ASSURED GUARANTY LTD
Form 10-Q
August 10, 2009
Table of Contents

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

x QUARTERLY REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the Quarterly Period Ended June 30, 2009

OR

o TRANSITION REPORT PURSUANT TO SECTION 13 OR 15 (d) OF THE SECURITIES EXCHANGE ACT OF 1934

transition Period from to

Commission File No. 001-32141

ASSURED GUARANTY LTD.

(Exact name of registrant as specified in its charter)

Bermuda	**98-0429991**
(State or other jurisdiction of incorporation)	(I.R.S. employer identification no.)

30 Woodbourne Avenue

Hamilton HM 08

Bermuda

(address of principal executive office)

(441) 299-9375

(Registrants telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. YES x NO o

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). YES o NO o

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer or a smaller reporting company. See definition of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act.

Large accelerated filer x	Accelerated filer o
Non-accelerated filer o (Do not check if a smaller reporting company)	Smaller reporting company o

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes o No x

The number of registrant s Common Shares ($0.01 par value) outstanding as of July 31, 2009 was 156,599,838 (excludes 455,234 unvested restricted shares).

Table of Contents

ASSURED GUARANTY LTD.

INDEX TO FORM 10-Q

		Page
PART I. FINANCIAL INFORMATION		
Item 1.	Financial Statements:	
	Consolidated Balance Sheets (unaudited) as of June 30, 2009 and December 31, 2008	3
	Consolidated Statements of Operations and Comprehensive Income (unaudited) for the Three and Six Months Ended June 30, 2009 and 2008	4
	Consolidated Statements of Shareholders Equity (unaudited) for Six Months Ended June 30, 2009	5
	Consolidated Statements of Cash Flows (unaudited) for Six Months Ended June 30, 2009 and 2008	6
	Notes to Consolidated Financial Statements (unaudited)	7
Item 2.	Management s Discussion and Analysis of Financial Condition and Results of Operations	68
Item 3.	Quantitative and Qualitative Disclosures About Market Risk	130
Item 4.	Controls and Procedures	131
PART II. OTHER INFORMATION		
Item 1.	Legal Proceedings	132
Item 1A.	Risk Factors	135
Item 2.	Unregistered Sales of Equity Securities and Use of Proceeds	137
Item 6.	Exhibits	137

Table of Contents

PART I   FINANCIAL INFORMATION

Item 1. Financial Statements

Assured Guaranty Ltd.

Consolidated Balance Sheets
(in thousands of U.S. dollars except per share and share amounts)

(Unaudited)

	June 30, 2009	December 31, 2008
Assets		
Fixed maturity securities, at fair value (amortized cost: $3,418,383 in 2009 and $3,162,308 in 2008)	$ 3,413,257	$ 3,154,137
Short-term investments, at cost which approximates fair value	1,170,970	477,197
Total investments	**4,584,227**	**3,631,334**
Cash and cash equivalents	8,507	12,305
Accrued investment income	31,477	32,846
Deferred acquisition costs	374,087	288,616
Prepaid reinsurance premiums	23,121	18,856
Reinsurance recoverable on ceded losses	4,533	6,528
Premiums receivable	752,892	15,743
Goodwill	85,417	85,417
Credit derivative assets	146,350	146,959
Deferred tax asset	209,109	129,118
Current income taxes receivable	26,351	21,427
Salvage recoverable	199,828	80,207
Committed capital securities, at fair value	10,158	51,062
Other assets	39,682	35,289
Total assets	**$ 6,495,739**	**$ 4,555,707**
Liabilities and shareholders equity		
Liabilities		
Unearned premium reserves	$ 2,222,717	$ 1,233,714
Reserves for losses and loss adjustment expenses	200,287	196,798
Profit commissions payable	10,220	8,584
Reinsurance balances payable	33,754	17,957
Funds held by Company under reinsurance contracts	30,000	30,683
Credit derivative liabilities	957,752	733,766
Long-term debt	516,974	347,210
Other liabilities	169,116	60,773
Total liabilities	**4,140,820**	**2,629,485**
Commitments and contingencies		
Shareholders equity		
Common stock ($0.01 par value, 500,000,000 shares authorized; 134,445,139 and 90,955,703 shares issued and outstanding in 2009 and 2008)	1,344	910
Additional paid-in capital	1,733,997	1,284,370
Retained earnings	622,369	638,055

Accumulated other comprehensive (loss) income		(2,791)		2,887
Total shareholders equity		**2,354,919**		**1,926,222**
Total liabilities and shareholders equity	**$**	**6,495,739**	**$**	**4,555,707**

The accompanying notes are an integral part of these consolidated financial statements.

Table of Contents

Assured Guaranty Ltd.

Consolidated Statements of Operations and Comprehensive Income
(in thousands of U.S. dollars except per share amounts)

(Unaudited)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2009	**2008**	**2009**	**2008**
Revenues				
Net earned premiums	$ 78,634	$ 51,685	$ 227,080	$ 98,518
Net investment income	43,300	40,232	86,901	76,806
Net realized investment (losses) gains (includes impairment losses of $14,833, consisting of $36,466 of total other-than-temporary impairment losses, net of $21,633 recognized in other comprehensive income, for the quarter ended June 30, 2009)	(4,888)	1,453	(21,998)	2,080
Change in fair value of credit derivatives				
Realized gains and other settlements on credit derivatives	27,816	31,793	48,395	59,410
Unrealized (losses) gains on credit derivatives	(254,284)	708,502	(227,302)	448,881
Net change in fair value of credit derivatives	(226,468)	740,295	(178,907)	508,291
Fair value (loss) gain on committed capital securities	(60,570)	8,896	(40,904)	17,407
Other income	492	153	1,394	178
Total revenues	**(169,500)**	**842,714**	**73,566**	**703,280**
Expenses				
Loss and loss adjustment expenses	38,030	38,125	117,784	93,263
Profit commission expense	2,071	1,022	2,326	2,202
Acquisition costs	16,548	11,825	39,969	23,708
Other operating expenses	22,594	19,665	50,291	48,303
FSAH acquisition-related expenses	24,225		28,846	
Interest expense	6,484	5,820	12,305	11,641
Other expenses	1,868	1,715	3,268	2,450
Total expenses	**111,820**	**78,172**	**254,789**	**181,567**
(Loss) income before (benefit) provision for income taxes	(281,320)	764,542	(181,223)	521,713
(Benefit) provision for income taxes				
Current	(9,874)	7,212	1,701	17,325
Deferred	(101,442)	212,114	(98,409)	128,381
Total (benefit) provision for income taxes	**(111,316)**	**219,326**	**(96,708)**	**145,706**
Net (loss) income	**(170,004)**	**545,216**	**(84,515)**	**376,007**
Other comprehensive income (loss), net of taxes				
Unrealized holding gains (losses) on fixed maturity securities arising during the year	59,667	(41,289)	49,965	(46,186)
	7,114	(895)	24,189	(1,289)

Reclassification adjustment for realized losses (gains) included in net (loss) income				
Change in net unrealized gains on fixed maturity securities	66,781	(42,184)	74,154	(47,475)
Unrealized losses on fixed maturity securities related to factors other than credit	(19,968)		(19,968)	
Change in cumulative translation adjustment	6,384	(458)	(2,003)	(101)
Cash flow hedge	(104)	(104)	(209)	(209)
Other comprehensive income (loss), net of taxes	**53,093**	**(42,746)**	**51,974**	**(47,785)**
Comprehensive (loss) income	**$ (116,911)**	**$ 502,470**	**$ (32,541)**	**$ 328,222**
Earnings per share:				
Basic	$ (1.82)	$ 6.01	$ (0.91)	$ 4.38
Diluted	$ (1.82)	$ 5.96	$ (0.91)	$ 4.35
Dividends per share	$ 0.045	$ 0.045	$ 0.09	$ 0.09

The accompanying notes are an integral part of these consolidated financial statements.

4

Table of Contents

Assured Guaranty Ltd.

Consolidated Statements of Shareholders Equity
For Six Months Ended June 30, 2009
(in thousands of U.S. dollars except per share amounts)

(Unaudited)

	Common Stock	Additional Paid-in Capital	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Total Shareholders Equity
Balance, December 31, 2008	**$ 910**	**$ 1,284,370**	**$ 638,055**	**$ 2,887**	**$ 1,926,222**
Cumulative effect of accounting change - Adoption of FAS 163 effective January 1, 2009			19,443		19,443
Cumulative effect of accounting change - Adoption of FSP 115-2 effective April 1, 2009			57,652	(57,652)	
Net loss			(84,515)		(84,515)
Dividends ($0.09 per share)			(8,199)		(8,199)
Dividends on restricted stock units		67	(67)		
Net proceeds from issuance of common stock	443	447,647			448,090
Common stock repurchases	(10)	(3,666)			(3,676)
Shares cancelled to pay withholding taxes	(1)	(982)			(983)
Shares issued under ESPP		205			205
Share-based compensation and other	2	6,356			6,358
Change in cash flow hedge, net of tax of $(113)				(209)	(209)
Change in cumulative translation adjustment				(2,003)	(2,003)
Unrealized losses related to factors other than credit, net of tax of $(1,665)				(19,968)	(19,968)
All other unrealized gains on fixed maturity securities, net of tax of $12,739				74,154	74,154
Balance, June 30, 2009	**$ 1,344**	**$ 1,733,997**	**$ 622,369**	**$ (2,791)**	**$ 2,354,919**

The accompanying notes are an integral part of these consolidated financial statements.

Table of Contents

Assured Guaranty Ltd.

Consolidated Statements of Cash Flows
(in thousands of U.S. dollars)

(Unaudited)

	Six Months Ended June 30, 2009	Six Months Ended June 30, 2008
Operating activities		
Net (loss) income	$ (84,515)	$ 376,007
Adjustments to reconcile net (loss) income to net cash flows provided by operating activities:		
Non-cash interest and operating expenses	8,542	10,771
Net amortization of (discount) premium on fixed maturity securities	(4,810)	2,295
Accretion of discount on premium receivable	(10,812)	
(Benefit) provision for deferred income taxes	(98,409)	128,381
Net realized investment losses (gains)	21,998	(2,080)
Unrealized losses (gains) on credit derivatives	227,302	(448,881)
Fair value loss (gain) on committed capital securities	40,904	(17,407)
Change in deferred acquisition costs	16,365	(25,282)
Change in accrued investment income	1,369	(5,451)
Change in premiums receivable	(4,899)	1,962
Change in prepaid reinsurance premiums	2,360	(7,121)
Change in unearned premium reserves	161,350	320,214
Change in reserves for losses and loss adjustment expenses, net	(73,400)	19,843
Change in profit commissions payable	1,636	(11,583)
Change in funds held by Company under reinsurance contracts	(683)	3,852
Change in current income taxes	(4,924)	(3,372)
Tax benefit for stock options exercised		(10)
Other changes in credit derivatives assets and liabilities, net	(2,707)	(2,820)
Other	6,113	(7,956)
Net cash flows provided by operating activities	**202,780**	**331,362**
Investing activities		
Fixed maturity securities:		
Purchases	(827,862)	(840,455)
Sales	705,004	252,503
Maturities	5,500	3,350
(Purchases) sales of short-term investments, net	(693,637)	17,807
Net cash flows used in investing activities	**(810,995)**	**(566,795)**
Financing activities		
Net proceeds from issuance of common stock	448,495	248,978
Net proceeds from issuance of equity units	167,972	
Dividends paid	(8,199)	(7,769)
Repurchases of common stock	(3,676)	

Share activity under option and incentive plans	(778)	(3,833)
Tax benefit for stock options exercised		10
Net cash flows provided by (used in) financing activities	**603,814**	**237,386**
Effect of exchange rate changes	603	123
(Decrease) increase in cash and cash equivalents	(3,798)	2,076
Cash and cash equivalents at beginning of period	12,305	8,048
Cash and cash equivalents at end of period	**$ 8,507**	**$ 10,124**
Supplementary cash flow information		
Cash paid during the period for:		
Income taxes	$ 6,836	$ 20,700
Interest	$ 11,800	$ 11,800

The accompanying notes are an integral part of these consolidated financial statements.

Assured Guaranty Ltd.
Notes to Consolidated Financial Statements

June 30, 2009

(Unaudited)

1. Business and Organization

Assured Guaranty Ltd. is a Bermuda-based holding company which provides, through its operating subsidiaries, credit enhancement products to the public finance, structured finance and mortgage markets (together with its subsidiaries, the Company). Credit enhancement products are financial guarantees or other types of support, including credit derivatives, which improve the credit of underlying debt obligations. The Company issues policies in both financial guaranty and credit derivative form. Assured Guaranty Ltd. applies its credit expertise, risk management skills and capital markets experience to develop insurance, reinsurance and derivative products that meet the credit enhancement needs of its customers. Under a reinsurance agreement, the reinsurer, in consideration of a premium paid to it, agrees to indemnify another insurer, called the ceding company, for part or all of the liability of the ceding company under one or more insurance policies that the ceding company has issued. A derivative is a financial instrument whose characteristics and value depend upon the characteristics and value of an underlying security. Assured Guaranty Ltd. markets its products directly to and through financial institutions, serving the U.S. and international markets. Assured Guaranty Ltd. s financial results include four principal business segments: financial guaranty direct, financial guaranty reinsurance, mortgage guaranty and other. These segments are further discussed in Note 14.

Financial guaranty insurance provides an unconditional and irrevocable guaranty that protects the holder of a financial obligation against non-payment of principal and interest when due. Financial guaranty insurance may be issued to the holders of the insured obligations at the time of issuance of those obligations, or may be issued in the secondary market to holders of public bonds and structured securities. A loss event occurs upon existing or anticipated credit deterioration, while a payment under a policy occurs when the insured obligation defaults. This requires the Company to pay the required principal and interest when due in accordance with the underlying contract. The principal types of obligations covered by the Company s financial guaranty direct and financial guaranty assumed reinsurance businesses are structured finance obligations and public finance obligations. Because both businesses involve similar risks, the Company analyzes and monitors its financial guaranty direct portfolio and financial guaranty assumed reinsurance portfolio on a unified process and procedure basis.

Mortgage guaranty insurance is a specialized class of credit insurance that provides protection to mortgage lending institutions against the default of borrowers on mortgage loans that, at the time of the advance, had a loan to value in excess of a specified ratio. Reinsurance in the mortgage guaranty insurance industry is used to increase the insurance capacity of the ceding company, to assist the ceding company in meeting applicable regulatory and rating agency requirements, to augment the financial strength of the ceding company, and to manage the ceding company s risk profile. The Company provides mortgage guaranty protection on an excess of loss basis.

The Company has participated in several lines of business that are reflected in its historical financial statements but that the Company exited in connection with its 2004 initial public offering (IPO). The results from these lines of business make up the Company s Other segment discussed in Note 14.

Table of Contents

The Company s subsidiaries have been assigned the following insurance financial strength ratings as of the date ofhis filling. These ratings are subject to continuous review:

	Moody s	S&P	Fitch
Assured Guaranty Corp. (AGC)	Aa2(Excellent)	AAA(Extremely Strong)	AA(Very Strong)
Assured Guaranty Re Ltd. (AG Re)	Aa3(Excellent)	AA(Very Strong)	AA-(Very Strong)
Assured Guaranty Re Overseas Ltd. (AGRO)	Aa3(Excellent)	AA(Very Strong)	AA-(Very Strong)
Assured Guaranty Mortgage Insurance Company	Aa3(Excellent)	AA(Very Strong)	AA-(Very Strong)
Assured Guaranty (UK) Ltd. (AG(UK))	Aa2(Excellent)	AAA(Extremely Strong)	AA(Very Strong)
Financial Security Assurance Inc. (FSA)	Aa3(Excellent)	AAA(Extremely Strong)	AA+(Very Strong)
FSA Insurance Company	Aa3(Excellent)	AAA(Extremely Strong)	AA+(Very Strong)
Financial Security Assurance International Ltd.	Aa3(Excellent)	AAA(Extremely Strong)	AA+(Very Strong)
Financial Security Assurance (U.K.) Ltd	Aa3(Excellent)	AAA(Extremely Strong)	AA+(Very Strong)

On May 4, 2009, Fitch Inc. (Fitch) downgraded the debt and insurer financial strength ratings of Assured Guaranty Ltd. and its subsidiaries, as applicable, based on Fitch s concerns that Assured Guaranty Ltd. continued to face negative credit migration within the combined insured portfolio, primarily related to structured finance, outpacing its ability to build capital resources through earnings retention. It cited mortgage-related exposures as a particular area of concern, as well as exposures to trust preferred securities collateralized debt obligations (TruPS CDOs) and other structured finance transactions which have been subject to ratings downgrades. Fitch downgraded the insurer financial stronger ratings of AGC and AG(UK) to AA from AAA , downgraded the insurer financial strength ratings of AG Re, AGRO and Assured Guaranty Mortgage Insurance Company to AA- from AA and the debt ratings of Assured Guaranty US Holdings Inc. (AGUS). All such ratings were placed on Rating Watch Evolving. On May 11, 2009, Fitch downgraded the insurer financial strength relating of FSA and certain other affiliates to AA+ from AAA and the long term rating of Financial Security Assurance Holding Ltd. (FSAH) to A+ from AA . All such rating remain on Rating Watch Negative. Fitch cited as the primary reason for this action Fitch s view of the residual risks retained by FSA following the transfer of its financial products business to Dexia S.A. (Dexia), which transfer is described in greater detail below. On August 10, 2009, Fitch placed the debt and insurer financial strength ratings of the Company and its subsidiaries on Rating Watch Negative, a change from Rating Watch Evolving. It confirmed that the ratings of FSAH and its subsidiaries remained on Rating Watch Negative. Fitch reported that it is currently in the process of analyzing the insured portfolios and overall capital adequacy of AGC, AG Re and FSA, and that the Rating Watch Negative reflects concerns with respect to further credit deterioration in mortgage-related exposures, which could negatively impact the capital positions of the companies. It noted that credit deterioration in other areas of the insured portfolios, including TruPS CDOs and public finance exposures, could also place additional pressure on claims paying resources, as could ratings-based triggers which could force termination or collateralization of insured exposures at AGC or the claw-back of certain businesses underwritten by AG Re. Fitch notes that it expects to complete its rating review over the next four to six weeks. There is no assurance that Fitch will not take further action on our ratings.

On May 20, 2009, Moody s Investors Service (Moody s) placed under review for possible downgrade the Aa2 insurance financial strength rating of AGC, as well as the ratings of other entities within the Assured group. In its public announcement of the rating action, Moody s stated that this action reflects its view that despite recent improvements in the Company s market position, the expected performance of its insured portfolio particularly the mortgage-related risks has substantially worsened. At the same time, Moody s also placed the Aa3 insurance financial strength ratings of FSA and its affiliated insurance operating companies on review for possible downgrade. In its public announcement of the rating action, Moody s cited its growing concerns about FSA s business and financial profile as a result of further deterioration in FSA s U.S. mortgage portfolio and the related adverse effect on its capital adequacy, profitability, and market traction. In both press releases, Moody s noted that it has taken a more negative view of mortgage-related exposures and Assured Guaranty Ltd. s pooled corporate exposures in light of worse-than-expected performance trends, and recognized the continued susceptibility of the insured portfolio to the weak economic environment. Moody s also commented that the deterioration in the insured portfolios could have negative implications for the companies franchise values, profitability and financial flexibility given the likely sensitivity of those business attributes to its capital position. Moody s also noted that the market dislocation caused by the declining financial strength of financial guaranty insurers may alter the competitive dynamics of the industry by encouraging the entry of new participants or the growth of alternative forms of execution. There can be no assurance as to the outcome of Moody s review.Moody s did note on June 17, 2009, in respect of the securities of AGUS, that in light of the high sensitivity of the Company s financial profile to RMBS and CDOs, meaningful increases in Moody s stress loss estimates for these exposures, which are possible, combined with the subordination of the AGUS securities, could result in a multiple-notch downgrade of the AGUS securities, perhaps below

investment grade. On July 24, 2009, Moody s announced that it expects to conclude its ratings review of the companies by mid-August 2009.

On July 1, 2009, Standard & Poor s, a division of The McGraw-Hill Companies, Inc. (S&P) published a Research Update in which it affirmed its AAA counterparty credit and financial strength ratings on AGC and FSA. At the same time, S&P revised its outlook on AGC and AG(UK) to negative from stable and continued its negative outlook on FSA. S&P cited as a rationale for its actions the large single risk concentration exposure that Assured Guaranty Ltd. and FSA retain to Belgium and France prior to the posting of collateral by Dexia in October 2011, all in connection with the acquisition of FSAH by a subsidiary of Assured Guaranty Ltd., which

8

acquisition is described in greater detail below. In addition, the outlook also reflects S&P s view that the change in the competitive dynamics of the industry with the potential entrance of new competitors, alternative forms of credit enhancement and limited insurance penetration in the U.S. public finance market could hurt the companies business prospects. There can be no assurance that S&P will not take further action on our ratings.

Acquisition of Financial Security Assurance Holdings Ltd.

On July 1, 2009, the Company, through its fully-owned subsidiary, AGUS, purchased FSAH and, indirectly, all of its subsidiaries other than those involved in its financial products business, including its principal operating subsidiary, the financial guaranty insurance company Financial Security Assurance, Inc. from Dexia Holdings, Inc. (Dexia Holdings), which is a subsidiary of Dexia. The former FSAH subsidiaries that were involved in the financial products business were transferred to Dexia at closing and the Company is indemnified, through guarantees issued by Dexia and affiliated entities and the French and Belgian governments, against exposure to FSAH s financial products segment, which includes its guaranteed investment contract business, medium term note business and leveraged tax lease business.

The purchase price paid by the Company was approximately $546 million in cash and approximately 22.3 million common shares of the Company for a total purchase price of approximately $822 million. The issuance of these 22.3 million common shares is in addition to the common shares issued by the Company on June 24, 2009 as discussed below. Dexia Holdings owns approximately 14.0% of Assured Guaranty Ltd. s issued common shares as a result of this transaction. Dexia Holdings has agreed that the voting rights with respect to all Assured Guaranty Ltd. s common shares issued pursuant to the Purchase Agreement will constitute less than 9.5% of the voting power of all issued and outstanding Assured Guaranty Ltd. s common shares. Dexia Holdings has also agreed to a standstill arrangement until the date on which it and its affiliates beneficially own Assured Guaranty Ltd. s common shares in an amount less than 10% of the outstanding Assured Guaranty Ltd. s common shares. In addition, Dexia Holdings has agreed that, until November 14, 2009, the first anniversary of the date of the Purchase Agreement, it will not transfer any of the Assured Guaranty Ltd. s common shares issued pursuant to the Purchase Agreement without the consent of the Company, other than to one or more of its affiliates that agrees to abide by the voting and other restrictions described above.

The Company financed the cash portion of the acquisition with the proceeds of the public equity offering discussed below.

Common Share and Equity Units Offerings

On June 24, 2009, the Company completed the sale of 44,275,000 of its common shares (including 5,775,000 common shares allocable to the underwriters pursuant to the overallotment option) at a price of $11.00 per share. Concurrent with the common share offering, the Company along with AGUS sold 3,450,000 equity units (including 450,000 equity units allocable to the underwriters) at a stated amount of $50 per unit. The equity units initially consist of a forward purchase contract and a 5% undivided beneficial ownership interest in $1,000 principal amount 8.50% senior notes due 2014 issued by AGUS (8.50% Senior Notes). Under the purchase contract, holders are required to purchase the Company s common shares no later than June 1, 2012. The threshold appreciation price of the equity units is $12.93, which represents a premium of 17.5% over the public offering price in the common share offering. The 8.50% Senior Notes are fully and unconditionally guaranteed by Assured Guaranty Ltd. The net proceeds after underwriting expenses and offering costs for these two offerings totaled approximately $616.5 million. Of that amount, the net proceeds from the equity offering were $170.8 million, which was allocated between $168.0 million recognized as long-term debt and $2.8 million of the purchase contract recognized in additional paid-in-capital in shareholders equity in the consolidated balance sheets.

In conjunction with the acquisition, the Company entered into an Amendment to the Investment Agreement dated as of November 13, 2008 with investment funds affiliated with WL Ross Group, L.P. (WLR Funds), which amended the Investment Agreement (the Investment Agreement) dated as of February 28, 2008 between the Company and WLR Funds, which provided a back up funding commitment to finance the acquisition. Pursuant to pre-emptive rights set forth in the Investment Agreement, WLR Funds, which are affiliated with Wilbur L. Ross, Jr., who is one of the Company s directors, purchased 3,850,000 common shares of the

Table of Contents

Company in the Company s June 2009 public common share offering at $11.00 per common share, the public offering price in the public offering. As of the date of this filing the WLR Funds own approximately 10.2% of the outstanding common stock of the Company.

2. Basis of Presentation

The unaudited interim consolidated financial statements, which include the accounts of the Company, have been prepared in conformity with accounting principles generally accepted in the United States of America (GAAP) and, in the opinion of management, reflect all adjustments, which are of a normal recurring nature, necessary for a fair statement of the Company s financial condition, results of operations and cash flows for the periods presented. The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities as of the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. These unaudited interim consolidated financial statements cover the three-month period ended June 30, 2009 (Second Quarter 2009), the three-month period ended June 30, 2008 (Second Quarter 2008), the six-month period ended June 30, 2009 (Six Months 2009) and the six-month period ended June 30, 2008 (Six Months 2008). Operating results for the three- and six-month periods ended June 30, 2009 are not necessarily indicative of the results that may be expected for a full year. These financial statements include the effects of the Company s common share and equity units offering that took place on June 24, 2009 but do not include the effects of the acquisition of FSAH, which occurred effective July 1, 2009. The Company s financial statements as of September 30, 2009 will include the effects of the FSAH acquisition, including three months of operating results attributable to FSAH entities.

Certain prior year items have been reclassified to conform to the current year presentation. These unaudited interim consolidated financial statements should be read in conjunction with the Company s consolidated financial statements included in the Company s Annual Report on Form 10-K for the year ended December 31, 2008, filed with the Securities and Exchange Commission. All intercompany accounts and transactions have been eliminated. The Company has evaluated all subsequent events through August 10, 2009, the date the financial statements were issued.

Certain of the Company s subsidiaries are subject to U.S. and U.K. income tax. The provision for income taxes is calculated in accordance with Statement of Financial Accounting Standards (FAS) No. 109, Accounting for Income Taxes . The Company s provision for income taxes for interim financial periods is not based on an estimated annual effective rate due to the variability in changes in fair value of its credit derivatives, which prevents the Company from projecting a reliable estimated annual effective tax rate and pre-tax income for the full year of 2009. A discrete calculation of the provision is calculated for each interim period.

Volatility and disruption in the global financial markets including depressed home prices and increasing foreclosures, falling equity market values, rising unemployment, declining business and consumer confidence and the risk of increased inflation, have precipitated an economic slowdown. The conditions may adversely affect the Company s future profitability, financial position, investment portfolio, cash flow, statutory capital, financial strength ratings and stock price. Additionally, future legislative, regulatory or judicial changes in the jurisdictions regulating the Company may adversely affect its ability to pursue its current mix of business, materially impacting its financial results.

Adoption of FAS 163

Effective January 1, 2009, the Company adopted Statement of Financial Accounting Standards No. 163, Accounting for Financial Guarantee Insurance Contracts (FAS 163). FAS 163 requires that an insurance enterprise recognize a claim liability prior to an event of default (insured event) when there is evidence that credit deterioration has occurred in an insured financial obligation. FAS 163 also clarifies the methodology to be used for financial guaranty premium revenue recognition and claim liability measurement, as well as requiring expanded disclosures about the insurance enterprise s risk management activitiesFAS 163 has been applied to all existing and future financial guaranty insurance contracts written by the Company.

Table of Contents

The accounting changes prescribed by the statement were recognized by the Company as a cumulative effect adjustment to retained earnings as of January 1, 2009.

Premium Revenue Recognition

Premiums are received either upfront or in installments.

Upon Adoption of FAS 163

The Company recognizes a liability for the unearned premium revenue at the inception of a financial guarantee contract equal to the present value of the premiums due or expected to be collected over the period of the contract. If the premium is a single premium received at the inception of the financial guarantee contract, the Company measures the unearned premium revenue as the amount received. The period of the contract is the expected period of risk that generally equates to the contract period. However, in some instances, the expected period of risk is significantly shorter than the full contract period due to expected prepayments. In those instances where the financial guarantee contract insures a homogeneous pool of assets that are contractually prepayable and where those prepayments are probable and the timing and amount of prepayments can be reasonably estimated the Company uses the expected period of risk to recognize premium revenues. The Company adjusts prepayment assumptions when those assumptions change and recognizes a prospective change in premium revenues as a result. The adjustment to the unearned premium revenue is equal the adjustment to the premium receivable with no effect on earnings at the time of the adjustment.

The Company recognizes the premium from a financial guarantee insurance contract as revenue over the period of the contract in proportion to the amount of insurance protection provided. As premium revenue is recognized, a corresponding decrease in the unearned premium revenue occurs. The amount of insurance protection provided is a function of the insured principal amount outstanding. Therefore, the proportionate share of premium revenue to be recognized in a given reporting period is a constant rate calculated based on the relationship between the insured principal amount outstanding in a given reporting period compared with the sum of each of the insured principal amounts outstanding for all periods. When the issuer of an insured financial obligation retires the insured financial obligation before its maturity and replaces it with a new financial obligation, referred to as a refunding, the financial guarantee insurance contract on the retired financial obligation is extinguished. The Company immediately recognizes any nonrefundable unearned premium revenue related to that contract as premium revenue and any associated acquisition costs previously deferred as an expense.

The following table provides information for financial guaranty insurance contracts where premiums are received on an installment basis as of and for the six months ended June 30, 2009 (dollars in thousands):

Premiums receivable, net of ceding commissions (end of period)(1)	$	732,504
Unearned premium reserves (end of period)(2)	$	933,771
Accretion of discount on premium receivable	$	10,812
Weighted-average risk-free rate to discount premiums		2.7%
Weighted-average period of premiums receivable (in years)		10.4

(1) Includes $94.8 million of ceding commissions due on future installment premium receivable.

(2) Includes unearned premium related to the upfront portion of premiums received on bi-furcated deals.

Table of Contents

The premiums receivable expected to be collected are:

(dollars in thousands)		
2009 (July 1 September 30)	$	36,605
2009 (October 1 December 31)		17,546
2010 (January 1 March 31)		17,512
2010 (April 1 June 30)		15,181
2010 (July 1 December 31)		27,635
2011		50,112
2012		47,845
2013		41,259
2014 - 2018		164,027
2019 - 2023		119,010
2024 - 2028		93,285
2029 - 2033		73,087
2034 - 2038		32,754
2039 - 2043		12,577
2044 - 2048		3,970
2049 - 2053		460
2054 - 2056		27
Total premiums receivable, net of ceding commissions	$	752,892

The following table provides a reconciliation of the beginning and ending balances of premium receivable:

(dollars in thousands)		
Balance as of January 1, 2009	$	737,181
Add: premiums written - net		376,799
Add: accretion of premium receivable discount		10,812
Less: premium payments received		(371,900)
Balance as of June 30, 2009	$	752,892

The accretion of premium receivable discount is included in earned premium in the Company s statement of operations. The above amounts are presented net of applicable ceding commissions.

The future expected financial guarantee premium revenue that the Company expects to recognize are:

(dollars in thousands)		
2009 (July 1 September 30)	$	49,750
2009 (October 1 December 31)		48,713
2010 (January 1 March 31)		45,654
2010 (April 1 June 30)		46,001
2010 (July 1 December 31)		88,639
2011		165,333
2012		150,753

2013		136,441
2014 - 2018		538,190
2019 - 2023		374,382
2024 - 2028		260,215
After 2028		305,678
Total future expected financial guarantee premium revenue	$	2,209,749

Table of Contents

In the Company s reinsurance businesses, the Company estimates the ultimate written and earned premiums to be received from a ceding company at the end of each quarter and the end of each year because some of the Company s ceding companies report premium data anywhere from 30 to 90 days after the end of the relevant period. Written premiums reported in the Company s statement of operations are based upon reports received from ceding companies supplemented by the Company s own estimates of premium for which ceding company reports have not yet been received. Differences between such estimates and actual amounts are recorded in the period in which the actual amounts are determined.

Prior to Adoption of FAS 163

Prior to January 1, 2009, upfront premiums were earned in proportion to the expiration of the amount at risk. Each installment premium was earned ratably over its installment period, generally one year or less. Premium earnings under both the upfront and installment revenue recognition methods were based upon and were in proportion to the principal amount guaranteed and therefore resulted in higher premium earnings during periods where guaranteed principal was higher. For insured bonds for which the par value outstanding was declining during the insurance period, upfront premium earnings were greater in the earlier periods thus matching revenue recognition with the underlying risk. The premiums were allocated in accordance with the principal amortization schedule of the related bond issue and were earned ratably over the amortization period. When an insured issue was retired early, was called by the issuer, or was in substance paid in advance through a refunding accomplished by placing U.S. Government securities in escrow, the remaining unearned premium reserves were earned at that time. Unearned premium reserves represented the portion of premiums written that were applicable to the unexpired amount at risk of insured bonds.

Deferred Acquisition Costs

Acquisition costs incurred, other than those associated with financial guarantees written in credit derivative form, that vary with and are directly related to the production of new business are deferred in proportion to written premium and amortized in relation to earned premiums. These costs include direct and indirect expenses such as ceding commissions, brokerage expenses and the cost of underwriting and marketing personnel. Management uses its judgment in determining what types of costs should be deferred, as well as what percentage of these costs should be deferred. The Company annually conducts a study to determine which operating costs vary with, and are directly related to, the acquisition of new business and qualify for deferral. Ceding commissions received on premiums the Company cedes to other reinsurers reduce acquisition costs. Anticipated losses, loss adjustment expenses and the remaining costs of servicing the insured or reinsured business are considered in determining the recoverability of acquisition costs. Acquisition costs associated with credit derivative products are expensed as incurred. When an insured issue is retired early, as discussed above in the Premium Revenue Recognition section, the remaining related deferred acquisition cost is expensed at that time. Ceding commissions, calculated at their contractually defined rate, associated with future installment premiums on assumed and ceded reinsurance business were recorded in deferred acquisition costs upon the adoption of FAS 163 with a corresponding offset to premium receivable.

Reserves for Losses and Loss Adjustment Expenses

The Company s financial guarantees written in credit derivative form have substantially the same terms and conditions in respect of the obligation to make payments upon the failure of an obligor to pay as its financial guaranty contracts written in insurance form. Under GAAP, however, the former are subject to derivative accounting rules and the latter are subject to insurance accounting rules.

Financial Guaranty Contracts Upon Adoption of FAS 163

The Company recognizes a reserve for losses and loss adjustment expenses on a financial guarantee insurance contract when the Company expects that a claim loss will exceed the unearned premium revenue for that contract based on the present value of expected net cash outflows to be paid under the insurance contract. The unearned premium revenue represents the insurance enterprise s stand-ready obligation under a financial guarantee insurance contract at initial recognition. Subsequently, if the likelihood of a default (insured event) increases so that the present value of the expected net cash outflows expected to be paid under the insurance contract exceeds the

13

Table of Contents

unearned premium revenue, the Company recognizes a reserve for losses and loss adjustment expenses in addition to the unearned premium revenue.

A reserve for losses is equal to the present value of expected net cash outflows to be paid under the insurance contract discounted using a current risk-free rate. That current risk-free rate is based on the remaining period (contract or expected, as applicable) of the insurance contract. Expected net cash outflows (cash outflows, net of potential recoveries, expected to be paid to the holder of the insured financial obligation, excluding reinsurance) are probability-weighted cash flows that reflect the likelihood of possible outcomes. The Company estimates the expected net cash outflows using the internal assumptions about the likelihood of possible outcomes based on all information available. Those assumptions consider all relevant facts and circumstances and are consistent with the information tracked and monitored through the Company s risk-management activities.

The Company updates the discount rate each reporting period and revises expected net cash outflows when increases (or decreases) in the likelihood of a default (insured event) and potential recoveries occur. The discount amount is accreted on the reserve for losses and loss adjustment expenses through earnings in incurred loss and loss adjustment expenses (recoveries). Revisions to a reserve for loss and loss adjustment expenses in periods after initial recognition are recognized as incurred loss and loss adjustment expenses (recoveries) in the period of the change.

Financial Guaranty Contracts Prior to Adoption of FAS 163

Prior to January 1, 2009, reserves for losses for non-derivative transactions in the Company s financial guaranty direct and financial guaranty assumed reinsurance included case reserves and portfolio reserves. Case reserves were established when there was significant credit deterioration on specific insured obligations and the obligations were in default or default was probable, not necessarily upon non-payment of principal or interest by an insured. Case reserves represented the present value of expected future loss payments and loss adjustment expenses, net of estimated recoveries, but before considering ceded reinsurance. This reserving method was different from case reserves established by traditional property and casualty insurance companies, which establish case reserves upon notification of a claim and establish incurred but not reported reserves (IBNR) for the difference between actuarially estimated ultimate losses and recorded case reserves. Financial guaranty insurance and assumed reinsurance case reserves and related salvage and subrogation, if any, were discounted at the taxable equivalent yield on the Company s investment portfolio, which was approximately 6%, during 2008.

The Company recorded portfolio reserves in its financial guaranty direct and financial guaranty assumed reinsurance business. Portfolio reserves were established with respect to the portion of the Company s business for which case reserves were not established.

Portfolio reserves were not established based on a specific event, rather they were calculated by aggregating the portfolio reserve calculated for each individual transaction. Individual transaction reserves were calculated on a quarterly basis by multiplying the par in-force by the product of the ultimate loss and earning factors without regard to discounting. The ultimate loss factor was defined as the frequency of loss multiplied by the severity of loss, where the frequency was defined as the probability of default for each individual issue. The earning factor was inception to date earned premium divided by the estimated ultimate written premium for each transaction. The probability of default was estimated from rating agency data and was based on the transaction s credit rating, industry sector and time until maturity. The severity was defined as the complement of recovery/salvage rates gathered by the rating agencies of defaulting issues and was based on the industry sector.

Portfolio reserves were recorded gross of reinsurance. The Company did not cede any amounts under these reinsurance contracts, as the Company s recorded portfolio reserves did not exceed the Company s contractual retentions, required by said contracts.

The Company recorded an incurred loss that was reflected in the statement of operations upon the establishment of portfolio reserves. When the Company initially recorded a case reserve, the Company reclassified the corresponding portfolio reserve already recorded for that credit within the balance sheet. The difference between the initially recorded case reserve and the reclassified portfolio reserve was recorded as a charge in the Company s

Table of Contents

statement of operations. Any subsequent change in portfolio reserves or the initial case reserves were recorded quarterly as a charge or credit in the Company s statement of operations in the period such estimates changed.

Mortgage Guaranty and Other Lines of Business

Mortgage guaranty and other lines of business are not in the scope of FAS 163. Reserves for losses and loss adjustment expenses in the Company s mortgage guaranty line of business include case reserves and portfolio reserves. Case reserves are established when there is significant credit deterioration on specific insured obligations and the obligations are in default or default is probable, not necessarily upon non-payment of principal or interest by an insured. Case reserves represent the present value of expected future loss payments and loss adjustment expenses (LAE), net of estimated recoveries, but before considering ceded reinsurance. This reserving method is different from case reserves established by traditional property and casualty insurance companies, which establish case reserves upon notification of a claim and establish IBNR reserves for the difference between actuarially estimated ultimate losses and recorded case reserves.

The Company also records portfolio reserves for mortgage guaranty line of business in a manner consistent with its financial guaranty business prior to the adoption of FAS 163. While other mortgage guaranty insurance companies do not record portfolio reserves, rather just case and IBNR reserves, the Company records portfolio reserves because the Company writes business on an excess of loss basis, while other industry participants write quota share or first layer loss business. The Company manages and underwrites this business in the same manner as its financial guaranty insurance and reinsurance business because management believes they have similar characteristics as insured obligations of mortgage backed securities.

The Company also records IBNR reserves for its other line of business. IBNR is an estimate of losses for which the insured event has occurred but the claim has not yet been reported to the Company. In establishing IBNR, the Company uses traditional actuarial methods to estimate the reporting lag of such claims based on hi