Assured Guaranty Ltd. (AGO)
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Second Quarter 2022 Earnings Call

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Thank you operator. And thank you all for joining Assured Guaranty for our Second Quarter 2022 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 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 a 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 most recent presentations and SEC filings, most current financial filings, and for the risk factors.

This presentation also includes references to non-GAAP financial measures.

We present the GAAP financial measures most directly comparable to the non-GAAP financial measures referenced in this presentation, along with a reconciliation between such GAAP and non-GAAP financial measures, in our current Financial Supplement and Equity Investor Presentation, which are on our website at AssuredGuaranty.com.

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 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 call.

At the halfway mark of 2022, Assured Guaranty's adjusted operating shareholders' equity per share and adjusted book value per share were at the highest levels in our history, $90.18 and $134.91, respectively.

The second quarter and first half of 2022 were marked by extreme market volatility, rapidly increasing inflation, and Fed action to raise interest rates. Rob will cover how the shifting interest rate environment affected our financial results. But I am pleased to say that our core insurance business continued to perform well in this year's volatile markets.

New business production has been strong, and consistent with recent years' excellent results. First half 2022 PVP totaled $145 million, and its sources were diversified across U.S public finance, international infrastructure and global structured finance.

In terms of direct PVP, we again produced more than $100 million of first-half direct PVP, making it five times out of the last six years that we have exceeded that milestone. In U.S. public finance during the same period, this year's $106 million of first-half direct PVP was second only to last year's first half production and would have easily been the best first half of any year with the inclusion of one large transaction that sold in the second quarter and closed in the third.

During the first half of 2022, municipal bond yields trended higher, and credit spreads also widened, though to a lesser extent. The June 30th benchmark yield of 3.18% for 30-year AAA GO bonds reflected a 65 basis point increase in the second quarter alone, and was more than double the yield at the start of the year. However, yields and spreads were unusually volatile. New-money issues rose modestly in par volume and dominated the market, but rising interest rates also pushed some potential refundings, including taxable advance refundings, out of the money, causing overall market volume to decline.

We continue to see high demand for bond insurance compared with pre-pandemic levels. First-half 2022 insured penetration of 8.8% was higher than the 8.4% in the first half of 2021 and significantly higher than the 5.9% of 2019's first half. We believe that two important factors have helped to amplify the use of bond insurance: wider investor awareness that insurance offers safety from the many potential consequences of volatile economic conditions, and a larger number of issuers recognizing the cost-effectiveness of bond insurance.

For the first half of 2022, Assured's share of the insured primary municipal bond market exceeded 56%. We guaranteed 380 new issues with a total of $10 billion in insured par sold. We set twelve-year records for first-half secondary market par written, at almost $1.8 billion, and combined primary and secondary market insured par sold, at $11.8 billion. Our direct gross par written on U.S. municipal transactions closed during the first half was also the highest in twelve years. Contributing to this were 17 primary-market transactions where we guaranteed $100 million or more of par each. We believe deals of this size reflect significant institutional demand for our insurance due to the financial strength of our guaranty and the relative price stability and increased market liquidity our insurance can provide.

Looking at the second quarter, our insured par sold totaled $6.5 billion, of which $1.4 billion was secondary-market par. Total insurance penetration for the quarter was 8.9%. Our bond insurance market share was over 54%. We also guaranteed 10 large transactions sold in the quarter that utilized over $100 million of our insurance each.

These included a $608 million New York Power Authority issue entirely wrapped by Assured Guaranty and a $460 million portion of an Alameda Corridor Transportation Authority issue, which closed after the quarter-end and has contributed to the strong start we've seen for our third quarter PVP results. In fact, across our company, in the weeks since the third quarter began, we have already written more than $75 million of PVP. Remember, our first half total PVP was $145 million.

In a sign that investors recognize the strength of our guaranty, we continue to add value on double-A credits. For the first half of 2022, we insured $1.6 billion of par sold through 79 primary and secondary market policies on bonds rated in the double-A category by S&P or Moody's, or both. This included $1.1 billion of par on 52 deals sold in the second quarter, of which approximately $300 million was insured in the secondary market.

International public finance produced $30 million of PVP during the first half of 2022, including $18 million in the second quarter. In May, we wrote a large secondary-market guarantee for an institutional investor. Our pipeline of potential international public finance transactions looks very good and includes a number of significant transactions that we consider likely to close in 2022, and as I have said previously, we have already seen a strong start in the third quarter.

In global structured finance, we continue to see potential opportunities with such clients as life insurers, banks, other direct lenders, pension funds and asset-backed investors. We closed our second guaranty of a subscription finance facility for a bank during the second quarter and see many opportunities to work with new counterparties in the fund finance sector. The CLO market remains an important area of focus, and we are speaking with current and potential CLO investors about opportunities created by the recent spread widening.

Most importantly, our insured portfolio quality continues to improve. During the first six months of this year, our exposure to below investment grade credits decreased by almost $2 billion of par, including the $1.3 billion of Puerto Rico exposure we extinguished as a result of the Commonwealth GO/PBA Plan of Adjustment. Our BIG par exposure now represents only 2.3% of our insured portfolio.

On our last call, I mentioned that as part of the Commonwealth GO/PBA Plan of Adjustment, we received cash and new GO bonds totaling approximately $1.2 billion plus additional Contingent Value Instruments.

In addition, concerning the Highways and Transportation Authority revenue bonds, in July we received from the Commonwealth, pursuant to the Commonwealth GO/PBA Plan of Adjustment and the terms of the HTA Plan Support Agreement, $147 million of cash and $668 million notional of Contingent Value Instruments. The HTA Plan of Adjustment confirmation hearing has been set for August 17th and 18th. Assuming the current HTA Plan is confirmed and implemented, we expect to receive additional recoveries in the fourth quarter.

Virtually all responsible parties understand that completing the island's debt restructurings is a key factor for further economic progress in Puerto Rico. The Title III court is applying pressure to complete mediation to achieve a consensual resolution of the treatment of the Puerto Rico Electric Power Authority revenue bonds, our last unresolved Puerto Rico exposure. On July 29th, the judge extended the term of the mediation to August 15th.

The improved quality of our already high-quality insured portfolio adds to the reasons for our insurance subsidiaries' high financial strength ratings. S&P has recently reaffirmed its AA financial strength ratings for all our financial guaranty companies, citing both our "very strong" financial risk profile and "very strong" business risk profile in its annual review of Assured Guaranty. Its report describes many strengths supporting our AA ratings, including S&P's view that we have "excellent capital and earnings with a meaningful capital adequacy buffer." You can read the entire report on our website, AssuredGuaranty.com.

On the asset management side of our business during the second quarter, we increased assets under management by approximately $950 million to $17.9 billion, of which 96% is now fee-earning. Third-party inflows totaled $1.3 billion. We closed a new CLO and held an oversubscribed final closing for our latest healthcare fund, and we continue to execute on our other strategic objectives.

Given the uncertainty in this economic environment, it's good to reflect on the proven resiliency of our company. In the first year of the pandemic we saw investor appetite for bond insurance increase, and that heightened interest has been maintained, as this year's developments continue to remind investors that the future is often volatile. We have succeeded through decades of economic cycles by delivering on our commitments to protect investors' principal and interest against all risks while proving our resilience through disciplined risk management and responsible stewardship of capital.

Our insurance subsidiaries' aggregate $11 billion of claims-paying resources today are approximately the same as what they were at the end of 2007 even though, since then, we have paid gross claims exceeding $13 billion to keep investors whole and returned more than $5 billion to shareholders through share buybacks and dividends. We maintained those numbers by mitigating losses on the gross claim payments to only $6 billion of net claims through recoveries, reinsurance and reimbursements; and by earning more than $6 billion in adjusted operating income over the same period. Our $11 billion of claims-paying resources now supports a smaller and higher quality portfolio of insured risks. By every measurement that compares our capital resources to insured exposure, our insured leverage is less than half what it was at the end of 2009.

This resilience has positioned us to thrive as business and market conditions are creating more incentives for the use of financial guarantees. We have never been better prepared to serve our clients, protect our policyholders and create value for our 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.

In the second quarter of 2022, adjusted operating income was $30 million, or $.46 per share, compared with $120 million, or $1.59 per share in the second quarter of 2021.

The largest drivers of the quarter-over-quarter variance are mark-to-market movements on:

- alternative investments, which had a $27 million after tax loss in the second quarter of 2022 vs. a $38 million after tax gain in the second quarter of last year, and

- the trading portfolio, which consists of Puerto Rico contingent value instruments, and experienced a $15 million loss in the second quarter of 2022.

Our core underwriting results, excluding these fair value adjustments, remain strong. As I mentioned in the past, quarter-to-quarter comparisons of adjusted operating income are volatile due to the nature of these investments, and the corresponding accounting that requires recognition of these mark-to-market movements in income.

However, it is important to note that:

- For the AssuredIM Funds, which account for most of this variance, the inception-to-date mark is a pretax gain of $98 million. This represents a 10.8% total return, which is in line with our targeted return, demonstrating the value of our investment diversification strategy into alternative investments.

- As for the Puerto Rico CVIs – or Contingent Value Instruments – the Company received these instruments as part of the March 2022 resolution of the GO/PBA exposures, which resulted in a $1.3 billion reduction of our insured exposure to Puerto Rico. We now manage this component of our Puerto Rico exposure as tradable instruments. Any gains and losses we recognize in adjusted operating income on this portfolio are a reflection of current market pricing.

Both of these mark-to-market adjustments, which account for $80 million of the variance, are reflected in the Insurance segment, which had adjusted operating income of $55 million in the second quarter of 2022, compared with $152 million in the prior year.

Insurance segment net earned premiums and credit derivative revenues were $86 million in the second quarter of 2022, compared with $106 million in the same period of last year. The refunding component of earned premiums, as well as changes in debt service assumptions, accounted for the majority of the change.

Economic development on our BIG insured portfolio was a benefit of $32 million, primarily consisting of a $39 million benefit in U.S. RMBS. Included in total economic development is the effect of increasing discount rates, which was a benefit of $42 million in the second quarter of 2022, across all sectors. This resulted in a benefit in loss expense of $17 million, which is a function of both economic development, and amortization of deferred premium revenue.

For the insurance segment, income from the investment portfolio consists of several components: net investment income on the available for sale portfolio, and changes in fair value of trading securities and alternative investments.

- Net investment income was $66 million in the second quarter of 2022, compared with $71 million in the second quarter of 2021, primarily due to lower average balances.

- Equity in earnings on alternative investments was a net loss of $34 million in the second quarter of 2022. The losses were a result of lower net asset values of the CLO funds, and dilution from rebalancing following a final fundraising close for the healthcare fund. In the second quarter of last year, these funds had gains of $48 million. This volatility was the single largest driver of the quarter-over-quarter period variance of adjusted operating income.

- Fair value losses on the trading portfolio were $18 million which represent mark-to-market movements on the Puerto Rico Contingent Value Instruments.

The Asset Management segment adjusted operating income increased to break-even in the second quarter of 2022.

With respect to our capital management objectives, we repurchased 2.6 million shares for $151 million in the second quarter of 2022. Subsequent to the quarter close, we repurchased over 600,000 shares for $35 million. On August 3, 2022, the Board of Directors authorized the repurchase of an additional $250 million of our common shares, which brings our current remaining authorization to $365 million.

Continued share repurchases, along with our positive adjusted operating income and new business production, have propelled operating shareholders' equity and adjusted book value per share to new records of over $90 and $134, respectively.

Since the beginning of our repurchase program in 2013, we have returned $4.5 billion to shareholders, resulting in a 71% reduction in total shares outstanding.

From a liquidity standpoint, the holding companies currently have cash and investments of approximately $189 million, of which $135 million resides in AGL. These funds are available for liquidity needs, or for use in the pursuit of our strategic initiatives to either expand our business or repurchase shares to manage our capital.

As we look forward to the rest of the year, we remain optimistic that

- the interest rate environment will be more conducive to new insurance business production

- the asset management segment and alternative assets strategies will continue to contribute to the Company's progress towards its long-term strategic goals, and

- Puerto Rico - our largest single below-investment-grade exposure - will be substantially resolved by the end of the year. In a sign of continued progress, we received $147 million in cash and $668 million in original notional Contingent Value Instruments in July as a part of the pending HTA settlement.

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

QUESTION & ANSWER SESSION

Operator
[Operator Instructions]

Thomas McJoynt, *Keefe, Bruyette, & Woods*
Could you go into a bit more detail on the earned premium declines? I think you attributed to – somewhat to a change in debt service assumptions. And what does that mean for the go-forward recognition of premiums, kind of what you expect there?

Robert Bailenson
So half of it was due to a decline in refundings, and the other part was an extension of life of a transaction because CPI. They're related to CPI index in the U.K. And when you have significant amount of premium associated with that, you have to reallocate that and it's more exposure – you have more exposure. And if you have more exposure, you then

have to earn it over a longer period of time, which makes it so – which then slows down your expected earned premium.

Dominic Frederico
So it doesn't make it smaller. It just makes it go over a longer period of time.

Thomas McJoynt
Okay. Got it. And then it sounds like your demand for your wrap remains strong. Can you talk about pricing on new business relative to the in-force book, both from a perhaps pricing power perspective as well as considering perhaps a more uncertain economic outlook?

Dominic Frederico
Well, as you know, we get paid on debt service, which means as interest rates go up, debt service increases, therefore, the premium calculation of rate times debt service becomes higher. And number two, typically, as interest rates go up, spreads widen and we get paid based on the percentage of spread, that becomes even a more favorable market for us relative to the returns. We calculate return on a transaction-by-transaction basis and business-by-business basis and then compare across quarters and years. So our goal is always to get a double-digit return. Obviously, there is volatility in that as sometimes there's a larger transaction that might come in higher or lower on the basis and it's because we do – given amount per quarter, it could fluctuate the results.

But at the end of the day, we're hitting our target in terms of return. We think the market will continue to get better for us as the year progresses. The first half of the year has been so volatile. There's been a little bit of a sticker shock relative to the issuance in the marketplace. As we said, new money is up a bit, bug there is virtually little activity on the refunding side. However, this environment for us then creates an even better environment for secondary market transactions. And of course, we talked about secondary market in our narrative where to give you a statistic, we have written as much business as of the 6 months in the secondary market that I think is twice what we wrote all last year – a point of comparison. So in the secondary market, obviously, is higher price, higher return business. So the more that, that complements direct primary business really drives ROEs up to a very reasonable or not reasonable but profitable levels for the company.

Robert Bailenson
And to give you some of those numbers on secondary market, as Dominic just talked about, in the second quarter, we wrote $27 million of PVP. For the 6 months, it was $50 million of PVP. And that's over $1.4 billion of par for the quarter so $1.7 billion of par for 6 months.

Thomas McJoynt
Okay. Good, helpful numbers. And then just lastly, could you kind of remind us what your latest sort of calculation is for how much excess capital that you currently have? And whether that be the -- a method we're looking at perhaps rating agency levels or above an acceptable leverage of CPR to gross par or anything else that you think is relevant?

Dominic Frederico
Well, we look at it from 2 bases, right? One, rating agency because it's important that we maintain our AA rating from S&P, and then two, from our own internal capital models make sure we continue to provide the necessary protection and buffer relative to the marketplace to ensure the company remains financially strong. Obviously, it's getting a little bit easier for us as the portfolio continues to amortize down, therefore the leverage ratio decreases. The excess capital position has remained relatively significant. Now the only number we've given you is 2019, we're trying to go to 2020 number, which is over $2 billion, and we're still kind of maintaining a significant level of excess capital. And as you well know, in our capital management strategy, the majority of that has been obviously position relative to share buybacks, which we will continue as part of our capital management strategy.

But we will continue to evaluate circumstances and situations as the market continues to evolve, portfolio amortizes, the higher risk in the portfolio basically continue to decline. And therefore, that excess capital position, we still think is significant. And remember, that's after returning around $4 billion of capital to shareholders. So we've still got a long way to go relative to working the capital down to a reasonable level that we think can provide us the opportunity for higher ROEs, therefore, move up the ROE relative to the cost of capital to get the valuation of the company will improve.

And we look forward with a very strong optimism that, a, the financial guarantee business is growing. Its profitability is widening that should contribute to higher earned premiums. For the next few years, we're still managing the capital down. As we talked a little bit about on the asset management side, we finally got the platform stabilized and breakeven. Now we started to have to build the verticals to start to improve the profitability of that operation.

If you look at all three combined, I think it puts us in a very good situation relative to continue the improvement of ROE against the capital base with the two lines of business is functioning very, very well in this marketplace.

Operator
We'll take our next question from the line of Geoffrey Dunn with Dowling & Partners.

Geoffrey Dunn, *Dowling & Partners*
Rob, I wanted to understand how the new mark on trading securities, I believe that applies to the CVIs you received. But – that is a mark, if I understand correctly, has occurred since you received those CVIs on July 8th. Or does that extend back to some of the instruments you received on the GOs as well?

Robert Bailenson
Yes. It extends back to when we received the original CVIs.

Geoffrey Dunn
Okay. So – but it includes some of the HTA stuff, too? Or no?

Robert Bailenson
The HTA stuff came in very late. So the mark-to-market movement is primarily related to that. General obligations, not HTA.

Geoffrey Dunn
Okay. So what I wanted to understand is with the mark-to-market noise and obviously, it's going to bounce around each quarter, does that affect your recovery assumptions on CVIs to be received in the future here with respect to your reserving at all? Or is it truly just mark noise that doesn't have any implications on the core reserve position?

Dominic Frederico
So if you remember, Geoff, we book a recovery estimate. Once you physically receive the entrance of the recovery, they get priced on the day of receipt. That sets the recovery period relative to the insurance policy and now become an investment in the investment portfolio, now subject to any other volatility in terms of pricing in the investment portfolio until you either hold them to maturity or sell.

Robert Bailenson
Yes. So we've already locked in what's going to be in our reserve. And now it's actually going to go through that investment portfolio.

Geoffrey Dunn
That I understand. I'm just wondering if the trading securities you now have in any way influence your recovery expectation on the CVI still to be received in the future?

Dominic Frederico
Not for the insurance policy, but now for the investment return, right? So you got to make sure you understand that at the date of the settlement, that locks in the recovery ultimately on the insurance policy, period end quote. Now it's no longer having anything to do with recovery on insurance, what the ultimately claim was and now becomes an investment. And obviously, if you look at those investments, we continue to evaluate market conditions, expectations for their returns, what the market returns are. And therefore, we'll manage that balance accordingly as we go through the period.

Robert Bailenson
And Geoff, we've already received – we've already received all of the CVIs that we were going to get from the GOs and the transportation. So we do not expect – we're not getting anymore. So it will not affect any reserve assumptions.

Geoffrey Dunn
Okay. So – and then on the HTA, then all that's remaining is new bonds? Or is there a cash and new bond component still to come?

Robert Bailenson
It's – there's a cash and new bonds component coming when the plan is approved.

Geoffrey Dunn
Got it. Okay, great. Thank you.

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

Robert Tucker
Thank you, operator, and thank you all 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
This concludes today's conference call. Thank you for attending. You may now disconnect your lines. Have a great day.