Assured Guaranty Ltd. (AGO)
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Q2 2013 Earnings Call

Robert Tucker
Managing Director, Corporate Communications and Investor Relations

Thank you operator.

Good morning and thank you for joining Assured Guaranty for our second quarter 2013 financial results conference call.

Today's presentation is made pursuant to the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. It may contain forward-looking statements about our new business and credit outlooks, market conditions, credit spreads, financial ratings, loss reserves, financial results, future reps and warranty settlement agreements or other items that may affect our future results.

These statements are subject to change due to new information or future events, therefore you should not place undue reliance on them, as we do not undertake any obligation to publicly update or revise them, except as required by law.

If you are listening to the replay of this call, or if you are reading the transcript of the call, please note that our statements made today may have been updated since this call.

Please refer to the Investor Information section of our website for our recent presentations, SEC filings, most current financial filings, and for the risk factors.

In turning to the presentation, our speakers today are: Dominic Frederico, President and Chief Executive Officer of Assured Guaranty Limited, and Rob Bailenson, our Chief Financial Officer. After their remarks, we will open the call to your questions.

As the webcast is not enabled for Q&A, please dial in to the call if you would like to a ask question.

I will now turn the call over to Dominic.

Dominic Frederico, President and CEO

Thank you Robert, and welcome to everyone attending today's call.

I'd like to start the call by discussing two important developments that were part of our 2013 three prong new strategic initiatives. First, we increased our capital flexibility by obtaining permission from the Maryland and New York insurance regulators for our direct financial guaranty subsidiaries to reassume contingency reserves previously ceded to AG Re. And second, we launched MAC, the new municipal bond insurance platform we promised in January.

To my first point, AGC and AGM expect to reassume the contingency reserves from AG Re over a three-year period. The reassumptions permit AG Re to reduce collateral that was required to secure its reinsurance liabilities to AGC and AGM by approximately $171 million in 2013, and by $517 million in total over three years. Additionally, AGM and AGC will not cede contingency reserves to AG Re in the future. The reassumptions have no impact on the statutory capital or rating agency capital of AGC and AGM as the contingency reserves are considered part of statutory capital of each company.

The second important development was the launch of Municipal Assurance Corporation. MAC is intended to expand market demand for bond insurance by appealing to issuers and investors who prefer a bond insurer with exposure to only the most familiar and well understood types of U.S. municipal bonds, such as general obligations, tax-backed issues and public electric, water, sewer and transportation revenue bonds.

MAC's profile is unique in the industry. It starts out with a $111 billion, of 100% investment grade, geographically diversified portfolio of U.S. municipal bonds, which it reinsured from our other two U.S. subsidiaries, AGM and AGC. In addition to ceding business to MAC, AGM and AGC provided approximately $800 million in cash and securities to capitalize the new company and become its joint owners.

As a result, on day one, MAC launched as a fully functioning bond insurer with $1.5 billion in claims-paying resources, including a $709 million stockpile of unearned premiums, which means it is already generating significant income and has substantial liquidity.

It is important to understand that MAC does not have the start-up risks and expenses you would typically associate with a de novo company. It has been profitable from day one and shares the proven public finance underwriting, surveillance and legal resources that AGM and AGC have developed for over 25 years, as well as our well-established information technology and financial reporting infrastructure.

Furthermore, MAC is the only truly active bond insurer with a AA+ rating by a nationally recognized statistical rating organization. MAC is rated AA+ by Kroll Bond Ratings and AA- by S&P. Both ratings have stable outlooks.

Separately, I'd like to mention some positive news from our European subsidiary, where for the first time since the global financial crisis began, UK public-private partnership financings have been funded in the capital markets. What made it possible was our guarantee. This marks the return of the pre-crisis model for funding infrastructure in the bond market. Our wrap provides not only credit enhancement to meet investors' risk guidelines, but also informed credit analysis and diligence at origination, and the long-term surveillance essential for these projects.

We guaranteed two UK PPP issues in July: a £102 million PFI bond to finance a redevelopment project in Leeds and a £63 million financing for the University of Edinburgh student accommodations. These transactions will be reflected in our third quarter results, and we are optimistic about other transactions of this type in our pipeline.

All these positive developments reflect our ability to adjust to changing market conditions, such as the current low interest rate environment and the slow recovery of the financial guaranty insurance market. In the same vein, we have continued to focus on our alternative strategies of share repurchases, rep and warranty recoveries, exposure terminations and reinsurance recapture to enhance our shareholder value. So far this year, we have continued to generate significant success in most of these important areas.

Focusing on the second quarter, we finalized two RMBS rep and warranty settlement agreements relating to $367 million in remaining net par outstanding. I spoke at some length on our last call about one of these, our settlement with UBS, which gave us an initial cash payment of $358 million and the benefit of a collateralized loss-sharing reinsurance arrangement for future losses. We subsequently fully settled our rep and warranty claims with Flagstar. In addition to receiving a $105 million cash payment from Flagstar, we will be further reimbursed for future RMBS claims in our Flagstar transactions.

Also in the quarter, we agreed to terminate 35 policies totaling $2.6 billion of net par outstanding while receiving 100% of the expected premiums. These positive results were off-set somewhat by an increase in loss reserves mainly associated with our Detroit exposure.

Regarding new business, we've said that demand for insurance will improve as interest rates increase, we saw evidence of that after rates increased in June. As market conditions improve, we will be well positioned with our multiple platforms to meet issuer and investor needs. That said, overall U.S. municipal production, both par written and PVP were down versus second quarter 2012 results, partly because market volume was down 22% from last year.

For the industry, however, municipal insurance penetration was higher in the second quarter than in the first, moving up from 2.6% to 3.9%. It also moved from 8% to 14% for single-A credits. So there are positive indicators in terms of future demand as interest rates rise.

Of course, the biggest municipal news in recent weeks concerns Detroit, the largest U.S. municipal ever to seek bankruptcy protection. Most of our Detroit-related exposure is to revenue bonds of the water and sewage disposal systems, which provide essential services to areas that extend significantly beyond the city limits. These services are essential to the state of Michigan, serving, respectively, 38% and 28% of its population. Wholesale purchasers outside Detroit generate 77% of the water system operating revenues and 56% of sewage disposal system operating revenues, both systems are cash flow positive, and in fiscal year 2012, net revenues covered debt service on the first and second lien bonds of the water and sewer systems comfortably. Since these obligations are secured by liens on "special revenues" and the systems are cash-flow positive, timely payment of debt service should be insulated from the financial difficulties of the City of Detroit.

We also have exposure to Detroit unlimited tax general obligation bonds. The city's voters approved the debt, and the bond resolution unequivocally and irrevocably pledges the city's full faith and credit, unlimited taxing power, and the resources of the city, for the timely payment of the principal and interest. Our GO ULT exposure is $146 million in net par with an average annual debt service amount over the next ten years of $15.3 million per year. We believe the city's pledge of its unlimited taxing power and resources is not, legally or morally, on the same level of priority as unsecured obligations to vendors and other creditors.

Lastly, through reinsurance, we have $175 million in net par exposure to General Fund obligations of the city, for which the average annual debt service over the next ten years equals $12.4 million per year, and since this is a reinsured exposure, we will follow the fortunes of the primary insurer in their settlement discussions.

As we see certain municipalities encounter financial difficulties, mostly resulting from their own actions, it is very concerning how quickly they attempt to transfer the burden of their decisions and seek remedies from parties that will not resolve their long-term financial issues.

Also, how do we evaluate the moral compasses of our public officials or their nominees when they are so willing to ignore pledges or commitments that they have made and that have been honored for years - and furthermore, that form the foundation for how capital markets provide necessary funding to municipalities. How can public officials be trusted to honor any of their other pledges to citizens if they can so easily ignore obligations that were voter approved, recommended by them or their predecessors, and provide essential support to the municipality?

The long-term consequences of pursuing such a strategy for the citizens of the city and its state are likely to be costly. They include the reduced ability to attract new businesses and residents, as well as to provide for the maintenance and improvements to infrastructure that are necessary to maintain its current services and encourage new investment. None of these things can be initiated by a city caught up in operational failure and bankruptcy.

Financially, Michigan has already started to see the impact as some investment grade borrowers have found it necessary to increase yields and three have announced that they needed to delay expected bond offerings. Given the pressing need to maintain, upgrade and expand the nation's public infrastructure, it is unconscionable that a few elected or appointed public officials would pursue policies that would weaken confidence in the bedrock principle of public finance that has been built over decades and provides a valuable resource to all municipalities.

As always, we will continue to honor our insurance commitment to our Detroit policyholders. We will also continue to enforce our rights to compel Detroit to honor the pledges it made to induce the capital markets to extend it credit.

Negotiated settlements can be challenging but are achievable. An example is the conditional agreement announced in June and approved in Federal bankruptcy court this week, which provides a framework for resolving Jefferson County, Alabama's sewer indebtedness.

I'll conclude by saying that we are optimistic about the future, especially as interest rates rise. With Europe coming back online, and MAC and AGM positioned for continued leadership in the municipal market, as well as AGC's ability to execute selected, high-quality structured financings, we are well equipped to serve our markets while managing our capital efficiently.

I will now turn the call over to Rob.

Robert Bailenson, Chief Financial Officer

Thank you Dominic, and good morning to everyone on the call.

Operating income for the second quarter 2013 was $98 million. This brings our year-to-date operating income to $358 million, which is a 94% increase over the six month period ended June 30, 2012.

Second quarter 2013 operating income was lower than second quarter 2012, largely due to the scheduled amortization of the insurance portfolio and lower premium accelerations, offset in part by reduced losses and other expenses.

On a year-to-date basis, operating income benefited from various settlement agreements - including UBS - while 2012 reflected losses on Greek exposures.

On a per-share-basis, operating income was 52 cents for the second quarter of 2013, and $1.87 on a year-to-date basis.

During the second quarter of 2013, we repurchased 9.6 million shares at an average price of $21.42 per share, bringing our year-to-date repurchases to 11.5 million shares, or $244 million.

On a per-share basis, our share buybacks added $1.65 to adjusted book value, 66 cents to operating book value and 20 cents to GAAP book value. Share repurchases added 2 cents to second quarter operating income per share and 4 cents to our year-to-date operating income per share.

We have $71 million left in our current share buyback authorization, which we will use at our discretion. One of the most important drivers of our ability to execute future share repurchases is the level of unencumbered assets at AG Re, our Bermuda reinsurance subsidiary, which is the primary source of cash for the holding company.

As of July 31, 2013, AG Re had unencumbered assets available for dividends of approximately $280 million. However, the amount of unencumbered assets varies each quarter based on changes in both: the amount of ceded reserves, and the fair value of the underlying assets in the reinsurance trusts. Our exposure to Detroit pension obligation bonds was assumed by AG Re from a third party ceding company, and we expect that unencumbered assets will decline in the third quarter of 2013 when we post additional assets to the trust accounts as required by our reinsurance agreements. As a general rule, trust accounts are adjusted on a quarter lag to allow the ceding companies to finalize their calculations and report their balances to us.

Premium accelerations due to refundings and negotiated terminations of insurance and CDS contracts were $60 million in the second quarter of 2013, consisting of $31 million in negotiated terminations and $29 million in refundings of public finance transactions. This compares to a total of $69 million in accelerations and terminations in the second quarter of 2012. On a year-to-date basis, accelerations and terminations were $174 million, which represents a 64% increase over the comparable period in 2012.

In addition to the immediate benefit to operating income, terminations and refundings have the added benefit of deleveraging our capital and increasing the rate at which excess capital is released. This is reflected in the 10% decline in the statutory "net-par-to-qualified-statutory-capital" ratio, which went from 84:1 at the end of 2012, to 76:1 at the end of June 30, 2013.

While low interest rates provide an incentive for municipal obligors to refund existing bonds and thereby accelerate premium revenues, the flip side is that they lower reinvestment rates in our investment portfolio. This has caused a slight decline in net investment income, from $97 million in the second quarter of 2012, to $94 million in the second quarter of 2013.

The overall pre-tax book yield was 3.81% at June 30, 2013, compared with 3.88% at June 30, 2012.

Economic loss development was $87 million in second quarter 2013, primarily reflecting losses from Detroit and RMBS transactions, partially offset by positive development in other sectors.

Second quarter 2013 operating expenses were $52 million, which was relatively flat compared to second quarter of 2012. For each of the remaining quarters of 2013, I expect operating expenses will be between $50 and $55 million.

Interest expense was down $4 million to $21 million due primarily to the redemption of the equity units in June of 2012.

The effective tax rate on operating income was 29.4% for the second quarter of 2013, compared with 29.9% for the second quarter of 2012. The relatively high effective tax rate for the second quarters of 2013 and 2012 was due to operating losses in AG Re during these periods. On a year to date basis, the effective tax rate on operating income was 26.8% in 2013 and 25.7% in 2012.

Adjusted book value per share increased to $49.06, from $47.17 at December 31, 2012, primarily due to the share repurchase program. Operating shareholders' equity per share increased to a record $32.45 from $30.05, reflecting the impact of the share repurchase program, and year-to-date operating income.

I'll now turn the call over to our operator, to give you instructions for the Q&A period.

Question and Answer Section

Operator: Thank you. We will now begin the question-and-answer session. [Operator Instructions] Our first question comes from Geoff Dunn of Dowling & Partners. Please go ahead.

Geoffrey M. Dunn

Thank you. Good morning

Dominic Frederico

Morning.

Geoffrey Dunn

First, could you comment the ratio of PVP to par dropped down significantly this quarter. Can you discuss what drove that? It didn't look like the average rating changed that much.

Dominic Frederico

No. But it really does break down by issuers in terms of who's in the market and obviously the rates and spreads at the time. So it's more reflective of the type of business in the current market conditions than anything else, Geoff.

Geoffrey M. Dunn

Would that be expected to read out on the third quarter or with rate changing, et cetera? Are we looking at a lower run rate there?

Dominic Frederico

No. I think we'll rebound as rates change and spreads widen which we've seen a little bit of that at the end of the quarter.

Geoffrey M. Dunn

Okay. And then could you again explain what you expect to happen to AG Re on the unencumbered assets? I didn't quite fully understand that even though the third quarter of that you saw you said I think will lead this to a decline?

Robert Bailenson

Yes. I mean, Geoff, we have about $280 million of unencumbered assets at AG Re. We also have $47 million at the holding company. As you know AG Re is a significant supporter of the dividends to the holding companies for our equity dividend. And AG Re did assume $175 million of pension obligation bonds from Detroit that Dominic mentioned from a seeding company.

And as required under our reinsurance agreements, when we are ceded a loss reserve or sent a loss reserve on a bordereau, we're required to put those assets in trusts. We are expecting to be ceded a loss reserve on that obligation. We just don't know the number at this time.

Dominic Frederico

The second then, Geoff, too is remember these are in collateral trust that are represented by securities. So as interest rates change and the valuation of the securities change, it requires us in a rising interest rate environment to top up the trust obviously in a declining interest rate environment.

With a fixed income portfolio, you'd see gains in the portfolio. So both of those are kind of a drain on the free assets that we have to anticipate and try to plan for quarter-to-quarter, making sure we still leave enough cushion to pay the necessary dividend expenses, et cetera, at least for the time being while we still rely on AG Re as the principal source of cash flow to the parent company.

Geoffrey M. Dunn

Okay. So from a high level, you guys have been very aggressive with returning capital to date. You made progress o n capitalizing MAC and restructuring AG Re this quarter. How do we think about the pace of capital return if you still find the stock attractive? Is this something where we're running into a slowdown in activity or do you think your resources will continue to support a good clip of repurchase business?

Dominic Frederico

Well remember, we had a strategy to address this, right? So first and foremost, we look first to our ratings and make sure that anything we do relative to the return of capital has no impact on ratings. The second thing we have to do is look to liquidity or the free unencumbered assets currently at AG Re, right?

As we said, we had a three-prong strategy. We accomplished two of the three in the quarter, the launch of MAC, and the restructuring at least from a contingency reserve and reinsurance part with both New York and Maryland.

And we still have the third component of the restructuring, which we didn't refer to in the quarter because it hasn't been completed yet. There are some administrative issues and issues relative to global regulation that have to be resolved. And we hope to get them resolved in the near term, which would then take this pressure off of AG Re.

So in the meantime, we have to look at AG Re, manage accordingly as Rob said, the available or free cash flow, and obviously maintain our ratings. And then to the extent we have the free cash flow and we're comfortable to ratings provide that as part of our official capital – efficient capital management which is absolutely the return of capital to shareholders.

Geoffrey M. Dunn

Okay, great. Thank you.

Operator: Our next question comes from Sean Dargan of Macquarie. Please go ahead.

Sean Dargan

Yes, thank you. Good morning. I just want to follow-up on what Dominic was just talking about the third component in – it sounds like global regulators are involved. Can you give us any more color on what form this may take to enable you to not have to pay the withholding tax and bringing capital out of the U.S.?

Dominic Frederico

I think you can kind of follow that lead, right? So we said it involves restructuring, we said it involves regulators sign-off an approval and as we're ready to announce exactly what we've – we obviously chosen a strategic direction. We've done the majority of the required applications, et cetera. We're now in the final stages of just resolving some open issues. Relative to the basically administrative and global regulation which we hope to finally resolve in this quarter.

And as we get that done, you can figure that it involves the restructuring and therefore provides a greater liquidity of capital through the entire organization.

Sean Dargan

Okay, thanks. And the news flow out of Detroit has been pretty steady and sometimes confusing. Can you just tell us where this – I guess there's a federalism issue. Can you just tell us where this stands in terms of state court and how it looks like it's going – how this proceeding is going to go forward?

Dominic Frederico

Well, yes, you're basically in untested waters, right? So historically, the full-pledge of taxing resources or taxing authority, full faith and credit, and resources has typically been considered secured and always has been worked out as opposed to eliminated or written down. Obviously, the early indications out of Detroit were they were not going to honor. They were going to treat the ULT bonds or the tax-backed bonds as unsecured creditors. And a lot of people quote, well, this is protected by the state constitution. That's like retirement benefits; well, so is the bond obligations. And the tricky part here is as you apply for bankruptcy, you're now in federal court not state court, and therefore the state constitution will typically be secondary to the federal.

Federal trumps state typically in a federal bankruptcy proceeding so that is where the confusion lies. We look at it on a broader base, so hang on a second, this full faith and credit pledge is not a promise; it is a pledge. You commit resources, the taxing authority et cetera to make sure that these obligations are met and we don't consider that an unsecured credit.

Number two, there is an enormous impact not only to Detroit but especially to the state of Michigan to the extent that the governor and the legislature do not support the position of, basically, the people that provide funding for valuable infrastructure needs and expansion, et cetera, to those municipalities, if you're going to consider them not protected.

So there's an issue of federal versus state. There's an issue what has historically been treated as secured with a true foundation if you read the language appears to provide that lien position and yet, Detroit has chosen a different way and I think what you've seen recently at least in the market, that's kind of the market's reaction. Obviously, there've been three cities that had to pull back bond offerings because it was either going to be executed at a cost that they couldn't accept or could not get executed at all, and that's a reality of life, it's like anything else. If you as an individual default on credit, trust me, you're going to have a tough time getting credit.

And for all the right reasons, you can't go out and make these unequivocal and irrevocable pledges and then pretend like they don’t exist. Right and especially, where these are people that are providing you valuable resources that allow you to do the investment but it's going to be necessary to turn around any economic situation.

And as I've said, my biggest issue is where’s the moral compass of these elected officials that say, yes, we have the obligation and especially if we look at Rhode Island, from the Studio 38 bond, you had a center up there, and said, yes, we have the money, we have the obligation, you know what let's just walk away from it. Well, I have a really problem with that and it says, what is this person all about and how do I value anything this guy says or this individual says as being reasonable or something I can count on? So if I’m a citizen of these areas I say, well, how do I rely on the guy I just elected if he immediately turns around and revokes all responsibility relative to what is a very strongly worded and provides extreme value to the municipality of these commitments?

So Detroit's going to play out over a long period of time, it's really start off kind of in a situation and is not being tested. Again, we feel very comfortable it's where we are at relative to our exposures and how this thing ultimately plays out but the whole concept that you're referring to is this kind of difference in federal law and state law.

Sean Dargan

Thank you.

Operator: Our next question comes from Brian Meredith of UBS. Please go ahead.

Brian Meredith

Yes, good morning. A couple of questions to you, for you. First, I'm wondering if you could give us what your total certificate of participation kind of a par exposure is, and how much of that is below investment grade?

Dominic Frederico

For Detroit or for everybody?

Brian Meredith

Just in general, kind of – get a sense of kind of what it's like?

Dominic Frederico

Well I don't have that number off the top of my head. I mean, obviously we list all of our large exposures, we list all of our below investment grade exposures. We did look at that, Brian. I just don't have the number with me.

Brian Meredith

Okay. Okay, I'll follow up on that one.

Dominic Frederico

Yes. We have never kind of released that.

Robert Bailenson

I will get back to you.

Brian Meredith

Great thanks. And then, just the second question. I'm just curious, Dominic. Have we seen any kind of change in the pricing in the market, given that BAM's out there now? Is it affecting pricing at all?

Dominic Frederico

Well, you're seeing obviously a widening out of spreads. So you're starting to see pricing change. Obviously, you're seeing it from Michigan because people say, well, this is a national problem. I do, I know it's a Michigan problem. Concerned states do stand behind the financial efficacy of their municipalities. So I think you look at what Rhode Island did, you look at what Pennsylvania did, but I think in certain places, yes.

And for us, we have to look at our underwriting and our risk assessment so you brought up the general fund liability. It's like pension certificates. Well, obviously, we're no longer into that business. So any one that was looking at that as a potential source of being able to fund those liabilities because of how Stockton has tried to treat them, how Detroit is trying to treat them. Obviously they've become no longer as underwritable for us and therefore those things we're going to have a lot of tougher time getting placed in the market if at all.

And if so, at what price do they get placed in the market? So I think everything, like anything else in any business, your pricing model has to take in consideration all costs. And as the risk cost goes up, the pricing model has to accommodate that, but in our case, we really do write to a zero loss ratio, right? So at the end of the day, that becomes a risk that we can no longer do.

Brian Meredith

Great. Thank you.

Dominic Frederico

You're welcome.

Operator: [Operator Instructions] And our next question comes from Bill Clark of KBW. Please go ahead.

William Clark

Dominic, you mentioned a couple of deals that ended up getting postponed and you also kind of said it was maybe just a Michigan-only problem. But I'm just wondering if you've seen any kind of movement towards your industry in terms of potentially being able to provide some solutions there or enhancements that would help kind of get some of those deals completed?

Dominic Frederico

Well, that's a good point. And typically, we would look to provide valuable services and the access to the market, but we have to be in a secured position. So obviously, anything that we would propose would have to protect the company first and foremost. Obviously, underwriting is job one, two, three and four. And therefore, if they're willing to come back to the market in some sort of a secured position, a dedicated revenue position, obviously, we'd be available to help them.

William Clark

Okay. And then on refundings and terminations, it's kind of come down at a pretty quick pace the last couple of quarters. Just wondering if we've hit a level that you think is kind of sustainable for the near term or kind of just depends on interest rate movement and those things, and it's just going to bounce around from here.

Dominic Frederico

Well, if you look at our strategy for 2013 and it was just similar in 2012 and 2011, right? It's obviously less reliant on new business because where interest rates are and spreads are and overall demand, which we see improving a bit towards the end of the quarter as I said. But over these last few years, it's been very low, so you're going to have to make your money in a different way.

So we've concentrated on rep and warranties and I think we've been the most successful company in pursuing that strategy and generating significant positive results. We looked at the terminations as both an earnings benefiter because you get to recognize the premium and at the same time, you're deleveraging the company and therefore creating excess capital. Those things don't move uniformly. So therefore, income is going to be lumpy.

And as you look at our quarter, it's below consensus. We might argue that people didn't quite factor in Detroit to a level they should have. But it's because we have so much accelerations and recoveries in the first quarter and you don't see that same amount of volume. But we still believe there is a lot of activity and opportunity remaining in the portfolio, leases we look at over the next say 12, 18 months. And we continue to focus a lot of our resources on exactly the execution of that strategy.

And today, it’s a lot more focused, we think it will be further assisted as these new capital rules take further hold in Europe specifically where we do have a lot of counter-party exposure in Europe, and they're going to need to start to manage the capital exposure differently; therefore they might terminate further deals that we target. At the same time, we have negotiated some amends where we're dealing with the counter-party and it might be an RMBS issue where we either have other exposure with them on the CDS that we try wrap everything into a single bundle of an effective remedy to solve the problem. And you've seen a little of that in the current quarter.

So, I think there is still volume out there to be had, but the numbers are going to be lumpy. So it's hard to predict quarter after quarter in terms of what the number would be.

William Clark

Okay. Thank you very much.

Dominic Frederico

You're welcome.

Operator: Our next question is from Scott Frost with Bank of America Merrill Lynch. Please go ahead.

Scott Frost

Hi. I'd like to talk about Kroll a little bit. Kroll, it's a three-year old NRSRO run by Jules Kroll but not affiliated with Kroll Inc. that Marsh bought and sold. Why do we believe that investors and issuers will accept Kroll as an alternative to Moody's or Fitch?

Dominic Frederico

Well I think the market has been looking for alternatives to the existing incumbents based on obviously the problems that have been experienced through the financial crisis with the stability or consistency of ratings. Obviously, we believe we're a poster child for that inconsistency.

And there are some really interesting numbers, if you look at our numbers as of January 1, 2008 and January 1, 2013. And if you don't conclude we're a lot stronger company over that period of time, I don't know what else you could conclude yet our ratings are obviously significantly different than that.

But first and foremost, Kroll's been very transparent in their approach to how they rate and their rating methodology, which is out there for anyone to see. So one way you get comfort is you make sure people understand how you approach things and are very clear and transparent about it, which they've done. I think they've been very thorough in the credit work they've done.

On the municipal side, for the municipalities they've rated, I think they've put out very, very strong reports. I think the report that they did on us following their own methodology was obviously very complete and thorough. They have a very experienced team if you look at the people that they employ.

And as I said, I think the market is looking for someone that's going to be consistent, transparent, and stand behind the rating and the methodology. And if you look at the Kroll approach, it is very much deeply embedded in financial strength. And since these are called our financial strength ratings and really should look to what is the probability of a potential default and obviously the lower the probability, the higher the rating, I think they've basically stayed to that knitting, which is I think how you have to look at financial strength ratings.

If you want to talk about enterprise ratings more of on an equity basis, then fine. You have the right to make any subjective adjustments you want. But if you're looking at financial strength from the standpoint of an investor/bondholder that says, will I get paid my timely principal and interest? That's the most important thing I have to concern myself with, I think Kroll stayed close to that faith, that religion in how they looked at rating.

So I think there is an opportunity for them. As I said, transparency is king, clarity is king and they've taken a consistent approach and we're happy to have them and we obviously welcome other people coming into the market that come in on the same type of basis.

Scott Frost

Well, that's the other thing that sort of stuck out. I mean most of the personnel there look like they're former rating agency guys from S&P and Moody's and Fitch.

Dominic Frederico

I hate to tell you, a lot of our guys are exactly the same way. There's kind of a training ground...

Scott Frost

No, that’s fine, that wasn't a criticism that was just a fact. I mean I was – what I’m trying to...

Dominic Frederico

Well, you can make it a criticism. I'm okay with that as well.

S. Frost

What I'm trying to figure out is I mean it sounds like what you're saying is you think this is a better process than Moody's or Fitch and that's why you chose it. And what I'm trying to figure out is, has the feedback from issuers and ultimately investors been yes, I will accept a lower rating on a wrapped bond because I believe Kroll's ratings versus say Moody's or Fitch or versus an unwrapped bond. I mean, has that been what's been going on or what's been sort of the color so far?

Dominic Frederico

Well, I think you need to talk to them, more importantly, about how they believe their market penetration is. But obviously they’ve been new to the game; it takes a while to generate critical mass. I think they've been very successful in what they've been able to rate to date. And we can only, much like you, watch and see how strong the acceptance is, how wide their acceptance becomes as they get to rate more things. I think we look at that as a true value, get in on kind of the ground floor and as it grows, get the benefit of their growth. I'm sure with Mr. Kroll's success that he's going to put the right resources and make sure this is as successful as any of the other ventures that he's done and we're happy to be a part of it.

Scott Frost

Okay, great. Thank you.

Dominic Frederico

You're welcome.

Operator: Our next question is from Josh Bederman of Pyrrho Capital. Please go ahead.

Joshua Bederman

Hi, guys. Can you – you guys on the fourth quarter call gave an estimate of $800 million of excess capital above your AAA rating. Can you update that estimate for where we are now at June 30?

Dominic Frederico

Well, the only one that we look at that has given us a capital model that we can actually calculate is Standard & Poor's. And as of their most recent rating, I think they evaluated us with either $500 million or $600 million of excess capital. There are still some questions that we have relative to that capital calculation. There are some strange numbers on RMBS that we'd like to get a further explanation, but I think that's the last number that's been communicated.

Joshua Bederman

Okay. Thanks. And then just one more thing, you said there's about $47 million of unencumbered assets at the HoldCo, $280 million at AG Re, but that might go down. You're working on the structural changes here. So what else – what do you guys look at as the kind of unencumbered assets that will be available post the finalization of all the administrative stuff with your restructuring?

Dominic Frederico

Well, that number is going to be significant because remember, if you pay – from my comments, we got roughly $170 million of contingency reserve released in current period. However, there's an agreement that AG Re will no longer have to post any contingency reserves. And that number in the aggregate including the $170 million is $517 million. So our expectation is that over the next two years, the remainder of that gets released so obviously that would provide significant free cash flow to AG Re.

Joshua Bederman

Okay. And then...

Robert Bailenson

In addition...

Joshua Bederman

Sorry, go ahead.

Robert Bailenson

We will – we have two operating subsidiaries in the U.S. and we can dividend up to the holding company and assuming we get what we want to get accomplished, that money could be used as well.

Joshua Bederman

And what's that figure?

Robert Bailenson

We – I mean...

Dominic Frederico

It's in the Q.

Robert Bailenson

It's in the Q. We have a 10% – you can dividend up to 10% of its statutory surplus.

Joshua Bederman

Yes.

Robert Bailenson

And so that number is about, I would – I think it's about $200 million a year.

Joshua Bederman

Okay.

Robert Bailenson

Both companies.

Joshua Bederman

Great. Thank you.

Operator: Your next question is from Larry Vitale of Moore Capital. Please go ahead.

Larry Vitale

Hi, good morning. I just had a couple of follow ups. The $87 million of economic loss, can you break that down? Detroit, RMBS and then you said there were some recoveries in there as well?

Dominic Frederico

Yes, Larry. There's a kind of adjustments or positives and negatives. The predominant charge in the quarter though is good old Detroit.

Larry Vitale

Okay, all right. Thanks, Dominic. And then rep and warranty reserves or, sorry, the rep and warranty cases that you're involved with, what's left? You've settled a lot of these things.

Dominic Frederico

We still have some of the old boys left. So in the quarter we settled two, we're close to a third. Obviously, the big boy is Credit Suisse, who's probably the most in terms of par left. But then, remember we told you we still have the swap side open with Deutsche Bank. We have the swap side open with Bank of America. We have a couple of other small guys in there. So there's probably about three or four still left of which Credit Suisse and the swaps on Deutsche Bank are the two largest.

Larry Vitale

Okay. All right. And my last question is, your $175 million reinsurance exposure to Detroit. You expect to get loss reserves ceded to you. Do you have any idea how much that might be? If you could ballpark it for us. And then, are you required to collateralize those on a dollar-for-dollar basis? (inaudible) So if you get $100 million ceded to you, you have to put up collateral of $100 million? I'm just making that number up.

Dominic Frederico

Right. No, you're fine. So there's two questions in there. A , we have a view of what the loss is worth in terms of how this will proceed. And obviously, we'll discuss that with the ceding company as we have to follow their fortunes. But to your latter question, you are exactly right. If they advise of a case reserve, we have to post that amount of collateral whether we agree or not agree with the amount of the case reserve being advised.

Larry Vitale

Okay. Okay. That's helpful. Thanks.

Dominic Frederico

You're welcome.

Operator: This concludes our question-and-answer session. I'd like to turn the conference back over to Mr. Tucker for any closing remarks.

Robert S. Tucker

Thank you, operator. I'd like to thank everybody for joining us on today's call. If you have additional questions, please feel free to give us a call. Thank you very much.

Operator: Thank you. The conference has now concluded. Thank you for attending today's presentation. You may now disconnect.