Assured Guaranty Ltd. (AGO)
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Q3 2015 Earnings Call

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Managing Director, Corporate Communications and Investor Relations

Thank you operator. And thank you all for joining Assured Guaranty for our 2015 third quarter 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 and 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 a replay of this call, or if you are reading a 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 Ltd., 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 Chief Executive Officer

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

The third quarter of 2015 was another successful quarter for Assured Guaranty.

We produced $164 million of operating income and continued to build the company's financial strength, market position and value to our shareholders. Our year-to-date operating income of $582 million is 42% higher than the first nine months of last year. At September 30, operating shareholders' equity per share stood at a record $41.87 per share, and our record adjusted book value per share was just shy of $60.

As Rob will detail in a few minutes, we continued to optimize our capital usage during the quarter. Additionally, we continue to generate excess capital as our insured transactions amortize, and we further de-risk the portfolio with rep and warranty settlements, loss mitigation bond purchases and targeted terminations.

That said, the fundamental demand for our core product, municipal bond insurance, is increasing even in this environment of low yields and tight credit spreads. This is clear when you look at our industry's 51% growth in new insured par sold in the first nine months of the year compared with a 40% growth in total new issuance.

Insured penetration of the municipal bond market has generally fluctuated this year in line with interest rates. It grew to 7.5% in the second quarter and fell back to 6.1% in the third quarter as municipal bond yields dropped 30 basis points after an 85 basis point rise from their low point in January. Year-to-date penetration through September 30 was 6.5%, up from 6% in the first nine months of 2014, and that is a real achievement since the 30-year benchmark municipal yields averaged 45 basis points below the average for nine months of 2014.

If we look at the new issues sold with single-A underlying ratings, municipal bond insurers captured 17.9% of the par sold in the third quarter and 21.4% of the par sold year-to-date. In both the third quarter and year-to-date, more than half of the underlying single-A transactions were insured.

Assured Guaranty continues to lead the municipal bond insurance industry. We believe issuers, broker-dealers and investors recognize superior value -- in our financial strength, including our $12.4 billion of claims-paying resources; in our proven, profitable business model; and our insured bonds' exceptional market liquidity, with an average daily trading volume of more than $500 million during 2015.

In the third quarter, we guaranteed $3.1 billion of new municipal issues sold, representing 60% of the insured par and 56% of the insured issues during the quarter. We guaranteed 43 more transactions than the rest of the entire industry combined and in the month of August alone, we guaranteed 72% of the insured new-issue par. Additionally, we increased our secondary market par insured by 38% compared with the third quarter of 2014.

The credit quality of the municipal bonds we insured this year is better than last year, which helps explain why PVP in last year's first three quarters exceeded this year's results. While lower overall yields and tighter credits spreads also contributed to the reduced PVP generation, last year's Detroit Water and Sewer restructuring transaction was the most important factor contributing to the higher PVP in 2014. In looking at credit quality, it's worth noting that, year-to-date through September the 30th, we insured 48 transactions with double-A underlying ratings, including 12 in the third quarter. In comparison, during the first three quarters of 2014, we insured only 19 of such deals. The lower premium rate on double-A transactions still represents a good return because of the lower rating agency capital charges.

We also led the market because we provide superior service to a broad range of transactions. In the third quarter we insured 176 issues with par amounts of $25 million or less, while also insuring seven transactions where par exceeded $90 million. And, pricing during the third quarter saw a nice improvement relative to the first six months of 2015.

Now let me bring you up to date on Puerto Rico developments.

The Municipal Revenue Collections Center (known as CRIM by its Spanish acronym) and the Government Development Bank have come to an agreement that creates a trust for certain local property tax revenues that CRIM had refused to deposit with the GDB because of worries about the GDB's liquidity position and the appropriate segregation and investment of these deposits. These funds are pledged as security for the Puerto Rico

Municipal Finance Agency bonds, most of which are insured by Assured Guaranty. We are paying close attention to this matter and will take whatever action is necessary to ensure the timely application of the pledged revenues to the payment of the MFA bonds.

Turning to the Puerto Rico Electric Power Authority, or PREPA, in mid-September we declined to grant a further extension of our forbearance agreement in order to underscore the urgency of negotiations and to reserve all available options to protect our contractual rights. However, we continue to work with PREPA to reach a consensual settlement that is designed to put the utility on a sound financial footing going forward. If enabling legislation is passed by the Puerto Rico legislature, this potential agreement should result in modernization, long-term sustainable rates to customers, and continued access to efficient financing.

The Treasury and some Puerto Rico officials advocate a retroactive change in the law that, if enacted, would allow an unprecedented bankruptcy regime that has been called “Super Chapter 9,” an even worse idea for Puerto Rico and its residents than earlier proposals because we believe it would ultimately impair the Commonwealth’s economic prospects. As proposed, it would give the territory broader powers to impair long-term obligations than those afforded to any U.S. state. If enacted for Puerto Rico, Super Chapter 9 -- or, for that matter, approving the use of the current Chapter 9 in Puerto Rico -- would reward fiscal and operational mismanagement and harm bondholders and Puerto Rico residents alike by ignoring the real issues -- especially how to jumpstart economic growth -- and foreclosing the island’s future access to efficient financing.

At the same time, it would penalize those long-term investors in Puerto Rico, many of whom are citizens of the Commonwealth, who supported Puerto Rico with the express understanding that bankruptcy was not available and Puerto Rico would honor its constitutional and contractual obligations. There is no justification for initiatives that would retroactively undermine the Puerto Rican Constitution and the legal rights and remedies that were the basis on which bondholders agreed to provide financing for the island’s development.

We welcome the constructive involvement of Federal authorities if it helps address the root causes of Puerto Rico’s crisis. Incentivizing economic growth, facilitating access to efficient financing and providing Federal oversight of fiscal management would not only provide near-term financial relief, but also long-term economic sustainability. For example, modifications to provisions applicable to federal health care reimbursement, or oversight mechanisms like those used in the 1990s to assist the District of Columbia, could contribute to a solution. But any Federal initiatives should aim to restore and enhance Puerto Rico's capital market access, not impair it.

Federal and local officials should focus on solving the very serious structural problems that have been neglected for far too long: mismanagement, inefficiency, tolerance of tax evasion and lack of transparency. On this last point, Governor Padilla asserted in a recent congressional testimony that the Puerto Rico government has a history – in his words - "to hide information to the market so they were able to have more access to the market."

Such unconscionable behavior goes hand in hand with the widespread corruption described in a report of the Puerto Rico Civil Rights Commission released in July. This report enumerates many problems that are both serious and widespread. For example:

- Almost half the money collected by merchants for the sales and use tax is not remitted to the Department of Treasury of Puerto Rico.

- Additionally, more than 200,000 water consumers do not pay for it. This is obviously one reason that the Puerto Rico Aqueduct and Sewer Authority estimated in its August 2015 Preliminary Official Statement that almost 60% of the water it produces provides no revenue.

The Commonwealth government cannot wash its hands of this history by blaming it on prior administrations, because the problems still exist today. Now it claims the only viable solution is for the U.S. Congress to permit a wholesale abrogation of contracts, many of which are constitutionally protected. It would be bad public policy for Congress to approve a bankruptcy regime that permits the Commonwealth and its instrumentalities to impair debt that was sold to investors based on possibly misleading or incomplete disclosure practices, as the Governor claimed. Such Congressional action would condone inadequate disclosure, and run counter to the SEC's efforts to promote better disclosure practices in the municipal bond market. It would alarm not only the market for Puerto Rico debt but the entire municipal bond market. Investors would no longer be able to trust constitutionally protected promises to pay debt, and the cost of borrowing for states would almost certainly increase because it would no longer be certain that they could not declare bankruptcy. Some states might demand the same rights to impair obligations that are proposed for Puerto Rico, further harming the other states that have taken responsible steps to manage their fiscal affairs.

There is a better way. Fair and equitable negotiated agreements with creditors are the best solution because it is in everyone's interest to see Puerto Rico correct its operational shortcomings and build a robust economy based on real strengths, which is only possible if capital market investors resume funding essential infrastructure at a cost Puerto Rico can afford.

We have been a long-term partner of Puerto Rico and its people, helping to lower the cost of financing its roads, schools, utilities and other infrastructure for decades. As long as our rights are respected, and the government shows the political will to correct the longstanding deficiencies, we look forward to playing a constructive role in Puerto Rico's efforts to restructure its debt and improve its economy.

When I look ahead to the fourth quarter and next year, I see important opportunities. In our international business, in addition to new infrastructure transactions, we may have the opportunity to replace other legacy financial guarantors on existing insured transactions. On the structured finance side, the Basel III and Solvency II capital regimes are creating opportunities for us in the banking and life insurance sectors, respectively, where we provide tools for managing capital more efficiently. The global ABS market, like the U.S. public finance market, should offer more opportunities once yields rise and credit spreads widen.

This week Federal Reserve Chair Yellen said that an increase in the benchmark interest rate at the Fed's December meeting is a "live possibility." Whether or not it occurs that soon, an improving economy and labor market will almost certainly lead to an increase from the zero rate in the near term, which would likely result in higher interest costs for borrowers. As we have seen in the past, higher interest rates should increase demand for bond insurance. I'm confident about the future, and we will continue to look for prudent and creative ways to expand our market and create value for our policyholders and shareholders.

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.

Today, I would like to start with a discussion of operating income. For the third quarter of 2015 operating income was $164 million or $1.12 per share. That compares with $177 million or $1.05 per share in the third quarter of 2014.

This quarter's operating income reflects the continued success of:

- our loss mitigation efforts,
- the contribution to earnings from the Radian portfolio, and
- premium accelerations due to negotiated terminations of non-RMBS transactions.

It also includes higher U.S. public finance loss reserves reflecting recent developments in Puerto Rico, which Dominic just described.

Net earned premiums and credit derivative revenues were $252 million in the third quarter of 2015, compared with $166 million in the third quarter of 2014. This increase relates primarily to higher accelerations, which were $105 million in the third quarter of 2015, including $18 million from the Radian Asset portfolio. This compares with $36 million of accelerations in the third quarter of 2014. Net earned premiums and credit derivative revenues were further bolstered by the contribution from the Radian Asset portfolio we acquired in April 2015.

Net investment income in the third quarter of 2015 was higher than the third quarter of 2014 by $12 million. The increase was a direct result of a number of the Company's strategic initiatives, including: income on loss mitigation securities, alternative investments, and the contribution from the Radian Asset acquisition.

Total economic loss development was relatively flat for the third quarter of 2015. The economic benefit in the US RMBS and other structured finance sectors was a total of $94 million. For the public finance sector, we had $91 million in economic loss development mostly related to Puerto Rico exposures.

The US RMBS economic benefit of $76 million is primarily a result of several of our loss mitigation strategies, including one R&W settlement. Moreover, we successfully terminated several US RMBS transactions resulting in a decline in below-investment-grade net par outstanding of $921 million.

The economic benefit relating to the other structured finance sector was $18 million and driven primarily by one CMBS transaction that was acquired as part of the Radian Asset portfolio, and subsequently terminated. This reduced below-investment-grade net par outstanding by an additional $430 million.

The impact of changes in the risk-free discount rates was a loss of $11 million across all sectors.

With respect to our capital management strategy, in the third quarter of 2015, we purchased 5.4 million common shares for a total of $135 million at an average price of $25.17 per share.

From the close of the third quarter of 2015 through November 5th, we purchased an additional 1.7 million shares, and now have $143 million remaining under our share repurchase authorization. Since the beginning of 2013, we have repurchased a total of 54.6 million shares for $1.3 billion at an average price per share of $24.19, representing 28% of our total shares outstanding at the beginning of the repurchase program in 2013.

The impact of share repurchases on the third quarter of 2015 operating income per share was an increase of $0.24. Operating shareholders' equity and adjusted book value per share increased to record highs of $41.87 per share, and $59.97 per share, respectively.

As of October 31, we had approximately $55 million in cash and investments at the Bermuda holding company and approximately $74 million at the US holding companies.

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

Question and Answer Session

Operator

Thank you. We'll now begin the question-and-answer session. [Operator Instructions] The first question comes from Bose George of KBW. Please go ahead.

Bose George - KBW

Hi, guys good morning.

Dominic Frederico - President and Chief Executive Officer

Good morning.

Bose George

Let me just start with, you guys mentioned the investment income increase, is that a good run rate going forward and also same for the operating expense number which came in better than we had thought?

Rob Bailenson - Chief Financial Officer

The investment income number was elevated, Bose, due to a redemption that we had on an alternative investment that we put in the Cat space/ILS space in addition to which it was further benefited by an increased yield on the PREPA bond that we received as part of our purchase on July 1. So that bond has a significant yield, so I would say that the investment income number was a bit elevated due to that. And with respect to expenses, last quarter was elevated because we had the Radian acquisition expenses. This quarter I would say is more indicative of what expenses should be and I would expect that to be consistent going forward.

Bose George

Okay, great. Thanks and then just one on Puerto Rico. Do you have any upcoming debt payments before the January 1 apart from the GDB payment? And then do you think January 1 becomes kind of the new fallback date by which something needs to get resolved? Could this even go further than that?

Dominic Frederico - President and Chief Executive Officer

Well on the debt service payments, Bose, we don't have that much due and I think you are correct in looking at January 1 as being the real fallback date for PREPA. Obviously there are some other payments, the government's responsible for most importantly the GDB of which we have very, very little, so it is not significant on our books. So for us it's really January 1, but if you look at the schedule we provide in the financial supplement, our debt service relative to most of Puerto Rico exposures over the next five years is not insignificant, but pretty benign relative to overall exposure.

Bose George

And then just in terms of something being resolved by January 1, do you think the chances are reasonably good or do you think that could get pushed out as well?

Dominic Frederico

Well, I think there's been a lot of press coverage of this and a lot of statements made publicly by a lot of constituents right. There's a firm belief and we are also in that camp that there is a deal out there to be done, obviously the devil is always in the details and there is a lot of legislative activity that needs to be accomplished to make all the components of the deal work, but we are at this point in time still working hard to get a consensual agreement which we believe is achievable.

Bose George

Okay. Great, thank you.

Operator

The next question comes from Sean Dargan of Macquarie. Please go ahead.

Sean Dargan - Macquarie

Thanks and good morning. You know, given where you are in Puerto Rico and there is no restructuring announced, I think a lot of investors probably think there is a low probability of getting permission for extraordinary dividends out of AGC and AGM. I am wondering if you could maybe help us think about what the ordinary dividend capacity in 2016 will look like, some of the puts and takes, with stat net income, net investment income et cetera?

Rob Bailenson

Hi Sean, it's Rob. I would point you to page eight of the equity presentation because I think that clearly shows what we think our dividend limitations are at our operating subsidiaries. So when you look at that page, the dividend limitation out of AGM annually is around $260 million, at AGC it's about $89 million and at AG Re it's $271 million. Add that all up it is $576 million. If you take out the expenses you need at the holding company it is about $190-something million you get net about somewhere in the mid-300s. Yes, obviously we like to keep a cushion, so we said in the past that, at the end I would argue that it's somewhere in the mid-2s that would be available for share repurchase. So, I think that's based on these numbers that's what I think you should look at.

Sean Dargan

Okay and so mid-200s for full year 2016 would indicate a step down from what you've done this year. Is there anything else you can see on the horizon that might add to your share repurchase capacity?

Dominic Frederico

Well, we always look at further extension or the increase to debt is one of the tools that we would typically use, obviously depending on how the Puerto Rico schedule goes, if we get our PREPA deal done I think that takes a lot of marbles off the table. If there is further clarity around the other risks that are out there, which we have views on of course I think, '16 doesn't for me preclude the potential of a request for some additional dividend capacity. But I think, as we said many, many, many times it's still going rest on Puerto Rico, but a PREPA deal announced somewhere in this year would be a good first step. And then as we address the other exposures in 2016, I'm not willing to give up on '16 as a potential year for further activity.

Sean Dargan

Okay and just I guess following up on Bose's question, there is an awful lot of news flow at Puerto Rico and it's hard to tell what's important to you and what's not. So would a restructuring of PREPA be the most immediate concern that shareholders should be concerned about?

Dominic Frederico

Absolutely, obviously with the debt service schedule we've got as I said that's part of – most difficult – time we've got coming up January 1 and yet if you think about in the bigger context PREPA has always been described as the most troubled credit. It was the one that really facilitated a lot of the talk about the ability to pay and restructuring. So getting that off the table I think is a huge positive step and would potentially put some confidence back in the market that things can be worked out on a rational basis without government interference, meaning federal government interference and let the markets respond to the challenges that they have and use the tools that are available to them through the contracts, et cetera, to get things done.

Sean Dargan

Thank you.

Operator

[Operator Instructions] The next question comes from Brian Meredith of UBS. Please go ahead.

Brian Meredith - UBS

Yes, good morning everybody.

Dominic Frederico

Good morning Brian.

Brian Meredith

Couple of things, Rob just quickly can you give us the specific, what the redemption of the alternative, what the - was the actual dollar figure, just so we can kind of adjust my, kind of go forward investment income numbers?

Rob Bailenson

I believe it was around $4 million.

Brian Meredith

4 million, great, thanks. And second question, what was the driver behind the increase in the reserve for Puerto Rico this quarter?

Dominic Frederico

Okay. We finally got to the question of the day. So, you know, and Rob can give you a hell lot more detail. But remember, in GAAP we've got to go through a scenario analysis of probability weighting. As we look at everything that's happened, taking all available information, so one side of the ledger you look at available information in the third quarter and through to basically today, we have a potential PREPA restructuring deal, that is fact one.

Fact two, we have got potential Federal involvement including the possibility although we don't give it a high probability of some Super bankruptcy bill. Step three, to the extent that the Commonwealth feels that it can't pass obligations that invokes the potential and we do say potential in small gaps here of a claw back, claw back for us affects primarily our transportation exposure which of course you can read on our schedules of largest exposure that we have within the insured group as in respects Puerto Rico debt.

However, we should say if you really look at the technicalities of the claw back it is something very, very, very difficult to achieve and we think there is a lot of both remedies and defense against that, but be that as it may as we look at GAAP reserving all those things have to be scenarioed and therefore probability weighted and therein lies how we come out to our reserves.

So our reserves is really what we have to book relative to what the rules are around accounting it might contra or contradict our own specific views or guestimates of what we think ultimately happens, but this is not a manuscript, right? This is kind of something that had to be done based on a formulaic approach.

So those three main factors are the things that would have contributed to the reserve movement in the quarter, two of them which are negative, one being federal involvement, two being potential claw back. And although we would put the probabilities of those very low, put our probability on any loss estimate from those factors happening and ergo you get reserves. Does that help you?

Brian Meredith

Yes that’s very helpful and I guess just a quick follow up, so given which as you said would that mean under the current PREPA deal you are adequately reserved?

Dominic Frederico

Yes, we always do that. [Multiple Speakers] We’ll wish him well. We’ll come visit him on Sundays, but that would be not a very good outcome.

Rob Bailenson

I believe you signed the financials as well.

Dominic Frederico

But it’s always the CFO that goes to jail.

Brian Meredith

Great, thanks.

Dominic Frederico

And you’re welcome.

Operator

This concludes our question-and-answer session. I would like to turn the conference back over to Robert Tucker for any closing remarks.

Robert Tucker - MD, IR, Corporate Communications

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

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