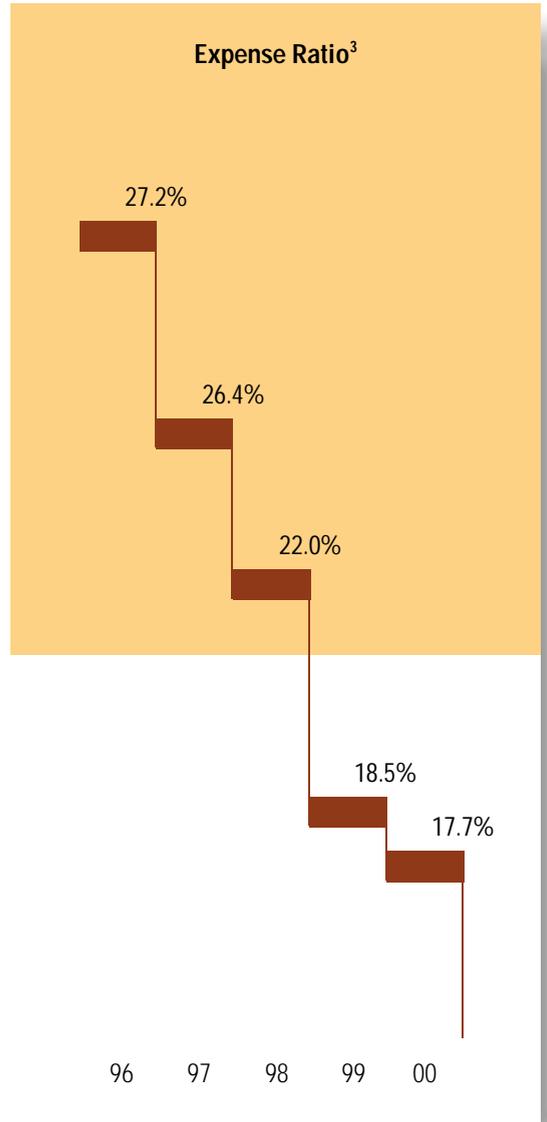
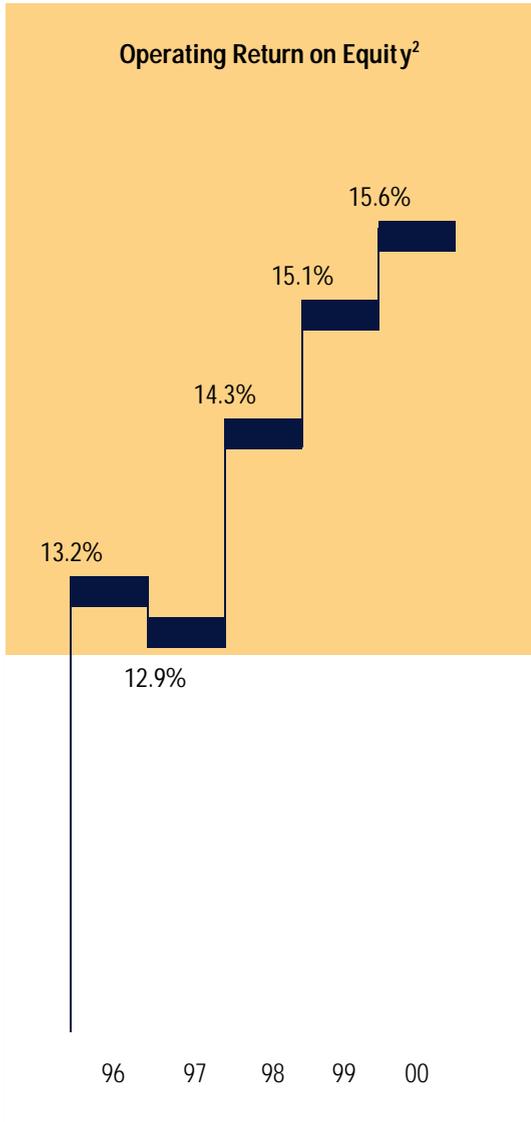
A handwritten signature in black ink, appearing to read "P. Lassiter". The signature is fluid and cursive, with a large initial "P" and a long, sweeping underline.

Phil Lassiter

5 - Y E A R P E R F O R M A N C E



¹ Core earnings and operating earnings are not substitutes for net income computed in accordance with accounting principles generally accepted in the United States of America, but are important measures used by management, equity analysts and investors to measure Ambac's financial results. Ambac Financial Group, Inc. defines operating earnings as net income, less the effect of realized gains and losses and certain non-recurring items. Core earnings is defined as operating earnings less net insurance premiums earned from refundings and calls. The definitions of operating earnings and core earnings used by Ambac Financial Group, Inc. may differ from definitions of operating earnings and core earnings used by other public holding companies of financial guarantors.



2 Operating return on equity is defined as operating earnings divided by average stockholders' equity, exclusive of unrealized gains/losses on the investment portfolio.

3 Expense ratio is calculated as financial guarantee underwriting and operating expenses divided by net premiums earned.

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.

P R E M I E R V A L U E S

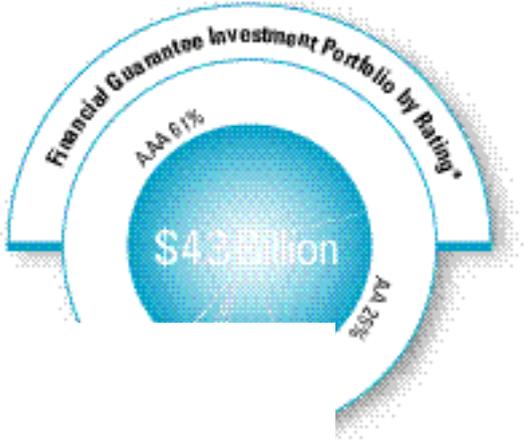
INNOVATION — We welcome new insights, new ideas, fresh perspectives. We value strategic thinking and are not afraid of change, recognizing that innovation is an essential success element for all companies in all industries.

EARNINGS/RETURNS — We understand that the 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.

HOME SWEET HOME. Throughout the U.S. and around the world, constant demand for housing presents financing challenges for governments, government-affiliated organizations and educational institutions. Ambac employs its credit analysis, structuring expertise and triple-A guarantee to create financing solutions to meet housing and mortgage finance needs.

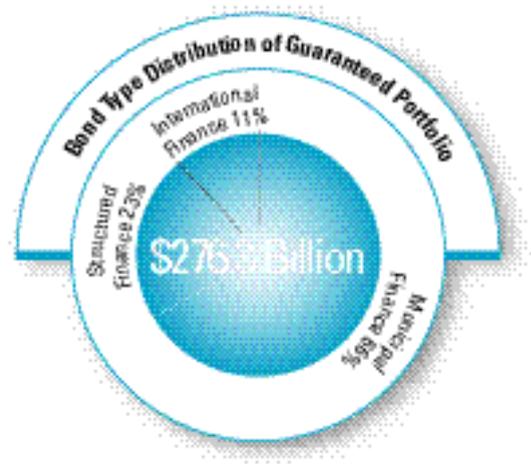
In the U.K., our extensive experience supporting housing financings began with the first-ever insured housing association issue and has continued with our dominance of financial guarantees in that sector. Ambac helps U.S. colleges and universities combine public financing with private sector management to create better and more cost-effective student housing choices. Using in-depth municipal housing finance experience, Ambac also helps private sector contractors structure efficient financings for expansion and renovation of aging military housing. Continued leadership in insuring mortgage-backed and home equity loan securitizations strengthens Ambac's ability to support housing issuers with innovative ideas and efficient execution.



* Based primarily on Standard & Poor's ratings.
♦ Below investment grade
• Not rated



GUARANTEEING THE FUTURE. Private sector issuers in emerging market countries often face limited financing options because of their home country's credit rating and currency fluctuations. Ambac helps quality issuers tap the global capital markets through complex transactions securitizing the future flows of U.S.-dollar offshore payments. These innovative deals, such as a South African bank's recent securitization of U.S.-dollar credit card receivables, are structured to cover bond payments by capturing cash flows offshore, protecting investors and, when combined with the Ambac guarantee, significantly strengthening the transaction.



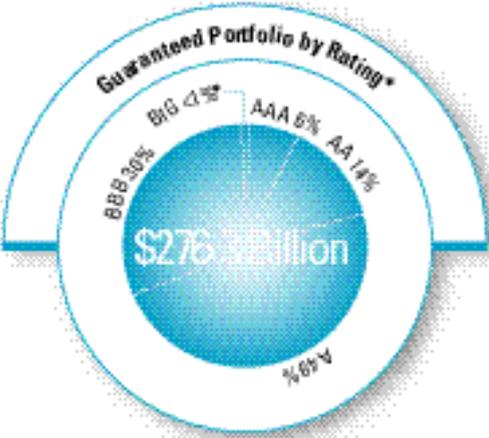


TAKING A PAGE FROM THE PRIVATE SECTOR BOOK. Ambac helps government issuers utilize their financial resources more efficiently by bringing the benefits of financing techniques long used by private sector issuers — such as securitization of future funds or interest rate swaps — to public finance issuers in the U.S. and around the world. Ambac also works with governments to help forge partnerships where private sector interests intersect with public need, such as the Las Vegas monorail, where the financing package included commitments from private sector partners. By focusing financings on specific projects, such as sports stadiums, air cargo facilities or transportation initiatives, and linking a developer's performance and obligations to the project, Ambac is helping governments move critical projects forward with minimal impact on a municipality's balance sheet or credit rating.



TURNING ASSETS INTO CAPITAL. Asset managers, financial institutions, insurance companies and corporate issuers look to Ambac for structured credit solutions that utilize credit enhancement in the form of financial guarantee policies or credit derivatives to meet financial challenges. We work with a full range of asset classes, including those not traditionally used in securitized structures, to help issuers strengthen balance sheets, generate leverage and improve credit portfolios. Flexibility in structuring, a willingness to work with complex structures, efficiency in execution and our valuable triple-A guarantee enable Ambac to support a broad range of portfolio types. Our enhancement can expand the distribution of the resulting securities and add liquidity to an issue.

EXPANDING GUARANTEES IN JAPAN. Issuers around the world are increasingly interested in the benefits financial guarantees add to a transaction. Ambac is bringing transaction structuring expertise and underwriting acumen to Japanese issuers through an exciting new alliance with Yasuda Kasai Financial Guarantee Insurance Co., Limited, the first triple-A-rated monoline financial insurance company licensed in Japan. Leveraging the strengths of both Yasuda and Ambac, the alliance will originate and execute financial guarantees for transactions of all types originating in Japan. Ambac's substantial expertise in structured transactions, including experience working with issuers throughout Europe and other international markets, will help expand the use of guarantees in the Japanese market.

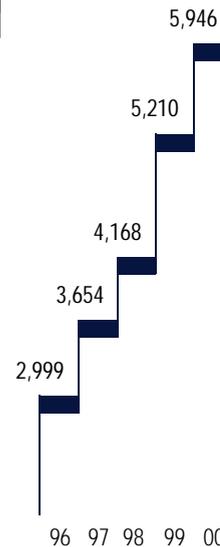


* Based upon internal Ambac ratings.
♦ Below investment grade





Total Claims-Paying Resources*
(\$ in millions)



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

STRENGTHENED BY EXPERIENCE, NOT BOUND BY TRADITION.

Depth of expertise distinguishes Ambac in the financial guarantee world. The credit analysis and transaction structuring acumen of our seasoned professionals span a wide range of financing structures, asset classes and major markets around the world. Our people combine this knowledge with a passion for innovation: creating new solutions to meet the specific and often unique needs of our clients. Ambac's exceptional financial strength enables us to insure large or multi-layered transactions that may be beyond the resources of other financial guarantee insurers. On every assignment, we thoughtfully apply our substantial intellectual capital to optimize transaction benefits and help clients prudently lower financing costs, enhance investor returns or improve their balance of assets and liabilities.



KEEPING AN EYE ON THE BALL. Underlying Ambac's continued success is an unwavering focus on risk management — for each transaction and the portfolio overall. A dedicated team of seasoned professionals using modern risk management tools enables the company to expand and manage its diversified portfolio of credits. Ambac adheres to a remote-loss underwriting standard and avoids undue concentrations of risk in its portfolio by establishing prudent limits and making effective use of reinsurance and other forms of risk transfer. When problems are identified, aggressive remedial action is taken to mitigate the risks and minimize any potential loss. By judiciously allocating and managing risk capital, Ambac preserves and enhances the long-term value of its business franchise.

THE AMBAC MANAGEMENT TEAM

Left to right: **Gregg L. Bienstock**, Human Resources; **Anne G. Gill**, Corporate Secretary; **Thomas J. Gandolfo**, Finance; **Dennis R. Santo**, Structured Finance; **Timothy S. Travers**, Utilities; **Iain H. Bruce**, Structured Finance; **Kathleen A. McDonough**, Public Finance; **John H. Bryan III**, Structured Finance; **David B. Nemschoff**, Structured Finance; **Mark A. Spinelli**, Public Finance.



Left to right: **Steven L. Dymant**, Financial Services; **Eulogio A. Ramos**, Financial Services; **Rodney D. Kumasaki**, Financial Services; **Nicholas G. Goumas**, Structured Finance; **Kevin J. Doyle**, General Counsel; **Thomas J. Adams**, Structured Finance; **John W. Uhlein III**, International Finance; **Robert D. Selvaggio**, Market Risk Management; **David A. MacDougall**, Portfolio Risk Management; **Kenneth S. Plotzker**, Technology.

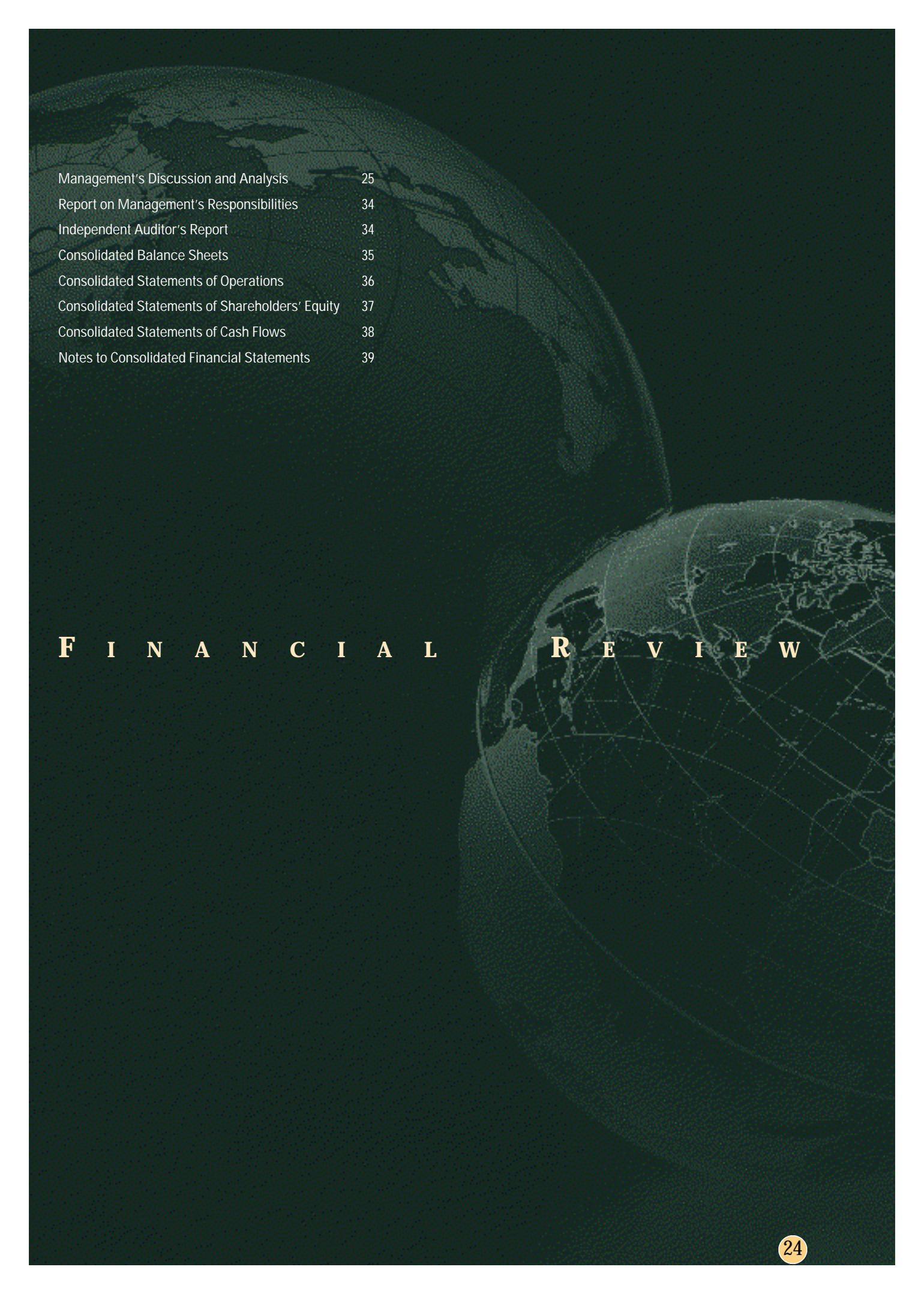


Left to right: **Jeffrey R. Fried**, Legal; **William T. McKinnon**, Credit Risk Management; **Howard C. Pfeffer**, Public Finance; **Andrea R. Merenyi**, International Finance; **Douglas C. Renfield-Miller**, International Finance; **Scott D. Gordon**, Structured Finance; **Michael J. Schozer**, Structured Finance; **Steven C. Renn**, Portfolio Risk Management; **David L. Boyle**, Vice Chairman; **Narayan Nair**, Internal Audit.



Left to right: **Frank J. Bivona**, Vice Chairman & CFO; **Brian S. Moore**, Investor Relations; **Robert W. Starr**, Finance; **Alessandra V. D'Imperio**, Credit Risk Management; **Robert G. Shoback**, Public Finance; **Ruben Selles**, Health Care; **David W. Wallis**, International Finance; **Peter J. Cain**, Portfolio Risk Management; **William T. Sullivan, Jr.**, Cadre Financial Services; **Kevin J. Burke**, Cadre Financial Services.





Management's Discussion and Analysis	25
Report on Management's Responsibilities	34
Independent Auditor's Report	34
Consolidated Balance Sheets	35
Consolidated Statements of Operations	36
Consolidated Statements of Shareholders' Equity	37
Consolidated Statements of Cash Flows	38
Notes to Consolidated Financial Statements	39

F I N A N C I A L R E V I E W

Management's Discussion and Analysis of Financial Condition and Results of Operations

GENERAL

Ambac Financial Group, Inc. ("AFGI"), headquartered in New York City, is a holding company whose subsidiaries provide financial guarantees and financial services to clients in both the public and private sectors around the world.

The following paragraphs describe the consolidated results of operations of AFGI and its subsidiaries (collectively referred to as the "Company") for 2000, 1999 and 1998, and its financial condition as of December 31, 2000 and 1999. These results are presented for the Company's two reportable segments: Financial Guarantee and Financial Services. This discussion should be read in conjunction with the consolidated financial statements and notes thereon included elsewhere in this report.

Materials in this annual report may contain information that includes or is based upon forward-looking statements within the meaning of the Securities Litigation Reform Act of 1995. Forward-looking statements give the Company's expectations or forecasts of future events. You can identify these statements by the fact that they do not relate strictly to historical or current facts and relate to future operating or financial performance.

Any or all of the Company's forward-looking statements here or in other publications may turn out to be wrong and are based on current expectations and the current economic environment. The Company's actual results may vary materially, and there are no guarantees about the performance of the Company's stock. Among 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. The Company undertakes no obligation to publicly correct or update any forward-looking statement if we later become aware that it is not likely to be achieved. You are advised, however, to consult any further disclosures we make on related subjects in the Company's reports to the Securities and Exchange Commission.

RESULTS OF OPERATIONS

Consolidated Net Income. The Company's net income in 2000 was \$366.2 million or \$3.41 per diluted share, an increase of 19% from \$307.9 million, and 18% from \$2.88 per diluted share in 1999. This increase was primarily attributable to growth in Financial Guarantee operating income. Financial Guarantee revenues increased by \$91.3 million, or 19%. Excluding realized gains and losses, Financial Guarantee revenues increased by 18%. Financial Guarantee total expenses increased \$10.4 million, or 17%.

The Company's net income in 1999 increased 21% from \$254.0 million, or \$2.37 per diluted share, in 1998. This increase was primarily attributable to the growth in both Financial Guarantee and Financial Services operating income.

FINANCIAL GUARANTEE

The Company provides financial guarantees for municipal and structured finance obligations through its principal operating subsidiary, Ambac Assurance Corporation ("Ambac Assurance"). Ambac Assurance serves clients in international markets through its wholly-owned subsidiary, Ambac Assurance UK Limited. Additionally, Ambac Assurance had served clients in international markets through its participation in MBIA•AMBAC International (the "JV Arrangement"), an unincorporated joint venture with MBIA Insurance Corporation ("MBIA"), which was restructured in 2000. See Note 6 of Notes to Consolidated Financial Statements for further discussion about the former JV Arrangement. Ambac Credit Products, L.L.C. ("ACP"), a wholly-owned subsidiary of Ambac Assurance, also provides credit protection in the global markets in the form of structured credit derivatives.

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

Gross Par Value Written. Ambac Assurance guaranteed \$71.3 billion of par value bonds during 2000, a decrease of 3% from \$73.3 billion in 1999. Par value written during 1999 represented an increase of 19% from \$61.5 billion written during 1998. Par value written during 2000 comprised \$21.4 billion from the guarantee of municipal bond obligations, \$30.4 billion from structured finance obligations and \$19.5 billion from international obligations, versus \$32.5 billion, \$33.4 billion and \$7.4 billion, respectively, in 1999 and \$33.9 billion, \$22.6 billion and \$5.0 billion, respectively, in 1998. The 2000 decrease in guaranteed municipal bond obligations was affected by a 12% decline in total municipal issuance, a reduction in insured market penetration from 48% in 1999 to 41% in 2000, and a reduction in Ambac's municipal market share during the period from 26% in 1999 to 22% in 2000. The decline in total issuance was largely attributable to the rising interest rate environment causing a decline in the refinancing component of the market during 2000. The decrease in guaranteed structured finance obligations during 2000 was principally due to lower issuance of mortgage-backed home equity securities, while the increase in international obligations guaranteed during 2000 reflects growth in the structured credit derivatives and asset-backed products.

Management anticipates, based on growth experienced in the last few years, that in the foreseeable future, the Company's structured finance and international businesses will grow more rapidly than the municipal market. Management believes that new business written in these markets may see large quarterly and annual variances primarily due to general market conditions and the developmental nature of these markets.

Gross Premiums Written. Gross premiums written in 2000 were \$483.1 million, an increase of 8% from \$445.2 million in 1999. This increase resulted from strong business activity in

Management's Discussion and Analysis of Financial Condition and Results of Operations

structured finance and international transactions partially offset by lower municipal transactions, as discussed above under "Gross Par Value Written." Gross premiums written in 1999 increased 23% from \$361.0 million in 1998. Business activity

in structured finance transactions as well as higher pricing in the municipal finance market spurred the increase. The following table sets forth the amounts of gross premiums written and related gross par written by type:

<i>(Dollars in millions)</i>	2000		1999		1998	
	Gross Premiums Written	Gross Par Written	Gross Premiums Written	Gross Par Written	Gross Premiums Written	Gross Par Written
Municipal finance:						
Up-front:						
New issue	\$203.1	\$17,660	\$261.5	\$27,242	\$228.2	\$29,616
Secondary market	14.0	1,261	14.8	1,570	14.6	1,400
Sub-total up-front	217.1	18,921	276.3	28,812	242.8	31,016
Installment:	22.4	2,495	21.7	3,649	17.7	2,899
Total municipal finance	239.5	21,416	298.0	32,461	260.5	33,915
Structured finance:						
Up-front	25.6	1,882	7.9	824	1.4	1,985
Installment	108.2	28,518	67.6	32,623	35.7	20,581
Total structured finance	133.8	30,400	75.5	33,447	37.1	22,566
International:						
Up-front	53.2	1,852	35.6	747	52.8	2,463
Installment	56.6	17,640	36.1	6,676	10.6	2,553
Total international	109.8	19,492	71.7	7,423	63.4	5,016
Total	\$483.1	\$71,308	\$445.2	\$73,331	\$361.0	\$61,497
Total up-front	\$295.9	\$22,655	\$319.8	\$30,383	\$297.0	\$35,464
Total installment	187.2	48,653	125.4	42,948	64.0	26,033
Total	\$483.1	\$71,308	\$445.2	\$73,331	\$361.0	\$61,497

Adjusted Gross Premiums.⁽¹⁾ While the majority of Ambac Assurance's municipal finance premiums written are collected up front at policy issuance, the majority of its structured finance and international premiums are collected on an installment basis. Adjusted gross premiums ("AGP") written, which are defined as gross up front premiums written plus the present value of estimated future installment premiums written on insurance policies and structured credit derivatives issued in the period, were \$658.9 million in 2000, up 11% from \$595.0 million in 1999. The increase during 2000 was driven by pricing increases for all business lines and was affected by changes in market issuance. International business activity increased during 2000, partially offset by declines in both municipal and structured finance issuance. AGP written in 1999 increased 30% from \$458.0 million in 1998. The increase in 1999 was primarily due to the increased business activity in structured finance transactions, especially on mortgage-backed and asset-backed securities. The aggregate net present value (calculated at a 7% discount rate) of estimated future installment premiums was \$763.9 million at December 31, 2000, up 45% from \$527.2 million at December 31, 1999.

Ceded Premiums Written. Ceded premiums written in 2000 were \$80.8 million, up 31% from \$61.8 million in 1999. Ceded premiums written in 2000 were affected by a large facultative cede of municipal health care exposure. Excluding this cession in 2000, ceded premiums written in 2000 increased 20% over ceded premiums written in 1999. The

increase is primarily due to increased gross premiums written as well as increased ceded premiums written on international policies and mortgage-backed business. Ceded premiums written in 1999 were up 25% from \$49.6 million in 1998. Ceded premiums written in 1998 were affected by a one-time cession of \$11.6 million of the purchased Connie Lee insured portfolio. Excluding this cession in 1998, ceded premiums written in 1999 increased 63% over ceded premiums written in 1998, primarily due to increased gross premiums written and increased premiums ceded on international business. Ceded premiums written were 17%, 14% and 14% of gross premiums written in 2000, 1999 and 1998, respectively.

Net Premiums Earned. Net premiums earned during 2000 were \$311.3 million, an increase of 18% from \$264.4 million in 1999. This increase was primarily the result of the larger financial guarantee book of business, partially offset by decreased refundings, calls, and other accelerations of previously insured obligations (collectively referred to as "refundings") during the year.

When a new or secondary market issue insured by Ambac Assurance has been refunded or called, any remaining unearned premium (net of refunding credits, if any) is generally earned at that time. Earnings on refundings typically relate to insured municipal obligations, where the premium is usually paid up front for the life of the policy. 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 during 2000

included \$22.2 million (net income per diluted share effect of \$0.12) from refundings of previously insured issues. Net premiums earned in 1999 included \$35.9 million (net income per diluted share effect of \$0.19) from refundings. Excluding the effect of accelerated earnings related to refundings, normal net premiums earned in 2000 were \$289.0 million, an increase of 26% from \$228.5 million in 1999. The increase in normal net premiums earned resulted from strong business written from prior periods in all areas, particularly structured and international finance.

Net premiums earned during 1999 increased 24% from \$212.7 million in 1998. This increase was primarily the result of the larger financial guarantee book of business, partially offset by decreased refundings. Net premiums earned in 1998 included \$46.9 million (net income per diluted share effect of \$0.25) from refundings. Excluding the effect of accelerated earnings related to refundings, normal net premiums earned in 1999 increased 38% from \$165.8 million in 1998.

Net Fees Earned and Other Income. Net fees earned and other income in 2000 was \$12.4 million, an increase of 103% from \$6.1 million in 1999. Included in net fees earned and other income are income earned from structured credit derivatives, deal structuring fees and commitment fees. During 2000, structured credit derivatives earned income was \$8.0 million, an increase of 105% from \$3.9 million in 1999, primarily due to increased volume in the business partially offset by mark-to-market losses related primarily to credit spread widening during the period. Net fees earned and other income increased 5% in 1999 from \$5.8 million in 1998. There were no revenues from structured credit derivatives in 1998.

Net Investment Income. Net investment income in 2000 was \$241.0 million, an increase of 15% from \$209.3 million in 1999. The increase was attributable to: (i) the growth of the investment portfolio resulting from the growth in the financial guarantee book of business; (ii) investment of new money at higher taxable rates during 2000 as opposed to primarily tax-exempt rates in 1999; and (iii) capital contributions from AFGI to Ambac Assurance totaling approximately \$200 million during the course of 1999. The contributions were in the form of taxable securities. Investments in tax-exempt securities amounted to 72% of the total fair value of the portfolio as of December 31, 2000, versus 74% as of December 31, 1999 and 1998. The average pre-tax yield-to-maturity on the investment portfolio was 6.20% as of December 31, 2000 compared with 6.08% and 6.17% at December 31, 1999 and 1998, respectively. Net investment income in 1999 increased 12% from \$186.2 million in 1998. This increase was primarily attributable to the growth of the investment portfolio resulting from the growth in the financial guarantee book of business as well as the above-mentioned capital contributions from AFGI during 1999.

Net Realized Gains (Losses). Net realized gains in 2000 were \$0.7 million, compared to net realized losses of \$5.7 million and net realized gains of \$3.7 million in 1999 and 1998, respectively. Included in net realized gains (losses) in 2000 are foreign exchange losses amounting to \$3.5 million. Foreign exchange gains/losses were not material in 1999 and 1998.

While investment realized gains and losses are generated as a result of the ongoing management of the investment portfolio, foreign exchange gains and losses result from the Company's policy of protecting its return on capital on international financial guarantees where the premium is received up-front in foreign currency. Returns on these policies are naturally hedged by investing in high-grade local currency securities.

Losses and Loss Adjustment Expenses. Losses and loss adjustment expenses in 2000 were \$15.0 million, versus \$11.0 million in 1999 and \$6.0 million in 1998. Losses and loss adjustment expenses are based upon estimates of the ultimate aggregate losses inherent in the financial guarantee portfolio. The liability for losses and loss adjustment expenses consists of the active credit reserve ("ACR"), which represents an estimate of the expected annual levels of debt service defaults resulting from credit failures on currently guaranteed issues that are not presently or imminently in default, and case basis loss reserves for obligations in monetary default, or, in the judgment 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, 2000 and 1999:

<i>(Dollars in millions)</i>	2000	1999
Net loss and loss adjustment expense reserves:		
Case basis*	\$ 31.0	\$ 26.2
ACR	100.3	94.8
Total	\$131.3	\$121.0

*After netting reinsurance recoverable amounting to \$1.1 million and \$0.5 million in 2000 and 1999, respectively.

Paid losses, net of salvage received, were \$4.6 million, \$2.2 million and (\$7.0) million in 2000, 1999 and 1998, respectively.

Underwriting and Operating Expenses. Underwriting and operating expenses of \$55.2 million in 2000 increased by 13% from \$48.8 million in 1999. Underwriting and operating expenses in 1999 increased 4% from \$46.7 million in 1998. 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. In 2000, gross underwriting and operating expenses were \$88.6 million, an increase of 19% from \$74.5 million in 1999. During 1999, gross underwriting and operating expenses increased 10% from \$67.8 million in 1998. The increases in gross underwriting and operating expenses in both 2000 and 1999 reflect the overall increased business activity in those years and are primarily attributable to higher compensation costs and premium taxes. Underwriting and operating expenses deferred were \$55.8 million, \$45.9 million, and \$38.2 million in 2000, 1999 and 1998, respectively. The amortization of previously deferred expenses and reinsurance commissions was \$22.5 million, \$20.8 million, and \$18.2 million in 2000, 1999 and 1998, respectively.

Management's Discussion and Analysis of Financial Condition and Results of Operations

FINANCIAL SERVICES

Through its financial services subsidiaries, the Company provides financial and investment products including investment agreements, interest rate swaps, funding conduits, investment advisory and cash management services, principally to its financial guarantee clients which include municipalities and their authorities, school districts, health care organizations and asset-backed issuers.

Revenues in 2000 grew 22% to \$62.7 million (excludes \$9.1 million in net realized losses) from \$51.6 million (excludes \$3.1 million in net realized losses) in 1999. This increase is primarily due to higher revenues from interest rate swaps provided to municipal issuers and related to a higher volume of business activity and higher post-inception revenues from existing business booked in prior years. This was partially offset by a decline in investment agreement revenue due to lower outstanding volume, which resulted from maturing investment agreements and declining municipal market issuance in 2000 compared to 1999. Revenues from investment advisory and cash management increased 16% in 2000 compared to 1999. Revenues in 1999 reflected a 4% increase from \$49.5 million (excludes \$17.1 million in net realized losses) in 1998. The 1998 net realized losses included a write-off of an electronic commerce business initiative and a trading position loss which were partially offset by realized gains on fixed-income securities in the investment agreement business during the period. The increase in revenue from 1998 to 1999 was primarily due to higher revenues on investment agreements from higher volume and improved net interest spreads, partially offset by lower revenues on interest rate swaps due to lower volume.

Financial services expenses in 2000 were \$24.8 million, versus \$25.8 million in 1999. Expenses in 1999 decreased 21% from \$32.5 million (excluding a \$3.0 million restructuring charge in 1998). This decrease was primarily due to savings related to the closing of its electronic commerce subsidiary, as discussed above.

CORPORATE ITEMS

Interest Expense. Interest expense was \$37.5 million, \$36.5 million and \$32.8 million in 2000, 1999 and 1998, respectively. The 1999 increase is primarily attributable to a full year's interest expense on AFGI's April 1998 issuance of \$200 million in debentures.

Other Revenue. Other revenue includes investment income of AFGI. Other revenue was \$2.3 million, \$9.9 million and \$13.7 million in 2000, 1999 and 1998, respectively. The 2000 and 1999 decreases are due to the capital contributions to Ambac Assurance during 1999 (see "Net Investment Income" section above).

Other Expenses. Other expenses include the operating expenses of AFGI. Other expenses were \$6.7 million in 2000, \$6.5 million in 1999, and \$7.1 million in 1998.

Income Taxes. Income taxes for 2000 were at an effective rate of 24.1%, compared to 23.9% and 22.8% for 1999 and 1998, respectively. The increasing effective tax rate is primarily the result of the growth in underwriting profits, which are taxed at maximum rates, in proportion to the primarily tax-advantaged investment income.

SUPPLEMENTAL ANALYTICAL FINANCIAL DATA

Core Earnings.⁽²⁾ In 2000, core earnings were \$359.0 million, an increase of 23% from \$292.6 million in 1999. This increase was primarily the result of continued higher normal premiums earned from the growth in the financial guarantee book of business, higher net investment income from financial guarantee operations and growth in Financial Services earnings (excluding its net realized losses). In 1999, core earnings increased 24% from \$236.5 million in 1998. The increase was primarily the result of higher normal premiums earned from the growth in the financial guarantee book of business and higher net investment income from financial guarantee 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 2000 were \$371.6 million, an increase of 19% from \$313.1 million in 1999. Operating earnings in 1999 increased 19% from \$263.3 million in 1998. 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 accounting principles generally accepted in the United States of America ("GAAP") to operating earnings and core earnings for the years ended December 31, 2000, 1999 and 1998:

<i>(Dollars in millions)</i>	2000	1999	1998
Net income	\$366.2	\$307.9	\$254.0
Net realized losses, after tax	5.4	5.2	7.1
Non-recurring items, after tax	—	—	2.2
Operating earnings	371.6	313.1	263.3
Premiums earned from refundings, after tax	(12.6)	(20.5)	(26.8)
Core earnings	\$359.0	\$292.6	\$236.5

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 and other subsidiaries' 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 2000, Ambac Assurance paid dividends of \$59.8 million on its common stock to AFGI. For further discussion, see Note 9 of Notes to Consolidated Financial Statements. Also, during 2000, Ambac Capital Corporation, a Financial Services wholly-owned subsidiary paid dividends of \$4 million on its common stock to AFGI.

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 it expects to receive from Ambac Assurance and other subsidiaries during 2001, and the income it expects to receive from its investment portfolio, management believes that AFGI will have sufficient liquidity to satisfy its needs over the next twelve months, including the ability to pay dividends on its 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.

Ambac Assurance Liquidity. The principal uses of Ambac Assurance's liquidity are the payment of operating expenses, reinsurance premiums, income taxes, dividends to AFGI, and capital investments in its subsidiaries. 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, net investment income and receipts from structured credit derivatives. During 1999, AFGI contributed \$200 million of capital to Ambac Assurance to support the growth in the financial guarantee business.

Financial Services Liquidity. The principal uses of liquidity by financial services subsidiaries are payment of investment agreement obligations pursuant to defined terms, net obligations under interest rate swaps and related hedges, operating expenses, income taxes, and dividends to AFGI. Management believes that its Financial 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 maturity schedule 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. Financial services subsidiaries maintain a portion of their assets 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 2001 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, 2000 and 1999, no amounts were outstanding under this credit facility.

Ambac Assurance maintains third party capital support in the form of seven-year irrevocable limited recourse credit facilities from a group of highly rated banks. These credit facilities provide liquidity to Ambac Assurance in the event claims from municipal or certain structured obligations in its covered portfolios exceed specified levels. Repayments of amounts drawn under the credit facilities are limited primarily to the amount of any recoveries of losses related to policy obligations in the covered portfolios. During 2000, total third party capital support was increased from \$750 million to \$800 million and its expiration reset to December 2, 2007. As of December 31, 2000 and 1999, no amounts were outstanding under these facilities.

ACP has a revolving credit facility with one major international bank for \$50 million that expires in June 2001 and provides a three-year term loan provision. The facility is available to ACP for general corporate purposes, including payments in regard to its structured credit derivative activities. As of December 31, 2000 and 1999, no amounts were outstanding under this facility.

Management's Discussion and Analysis of Financial Condition and Results of Operations

Stock Repurchase Program. The Board of Directors of AFGI has authorized the establishment of a stock repurchase program that permits the repurchase of up to 9,000,000 shares of AFGI's common stock. During 2000, AFGI acquired approximately 631,000 treasury shares for an aggregate amount of \$23.6 million. Since inception of the Stock Repurchase Program, AFGI has acquired approximately 7,491,000 shares for an aggregate amount of \$184.0 million.

Adjusted Book Value.⁽³⁾ Adjusted Book Value ("ABV") per share increased 22% to \$36.35 at December 31, 2000 from \$29.79 at December 31, 1999.

The following table reconciles book value per share to ABV per share as of December 31, 2000 and 1999:

	2000	1999
Book value per share	\$24.60	\$19.23
After-tax value of:		
Net unearned premium reserve	8.02	7.52
Deferred acquisition costs	(0.95)	(0.84)
Present value of installment premiums	4.71	3.27
Net unrealized (losses) gains on investment agreement liabilities	(0.03)	0.61
Adjusted book value per share	\$36.35	\$29.79

Balance Sheet. Total assets as of December 31, 2000 were \$10.12 billion, a decrease of 11% from \$11.35 billion at December 31, 1999. This reduction reflects lower outstanding volume in the investment agreement business resulting from maturing investment agreements and declining municipal market issuance. This was partially offset by strong cash flows from Financial Guarantee operations and investment activities and an increase in the market value of the investment portfolio resulting from lower interest rates at December 31, 2000 compared to December 31, 1999. Stockholders' equity as of December 31, 2000 was \$2.60 billion, an increase of 29% from \$2.02 billion at year-end 1999. The increase resulted primarily from net income for the year and net unrealized gains in the investment portfolio (classified as "Accumulated Other Comprehensive Income (Loss)" in stockholders' equity).

The following table summarizes the composition of the fair value of the Company's investment portfolio by segment at December 31, 2000, and 1999:

<i>(Dollars in millions)</i>	Financial Guarantee	Financial Services	Other	Total
2000:				
Fixed income securities:				
Municipal obligations	\$3,328.8	\$ 86.2	\$ —	\$3,415.0
Corporate obligations	422.1	551.6	7.0	980.7
Foreign government obligations	35.4	—	—	35.4
U.S. government obligations	49.4	23.3	—	72.7
Mortgage- and asset-backed securities (includes U.S. government agency obligations)	262.9	2,058.5	—	2,321.4
Other	0.7	0.2	5.0	5.9
	4,099.3	2,719.8	12.0	6,831.1
Short-term	218.5	0.5	34.5	253.5
	4,317.8	2,720.3	46.5	7,084.6
Fixed income securities pledged as collateral:				
Mortgage- and asset-backed securities (includes U.S. government agency obligations)	—	1,239.3	—	1,239.3
Total investments	\$4,317.8	\$3,959.6	\$46.5	\$8,323.9
Percent total	51.9%	47.6%	0.5%	100%
1999:				
Fixed income securities:				
Municipal obligations	\$2,923.5	\$ 39.4	\$ —	\$2,962.9
Corporate obligations	401.5	582.4	5.7	989.6
Foreign government obligations	19.0	—	—	19.0
U.S. government obligations	60.9	1.6	—	62.5
Mortgage- and asset-backed securities (including U.S. government agency obligations)	111.0	2,612.7	—	2,723.7
Other	—	—	3.1	3.1
	3,515.9	3,236.1	8.8	6,760.8
Short-term	207.1	1.5	12.3	220.9
	3,723.0	3,237.6	21.1	6,981.7
Fixed income securities pledged as collateral:				
Mortgage- and asset-backed securities (including U.S. government agency obligations)	—	1,980.8	—	1,980.8
Total investments	\$3,723.0	\$5,218.4	\$21.1	\$8,962.5
Percent total	41.5%	58.2%	0.3%	100%

The Company's investment objectives for the financial guarantee portfolio are to maintain an investment duration that closely approximates the expected duration of related financial guarantee liabilities and achieve the highest after-tax net investment income, while maintaining a conservative credit risk profile. The financial guarantee investment portfolio is subject to internal investment guidelines, which are approved by the Company's board of directors. Such guidelines set forth minimum credit rating requirements and credit risk concentration limits. As of December 31, 2000 and 1999, the Company's financial guarantee investment portfolio had a weighted average credit rating of AA.

Approximately 92% and 87% of the mortgage- and asset-backed securities in the financial guarantee portfolio is composed of securities issued by various U.S. government agencies, as of December 31, 2000 and 1999, respectively.

Short-term investments in the financial guarantee portfolio consisted primarily of money market funds, foreign and domestic time deposits, and discount notes.

The financial services investment portfolio consists primarily of assets funded with the proceeds from the issuance of investment agreement liabilities. The investment objectives of the portfolio are to match the investment security maturity schedule to the maturity schedule of related liabilities under the investment agreements and achieve the highest after-tax net investment income. The investment portfolio is subject to internal investment guidelines which are approved by the Company's board of directors. Such guidelines set forth minimum credit rating requirements and credit risk concentration limits. As of December 31, 2000 and 1999, the Company's Financial Services investment portfolio had a weighted average credit rating of AA.

Approximately 52% and 51% of the mortgage- and asset-backed securities in the financial services portfolio is composed of securities issued by various U.S. government agencies, as of December 31, 2000 and 1999, respectively.

Cash Flows. Net cash provided by operating activities was \$481.3 million, \$454.4 million and \$327.8 million during 2000, 1999 and 1998, respectively. These cash flows were primarily provided by the financial guarantee operations. Net cash (used in) provided by financing activities was (\$1,226.0) million, \$181.2 million and \$1,723.0 million during 2000, 1999 and 1998, respectively. Financing activity in 2000 included \$1,217.8 million used by the investment agreement business for net draws paid (net of investment agreements issued). Financing activities for the years ended 1999 and 1998 included \$199.2 million and \$1,391.9 million, respectively, in net investment agreements issued (net of draws paid). The total cash (used in) provided by operating and financing activities was (\$744.6) million, \$635.6 million and \$2,050.8 million during 2000, 1999 and 1998, respectively. From these totals, \$776.5 million, (\$630.3) million and (\$2,051.8) million was provided by (used in) investing activities, principally net proceeds from sales and maturities of investment securities during 2000 and primarily net purchases of investment securities during 1999 and 1998, 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 affiliates, manages a variety of risks, principally credit, market, 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.

Credit Risk. The Company is exposed to credit risk in various capacities including as an issuer of financial guarantees, as counterparty to derivative and other financial contracts and as a holder of investment securities. The Company's Portfolio Risk Management Committee ("PRMC") employs various procedures and controls to monitor and manage credit risk. The PRMC is comprised of senior credit professionals and senior management of the Company. Its purview is enterprise-wide and its focus is on risk limits and measurement, concentration and correlation of risk, and capital attribution in a portfolio context.

All financial guarantees issued are subject to a formal underwriting process. Various factors affecting the credit worthiness of the underlying obligation are evaluated during the underwriting process. Senior credit personnel approve all transactions prior to issuing a financial guarantee. Subsequent to issuance of a financial guarantee, the Company periodically performs reviews of exposures according to a pre-determined schedule based on the risk profile of the guaranteed obligations.

The company manages credit risk associated with its investment portfolio through adherence to specific investment guidelines. These guidelines establish limits based upon single risk concentration limits and minimum credit rating standards. Additionally, senior credit personnel monitor the portfolio on a continuous basis.

Market Risk. Market risk represents the potential for losses that may result from changes in the value of a financial instrument as a result of changes in market conditions. The primary market risks that would impact the value of the Company's financial instruments are interest rate risk, basis risk (taxable interest rates relative to tax-exempt interest rates, discussed below) and credit spread risk. Below we discuss each of these risks and the specific types of financial instruments impacted. Senior managers in the Company's Risk Management group are responsible for monitoring risk limits and applying 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 systems, models and stress test scenarios to monitor and manage market risk. This process includes frequent analyses of both parallel and non-parallel shifts in the yield curve, "Value-at-Risk" ("VaR") and changes in credit spreads. 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 that may be adversely affected by changes in interest rates consist primarily of investment securities, investment agreement liabilities, debentures, and cer-

Management's Discussion and Analysis of Financial Condition and Results of Operations

tain derivative contracts (primarily interest rate swaps) 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 the Company's investment securities, investment agreement liabilities, debentures and derivative hedges, assuming immediate changes in interest rates at specified levels at December 31, 2000 and 1999:

<i>(Dollars in millions)</i>	Estimated net fair value	Estimated change in net fair value
Change in interest rates		
2000:		
300 basis point rise	\$3,004	\$(967)
200 basis point rise	3,334	(637)
100 basis point rise	3,657	(314)
Base scenario	3,971	—
100 basis point decline	4,278	307
200 basis point decline	4,576	605
300 basis point decline	4,864	893
1999:		
300 basis point rise	\$2,513	\$(927)
200 basis point rise	2,814	(626)
100 basis point rise	3,123	(317)
Base scenario	3,440	—
100 basis point decline	3,763	323
200 basis point decline	4,098	658
300 basis point decline	4,454	1,014

Financial instruments that may be adversely affected by changes in basis include the Company's municipal interest rate swap portfolio. The Company, through its affiliate 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 tax-exempt interest rates change in relation to taxable interest rates, the Company will experience a mark-to-market gain or loss. Since late 1995, most municipal interest rate swaps transacted by AFSLP contain provisions that are designed to protect the Company against certain forms of tax reform, thus mitigating its basis risk. The estimation of potential losses arising from adverse changes in market relationships, known as VaR, is a key element in management's monitoring of basis risk for the municipal interest rate swap portfolio. The Company has developed a VaR methodology to estimate potential losses over a specified holding period and based on certain probabilistic assessments. The Company's methodology estimates VaR 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, 2000 and 1999, the Company's VaR, for its interest rate swap portfolio, calculated at a ninety-nine percent confidence level, averaged approximately \$1.3 million and \$1.1 million, respectively. The Company's VaR

ranged from a high of \$1.8 million to a low of \$0.8 million in 2000, and from a high of \$1.3 million to a low of \$0.9 million in 1999. Since no single measure can capture all dimensions of market risk, the Company supplements its VaR 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.

Financial instruments that may be adversely affected by changes in credit spreads include the Company's outstanding structured credit derivative contracts. The Company, through its affiliate ACP, enters into structured credit derivative contracts. These contracts require ACP to make payments upon the occurrence of certain defined credit events relating to an underlying obligation (generally a fixed income obligation). If credit spreads of the underlying obligations change, the market value of the related structured credit derivative changes. As such, ACP could experience mark-to-market gains or losses. Market liquidity could also impact valuations. Changes in credit spreads are generally caused by changes in the market's perception of the credit quality of the underlying obligations. The majority of ACP's contracts are partially hedged with various financial institutions or structured with first loss protection. Such structuring mitigates ACP's risk of loss and reduces the price volatility of these financial instruments. Personnel in the Company's credit surveillance group monitor credit spread risk. Additionally, management models the potential impact of credit spread changes on the value of its contracts. The following table summarizes the estimated change in fair value (based primarily on the valuation models discussed above) on the net balance of the Company's net structured credit derivative position assuming immediate changes in credit spreads at specified levels at December 31, 2000 and 1999:

<i>(Dollars in millions)</i>	Estimated net fair value	Estimated unrealized gain/loss
Change in credit spreads		
2000:		
75 basis point widening	\$(14)	\$(7)
50 basis point widening	(11)	(4)
25 basis point widening	(8)	(1)
Base scenario	(7)	—
25 basis point narrowing	(4)	3
50 basis point narrowing	0	7
75 basis point narrowing	4	11
1999:		
75 basis point widening	\$(4)	\$(3)
50 basis point widening	(3)	(2)
25 basis point widening	(1)	(1)
Base scenario	(1)	—
25 basis point narrowing	1	2
50 basis point narrowing	2	3
75 basis point narrowing	2	3

Liquidity Risk. Liquidity risk relates to the possible inability to satisfy contractual obligations when due. This risk is present in financial guarantee contracts, structured credit derivatives, 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. ACP manages the liquidity risk inherent in the structured credit derivative portfolio by holding cash and short-term investments, closely matching the dates that derivative payments are made and received, and by maintaining a revolving credit agreement. The investment agreement business manages liquidity risk by matching the maturity schedules of its invested assets, including hedges, with the maturity schedules of its investment agreement liabilities. Additionally, the Company's policy is to maintain a minimum level of cash and short-term assets equivalent to a specified percentage of its investment agreement liabilities outstanding. AFSLP maintains cash and short-term investments, closely matches the dates swap payments are made and received, and limits the amount of risk hedged with futures contracts. See additional discussion in "Liquidity and Capital Resources" section.

Operational Risk. 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. Legal risks attendant to the Company's businesses include uncertainty with respect to the enforceability of the obligations insured by Ambac Assurance and the security therefor, as well as uncertainty with respect to the enforceability of the 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.

Footnotes.

(1) Adjusted gross premiums ("AGP") written, which is not promulgated under GAAP, is used by management, equity analysts and investors to measure the financial results of the Company. AGP 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 on insurance policies and structured credit derivatives issued in the period. The definition of AGP written used by the Company may differ from definitions of AGP written used by other public holding companies of financial guarantee insurers.

AGP written includes the net retention on international business written pursuant to a reinsurance arrangement with MBIA.

(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.

Report on Management's Responsibilities

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 accounting principles generally accepted in the United States of America 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 auditing standards generally accepted in the United States of America

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 and Chief Executive Officer



Frank J. Bivona
Vice Chairman and Chief Financial Officer

January 22, 2001

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, 2000 and 1999, 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, 2000. 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 auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the 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, 2000 and 1999, and the results of their operations and their cash flows for each of the years in the three-year period ended December 31, 2000 in conformity with accounting principles generally accepted in the United States of America.



KPMG LLP
New York, New York

January 22, 2001

Consolidated Balance Sheets

Ambac Financial Group, Inc. and Subsidiaries

(Dollars in thousands, except share amounts) December 31,

2000

1999

ASSETS:

Investments:

Fixed income securities, at fair value (amortized cost of \$6,743,450 in 2000 and \$7,019,043 in 1999)	\$ 6,825,152	\$ 6,757,706
Fixed income securities pledged as collateral, at fair value (amortized cost of \$1,238,401 in 2000 and \$2,009,141 in 1999)	1,239,349	1,980,765
Short-term investments, at cost (approximates fair value)	253,519	220,896
Other, at cost	5,852	3,168
Total investments	8,323,872	8,962,535
Cash	20,493	13,588
Cash pledged as collateral	24,935	—
Securities purchased under agreements to resell	255,786	103,000
Receivable for investment agreements	6,663	45,918
Receivable for securities sold	1,926	15,369
Investment income due and accrued	130,692	128,668
Reinsurance recoverable	1,091	500
Prepaid reinsurance	242,604	217,977
Deferred acquisition costs	153,424	135,324
Deferred income taxes	—	57,377
Loans	695,251	685,488
Receivable from brokers and dealers	—	717,000
Other assets	263,563	262,352
Total assets	\$10,120,300	\$11,345,096

LIABILITIES AND STOCKHOLDERS' EQUITY:

Liabilities:

Unearned premiums	\$ 1,546,290	\$ 1,431,076
Losses and loss adjustment expense reserve	132,445	121,475
Ceded reinsurance balances payable	10,892	15,028
Obligations under investment and payment agreements	3,509,049	4,180,513
Obligations under investment repurchase agreements	1,383,882	1,959,741
Deferred income taxes	106,035	—
Current income taxes	25,628	24,831
Debentures	424,061	423,995
Accrued interest payable	90,575	91,142
Other liabilities	291,394	268,696
Payable to brokers and dealers	—	717,000
Payable for securities purchased	3,935	93,149
Total liabilities	7,524,186	9,326,646

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, 2000 and December 31, 1999; issued shares – 106,020,537 at December 31, 2000 and 70,680,384 at December 31, 1999	1,060	707
Additional paid-in capital	533,558	525,012
Accumulated other comprehensive income (loss)	45,154	(187,540)
Retained earnings	2,035,209	1,713,446
Common stock held in treasury at cost, 469,932 shares at December 31, 2000 and 722,592 at December 31, 1999	(18,867)	(33,175)
Total stockholders' equity	2,596,114	2,018,450
Total liabilities and stockholders' equity	\$10,120,300	\$11,345,096

See accompanying Notes to Consolidated Financial Statements.

Consolidated Statements of Operations

Ambac Financial Group, Inc. and Subsidiaries

(Dollars in thousands except share amounts) Years Ended December 31,

	2000	1999	1998
REVENUES:			
Financial Guarantee:			
Gross premiums written	\$483,082	\$445,242	\$361,011
Ceded premiums written	(80,789)	(61,845)	(49,563)
Net premiums written	<u>\$402,293</u>	<u>\$383,397</u>	<u>\$311,448</u>
Net premiums earned	\$311,276	\$264,426	\$212,684
Net fees earned and other income	12,417	6,054	5,781
Net investment income	241,047	209,284	186,190
Net realized gains (losses)	681	(5,675)	3,735
Financial Services:			
Net revenue	62,675	51,607	49,510
Net realized losses	(9,110)	(3,124)	(17,096)
Other:			
Revenue	2,316	9,906	13,725
Net realized gains	8	797	2,507
Total revenues	<u>621,310</u>	<u>533,275</u>	<u>457,036</u>
EXPENSES:			
Financial Guarantee:			
Losses and loss adjustment expenses	15,000	11,000	6,000
Underwriting and operating expenses	55,235	48,804	46,720
Financial Services	24,805	25,782	35,540
Interest	37,477	36,525	32,761
Other	6,669	6,506	7,103
Total expenses	<u>139,186</u>	<u>128,617</u>	<u>128,124</u>
Income before income taxes	482,124	404,658	328,912
Provision for income taxes	115,952	96,741	74,918
Net income	<u>\$366,172</u>	<u>\$307,917</u>	<u>\$253,994</u>
Net income per share:			
Basic	\$3.49	\$2.94	\$2.42
Diluted	\$3.41	\$2.88	\$2.37
Weighted average number of common shares outstanding:			
Basic	105,031,473	104,869,721	104,909,565
Diluted	<u>107,415,430</u>	<u>107,049,315</u>	<u>106,995,080</u>

See accompanying Notes to Consolidated Financial Statements.

Consolidated Statements of Stockholders' Equity

Ambac Financial Group, Inc. and Subsidiaries
(Dollars in thousands) Years Ended December 31,

	2000	1999	1998
RETAINED EARNINGS:			
Balance at January 1	\$1,713,446	\$1,449,832	\$1,262,740
Net income	366,172	<u>366,172</u>	<u>307,917</u>
Dividends declared – common stock	(32,213)	(29,366)	(26,571)
Exercise of stock options	(12,196)	(14,937)	(40,331)
Balance at December 31	<u>\$2,035,209</u>	<u>\$1,713,446</u>	<u>\$1,449,832</u>
ACCUMULATED OTHER COMPREHENSIVE INCOME (LOSS):			
Balance at January 1	\$ (187,540)	\$ 159,313	\$ 135,223
Unrealized gains (losses) on securities, \$373,291, (\$552,645), and \$36,476, pre-tax in 2000, 1999 and 1998, respectively ⁽¹⁾	234,178	(346,211)	23,889
Foreign currency (loss) gain	(1,484)	(642)	201
Other comprehensive income (loss)	<u>232,694</u>	<u>232,694</u>	<u>24,090</u>
Total comprehensive income (loss)	<u>\$598,866</u>	<u>\$ (38,936)</u>	<u>\$278,084</u>
Balance at December 31	<u>\$ 45,154</u>	<u>\$ (187,540)</u>	<u>\$ 159,313</u>
PREFERRED STOCK:			
Balance at January 1 and December 31	\$ —	\$ —	\$ —
COMMON STOCK:			
Balance at January 1	\$ 707	\$ 707	\$ 707
Stock split effected as dividend	353	—	—
Balance at December 31	<u>\$ 1,060</u>	<u>\$ 707</u>	<u>\$ 707</u>
ADDITIONAL PAID-IN CAPITAL:			
Balance at January 1	\$ 525,012	\$ 519,305	\$ 500,107
Exercise of stock options	8,899	5,707	19,198
Stock split effected as dividend	(353)	—	—
Balance at December 31	<u>\$ 533,558</u>	<u>\$ 525,012</u>	<u>\$ 519,305</u>
COMMON STOCK HELD IN TREASURY AT COST:			
Balance at January 1	\$ (33,175)	\$ (33,067)	\$ (26,295)
Cost of shares acquired	(23,618)	(17,626)	(52,738)
Shares issued under equity plans	37,926	17,518	45,966
Balance at December 31	<u>\$ (18,867)</u>	<u>\$ (33,175)</u>	<u>\$ (33,067)</u>
TOTAL STOCKHOLDERS' EQUITY AT DECEMBER 31	<u>\$2,596,114</u>	<u>\$2,018,450</u>	<u>\$2,096,090</u>
⁽¹⁾ Disclosure of reclassification amount:			
Unrealized holding gains (losses) arising during period	\$ 230,985	\$ (351,412)	\$ 34,526
Less: reclassification adjustment for net (losses) gains included in net income	(3,193)	(5,201)	10,637
Net unrealized gains (losses) on securities	<u>\$ 234,178</u>	<u>\$ (346,211)</u>	<u>\$ 23,889</u>

See accompanying Notes to Consolidated Financial Statements.

Consolidated Statements of Cash Flows

Ambac Financial Group, Inc. and Subsidiaries
(Dollars in thousands) Years Ended December 31,

	2000	1999	1998
CASH FLOWS FROM OPERATING ACTIVITIES:			
Net income	\$366,172	\$307,917	\$253,994
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation and amortization	3,614	2,969	2,460
Amortization of bond premium and discount	(12,972)	(4,444)	(4,942)
Current income taxes	797	17,882	(2,067)
Deferred income taxes	24,300	3,274	(2,034)
Deferred acquisition costs	(18,100)	(14,705)	(14,623)
Unearned premiums, net	90,587	118,805	98,796
Losses and loss adjustment expenses	10,379	8,819	13,030
Ceded reinsurance balances payable	(4,136)	8,452	(2,682)
Investment income due and accrued	(2,024)	(2,739)	(47,239)
Accrued interest payable	(567)	1,527	43,598
Net realized losses	8,421	8,002	10,854
Other, net	14,857	(1,359)	(21,349)
Net cash provided by operating activities	481,328	454,400	327,796
CASH FLOWS FROM INVESTING ACTIVITIES:			
Proceeds from sales of bonds	1,636,904	2,403,583	2,020,463
Proceeds from matured bonds	1,843,482	1,371,715	1,034,511
Purchases of bonds	(2,502,176)	(4,427,369)	(4,746,366)
Change in short-term investments	(32,623)	(101,368)	16,750
Securities purchased under agreements to resell	(152,786)	149,295	(166,829)
Loans	(9,763)	(11,558)	(170,738)
Other, net	(6,553)	(14,591)	(39,617)
Net cash provided by (used in) investing activities	776,485	(630,293)	(2,051,826)
CASH FLOWS FROM FINANCING ACTIVITIES:			
Dividends paid	(32,213)	(29,366)	(26,571)
Proceeds from issuance of investment agreements	1,637,935	3,051,508	3,628,266
Payments for investment agreement draws	(2,855,766)	(2,852,350)	(2,236,348)
Proceeds from issuance of debentures	—	—	193,700
Payment agreements	9,763	11,558	170,738
Purchases of treasury stock	(23,618)	(17,626)	(52,738)
Proceeds from sale of treasury stock	37,926	17,518	45,966
Net cash (used in) provided by financing activities	(1,225,973)	181,242	1,723,013
NET CASH FLOW	31,840	5,349	(1,017)
Cash and cash pledged as collateral at January 1	13,588	8,239	9,256
Cash and cash pledged as collateral at December 31	\$ 45,428	\$ 13,588	\$ 8,239
SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION:			
Cash paid during the year for:			
Income taxes	\$ 82,400	\$ 70,100	\$ 66,853
Interest expense on debt	\$ 34,304	\$ 36,743	\$ 33,056
Interest expense on investment agreements	\$286,589	\$298,309	\$252,713

See accompanying Notes to Consolidated Financial Statements.

Notes to Consolidated Financial Statements

(Dollar amounts in thousands, except share amounts)

1 BACKGROUND

Ambac Financial Group, Inc. (“AFGI”) is a holding company whose subsidiaries provide financial guarantees and financial services to clients in both the public and private sectors around the world. AFGI’s principal operating subsidiary, Ambac Assurance Corporation (“Ambac Assurance”), a leading provider of financial guarantees for municipal and structured finance obligations, has earned triple-A ratings, the highest ratings available from Moody’s Investors Service, Standard & Poor’s Ratings Services, Fitch, Inc., and Rating and Investment Information, Inc. AFGI’s Financial Services segment provides financial and investment products including investment agreements, interest rate swaps, funding conduits, investment advisory and cash management services, principally to its financial guarantee clients which include municipalities and their authorities, school districts, health care organizations and asset-backed issuers.

2 SIGNIFICANT ACCOUNTING POLICIES

The accompanying consolidated financial statements of AFGI and subsidiaries (the “Company”) have been prepared on the basis of accounting principles generally accepted in the United States of America (“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 inter-company balances have been eliminated.

Net Income Per Share: Basic net income per share is computed by dividing net income by the weighted-average number of common shares outstanding during the year. Diluted net income per share is computed similar to basic net income per share except that the weighted average shares outstanding are increased to include 2,383,957, 2,179,594 and 2,085,515 additional shares from the assumed conversion of dilutive stock options and restricted stock units at December 31, 2000, 1999 and 1998, respectively. The number of additional shares is calculated by assuming that outstanding stock options were exercised and that the proceeds from such exercises were used to acquire shares of common stock at the average market price during the year.

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 primarily 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 (Loss)” 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 and Securities Sold Under Agreements to Repurchase: Securities purchased under agreements to resell are collateralized investment 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. Securities sold under agreements to repurchase are collateralized financing transactions, and are recorded at their contracted resale amounts, plus accrued interest. The Company nets securities purchased under agreements to resell and securities sold under agreements to repurchase that are executed with the same counterparty under legally enforceable netting agreements that meet the applicable netting criteria. At December 31, 2000 and 1999, collateral underlying securities purchased under agreements to resell had an average credit rating of triple-A and a weighted average maturity of less than 30 days.

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 income over the contractual life of the loan using the interest method or the straight-line method if not materially different.

Notes to Consolidated Financial Statements

(Dollar amounts in thousands, except share amounts)

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 Services revenue.

Premium Revenue Recognition: Up-front premiums are earned pro-rata over the period of risk. Premiums are allocated to each bond maturity based on par amount and are earned on a straight-line basis over the term of each maturity. Installment premiums are earned over each installment period, generally one year or less. 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 Expense Reserve: The reserve for losses and loss adjustment expenses consists of the active credit reserve ("ACR") and case basis loss and loss adjustment 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 guaranteed issues that are not presently or imminently in default. When losses occur (actual monetary defaults or defaults which are imminent on guaranteed 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 2000, 1999 and 1998, paid losses, net of salvage received, were \$4,622, \$2,182, and (\$7,030), respectively. All or parts 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, 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 \$22,472, \$20,843 and \$18,248 for 2000, 1999 and 1998, respectively. Deferred acquisition costs, net of such amortization, amounted to \$18,100, \$14,705 and \$14,623 for 2000, 1999 and 1998, respectively.

Depreciation and Amortization: Depreciation of furniture and fixtures and electronic data processing equipment is charged 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 goodwill attributable to the acquisition of certain subsidiaries, is charged over the estimated useful lives of the respective assets, ranging from three to 15 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) for hedging purposes as part of its overall interest rate risk management.

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 (Loss)" 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). Effective January 1, 2001, the Company will change its accounting for derivative hedging. See "Accounting Standards" section of these Notes to Consolidated Financial Statements for details.

Derivative Contracts Held for Trading Purposes: The Company, through its subsidiary Ambac Financial Services, L.P. ("AFSLP"), provides interest rate swaps to states, municipalities and their authorities, and other entities in connection with their financings. The Company, through its subsidiary Ambac Credit Products LLC ("ACP"), enters into structured credit derivative transactions with various financial institutions. AFSLP's interest rate swaps and ACP's structured credit derivatives are classified as held for trading purposes. These contracts are

recorded on trade date at fair value. Changes in fair value are recorded as a component of Financial Services segment income for interest rate swaps and as a component of Financial Guarantee segment income for structured credit derivatives. The fair values of interest rate swaps and structured credit derivatives are determined by broker quotes or valuation models (when broker quotes are not available). Contracts 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. Gross asset and gross liability balances for interest rate swaps and structured credit derivatives are recorded as other assets or other liabilities on the Consolidated Balance Sheets.

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.

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 non-qualified 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.

Foreign Currency: Financial statement accounts expressed in foreign currencies are translated into U.S. dollars in accordance with FAS Statement 52 "Foreign Currency Translation" ("FAS 52"). Under FAS 52, functional currency assets and liabilities are translated into U.S. dollars using exchange rates in effect at the balance sheet dates and the related translation adjustments are recorded as a separate component of comprehensive income, net of any related taxes. Functional currencies are generally the currencies of the local operating environment. Income statement accounts expressed in functional currencies are translated using average exchange rates. Foreign currency gains and losses arising primarily from transactions in or translation of short-term investment securities and cash denominated in foreign currency are reflected in net income. The Consolidated Statements of Operations include pre-tax losses from such foreign exchange items of \$4,809, \$841 and \$129 for 2000, 1999 and 1998, respectively.

Securitization of Financial Assets: From time to time, the Company sells certain financial assets to a qualifying special-purpose entity ("QSPE"). The QSPE is a non-consolidated, bankruptcy-remote entity. It finances its purchases through issuance of beneficial interests in the form of medium-term notes that are collateralized by the purchased financial assets. Proceeds from sales to the QSPE were \$159,937, \$100,027 and \$0 for 2000, 1999 and 1998, respectively.

Under the terms of an administrative services agreement, the Company will provide the QSPE certain administrative and operational support duties, including servicing responsibilities. The Company received up-front fees for providing such services of \$180, \$60 and \$0, for 2000, 1999 and 1998, respectively. These fees are amortized over the life of the medium-term notes. The Company has not retained any interest in the transferred assets.

Accounting Standards: In June 1998, the Financial Accounting Standards Board issued FAS Statement 133, "Accounting for Derivative Instruments and Hedging Activities" ("FAS 133"). FAS 133, as amended by FAS 138 and related implementation guidance (collectively "the Standard"), establishes accounting and reporting standards for derivative instruments and hedging activities. The Company will adopt the Standard on January 1, 2001. The Standard requires the Company to record all of its derivative contracts on the balance sheet at fair value. The recognition of the change in the fair value of such derivative contracts depends on a number of factors, including the intended use of the derivative and the extent to which it is effective as part of a hedge transaction. Upon adoption the Company will record transition adjustment losses of \$0.9 million (net of related income tax) in Accumulated Other Comprehensive Income and \$0.4 million (net of related income tax) in net income. Further, the adoption of the Standard will result in the Company recognizing \$7.1 million of derivative instrument assets, \$2.6 million of derivative instrument liabilities, and increasing the carrying amounts of hedged liabilities by \$6.5 million.

Notes to Consolidated Financial Statements

(Dollar amounts in thousands, except share amounts)

The Company currently expects that its derivative contracts held for purposes other than trading (primarily interest rate swaps) will be effective as hedges. As such, it does not expect that the adoption of the Standard will increase the volatility of reported earnings.

Currently, both AFSLP and ACP provide derivative contracts classified as held for trading purposes and therefore present the changes in fair value of their derivative transactions as a component of the Company's operating income.

In September 2000, the Financial Accounting Standards Board issued FAS Statement 140, "Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities (a replacement of FAS 125)" ("FAS 140"). FAS 140 revises the standards for accounting for securitizations and other transfers of financial assets and collateral and requires certain disclosures. The statement requires the Company to reclassify certain financial assets pledged as collateral and to disclose certain information about its collateral activities. The Company has implemented FAS 140 as of December 31, 2000. There was no impact on the financial results of the Company other than the reclassification and/or disclosure about certain financial assets pledged or accepted as collateral.

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

3 STOCK SPLIT

On October 18, 2000, the Company's board of directors approved a three-for-two split of the Company's common stock in the form of a 50% common stock dividend, payable on December 12, 2000 to shareholders of record on November 27, 2000. This resulted in the issuance of 35,300,000 shares of common stock along with a corresponding decrease of \$353 in "Additional Paid-in Capital" in stockholders' equity. All references to the number of shares (other than common stock authorized at December 31, 2000 and 1999, and common stock issued at December 31, 1999), per share amounts, cash dividends and any other reference to shares in the consolidated financial statements and the related notes, have been adjusted to reflect the split on a retroactive basis. Previously awarded stock options and restricted stock units have been adjusted to reflect the split.

4 INVESTMENTS

The amortized cost and estimated fair value of investments in fixed income securities and short-term investments at December 31, 2000 and 1999 were as follows:

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
2000:				
Fixed income securities:				
Municipal obligations	\$3,295,256	\$140,781	\$21,073	\$3,414,964
Corporate obligations	1,027,211	15,840	62,305	980,746
Foreign government obligations	36,241	83	954	35,370
U.S. government obligations	69,349	3,362	1	72,709
Mortgage- and asset-backed securities (includes U.S. government agency obligations)	2,315,393	14,310	8,341	2,321,363
Short-term	253,519	—	—	253,519
	6,996,969	174,376	92,674	7,078,671
Fixed income securities pledged as collateral:				
Mortgage- and asset-backed securities (includes U.S. government agency obligations)	1,238,401	3,170	2,222	1,239,349
Total investments	\$8,235,370	\$177,546	\$94,896	\$8,318,020
1999:				
Fixed income securities:				
Municipal obligations	\$3,094,469	\$40,986	\$172,516	\$2,962,939
Corporate obligations	1,074,558	8,538	93,636	989,460
Foreign government obligations	19,544	85	585	19,044
U.S. government obligations	63,197	778	1,496	62,479
Mortgage- and asset-backed securities (includes U.S. government agency obligations)	2,767,275	1,014	44,505	2,723,784
Short-term	220,896	—	—	220,896
	7,239,939	51,401	312,738	6,978,602
Fixed income securities pledged as collateral:				
Mortgage- and asset-backed securities (includes U.S. government agency obligations)	2,009,141	—	28,376	1,980,765
Total investments	\$9,249,080	\$51,401	\$341,114	\$8,959,367

The amortized cost and estimated fair value of fixed income securities and short-term investments at December 31, 2000, by contractual maturity, were as follows:

	Amortized Cost	Estimated Fair Value
Due in one year or less	\$ 383,124	\$ 384,392
Due after one year through five years	388,782	399,150
Due after five years through ten years	381,101	394,283
Due after ten years	3,528,569	3,579,483
	4,681,576	4,757,308
Mortgage- and asset-backed securities	3,553,794	3,560,712
	\$8,235,370	\$8,318,020

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 \$5,793 and \$5,442 at December 31, 2000 and 1999, 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 segment was comprised of the following:

	2000	1999	1998
Fixed income securities	\$232,876	\$202,805	\$181,437
Short-term investments	9,904	7,790	8,139
Total investment income	242,780	210,595	189,576
Investment expense	(1,733)	(1,311)	(3,386)
Net investment income	\$241,047	\$209,284	\$186,190

The Financial Guarantee segment had gross realized gains of \$9,633, \$8,050 and \$14,219 in 2000, 1999 and 1998, respectively, and gross realized losses of \$8,952, \$13,725 and \$10,484 in 2000, 1999 and 1998, respectively.

Net investment income related to the investment agreement business comprises gross investment income from its investment portfolio less interest expense from investment agreement liabilities, and is a component of Financial Services net revenue. The following table summarizes net investment income for the investment agreement business:

	2000	1999	1998
Gross interest income	\$303,165	\$323,175	\$281,904
Gross interest expense	283,003	299,523	263,586
Net investment income	\$ 20,162	\$ 23,652	\$ 18,318

The Financial Services segment had gross realized gains of \$5,605, \$44,634 and \$22,592 in 2000, 1999 and 1998, respectively, and gross realized losses of \$14,715, \$47,758 and \$39,688 in 2000, 1999 and 1998, respectively. Gross realized gains and losses in 2000 and 1999 reflect actions taken to re-balance the investment agreement investment portfolio. This re-balancing caused the cash flows of invested assets to be more naturally matched to the cash flows of related liabilities, which allowed the Company to significantly reduce its derivative hedges. Gross realized gains and losses in 1998 include 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. The gains were \$2,967 and losses were \$18,638. Gross realized losses in 1998 also includes the Company's \$11,548 write-off of its investment in its electronic commerce business initiative.

As of December 31, 2000 and 1999, the Company held securities subject to agreements to resell for \$255,786 and \$103,000, respectively. The fair value of those securities at December 31, 2000 and 1999 amounted to \$274,682 and \$105,505, respectively, of which \$201,888 and \$63,271, respectively, was pledged to counterparties in connection with certain investment agreements (including agreements structured as investment repurchase agreements).

In conjunction with its investment agreement business, the Company routinely enters into security collateral swaps, whereby repurchase and reverse repurchase agreements are entered into simultaneously with the same counterparty. Under the terms of the security collateral swap agreements, both the Company and the counterparties have identical rights to pledge or rehypothecate the securities sold or purchased under the agreement. The fair value of securities sold by the Company under agreements to repurchase amounted to \$1,239,349 and \$1,980,765 at December 31, 2000 and 1999, respectively. Such amounts have been classified separately as "Fixed income securities pledged as collateral" on the Consolidated Balance Sheets. The fair value of securities simultaneously purchased by the Company under agreements to resell amounted to \$1,219,309 and \$1,708,261 at December 31, 2000 and 1999, respectively.

Securities that are purchased under agreements to resell under the security collateral swap arrangement are typically pledged in connection with certain investment agreements (including agreements structured as investment repurchase agreements). As of December 31, 2000 and 1999, the Company had repledged to certain municipalities securities purchased under agreements to resell with a fair value of \$1,074,714 and \$1,708,261, respectively. As of December 31, 2000 and 1999, the Company had pledged securities from its investment portfolio with a fair value of \$1,491,318 and \$1,865,606 to investment agreement counterparties. Securities pledged to investment agreement counterparties are typically maintained in a tri-party collateral account and cannot be pledged or rehypothecated by the counterparty.

The Company had entered into a security borrowing agreement, 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 agreement was terminated during 2000. As of December 31, 1999, the Company had \$717,000 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.

At December 31, 2000, the Company also had pledged cash to brokers with regard to its interest rate swap and structured credit derivatives businesses in the amount of \$24,935. Such amount has been classified separately as "Cash pledged as collateral" on the Consolidated Balance Sheets.

Notes to Consolidated Financial Statements

(Dollar amounts in thousands, except share amounts)

5 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 there-

on. 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, 2000 and 1999 the interest rates on these loans ranged from 6.25% to 8.42%.

6 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,	2000		1999		1998	
	Written	Earned	Written	Earned	Written	Earned
Direct	\$440,111	\$334,908	\$420,669	\$289,053	\$333,652	\$238,452
Assumed	42,971	32,530	24,573	19,161	27,359	7,367
Ceded	(80,789)	(56,162)	(61,845)	(43,788)	(49,563)	(33,135)
Net premiums	\$402,293	\$311,276	\$383,397	\$264,426	\$311,448	\$212,684

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. As of December 31, 2000, Ambac Assurance held letters of credit and collateral amounting to approximately \$249,166 from its reinsurers to cover liabilities ceded under the aforementioned reinsurance contracts. There were no reinsurance recoverables on paid losses as of December 31, 2000 and 1999. As of December 31, 2000, prepaid reinsurance of approximately \$171,341 was associated with Ambac Assurance's three largest reinsurers. The Company pledged cash and fixed income securities to foreign insurers of \$9,386 and \$9,450 at December 31, 2000 and 1999, respectively, related to business assumed from those insurers.

From 1995 to March 2000, Ambac Assurance and MBIA Insurance Corporation ("MBIA") marketed financial guarantees outside of the United States via an unincorporated joint venture, MBIA•AMBAC International (the "Joint Venture"). Under the Joint Venture, financial guarantee policies were issued separately by each of the companies. While retaining the right to act individually, each company had the opportunity to reinsure up to 50% of the international financial guarantee business written by the other company as part of the

Joint Venture. In 2000, Ambac Assurance and MBIA restructured their Joint Venture arrangement. While Ambac Assurance and MBIA continued having reciprocal reinsurance arrangements for international business in 2000, the companies marketed and originated financial guarantees independently. Premiums assumed from MBIA under this arrangement were \$37,384, \$24,503 and \$18,715 in 2000, 1999 and 1998, respectively, and premiums ceded to MBIA under this arrangement were \$36,807, \$27,418 and \$15,505 in 2000, 1999 and 1998, respectively.

7 STOCKHOLDERS' EQUITY

The Company is authorized to issue 200,000,000 shares of Common Stock, par value \$0.01 per share, of which 106,020,537 were issued as of December 31, 2000. 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, 2000.

Dividends declared per share amounted to \$0.31, \$0.28 and \$0.25 in 2000, 1999 and 1998, 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 9,000,000 shares of the Company's Common Stock. As of December 31, 2000, approximately 7,491,000 shares had been repurchased under this program for an aggregate amount of \$183,950.

Stockholder Rights Plan: The Company adopted a Stockholder Rights Plan under which stockholders received (after giving effect to two stock splits 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.

8 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
2001	\$ 6,363
2002	6,305
2003	6,316
2004	6,329
2005	5,836
All later years	81,793
	<u>\$112,942</u>

Rent expense for the aforementioned leases amounted to \$5,578, \$5,347 and \$5,537 for the years ended December 31, 2000, 1999 and 1998, respectively. Total future rental receipts under sublease agreements are estimated at \$2,290.

9 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. Based upon these restrictions, at December 31, 2000, the maximum amount that will be available during 2001 for payment of dividends by Ambac Assurance is approximately \$165,000. Ambac Assurance paid cash dividends of \$59,800, \$52,000 and \$48,000 on its common stock in 2000, 1999 and 1998, respectively.

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. Such limits are specific to the type of insured obligation (for example, municipal or asset-backed). The limits compare the insured net par outstanding or average annual debt service, as applicable, net of reinsurance and collateral, for a single risk to the insurer's qualified statutory capital, which is defined as the sum of the insurer's policyholder's surplus and contingency reserves. As of December 31, 2000 and 1999, Ambac Assurance and its subsidiaries were in compliance with these regulatory requirements.

Statutory capital and surplus was \$1,655,151 and \$1,503,303 at December 31, 2000 and 1999, respectively. Qualified statutory capital was \$2,735,899 and \$2,420,455 at December 31, 2000 and 1999, respectively. Statutory net income for Ambac Assurance was \$381,328, \$262,756 and \$271,808 for 2000, 1999 and 1998, 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.

Notes to Consolidated Financial Statements

(Dollar amounts in thousands, except share amounts)

Effective January 1, 2001 the National Association of Insurance Commissioners' ("NAIC") codified statutory accounting principles ("SAP") and stated that such codified accounting principles shall be adopted by all U.S. insurance companies. The purpose of such codification is to provide a comprehensive basis of accounting and reporting to insurance departments. Although codification is expected to be the foundation of a states statutory accounting practice, it may be subject to modification by practices presented or permitted by a state's insurance commissioner. Therefore, statutory financial statements will continue to be prepared on the basis of accounting practices prescribed or permitted by the insurance department of the state of domicile. Ambac Assurance has determined that the adoption of the codification does not have a material effect on its statutory capital.

10 INCOME TAXES

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

	2000	1999	1998
Current taxes	\$ 91,779	\$89,543	\$72,608
Deferred taxes	24,173	7,198	2,310
	\$115,952	\$96,741	\$74,918

The total effect of income taxes on income and stockholders' equity for the years ended December 31, 2000 and 1999 was as follows:

	2000	1999
Total income taxes charged to income	\$115,952	\$ 96,741
Income taxes charged (credited) to stockholders' equity:		
Unrealized gains (losses) on investment securities	139,112	(206,433)
Exercise of stock options	(8,899)	(5,707)
Total charged (credited) to stockholders' equity	130,213	(212,140)
Total effect of income taxes	\$246,165	\$(115,399)

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:

	2000	%	1999	%	1998	%
Tax computed at statutory rate	\$168,743	35.0%	\$141,630	35.0%	\$115,119	35.0%
Reductions in expected tax resulting from:						
Tax-exempt interest	(50,479)	(10.5)	(43,241)	(10.7)	(38,926)	(11.8)
Other, net	(2,312)	(0.4)	(1,648)	(0.4)	(1,275)	(0.4)
Income tax expense	\$115,952	24.1%	\$ 96,741	23.9%	\$ 74,918	22.8%

The tax effects of temporary differences that give rise to significant portions of the deferred tax liabilities and deferred tax assets at December 31, 2000 and 1999 are presented below:

	2000	1999
Deferred tax liabilities:		
Contingency reserve	\$ 163,957	\$153,613
Unrealized gains on bonds	20,608	—
Deferred acquisition costs	53,133	47,287
Unearned premiums	51,562	43,319
Investments	6,419	5,284
Other	3,660	2,347
Total deferred tax liabilities	299,339	251,850
Deferred tax assets:		
Tax and loss bonds	128,371	120,971
Unrealized loss on bonds	—	118,503
Loss reserves	35,281	33,339
Compensation	17,499	16,444
Alternative minimum tax carryforward	7,595	13,625
Amortization and depreciation	1,030	1,256
Other	3,528	5,089
Sub-total deferred tax assets	193,304	309,227
Valuation allowance	—	—
Total deferred tax assets	193,304	309,227
Net deferred tax assets (liabilities)	\$(106,035)	\$ 57,377

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

11 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 highest salary during five consecutive years of employment within the last ten 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, 2000 and 1999.

	2000	1999
Change in projected benefit obligation:		
Projected benefit obligation at beginning of year	\$11,201	\$12,433
Service cost	892	979
Interest cost	829	783
Actuarial loss (gain)	20	(2,702)
Benefits paid	(273)	(292)
Projected benefit obligation at end of year	\$12,669	\$11,201
Change in plan assets:		
Fair value of plan assets at beginning of year	\$12,841	\$10,934
Actual return on plan assets	(611)	1,679
Company contributions	—	520
Benefits paid	(273)	(292)
Fair value of plan assets at end of year	\$11,957	\$12,841
Funded status	\$ (712)	\$1,640
Unrecognized net gain	(916)	(2,615)
Unrecognized prior service cost	(781)	(931)
Unrecognized net transition asset	—	(1)
Pension liability included in other liabilities	\$ (2,409)	\$ (1,907)

Net pension costs for 2000, 1999 and 1998 included the following components:

	2000	1999	1998
Service cost	\$892	\$979	\$807
Interest cost on expected benefit obligation	829	783	684
Expected return on plan assets	(1,056)	(893)	(793)
Amortization of unrecognized transition asset	—	(3)	(3)
Amortization of prior service cost	(151)	(151)	(165)
Recognized net actuarial (gain) loss	(12)	39	15
Net periodic pension cost	\$502	\$754	\$545

The discount rate used in the determination of the actuarial present value for the projected benefit obligation was 7.50% for both 2000 and 1999. The expected long-term rate of return on assets was 9.25% for both 2000 and 1999. The rate of increase in future compensation levels used in determining the actuarial present value of the projected benefit obligation was 5.0% for both 2000 and 1999.

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 eligible base salary, plus a matching company contribution of 50% on contributions up to 6% of base salary made by eligible employees to the Savings Incentive Plan. The total cost of the Savings Incentive Plan was \$2,471, \$2,165 and \$2,063 in 2000, 1999 and 1998, 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 for the years ended December 31, 2000, 1999 and 1998 amounted to \$22,725, \$18,091 and \$16,095, respectively.

Postretirement Health Care and Other Benefits: The Company 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 \$358, \$497 and \$316 in 2000, 1999 and 1998, respectively. The unfunded accumulated postretirement benefit obligation was \$2,473 and the related accrued postretirement liability was \$2,551 as of December 31, 2000.

The assumed health care cost trend rates range from 7.4% in 2000, 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, 2000 by \$563 and the 2000 benefit expense by \$118. The weighted average discount rate used to measure the accumulated postretirement benefit obligation and 2000 expense was 7.5%.

12 GUARANTEES IN FORCE

The par amount of bonds guaranteed, net of reinsurance, was \$276,252,000 and \$240,307,000 at December 31, 2000 and 1999, respectively. As of December 31, 2000 and 1999, the guarantee portfolio was diversified by type of insured bond as shown in the following table:

	Net Par Amount Outstanding	
(Dollars in millions)	2000	1999
Municipal finance:		
Lease and tax-backed revenue	\$ 46,292	\$ 40,874
General obligation	39,432	39,777
Utility revenue	28,504	28,867
Health care revenue	17,837	18,628
Investor-owned utilities	10,560	9,393
Transportation revenue	10,496	10,247
Higher education	9,603	9,172
Housing revenue	7,146	7,033
Student loans	6,375	5,474
Other	4,065	3,550
Total municipal finance	180,310	173,015
Structured finance:		
Mortgage-backed and home equity	38,215	33,294
Asset-backed and conduits	22,121	16,398
Other	4,324	3,270
Total structured finance	64,660	52,962
International finance:		
Structured credit derivatives	15,313	2,110
Asset-backed and conduits	8,595	6,023
Utilities	1,803	1,188
Mortgage-backed and home equity	1,364	1,172
Sovereign/sub-sovereign	1,123	1,097
Other	3,084	2,740
Total international finance	31,282	14,330
	\$276,252	\$240,307

Notes to Consolidated Financial Statements

(Dollar amounts in thousands, except share amounts)

As of December 31, 2000 and 1999, the international guaranteed portfolio is shown in the following table by location of risk:

<i>(Dollars in millions)</i>	Net Par Amount Outstanding	
	2000	1999
United Kingdom	\$ 3,103	\$ 2,416
Australia	1,382	722
Japan	1,167	1,485
France	765	738
Mexico	608	569
Internationally diversified	20,962	5,686
Other international	3,295	2,714
Total international	\$31,282	\$14,330

Internationally diversified includes structured credit derivatives and other guarantees with multiple locations of risk and includes components of domestic exposure.

Direct financial guarantees in force (principal and interest) was \$480,631,000 and \$430,536,000 at December 31, 2000 and 1999, respectively. Net financial guarantees in force (after giving effect to reinsurance) was \$418,386,000 and \$374,484,000 as of December 31, 2000 and 1999, respectively.

In the United States, California was the state with the highest aggregate net par amount in force, accounting for 9.1% of the total at December 31, 2000, and no other state accounted for more than six percent. The highest single insured risk represented less than 1% of aggregate net par amount insured.

13 FINANCIAL INSTRUMENTS HELD FOR PURPOSES OTHER THAN TRADING

Derivative Financial Instruments: In the normal course of business, the Company becomes a party to interest rate swaps to reduce its exposure to fluctuations in interest rates. The total notional amount of such swaps at December 31, 2000 and 1999 was \$45,841 and \$46,492, respectively.

Notional 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 swaps held for purposes other than trading are used to manage interest rate risk by synthetically changing the nature of specific assets or liabilities.

Interest rate swaps that require the Company to pay a fixed rate are used primarily to hedge floating rate liabilities. At December 31, 2000, the Company has one pay fixed swap recorded with a notional of \$33,570, maturing in 2001, pay-

ing a fixed rate of 7.51% and receiving a variable rate of 7.23%. Interest rate swaps that require the Company to receive a fixed rate are used primarily to hedge fixed rate liabilities. At December 31, 2000, the Company has one receive fixed swap recorded with a notional of \$12,271, final maturity in 2015, receiving a fixed rate of 6.46% and paying a variable rate of 6.82%. The floating rate side of the Company's interest rate swaps is based on LIBOR.

Fair Values of Financial Instruments Held for Purposes Other Than Trading:

The following fair value amounts were 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 primarily 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 approximate 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, represented securities borrowed from various counterparties secured by Company-owned securities, were assumed to approximate carrying value.

Debentures: The fair value of the debentures is based on quoted market prices.

Obligations under investment, repurchase and payment agreements: The fair value of the liability for investment agreements and repurchase agreements (including accrued interest) is estimated based upon internal valuation models. The fair value of payment agreements is assumed to approximate carrying value.

Derivative contracts: Fair values of derivative contracts (futures and swaps) 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,	2000		1999	
<i>(Dollars in millions)</i>	Carrying Amount	Estimated Fair Value	Carrying Amount	Estimated Fair Value
Financial assets:				
Fixed income securities	\$6,825	\$6,825	\$6,757	\$6,757
Fixed income securities pledged as collateral	1,239	1,239	1,981	1,981
Short-term investments	254	254	221	221
Other investments	6	6	3	3
Cash	20	20	14	14
Cash pledged as collateral	25	25	—	—
Securities purchased under agreements to resell	256	256	103	103
Loans	695	695	685	685
Receivable from brokers and dealers	—	—	717	717
Financial liabilities:				
Debentures	424	432	424	403
Obligations under investment, repurchase and payment agreements (including accrued interest)	4,984	4,986	6,231	6,037
Payable to brokers and dealers	—	—	717	717
Derivative financial instruments:				
Interest rate swaps	(0)	(0)	(1)	(2)
Liability for financial guarantees written:				
Gross	1,546	1,082	1,431	1,002
Net of reinsurance	1,304	913	1,213	849
Gross installment premiums	—	653	—	454
Net installment premiums	—	535	—	369

14 FINANCIAL INSTRUMENTS CLASSIFIED AS 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. If actual or projected tax-exempt interest rates change in relation to taxable interest rates, the Company will experience a mark-to-market gain or loss. The AFSLP swap portfolio is classified as held for trading purposes.

ACP enters into structured credit derivative transactions. These structured credit derivatives require ACP to make payments upon the occurrence of certain defined credit events relating to an underlying obligation (generally a fixed income obligation). If credit spreads of the underlying obligations

change, the market value of the related structured credit derivative could change. As such, ACP could experience a mark-to-market gain or loss. Market liquidity could also impact valuations. Changes in credit spreads are generally caused by changes in the market's perception of the credit quality of the underlying obligations. The majority of ACP's contracts are partially hedged with various financial institutions or structured with first loss protection provided by the counterparty. Such structuring mitigates ACP's risk of loss and reduces the price volatility of these financial instruments. The ACP credit derivative portfolio is classified as held for trading purposes.

Notes to Consolidated Financial Statements

(Dollar amounts in thousands, except share amounts)

The following table summarizes information about the Company's financial instruments classified as held for trading purposes as of December 31, 2000 and 1999:

	Net Estimated Fair Value		Average Net Fair Value		Notional Amount
	Assets	Liabilities	Assets	Liabilities	
2000:					
Derivative financial instruments:					
Interest rate swaps	\$169,041	\$126,160	\$142,560	\$99,640	\$8,879,416
Structured credit derivatives	23,980	29,980	28,893	30,967	27,152,517
Futures contracts	—	—	—	—	461,500
1999:					
Derivative financial instruments:					
Interest rate swaps	\$177,192	\$129,773	\$134,991	\$96,526	\$6,260,740
Structured credit derivatives	27,704	27,438	13,572	13,069	6,315,954
Futures contracts	—	—	—	—	751,700

Financial instruments classified as held for trading purposes are carried at estimated fair value. The aggregate amount of revenue recognized from derivative financial instruments classified as held for trading purposes was \$36,706, \$20,301 and \$705 for 2000, 1999 and 1998, 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.

15 LONG-TERM DEBT AND LINES OF CREDIT

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

As of December 31,	2000	1999
9% Debentures, due 2011	\$149,524	\$149,480
7% Debentures, due 2023	74,537	74,515
7.08% Debentures, due 2098	200,000	200,000
	\$424,061	\$423,995

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%, 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%, 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.

The Company and Ambac Assurance have a revolving credit facility with three major international banks for \$150,000, which expires in August 2001 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, 2000 and 1999, no amounts were outstanding under this credit facility.

Ambac Assurance maintains third party capital support in the form of seven-year irrevocable limited recourse credit facilities from a group of highly rated banks. These credit facilities provide liquidity to Ambac Assurance in the event claims from municipal and certain structured obligations in its covered portfolio exceed specified levels. Repayments of amounts drawn under the credit facilities are limited primarily to the amount of any recoveries of losses related to policy obligations in the covered portfolios. During 2000, such third party capital support was increased from \$750,000 to \$800,000, and its expiration reset to December 2007. As of December 31, 2000 and 1999, no amounts were outstanding under these credit facilities.

ACP has a revolving credit facility with one major international bank for \$50,000, which expires in June 2001, and provides for three-year term loans. The facility is available to ACP for general corporate purposes, including the settlement of transactions related to credit derivative instruments. As of December 31, 2000 and 1999, no amounts were outstanding under this credit facility.

16 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, 2000 and 1999, the interest rates on these agreements ranged from 4.00% to 8.14%. As of December 31, 2000 and 1999, the average yield on these agreements was 5.76% and 5.51%, respectively. Obligations under investment agreements and investment repurchase agreements as of December 31, 2000 and 1999 were as follows:

As of December 31,	2000	1999
Settled	\$4,191,017	\$5,408,848
Unsettled	6,663	45,918
	\$4,197,680	\$5,454,766

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
2001	\$1,977,961
2002	818,230
2003	188,266
2004	112,358
2005	34,313
All later years	1,059,889
	\$4,191,017

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, 2000 and 1999, 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
2001	\$ (175)
2002	7,525
2003	15,702
2004	23,568
2005	17,200
All later years	631,431
	\$695,251

17 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, 2000, approximately 6,600,000 shares were available for future grant under the Equity Plan and the Directors Plan. A summary of option activity is as follows:

	2000		1999		1998	
	Shares	Weighted Average Exercise Price	Shares	Weighted Average Exercise Price	Shares	Weighted Average Exercise Price
Outstanding at beginning of year	5,490,716	\$24.99	5,084,046	\$20.89	5,876,540	\$14.77
Granted	1,796,052	\$32.57	1,319,723	\$36.61	1,454,547	\$31.77
Exercised	(1,327,754)	\$20.87	(791,949)	\$16.73	(1,999,094)	\$10.52
Forfeited	(264,303)	\$33.35	(121,104)	\$31.85	(247,947)	\$22.97
Outstanding at end of year	<u>5,694,711</u>	<u>\$27.86</u>	<u>5,490,716</u>	<u>\$24.99</u>	<u>5,084,046</u>	<u>\$20.89</u>
Exercisable	<u>3,051,448</u>		<u>3,190,365</u>		<u>2,729,808</u>	

	Options Outstanding			Options Exercisable		
Range of Exercise Price	Number Outstanding at December 31, 2000	Weighted Average Remaining Contract Life	Weighted Average Exercise Price	Number Exercisable at December 31, 2000	Weighted Average Exercise Price	
\$ 6 to 16	1,247,256	3.0	\$14.57	1,247,256	\$14.57	
\$17 to 31	3,025,208	4.8	\$28.94	1,268,925	\$26.20	
\$32 to 54	1,422,247	4.8	\$37.22	535,267	\$36.73	
	<u>5,694,711</u>			<u>3,051,448</u>		

Notes to Consolidated Financial Statements

(Dollar amounts in thousands, except share amounts)

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, 2000, 1999 and 1998, would have been reduced to the pro-forma amounts indicated below:

	2000	1999	1998
Net Income:			
As reported	\$366,172	\$307,917	\$253,994
Pro-forma	\$357,581	\$300,410	\$248,089
Earnings per share:			
As reported	\$3.49	\$2.94	\$2.42
Pro-forma	\$3.40	\$2.87	\$2.36
Earnings per diluted share:			
As reported	\$3.41	\$2.88	\$2.37
Pro-forma	\$3.33	\$2.81	\$2.32

The weighted-average fair value (determined as of the date of the grants) of options granted in 2000, 1999 and 1998 was \$11.78 per share, \$11.25 per share, and \$8.73 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 2000, 1999 and 1998, respectively: (i) dividend yield of 0.92%, 0.74% and 0.85%; (ii) expected volatility of 30.3%, 26.3% and 20.5%; (iii) risk-free interest rates of 6.5%, 4.8% and 5.5%; and (iv) expected lives of approximately five 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.

18 SEGMENT INFORMATION

The Company has two reportable segments, as follows: (1) financial guarantee, which provides financial guarantees (including structured credit derivatives) for municipal and structured finance obligations; and (2) financial services, which provides investment agreements, interest rate swaps, funding conduits, 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. Amounts relating to the electronic commerce business, including the \$11,548 write-off of the investment in this initiative, are included in the Financial Services segment below for the year 1998. Total losses before income taxes for the electronic commerce business was \$6,946 for the year ended December 31, 1998.

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 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 services subsidiaries. Intersegment revenues include the premiums earned under those agreements. Such premiums are determined as if they were premiums to third parties, that is, at current market prices.

Information provided on the following page for "Corporate and Other" relates to Ambac Financial Group, Inc. corporate activities. Corporate and other revenue from unaffiliated customers consists primarily of interest income and realized gains or losses from investment securities.

The following table is a summary of the financial information by reportable segment as of and for the years ended December 31, 2000, 1999 and 1998:

	Financial Guarantee	Financial Services	Corporate and Other	Intersegment Eliminations	Total Consolidated
2000:					
Revenues:					
Unaffiliated customers	\$ 565,421	\$ 53,565	\$ 2,324	\$ —	\$ 621,310
Intersegment	3,827	(3,259)	63,844	(64,412)	—
Total revenues	\$ 569,248	\$ 50,306	\$ 66,168	\$(64,412)	\$ 621,310
Income before income taxes:					
Unaffiliated customers	\$ 495,186	\$28,760	\$ (41,822)	\$ —	\$ 482,124
Intersegment	3,827	(3,201)	63,844	(64,470)	—
Total income before income taxes	\$ 499,013	\$ 25,559	\$ 22,022	\$(64,470)	\$ 482,124
Identifiable assets	\$4,870,155	\$5,193,747	\$ 56,398	\$ —	\$10,120,300
1999:					
Revenues:					
Unaffiliated customers	\$ 474,089	\$ 48,483	\$ 10,703	\$ —	\$ 533,275
Intersegment	3,033	(3,574)	52,661	(52,120)	—
Total revenues	\$ 477,122	\$ 44,909	\$ 63,364	\$(52,120)	\$ 533,275
Income before income taxes:					
Unaffiliated customers	\$ 414,285	\$ 22,701	\$ (32,328)	\$ —	\$ 404,658
Intersegment	3,850	(3,595)	52,661	(52,916)	—
Total income before income taxes	\$ 418,135	\$ 19,106	\$ 20,333	\$(52,916)	\$ 404,658
Identifiable assets	\$4,184,010	\$7,104,825	\$ 56,261	\$ —	\$11,345,096
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

The following table summarizes gross premiums written and net premiums earned included in the financial guarantee segment, by location of risk for the years ended December 31, 2000, 1999 and 1998.

	2000	1999	1998
Gross premiums written:			
United States	\$373,269	\$373,523	\$297,565
United Kingdom	19,325	17,587	30,337
Japan	7,655	6,106	3,970
France	970	2,546	1,318
Australia	27,647	739	16,166
Mexico	16,232	11,115	413
Internationally diversified	14,754	11,971	4,436
Other international	23,230	21,655	6,806
Total:	\$483,082	\$445,242	\$361,011
Net premiums earned:			
United States	\$263,746	\$234,679	\$198,904
United Kingdom	7,068	3,054	1,754
Japan	6,252	5,513	1,941
France	1,133	1,132	1,745
Australia	3,058	1,373	686
Mexico	7,461	4,365	413
Internationally diversified	13,680	8,154	3,654
Other international	8,878	6,156	3,587
Total:	\$311,276	\$264,426	\$212,684

Internationally diversified includes guarantees with multiple locations of risk and includes components of domestic exposure.

Notes to Consolidated Financial Statements

(Dollar amounts in thousands, except share amounts)

19 QUARTERLY FINANCIAL INFORMATION (unaudited)

	First	Second	Third	Fourth	Full Year
2000:					
Gross premiums written	\$69,338	\$121,669	\$147,949	\$144,126	\$483,082
Net premiums written	53,211	95,422	127,872	125,788	402,293
Net premiums earned	71,158	80,921	78,695	80,502	311,276
Net investment income	57,631	58,902	61,090	63,424	241,047
Financial services revenue	14,442	21,127	10,856	16,250	62,675
Losses and loss adjustment expenses	3,249	3,600	3,908	4,243	15,000
Financial guarantee underwriting and operating expenses	13,478	13,876	13,208	14,673	55,235
Financial services expenses	6,479	6,276	5,808	6,242	24,805
Income before income taxes	112,094	122,170	119,340	128,520	482,124
Net income	85,638	92,640	90,908	96,986	366,172
Net income per share:					
Basic	0.82	0.88	0.86	0.92	3.49
Diluted	\$0.80	\$0.87	\$0.84	\$0.89	\$3.41
1999:					
Gross premiums written	\$90,154	\$98,708	\$106,841	\$149,539	\$445,242
Net premiums written	85,068	82,250	94,945	121,134	383,397
Net premiums earned	60,297	63,944	68,325	71,860	264,426
Net investment income	49,484	51,296	52,946	55,558	209,284
Financial services revenue	12,712	13,138	12,097	13,660	51,607
Losses and loss adjustment expenses	2,500	2,500	3,000	3,000	11,000
Financial guarantee underwriting and operating expenses	11,917	11,872	11,976	13,039	48,804
Financial services expenses	6,977	6,779	6,174	5,852	25,782
Income before income taxes	95,951	91,985	105,383	111,339	404,658
Net income	73,194	70,969	79,802	83,952	307,917
Net income per share:					
Basic	0.70	0.68	0.76	0.80	2.94
Diluted	\$0.68	\$0.66	\$0.75	\$0.78	\$2.88

Directors and Officers

BOARD OF DIRECTORS

PHILLIP B. LASSITER
Chairman and
Chief Executive Officer
Ambac Financial Group, Inc.

MICHAEL A. CALLEN * † ‡
President
Avalon Argus Associates
(Financial Consulting)

RENZO L. CAPORALI * †
Retired Chairman & CEO
Grumman Corporation
(Defense and Aerospace)

JILL M. CONSIDINE * †
Chairman and
Chief Executive Officer
The Depository Trust &
Clearing Corporation
(Financial Services Industry)

RICHARD DULUDE * † ‡
Retired Vice Chairman
Corning Incorporated
(Diversified Manufacturing)

ROBERT J. GENADER
President and
Chief Operating Officer
Ambac Financial Group, Inc.

W. GRANT GREGORY * † ‡
Chairman
Gregory & Hoenemeyer, Inc.
(Merchant Banking)

C. RODERICK O'NEIL * † ‡
Chairman
O'Neil Associates
(Investment and Financial
Consulting)

* Member Audit Committee

† Member Compensation and
Organization Committee

‡ Member Nominating Committee

EXECUTIVE OFFICERS

PHILLIP B. LASSITER
Chairman and
Chief Executive Officer

ROBERT J. GENADER
President and
Chief Operating Officer

FRANK J. BIVONA
Vice Chairman and
Chief Financial Officer
Finance and
Investment Group

DAVID L. BOYLE
Vice Chairman
Portfolio Risk
Management Group

GREGG L. BIENSTOCK
Managing Director,
Human Resources and
Employment Counsel

KEVIN J. DOYLE
Managing Director and
General Counsel

SENIOR OFFICERS

Financial Insurance

CONSUMER
ASSET-BACKED SECURITIES

IAIN H. BRUCE
Managing Director

THOMAS J. ADAMS
Managing Director

PUBLIC FINANCE
HOWARD C. PFEFFER
Senior Managing Director

PUBLIC FINANCE - EAST REGION
ROBERT G. SHOBACK
Managing Director

PUBLIC FINANCE - WEST REGION
KATHLEEN A. McDONOUGH
Managing Director

MARK A. SPINELLI
Managing Director

HEALTH CARE
RUBEN SELLES
Managing Director

UTILITIES
TIMOTHY S. TRAVERS
Managing Director

EUROPE
JOHN W. UHLEIN III
Managing Director
DAVID W. WALLIS
Managing Director

ASSET-BACKED SECURITIES AND
CONDUITS
JAPAN, AUSTRALIA AND
EMERGING MARKETS
DOUGLAS C. RENFIELD-MILLER
Managing Director
JOHN H. BRYAN III
Managing Director

NICHOLAS G. GOUMAS
Managing Director

ANDREA R. MERENYI
Managing Director

STRUCTURED FINANCE
AND CREDIT DERIVATIVES

MICHAEL J. SCHOZER
Managing Director

SCOTT D. GORDON
Managing Director

DAVID B. NEMSCHOFF
Managing Director

CREDIT RISK MANAGEMENT
WILLIAM T. McKINNON
Managing Director

ALESSANDRA V. D'IMPERIO
Managing Director

LEGAL
JEFFREY R. FRIED
Managing Director

Financial and Investment Services

MANAGEMENT SERVICES
STEVEN L. DYMANT
Managing Director

PORTFOLIO MANAGEMENT
EULOGIO (JOE) RAMOS
Managing Director
RODNEY D. KUMASAKI
Managing Director

CADRE FINANCIALSERVICES, INC.
WILLIAM T. SULLIVAN, JR.
Chairman
KEVIN J. BURKE
Chief Executive Officer

Portfolio Risk Management

PETER J. CAIN
Managing Director

DAVID A. MacDOUGALL
Managing Director

STEVEN C. RENN
Managing Director

ROBERT D. SELVAGGIO
Managing Director

Corporate

MAISIE CHANG
Rating Agencies/Reinsurance

THOMAS J. GANDOLFO
Managing Director and
Financial Controller

ANNE G. GILL
Corporate Secretary

BRIAN S. MOORE
Managing Director
Investor Relations

NARAYAN NAIR
Managing Director
Internal Audit

SUSAN OEHRIG
Corporate Marketing

KENNETH S. PLOTZKER
Managing Director and
Chief Information Officer

ROBERT W. STARR
Managing Director and Treasurer

Stockholder Information

Corporate Profile: Ambac Financial Group, Inc., headquartered in New York City, is a holding company whose affiliates provide financial guarantees and financial services to clients in both the public and private sectors around the world. Ambac's principal operating subsidiary, Ambac Assurance Corporation, is a leading guarantor of municipal and structured finance obligations. It has earned triple-A ratings, the highest ratings available, from Moody's Investors Service, Standard & Poor's Ratings Services, Fitch, Inc. and Rating and Investment Information, Inc.

CORPORATE HEADQUARTERS:
AMBAC FINANCIAL GROUP, INC.
 One State Street Plaza
 New York, New York 10004
 Tel: 212-668-0340
 Fax: 212-509-9190

OTHER LOCATIONS:
LONDON
 Hasilwood House
 60 Bishopsgate
 London EC2N 4BE, England
 Tel: 44 207 786 4300
 Fax: 44 207 786 4343

TOKYO
 Otemachi Financial Center 17th Floor
 5-4, Otemachi 1-chome,
 Chiyoda-ku, Tokyo 100-0004
 Japan
 Tel: 03 5219 2127
 Fax: 03 5219 2129
 Representative Director:
 Hideshi Amemiya

CADRE FINANCIAL SERVICES, INC.
CADRE SECURITIES, INC.
 905 Marconi Avenue
 Ronkonkoma, New York 11779
 Tel: 631-467-0200
 Fax: 631-580-8806

ANNUAL MEETING OF STOCKHOLDERS
 The Annual Meeting of Stockholders of Ambac Financial Group, Inc. will be held on Tuesday, May 1, 2001, 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 14, 2001. The Company estimates that it has approximately 40,000 stockholders.

FORM 10-K
 A copy of the Company's 2000 Annual Report on Form 10-K for the year ended December 31, 2000, 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
 Vice Chairman 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 2000 and 1999, as adjusted for the three-for-two common stock split, which occurred in December 2000.

Three Months Ended	2000 Market Price				1999 Market Price			
	High	Low	Close	Dividends Per Share	High	Low	Close	Dividends Per Share
March 31	35.75	25.92	33.58	\$0.0733	41.42	35.17	36.00	\$0.0667
June 30	39.00	29.75	36.57	\$0.0733	41.13	33.33	38.08	\$0.0667
September 30	50.04	36.38	48.83	\$0.0800	39.58	30.54	31.58	\$0.0733
December 31	58.31	47.00	58.31	\$0.0800	42.00	29.79	34.79	\$0.0733



Ambac Financial Group, Inc.
One State Street Plaza
New York, New York 10004
www.ambac.com

