ASSURED GUARANTY®

Assured Guaranty Ltd. (AGO)
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Q3 2014 Earnings Call

Robert Tucker
Managing Director, Corporate Communications and Investor Relations

Thank you, operator.

And thank you all for joining Assured Guaranty for our third quarter 2014 financial results conference call.

Today's presentation is made pursuant to the Safe Harbor provisions of the Private Securities Litigation Reform Act of 1995. The presentation may contain forward-looking statements about our new business and credit outlooks, market conditions, credit spreads, financial ratings, loss reserves, financial results, future rep 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'll open the call to your questions. As the webcast is not enabled for Q&A, please dial into the call if you would like to ask a question.

I will now turn the call over to Dominic.

Dominic Frederico
President and Chief Executive Officer

Thank you, Robert, and welcome to everyone joining today's third quarter 2014 earnings call.

Assured Guaranty, once again, produced strong results in the third quarter. Our operating income of $177 million was the highest in the past 6 quarters and adjusted book value per share reached $52.59, representing the largest quarterly increase in adjusted book value since 2009. Further, we repurchased 9.6 million common shares for $226 million. Our share repurchases this year, through September 30, have reduced the outstanding share count by 10%. Rob will speak in more detail about our financial results.

Today I want to highlight:

- the positive developments in our core U.S. municipal bond insurance business

- our progress in resolving our distressed credits

- the value we continue to create through our alternative strategies, and

- our outlook going forward.

Starting with public finance: During the third quarter, industry-wide, bond insurance was utilized on 7.9% of total new municipal par sold. This is a 111% increase compared with last year's third quarter, and you would have to go back to 2010 to find a similar penetration rate.

Assured Guaranty insured $3.8 billion of new issues sold in the third quarter, more par than in any quarter of the last two years. Compared with third quarter 2013, our par insured increased 157%, even though total market issuance rose just 6%.

Looking at the first nine months of 2014, while total municipal issuance was down 10%, total insured par was up 59%. This translates into a year-to-date 6% insured penetration rate, which is significant after two calendar years below 4%. Focusing on our target market – that is issues with "A" and “BBB” underlying ratings − the year-to-date industry penetration was 21% of par issued, in spite of historically low interest rates.

For Assured Guaranty, par insured has increased each quarter through the year, and our year-to-date par insured is 57% higher than in nine months of last year. Our year-to-date PVP of $90 million is 64% higher than in last year’s comparable period.

One reason for the growth in par insured has been the greater use of Assured Guaranty insurance on large transactions. Year-to-date through September, we have guaranteed 27 transactions with insured par of more than $50 million of which 10 were over $100 million. This compares to last year’s results of 16 transactions over $50 million in par and only 2 transactions over $100 million in par insured.

Increased demand on larger transactions represents a significant area of potential growth, as they make up approximately two-thirds of the total insurable volume. And we believe the increasing use of Assured Guaranty insurance on larger transactions reflects improved acceptance of our insurance by institutional investors.

There are good reasons for this trend. Events over the past 18 months have helped to refocus investors – both retail and institutional - on the important benefits of Assured Guaranty bond insurance. Those benefits include greater relative price stability and improved market liquidity, in addition to the certainty of timely payment of debt service and our highly valued credit selection, underwriting and surveillance process.

Specifically, investors have witnessed our insured bonds’ price stability first hand as those bonds tend to hold their market value while, for example, uninsured bonds of the same issuer trade at steep discounts. In July, for instance, while some uninsured PREPA bonds were trading below 40% of their par value, comparable Assured Guaranty insured bonds remained above 90% of their par value. More recently, the same uninsured PREPA bonds were pricing at 50% of par and our equivalent insured bonds at 99% of par.

Assured Guaranty continues to be the choice of investors as demonstrated by our quarterly results. In the third quarter of 2014, we captured 79% of the PVP written and guaranteed 66% of the insured par sold and 57% of the transactions, a true reflection of our premier market position.

Touching on structured finance, during the quarter we provided a secondary market wrap on an international diversified payment rights transaction, and we continue to see potential structured finance opportunities in a range of asset types, including other DPRs, the life insurance sector and lease financing.

Our structured and international finance activities currently form a relatively small part of our financial guaranty written premium, yet they are an important source of valuable opportunities and add a unique element of diversification to our business origination and portfolio risk management strategies.

Before I discuss our insured portfolio, I think it's important to once again highlight Moody's proposed changes to its rating criteria for bond insurers, which was published on July 15. As I explained on our last call, Moody's is proposing, yet again, to move the goalpost, making it almost impossible for any bond insurer to be rated above single-A by Moody's. I won't repeat the specifics I gave you on the last call, but I will ask you again to read Moody's request for comment. Although the official deadline for comment has passed, the final criteria have not yet been published and so we encourage you to give Moody's your feedback, especially if you have not already done so.

Turning to our insured portfolio: As a participant in certain distressed public finance situations, we have clearly benefited from the depth of our human and financial capital and the constructive approach we take to developing solutions. For example, we have obtained concessions from the City of Detroit in our settlements that, realistically, investors acting separately would find it extremely difficult to achieve, and particularly within the short time frame in which this case moved.

In August, we played an important role in resolving the dispute over Detroit's attempt to impair its water and sewer department's revenue bonds. And we did so in a manner that removed the threat of impairment on the bonds from the bankruptcy plan of adjustment and upheld the sanctity of the special revenue pledge. In the process, we insured approximately $841 million of the $1.8 billion in bonds issued to finance the department's voluntary tender offers for its outstanding water and sewer revenue bonds, including those we had previously insured.

As a result of strong market demand for our insured bonds, we were able not only to assist the issuer in accessing the market at a critical juncture, but also to improve the transaction's economic efficiency for the issuer.

It's important to recognize that over the last two years we have favorably resolved a number of distressed municipal credits in our insured portfolio, reflecting our position as one of the controlling parties entitled to direct remedies and our experienced negotiating ability. And, with Judge Rhodes set to issue his ruling later today on whether Detroit can exit bankruptcy, and Judge Klein approving the Stockton, California exit plan late last month, these two cities may soon join Harrisburg, Pennsylvania and Jefferson County, Alabama as credits that are largely in our rear-view mirror.

Turning to Puerto Rico, in the case of the Puerto Rico Electric Power Authority, we joined other creditors in a forbearance agreement that has given PREPA more time to craft a long-term solution. We were influential in shaping the terms of the agreement, including the condition that PREPA hire an experienced restructuring officer.

In looking more broadly at Puerto Rico, it's in the news almost every day, and frankly, we're going to be hearing about this credit for quite some time.

On the topic of our structured finance insured portfolio, we believe the RMBS risk has been remediated to a great extent. Today, there is very little potential to cause negative earnings volatility, because the amount of exposure has been greatly reduced, the transactions are well seasoned, and we have succeeded in reaching numerous loss mitigation agreements – including some long-term loss sharing arrangements. In fact, our companywide economic loss development in the third quarter was a benefit of $63 million, primarily due to our RMBS loss mitigation efforts.

In the third quarter, we completed three additional RMBS agreements and reached another agreement in principle, which was signed just yesterday. These agreements included the termination of an aggregate $1.5 billion of RMBS net par outstanding, which also contributed to a reduction in our below investment grade exposure. Our RMBS related insured exposures, which totaled over $30 billion at third quarter 2009, have now been reduced to $10.5 billion or just 2.5% of our net par outstanding, with the below investment grade portion going from $16.7 billion to $5.9 billion. After the close of the quarter, we finalized yet another RMBS agreement, which further reduced our net par outstanding by terminating over a half-billion dollars of exposure.

We also continued to mitigate loss and manage risk by purchasing bonds we have previously insured. In the third quarter, we purchased seven wrapped bonds at an average price of 87% of par. Separately, after removing our insurance, we sold two previously acquired positions, which resulted in a positive contribution to third quarter income.

To wrap up, we may look back and think of 2014 as a turning point for our industry, as the risk of loss caused by the housing collapse of 2008 subsides and investors increasingly appreciate the benefits of bond insurance in a public finance market where defaults are rare, but painful when they do occur. We do still face headwinds from low interest rates, but we have demonstrated our discipline and resilience through more difficult times. Overall, I believe the trends are in our favor. I am excited about our prospects and look forward to further increasing the value of our company for our policyholders and shareholders.

Now I’ll turn the call over to Rob.

Robert Bailenson
Chief Financial Officer

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

As Dominic mentioned, we had strong operating income this quarter of $177 million, which represents a 51% increase over the third quarter of 2013. On a per share basis, operating income was $1.05 per share, which is a 64% increase over the third quarter of 2013. The 30.5 million shares that we repurchased between March 2013 and September 30th, 2014 at a total cost of $702 million, contributed $0.14 per share to third quarter 2014 operating income.

Since October 1st, we have repurchased an additional 2.8 million shares for a total of $61 million, leaving our remaining share authorization at $301 million. This brings our total repurchases to date to 33.3 million shares at a total cost of $763 million, or an average cost per share of $22.92. As always, stock buybacks are contingent on our available free cash flow, capital position, maintenance of our ratings and other factors.

Net premiums earned were $149 million in the third quarter of 2014, compared to $173 million dollars in the third quarter 2013, which is consistent with the scheduled par amortization. Accelerations included in net earned premiums were $36 million, which were relatively flat compared to the third quarter of 2013.

Net positive loss development was the single largest driver of the increase in operating income in the third quarter of 2014 compared with the third quarter of 2013, and more than offset the decline in net premiums earned.

In the third quarter of 2014, economic loss development was a benefit of $63 million, and loss expense recognized in operating income was a benefit of $51 million.

Both measures were driven primarily by R&W settlements reached during the quarter that resulted in positive economic loss development of $93 million, offset in part by development in the underlying HELOC portfolio of $25 million. HELOC default assumptions were increased to reflect borrower reaction to the larger monthly payment they experience at the end of their interest only period, which was offset in part by lower severity assumptions.

On the public finance front, Dominic mentioned the positive developments in both the Detroit and Stockton bankruptcy proceedings since last quarter. Our loss estimates reflected the likelihood of these outcomes.

Operating shareholders' equity per share has been steadily increasing over the last several years and has hit $36.65 as of September 30, 2014, while adjusted book value per share rose to $52.59.

New business production and R&W settlements positively impacted operating shareholders' equity and adjusted book value this quarter. On a per share basis, the cumulative share repurchases since the beginning of 2013 contributed $2.16 to operating shareholders' equity per share and $4.66 to adjusted book value per share.

I'll now turn the call over to the operator to give you the instructions for the question and answer period. Thank you.

QUESTION & ANSWER SECTION

Operator
Yes. Thank you. We will now begin the question-and-answer session. [Operator Instructions] And the first question comes from Sean Dargan with Macquarie.

Sean Dargan, Macquarie
Thank you and good morning. I have a question for Dominic. Good morning. It's my perception that perhaps a headwind to your share price performance is a notion in the market that you may buy a run-off block of financial guarantee business and that would come at the expense of share repurchase. So in other words, you would use free cash available at the holding company to purchase something.

And I guess on a related matter, a CEO of a company who has a reason to sell its financial guarantee block was talking about reinsuring that block on a conference call last week. I'm just wondering if you could just give us further color on how if you were to make a bid on a block, if you would structure it as a reinsurance transaction, and what would be the implications to the share repurchase?

Dominic Frederico
Well, I think that's a good question and probably is part of some of the misunderstanding relative to the performance of the stock. So, first and foremost, understand that as we look at share repurchases, as you point out, we use holding company capital. There's a methodology and process as to how you can get capital to the holding company. Any acquisition that we would consider would not interfere or affect at all the holding company cash, cash position, or ability to continue the repurchasing of our share activity.

What we're looking to do, and to the extent that we have that opportunity, is to utilize the trapped surplus in our operating companies as the acquirer of any portfolio, reinsurance or company, such that it doesn't have any impact whatsoever on our share repurchase activity.

If anything, to the extent that we're successful in buying any of these portfolios, companies or reinsurance at any sort of a discount, it theoretically will create additional capacity for share buyback, because it will increase the operating surplus of the subsidiary companies where there is a limitation on dividend activity based on operating surplus and income.

So, if anything, this is a move that would positively impact share repurchases, not negatively. It will utilize trapped capital that are subject to a process and procedures and timing in terms of how that surplus can exit the subsidiaries. So, if you really think about it, if I do nothing with the trapped capital – and based on the amount of new business, that capital is being unused – I'll earn the portfolio rate of return, period. If I'm able to take some of that trapped surplus or trapped capital and go out and engineer a higher return and returns that we believe are acceptable in our target market, then that really does benefit earnings, it benefits surplus, it benefits the capacity for future dividends and will ultimately enhance the share repurchasing program.

Sean Dargan
Alright. Thank you. That's very helpful. And one follow-up question related to Puerto Rico. We've seen a dramatic decrease in the price of oil. And PREPA is heavily dependent on oil and firing the power plants. And I think there was some commentary out of Puerto Rican banks that lower oil prices are beneficial to GDP of the Commonwealth overall. I was just wondering if you have any thoughts on that.

Dominic Frederico
You know, two things. Lower oil prices will result in lower fuel adjustments, which is tied into the rates that the PREPA charges the customers. So, you're going to lose some revenue, but at the same token you should also gain some benefit to cost of goods sold theoretically in the price of oil. So, I think net-net-net, it's a positive, but I don't think it's a significant positive.

Sean Dargan
Got it. Thanks.

Operator
Thank you. And the next question comes from Geoffrey Dunn with Dowling & Partners.

Geoffrey Dunn, Dowling & Partners
Thank you. Good morning. I actually only have a quick number question. Rob, can you give us the updated balances for the HoldCo and intermediate HoldCo, please?

Robert Bailenson
Sure. In total, Geoff, we have $475 million as of September 30 at both HoldCos. If you want the breakdown, it was about $178 million in the U.S. holding company and about $298 million at the ultimate parent, AGL.

Geoffrey Dunn
Perfect. That's all I got. Thank you.

Robert Bailenson
You're welcome.

Operator
Thank you. And the next question comes from Josh Bederman with Pyrrho Capital.

Josh Bederman, Pyrrho Capital
Thanks. I think the last question actually answered a lot of what I was getting at, but I just wanted to see, you guys have obviously bought back half a billion dollars of your stock this year, just kind of get a sense of how you're thinking about whether that can continue, whether the resource for that can continue looking into 2015? Thanks.

Dominic Frederico
Well, obviously, we believe that capital management and really, saying the truth, that the return of capital is still needed to be a critical part of our long-term and short-term strategy as to how we manage our company. As we look at the volume in new business and the new business demand in the intervening periods, we're still going to be impacted significantly by the level of interest rates and the runoff of our portfolio.

So, we continue to not only generate strong earnings, but also run off significant exposure. Rob and I gave you some statistics on below investment grade, which is a big capital user, RMBS, which is a big capital user. As those decline, and at the same time you're making earnings, regardless of what the new business market turns into, you're still creating significant excess capital, and therefore we will still be in a very aggressive capital management strategy for a lot of the future term.

Obviously, we have dividend capacity, which we’re very clear in how we disclose. Any increases or enhancements to the buyback policies will be determined by our board of directors. So, that's something we have to consider. But we tell you the amount of cash, we tell you what is available for dividend activity out of the operating companies. Obviously, based on our change in tax residency, we've now created the facility to allow the free flow of capital up into the holding company. So, I think you can kind of project along with most people that we will be in this significant capital management program for quite a long time.

Josh Bederman
Thank you.

Operator
Thank you. And the next question comes from Larry Vitale with Moore Capital.

Larry Vitale, Moore Capital
Hi. Good morning. Looks like the unencumbered assets at AG Re went up by, I don't know, $256 million if I'm doing the math right. And I'm just wondering what that resulted from.

Robert Bailenson
Larry, as we told you, last quarter, we were just about getting the regulatory approval for the recapture of the contingency reserve back from AG Re, back to our subsidiaries in the U.S. That freed up unencumbered assets by about $244 million. That's the majority of the difference. And we said at September 30 at $483 million.

Larry Vitale
Okay. All right. That's helpful. Thank you, guys.

Robert Bailenson
Of unencumbered assets.

Larry Vitale
Yes. Yes.

Robert Bailenson
Thanks, Larry.

Larry Vitale
Okay. All right. Thanks. All right. One more. Can I do one more?

Dominic Frederico
Sure.

Robert Bailenson
Sure.

Dominic Frederico
You got to pay for it.

Larry Vitale
You talked about the dividend capacity out of New York on a forward 12-month basis but you talk about the dividend capacity out of Maryland only with respect to 2014. Can we assume that dividend capacity in 2015 out of AGC is going to also be about $69 million?

Robert Bailenson
I mean, I think that's fair, Larry. It's around 10% of surplus.

Larry Vitale
Okay. All right. Thank you, Rob.

Operator
Thank you. [Operator Instructions] And we do have a question from Bose George with KBW.

Bose George, KBW
Yes. Good morning. Just on the $500 million of RMBS exposure you mentioned was terminated after quarter-end. Could there be loss reversals on that piece?

Dominic Frederico
Typically, there is and it really depends on the specific transaction. Rob, do you want to...

Robert Bailenson
Well, we already, the accounting rules requires us to book that actually as a – like a type one subsequent event. So, we've taken the benefit of that tear-up in this quarter, but as – because it was in derivative form, you'll see the actual exposure come down in the next quarter.

Bose George
Okay. Great. Thanks.

Operator
Thank you. And as there are no more questions at the present time, I would like to turn the call back over to management for any closing comments.

Robert Tucker
Thank you, operator. I'd like to thank everyone 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. Have a nice day.