

ASSURED GUARANTY LTD  
Form 10-Q  
May 10, 2006

**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION**  
Washington, D.C. 20549

**FORM 10-Q**

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

For the Quarterly Period Ended March 31, 2006

**OR**

**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**

(State or other jurisdiction of incorporation)

**98-0429991**

(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  NO

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

Large accelerated filer

Accelerated filer

Non-accelerated filer

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

The number of registrant's Common Shares (\$0.01 par value) outstanding as of May 1, 2006 was 73,930,701.

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**ASSURED GUARANTY LTD.**

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**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)

	March 31, 2006	December 31, 2005
<b>Assets</b>		
Fixed maturity securities, at fair value (amortized cost: \$2,090,157 in 2006 and \$2,082,363 in 2005)	\$ 2,114,115	\$ 2,133,997
Short-term investments, at cost which approximates fair value	134,981	115,826
<b>Total investments</b>	<b>2,249,096</b>	<b>2,249,823</b>
Cash and cash equivalents	3,746	6,190
Accrued investment income	21,767	22,676
Deferred acquisition costs	195,897	193,442
Prepaid reinsurance premiums	13,344	12,478
Reinsurance recoverable on ceded losses	12,158	12,350
Premiums receivable	26,984	33,011
Goodwill	85,417	85,417
Unrealized gains on derivative financial instruments	52,202	53,037
Current income taxes receivable	3,101	3,005
Other assets	14,281	17,694
<b>Total assets</b>	<b>\$ 2,677,993</b>	<b>\$ 2,689,123</b>
<b>Liabilities and shareholders equity</b>		
<b>Liabilities</b>		
Unearned premium reserves	\$ 540,744	\$ 537,149
Reserves for losses and loss adjustment expenses	117,171	121,219
Profit commissions payable	28,048	52,993
Reinsurance balances payable	9,060	3,724
Deferred income taxes	25,390	26,629
Funds held by Company under reinsurance contracts	21,962	19,186
Unrealized losses on derivative financial instruments	11,788	12,652
Long-term debt	197,352	197,344
Other liabilities	53,061	56,714
<b>Total liabilities</b>	<b>1,004,576</b>	<b>1,027,610</b>
Commitments and contingencies		
<b>Shareholders equity</b>		
Common stock (\$0.01 par value, 500,000,000 shares authorized; 73,801,852 and 74,761,577 shares issued and outstanding in 2006 and 2005)	738	748
Additional paid-in capital	870,415	881,998
Unearned stock grant compensation		(14,756)
Retained earnings	779,939	747,691
Accumulated other comprehensive income	22,325	45,832
<b>Total shareholders equity</b>	<b>1,673,417</b>	<b>1,661,513</b>
<b>Total liabilities and shareholders equity</b>	<b>\$ 2,677,993</b>	<b>\$ 2,689,123</b>

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

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

	Three Months Ended	
	March 31,	
	2006	2005
<b>Revenues</b>		
Gross written premiums	\$ 55,384	\$ 78,097
Ceded premiums	(4,600 )	(1,628 )
Net written premiums	50,784	76,469
Increase in net unearned premium reserves	(2,729 )	(28,379 )
<b>Net earned premiums</b>	<b>48,055</b>	<b>48,090</b>
Net investment income	26,238	23,132
Net realized investment (losses) gains	(1,006 )	1,791
Unrealized gain on derivative financial instruments	29	3,072
Other income		283
<b>Total revenues</b>	<b>73,316</b>	<b>76,368</b>
<b>Expenses</b>		
Loss and loss adjustment expenses	(382 )	(9,396 )
Profit commission expense	1,308	987
Acquisition costs	10,785	10,216
Other operating expenses	17,150	14,508
Interest expense	3,375	3,296
Other expense	614	
<b>Total expenses</b>	<b>32,850</b>	<b>19,611</b>
<b>Income before provision for income taxes</b>	<b>40,466</b>	<b>56,757</b>
Provision for income taxes		
Current	2,643	5,083
Deferred	2,941	7,326
<b>Total provision for income taxes</b>	<b>5,584</b>	<b>12,409</b>
<b>Net income</b>	<b>34,882</b>	<b>44,348</b>
<b>Other comprehensive income, net of taxes</b>		
Unrealized holding losses on fixed maturity securities arising during the period	(24,060 )	(20,638 )
Reclassification adjustment for realized losses (gains) included in net income	658	(1,501 )
Change in net unrealized gains on fixed maturity securities	(23,402 )	(22,139 )
Cash flow hedge	(105 )	(105 )
<b>Other comprehensive loss, net of tax</b>	<b>(23,507 )</b>	<b>(22,244 )</b>
<b>Comprehensive income</b>	<b>\$ 11,375</b>	<b>\$ 22,104</b>
Earnings per share:		
Basic	\$ 0.47	\$ 0.60
Diluted	\$ 0.47	\$ 0.59
Dividends per share	\$ 0.035	\$ 0.03

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



Assured Guaranty Ltd.  
Consolidated Statements of Shareholders' Equity  
For the Three Months Ended March 31, 2006  
(in thousands of U.S. dollars except per share amounts)  
(Unaudited)

	Common Stock	Additional Paid-in Capital	Unearned Stock Grant Compensation	Retained Earnings	Accumulated Other Comprehensive Income	Total Shareholders Equity
<b>Balance, December 31, 2005</b>	\$ 748	\$ 881,998	\$ (14,756)	\$ 747,691	\$ 45,832	\$ 1,661,513
Net income				34,882		34,882
Dividends (\$0.035 per share)				(2,634)		(2,634)
Share activity under options and incentive plans, net		(622)				(622)
Cash flow hedge, net of tax of \$(56)					(105)	(105)
Unrealized loss on fixed maturity securities, net of tax of \$(4,066)					(23,402)	(23,402)
Reclassification due to adoption of FAS 123R	(10)	(14,746)	14,756			
Share-based compensation		3,785				3,785
<b>Balance, March 31, 2006</b>	\$ 738	\$ 870,415	\$	\$ 779,939	\$ 22,325	\$ 1,673,417

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

Assured Guaranty Ltd.  
Consolidated Statements of Cash Flows  
(in thousands of U.S. dollars)  
(Unaudited)

	Three Months Ended March 31,	
	2006	2005
<b>Operating activities</b>		
Net income	\$ 34,882	\$ 44,348
Adjustments to reconcile net income to net cash flows provided by operating activities:		
Non-cash interest and operating expenses	3,893	1,493
Net amortization of premium on fixed maturity securities	1,521	1,673
Provision for deferred income taxes	2,941	7,326
Net realized investment (losses) gains	1,006	(1,791)
Change in unrealized gains on derivative financial instruments	(29)	(3,072)
Change in deferred acquisition costs	(2,455)	(5,845)
Change in accrued investment income	909	(1,206)
Change in premiums receivable	6,027	(1,913)
Change in prepaid reinsurance premiums	(866)	924
Change in unearned premium reserves	3,595	27,464
Change in reserves for losses and loss adjustment expenses, net	1,480	(2,303)
Change in profit commissions payable	(24,945)	(17,790)
Change in funds held by Company under reinsurance contracts	2,776	1,631
Change in current income taxes	(96)	1,017
Tax benefit from employee stock options		4,059
Other	(10,229)	1,166
<b>Net cash flows provided by operating activities</b>	<b>20,410</b>	<b>57,181</b>
<b>Investing activities</b>		
Fixed maturity securities:		
Purchases	(260,522)	(317,195)
Sales	259,952	169,515
(Purchases) sales of short-term investments, net	(19,238)	112,309
<b>Net cash flows used in investing activities</b>	<b>(19,808)</b>	<b>(35,371)</b>
<b>Financing activities</b>		
Dividends paid	(2,632)	(2,274)
Share activity under option and incentive plans	(436)	
Repurchases of common stock		(14,740)
<b>Net cash flows used in financing activities</b>	<b>(3,068)</b>	<b>(17,014)</b>
Effect of exchange rate changes	22	(51)
(Decrease) increase in cash and cash equivalents	(2,444)	4,745
Cash and cash equivalents at beginning of period	6,190	16,978
<b>Cash and cash equivalents at end of period</b>	<b>\$ 3,746</b>	<b>\$ 21,723</b>
<b>Supplementary cash flow information</b>		
Cash paid during the period for:		
Income taxes	\$ 2,740	\$



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

**Assured Guaranty Ltd.**  
**Notes to Consolidated Financial Statements**  
**March 31, 2006**  
**(Unaudited)**

**1. Business and Organization**

Assured Guaranty Ltd. (the Company) is a Bermuda-based holding company which provides, through its operating subsidiaries, credit enhancement products to the public finance, structured finance and mortgage markets. Credit enhancement products are financial guarantees or other types of support, including credit derivatives, that improve the credit of underlying debt obligations. 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 9.

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 coordinated 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 the IPO, including, but not limited to, equity layer credit protection, trade credit reinsurance and title reinsurance. These lines of business make up the Company's other segment.

**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, consisting only of normal recurring adjustments, 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 March 31, 2006 ( First Quarter 2006 ) and the three-month period ended March 31, 2005 ( First Quarter 2005 ). Operating results for the three-month periods ended March 31, 2006 and 2005 are not necessarily indicative of the results that may be expected for a full year. Certain items in the prior year unaudited interim consolidated financial statements have been reclassified to conform with the current period 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, 2005, filed with the Securities and Exchange Commission.

Certain of the Company's subsidiaries are subject to U.S. income tax. The provision for income taxes is calculated in accordance with Statement of Financial Accounting Standards ( FAS ) 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 derivative financial instruments. A discrete calculation of the provision is calculated for each interim period.

### **3. Recent Accounting Pronouncements**

In February 2006, the Financial Accounting Standards Board ( FASB ) issued FAS No. 155, Accounting for Certain Hybrid Financial Instruments ( FAS 155 ) which amends FAS No. 133, Accounting for Derivative Instruments and Hedging Activities ( FAS 133 ) and FAS No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities ( FAS 140 ), and addresses issues raised in FAS 133 Implementation Issue No. D1, Application of Statement 133 to Beneficial Interests in Securitized Financial Assets. The primary objectives of FAS 155 are: (i) with respect to FAS 133, to address the accounting for beneficial interests in securitized financial assets and (ii) with respect to FAS 140, eliminate a restriction on the passive derivative instruments that a qualifying special purpose entity may hold. FAS 155 is effective for all financial instruments acquired or issued after the beginning of an entity's first fiscal year that begins after September 15, 2006. The Company is currently evaluating the implications of FAS 155 on its financial statements.

### **4. Impact of Reinsurance Transactions**

To limit its exposure on assumed risks, at the time of the IPO, the Company entered into certain proportional and non-proportional retrocessional agreements with other insurance companies, primarily subsidiaries of ACE Limited ( ACE ), to cede a portion of the risk underwritten by the Company. In addition, the Company enters into reinsurance agreements with non-affiliated companies to limit its exposure to risk on an on-going basis.

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In the event that any or all of the reinsurers are unable to meet their obligations, the Company would be liable for such defaulted amounts. Direct, assumed, and ceded amounts were as follows:

	Three Months Ended	
	March 31,	
	2006	2005
	(in thousands of U.S. dollars)	
<b>Premiums Written</b>		
Direct	\$ 30,248	\$ 23,755
Assumed	25,136	54,342
Ceded	(4,600 )	(1,628 )
Net	\$ 50,784	\$ 76,469
<b>Premiums Earned</b>		
Direct	\$ 21,228	\$ 21,230
Assumed	30,528	29,412
Ceded	(3,701 )	(2,552 )
Net	\$ 48,055	\$ 48,090
<b>Loss and Loss Adjustment Expenses</b>		
Direct	\$ (3,031 )	\$ (2,067 )
Assumed	3,292	(9,189 )
Ceded	(643 )	1,860
Net	\$ (382 )	\$ (9,396 )

Net written premiums for First Quarter 2006 were \$50.8 million compared with \$76.5 million for First Quarter 2005. Gross written premiums from our financial guaranty direct operations increased \$6.4 million in 2006 compared with 2005, as we continue to execute our direct business strategy. Offsetting this increase was a \$10.4 million and \$4.8 million reduction in treaty and facultative assumed premiums, respectively. Further offsetting the financial guaranty direct increase was an excess of loss reinsurance transaction of \$16.3 million written during First Quarter 2005 in our mortgage guaranty segment.

Loss and loss adjustment expenses ( LAE ) were \$(0.4) million and \$(9.4) million for First Quarter 2006 and First Quarter 2005, respectively. During First Quarter 2006, the Company increased the financial guaranty reinsurance segment's case reserves \$2.6 million and also incurred and paid a \$0.6 million loss in this segment. Offsetting these increases was a \$3.2 million settlement of a sub-prime mortgage transaction, offset by a related \$0.7 million subrogation receivable and a \$4.5 million release of case reserves in our financial guaranty direct segment and a litigation recovery of \$1.2 million in our other segment. During First Quarter 2005 the Company recovered \$6.8 million relating to a reinsurance claim incurred in 1998 and 1999. This recovery was received in connection with the completion of two settlements and is shown in the statements of operations and comprehensive income in loss and loss adjusted expenses. Recovery efforts relating to this and other claims are continuing. In addition, during First Quarter 2005, the Company recovered \$1.1 million relating to a litigation recovery.

Reinsurance recoverable on ceded losses and LAE as of March 31, 2006 and December 31, 2005 were \$12.2 million and \$12.4 million, respectively and are all related to our other segment. Of these amounts, \$12.1 million and \$12.3 million, respectively, relate to reinsurance agreements with ACE.

The following summarizes the Company's gross written premiums by significant client:

Gross Written Premiums by Client	Three Months Ended March 31,	
	2006	2005
	(\$ in millions)	
Financial Security Assurance Inc.	\$ 7.5	\$ 22.2
Ambac Assurance Corporation	4.3	10.7
MBIA Insurance Corporation	3.5	4.6
Financial Guaranty Insurance Company	3.4	2.3

## 5. Commitments and Contingencies

Lawsuits arise in the ordinary course of the Company's business. It is the opinion of the Company's management, based upon the information available, that the expected outcome of these matters, individually or in the aggregate, will not have a material adverse effect on the Company's financial position, results of operations or liquidity, although an adverse resolution of a number of these items could have a material adverse effect on the Company's results of operations or liquidity in a particular quarter or fiscal year.

On April 10, 2006, the Company's wholly owned subsidiary, Assured Guaranty Re Overseas Ltd. (AGRO), and a number of other parties, completed a settlement with JP Morgan Chase & Co. and certain of its related entities and affiliated persons, all of which were among the defendants in the *In re: National Century Financial Enterprises Inc. Investment Litigation* now pending in the United States District Court for the Southern District of Ohio - Eastern District. AGRO received approximately \$8.0 million (pre-tax) in April 2006, from the settlement. AGRO originally paid claims in 1999 of approximately \$41.7 million (pre-tax) related to National Century Financial Enterprises Inc. To date, including the settlement described above, the Company has recovered \$14.5 million (pre-tax). This is a partial settlement of the litigation, and the litigation will continue against other parties.

In April 2005, Assured Guaranty Corp. (AGC) received a Notice of Order to Preserve (Order) from the Office of the Commissioner of Insurance, State of Georgia (Commissioner). The Order was directed to ACE Limited, and all affiliates and requires the preservation of documents and other items related to finite insurance and a broad group of other insurance and reinsurance agreements. Also in April 2005, AGC, and numerous other insurers, received a subpoena from the Commissioner related to the initial phase of the Commissioner's investigation into finite-risk transactions. The subpoena requests information on AGC's assumed and ceded reinsurance contracts in force during 2004. AGC is cooperating with the Commissioner.

In the ordinary course of their respective businesses, certain of the Company's subsidiaries assert claims in legal proceedings against third parties to recover losses paid in prior periods. The amounts, if any, the Company will recover in these proceedings are uncertain, although recoveries in any one or more of these proceedings during any quarter or fiscal year could be material to the Company's results of operations in that particular quarter or fiscal year.

The Company is party to reinsurance agreements with all of the major monoline primary financial guaranty insurance companies. The Company's facultative and treaty agreements are generally subject to termination (i) upon written notice (ranging from 90 to 120 days) prior to the specified deadline for renewal, (ii) at the option of the primary insurer if the Company fails to maintain certain financial, regulatory and rating agency criteria which are equivalent to or more stringent than those the Company is otherwise required to maintain for its own compliance with state mandated insurance laws and to maintain a specified financial strength rating for the particular insurance subsidiary or (iii) upon certain changes of control of the Company. Upon termination under the conditions set forth in (ii) and (iii) above, the Company may be required (under some of its reinsurance agreements) to return to the primary insurer all statutory unearned premiums, less ceding commissions, attributable to reinsurance ceded pursuant to such agreements after which the Company would be released from liability with respect to the ceded business. Upon the occurrence of the conditions set forth in (ii) above, whether or not an agreement is terminated, the Company may be required to obtain a letter of credit or alternative form of security to collateralize its obligation to perform under such agreement or it may be obligated to increase the level of ceding commission paid.



## 6. Long-Term Debt and Credit Facilities

The Company's unaudited interim consolidated financial statements include long-term debt used to fund the Company's insurance operations, and related interest expense, as described below.

### *Senior Notes*

On May 18, 2004, Assured Guaranty US Holdings Inc., a subsidiary of the Company, issued \$200.0 million of 7.0% Senior Notes due 2034 for net proceeds of \$197.3 million. The proceeds of the offering were used to repay substantially all of a \$200.0 million promissory note issued to a subsidiary of ACE in April 2004 as part of the initial public offering ( IPO ) related formation transactions. The coupon on the Senior Notes is 7.0%, however, the effective rate will be approximately 6.4%, taking into account the effect of a cash flow hedge executed by the Company in March 2004. The Company recorded interest expense of \$3.3 million, including \$0.2 million of amortized gain on the cash flow hedge, for both the three months ended March 31, 2006 and 2005. These Senior Notes are fully and unconditionally guaranteed by Assured Guaranty Ltd.

### *Credit Facilities*

#### **\$300.0 million Credit Facility**

On April 15, 2005, Assured Guaranty Ltd. and certain of its subsidiaries entered into a \$300.0 million three-year unsecured revolving credit facility (the \$300.0 million credit facility ) with a syndicate of banks, for which ABN AMRO Incorporated and Bank of America, N.A. acted as lead arrangers and KeyBank National Association ( KeyBank ) acted as syndication agent. Under the \$300.0 million credit facility, each of AGC, AG (UK), a subsidiary of AGC organized under the laws of the United Kingdom, Assured Guaranty Ltd., Assured Guaranty Re Ltd. ( AG Re ) a subsidiary of the Company and AGRO are entitled to request the banks to make loans to such borrower or to request that letters of credit be issued for the account of such borrower. Two letters of credit have been issued, both on behalf of AGRO, with an aggregate stated amount of approximately \$20.7 million.

If drawn, the proceeds of the loans and letters of credit are to be used for working capital and other general corporate purposes of the borrowers and to support reinsurance transactions.

At the closing of the \$300.0 million credit facility, (i) AGC guaranteed the obligations of AG (UK) under such facility, (ii) Assured Guaranty Ltd. guaranteed the obligations of AG Re and AGRO under such facility and agreed that, if the Company Consolidated Assets (as defined in the related credit agreement) of AGC and its subsidiaries were to fall below \$1.2 billion, it would, within 15 days, guarantee the obligations of AGC and AG (UK) under such facility and (iii) Assured Guaranty Overseas US Holdings Inc., as a Material Non-AGC Subsidiary (as defined in the related credit agreement), guaranteed the obligations of Assured Guaranty Ltd., AG Re and AGRO under such facility. Subsequently, AG Re and AGRO, as Material Non-AGC Subsidiaries, both guaranteed the obligations of the other and of Assured Guaranty Ltd. under such facility.

The \$300.0 million credit facility's financial covenants require that Assured Guaranty Ltd. (a) maintain a minimum net worth of \$1.2 billion, (b) maintain an interest coverage ratio of at least 2.5:1, and (c) maintain a maximum debt-to-capital ratio of 30%. In addition, the \$300.0 million credit facility requires that AGC: (x) maintain qualified statutory capital of at least 80% of its statutory capital as of the fiscal quarter prior to the closing date of the facility and (y) maintain a ratio of aggregate net par outstanding to qualified statutory capital of not more than 150:1.

Furthermore, the \$300.0 million credit facility contains restrictions on Assured Guaranty Ltd. and its subsidiaries, including, among other things, in respect of their ability to incur debt, permit liens, become liable in respect of guaranties, make loans or investments, pay dividends or make distributions, dissolve or become party to a merger, consolidation or acquisition, dispose of assets or enter into affiliate transactions. Most of these restrictions are subject to certain minimum thresholds and exceptions. A default by one borrower will give rise to a right of the lenders to terminate the facility and accelerate all amounts then outstanding. As of March 31, 2006 and December 31, 2005, Assured Guaranty was in compliance with all of those financial covenants.

As of March 31, 2006 and December 31, 2005, no amounts were outstanding under this facility nor have there been any borrowings under this facility.

#### **Non-Recourse Credit Facility**

AGC is also party to a non-recourse credit facility with a syndicate of banks which provides up to \$175.0 million specifically designed to provide rating agency-qualified capital to further support AGC's claims paying resources. The facility expires in December 2010. As of March 31, 2006 and December 31, 2005, no amounts were outstanding under this facility nor have there been any borrowings under the life of this facility.

The Company's failure to comply with certain covenants under the Company's credit facilities could, subject to grace periods in the case of certain covenants, result in an event of default. This could require the Company to repay any outstanding borrowings in an accelerated manner.

#### **Committed Capital Securities**

On April 8, 2005, AGC entered into four separate agreements with four different unaffiliated custodial trusts pursuant to which AGC may, at its option, cause each of the custodial trusts to purchase up to \$50.0 million of perpetual preferred stock of AGC. The custodial trusts were created as a vehicle for providing capital support to AGC by allowing AGC to obtain immediate access to new capital at its sole discretion at any time through the exercise of the put option. If the put options were exercised, AGC would receive \$200.0 million in return for the issuance of its own perpetual preferred stock, the proceeds of which may be used for any purpose including the payment of claims. The put options were not exercised as of March 31, 2006. Initially, all of the CCS Securities were issued to a special purpose pass-through trust (the Pass-Through Trust). The Pass-Through Trust is a newly created statutory trust organized under the Delaware Statutory Trust Act formed for the purposes of (i) issuing \$200,000,000 of Pass-Through Trust Securities to qualified institutional buyers within the meaning of Rule 144A under the Securities Act of 1933, as amended, (ii) investing the proceeds from the sale of the Pass-Through Trust Securities in, and holding, the CCS Securities issued by the Custodial Trusts and (iii) entering into related agreements. Neither the Pass-Through Trust nor the Custodial Trusts are consolidated in Assured Guaranty Ltd.'s financial statements.

During First Quarter 2006, AGC incurred \$0.6 million of put option premiums which are an on-going expense. These expenses are presented in the Company's unaudited interim consolidated statements of operations and comprehensive income under other expense.

#### **7. Share-Based Compensation**

Effective January 1, 2006, the Company adopted FAS No. 123 (revised), Share-Based Payment (FAS 123R), which replaces FAS No. 123, Accounting for Stock-Based Compensation (FAS 123) and supersedes Accounting Principles Board Opinion (APB) No. 25, Accounting for Stock Issued to Employees (APB 25). FAS 123R requires all share-based compensation transactions with employees, including grants of employee stock options, to be recognized as compensation expense over the requisite service period based on their relative fair values.

Prior to the adoption of FAS 123R, the Company followed the guidance of APB 25 and did not record share-based compensation expense related to employee stock options in the statement of operations, since for all grants the exercise price was equal to the market value of the common stock on the grant date.

The Company elected to use the modified prospective transition method for implementing FAS 123R. Under this transition method, compensation expense includes: (a) compensation expense for all share-based payments granted prior to, but not yet vested as of, January 1, 2006, based on the grant date fair value estimated in accordance with the original provisions of FAS 123, and (b) compensation expense for all share-based payments granted on or after January 1, 2006, based on the grant date fair value estimated in accordance with the provisions of FAS 123R. Because we elected to use the modified prospective transition method, results for prior periods have not been restated and new awards are valued and accounted for prospectively upon adoption.



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Beginning January 1, 2006, upon adoption of FAS 123R, the Company recorded share-based compensation for the cost of stock options, restricted stock and the Stock Purchase Plan. Share-based compensation expense in First Quarter 2006 was \$3.2 million (\$2.7 million after tax). The effect on basic and diluted earnings per share for First Quarter 2006 was \$0.04. Included in First Quarter 2006 expense was \$0.6 million for stock award grants to retirement-eligible employees. The amount of share-based compensation capitalized in First Quarter 2006 as deferred acquisition costs ( DAC ) was \$0.6 million. Share-based compensation expense in First Quarter 2005 was \$1.4 million (\$1.2 million after tax), respectively. FAS 123R requires these awards to be expensed over the period through the date the employee first becomes eligible to retire and is no longer required to provide service to earn part or all of the award, regardless of the employees intent of retirement. The following table presents pre-DAC and pre-tax, share-based compensation cost by share-based type:

(in thousands of U.S. dollars)	Three Months Ended March 31,	
	2006	2005
<b>Share-Based Employee Cost</b>		
<i>Restricted Stock</i>		
Recurring amortization	\$ 1,807	\$ 1,179
Accelerated amortization for retirement eligible employees	443	
Subtotal	2,250	1,179
<i>Stock Options</i>		
Recurring amortization	1,044	
Accelerated amortization for retirement eligible employees	205	
Subtotal	1,249	
<i>ESPP</i>	32	
<b>Total Share-Based Employee Cost</b>	<b>3,531</b>	<b>1,179</b>
<b>Share-Based Directors Cost</b>		
<i>Restricted Stock</i>	67	30
<i>Restricted Stock Units</i>	184	158
<b>Total Share-Based Directors Cost</b>	<b>251</b>	<b>188</b>
<b>Total Share-Based Cost</b>	<b>\$ 3,782</b>	<b>\$ 1,367</b>

For First Quarter 2005, had the compensation expense been determined in accordance with the fair value method recommended in FAS 123, the Company's net income and net income per share would have been adjusted to the pro forma amounts indicated below:

(in thousands of U.S. dollars, except per share amounts)	Three Months Ended March 31, 2005	
Net income as reported	\$	44,348
Add: Stock-based compensation expense included in reported net income, net of income tax	1,208	
Deduct: Compensation expense, in accordance with FAS 123, net of income tax	2,307	
Pro forma net income	\$	43,249
Basic Earnings Per Share:		
As reported	\$	0.60
Pro forma	\$	0.58
Diluted Earnings Per Share:		
As reported	\$	0.59
Pro forma	\$	0.58

**Assured Guaranty Ltd. Share-Based Compensation Plans**

As of April 27, 2004, the Company adopted the Assured Guaranty Ltd. 2004 Long-Term Incentive Plan (the Incentive Plan ). The Incentive Plan authorizes the grant of incentive stock options, non-qualified stock



options, stock appreciation rights, and full value awards that are based on the Company's common shares. The number of common shares that may be delivered under the Incentive Plan may not exceed 7,500,000. As of March 31, 2006, 2,583,545 common shares were available for grant under the Incentive Plan. In January 2005, the Company implemented the Stock Purchase Plan ( "Stock Purchase Plan" ) in accordance with Internal Revenue Code Section 423. The Company reserved for issuance and purchases under the Stock Purchase Plan 100,000 shares of its common stock. As of March 31, 2006, 80,512 common shares were available for grant under the Stock Purchase Plan. The Incentive Plan and the Stock Purchase Plan are described more fully in the Company's 2005 Annual Report on Form 10-K.

### Stock Options

Nonqualified or incentive stock options may be granted to employees and directors of the Company. To date, the Company has only issued nonqualified stock options. All stock options granted to employees vest in equal annual installments over a three-year period and expire 10 years from the date of grant. None of our options have a performance or market condition. The following table summarizes stock option activity for the three months ended March 31, 2006:

Options	Options for Common Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term (years)	Aggregate Intrinsic Value(1) (in thousands)
Outstanding at December 31, 2005	2,457,302	\$ 18.05		
Granted	777,967	\$ 25.50		
Exercised	(10,669)	\$ 17.99		
Forfeited	(6,432)	\$ 18.01		
Outstanding at March 31, 2006	3,218,168	\$ 19.84	8.5	\$ 16,562
Vested and exercisable at March 31, 2006	804,072	\$ 17.93	7.8	\$ 5,686

(1) The aggregate intrinsic value was calculated based on the positive difference between the closing price of the Company's common stock on March 31, 2006 (i.e. \$25.00) and the weighted average exercise price of the underlying options.

The Company recorded \$1.2 million (\$1.0 million after tax) in share-based compensation related to stock options during First Quarter 2006. As of March 31, 2006 the total unrecognized compensation expense related to outstanding non-vested stock options was \$6.2 million, which will be adjusted in the future for actual forfeitures. The Company expects to recognize that expense over the weighted-average remaining service period of 1.7 years.

The weighted-average grant-date fair value of options granted were \$6.71 and \$4.51 for First Quarter 2006 and First Quarter 2005, respectively. The fair value of options issued is estimated on the date of grant using the Black-Scholes option-pricing model, with the following weighted-average assumptions used for grants in 2006 and 2005:

	Three Months Ended March 31,			
	2006		2005	
Dividend yield	0.5	%	0.7	%
Expected volatility	20.44	%	20.80	%
Risk free interest rate	4.6	%	4.1	%
Expected life	5 years		5 years	
Forfeiture rate	6.0	%	6.0	%

These assumptions were based on the following:

- The expected dividend yield is based on the current expected annual dividend and company share price on the grant date,
- Expected volatility is estimated at the date of grant based on the historical share price volatility, calculated on a daily basis,
- The risk-free interest rate is the implied yield currently available on U.S. Treasury zero-coupon issues with an equivalent remaining term to the granted stock options,
- The expected life is based on the average expected term of our guideline companies, which are defined as similar entities, since the Company has insufficient expected life data.
- The forfeiture rate is based on the rate used by our guideline companies, since the Company has insufficient forfeiture data. Estimated forfeitures will be reassessed at each balance sheet date and may change based on new facts and circumstances.

For options granted before January 1, 2006, the Company amortizes the fair value on an accelerated basis. For options granted on or after January 1, 2006, the Company amortizes the fair value on a straight-line basis. All options are amortized over the requisite service periods of the awards, which are generally the vesting periods, with the exception of retirement-eligible employees. For retirement-eligible employees options are amortized over the period through the date the employee first becomes eligible to retire and is no longer required to provide service to earn part or all of the award. The Company may elect to use different assumptions under the Black-Scholes option valuation model in the future, which could materially affect the Company's net income or earnings per share.

The total intrinsic value of options exercised during for First Quarter 2006 was \$0.1 million. During First Quarter 2006, an immaterial amount of cash was received from the exercise of stock options and a corresponding immaterial related tax benefit was recorded. No options were exercised during First Quarter 2005. The Company has a policy of issuing new shares to satisfy stock option exercises.

#### ***Restricted Stock Awards***

The Company has granted restricted stock awards to employees and directors of the Company. Restricted stock awards generally vest in equal annual installments over a four-year period. Restricted stock awards are amortized over the requisite service periods of the awards, which are generally the vesting periods, with the exception of retirement-eligible employees, discussed above. Prior to the adoption of FAS 123R, the Company presented restricted stock issuances on the balance sheet in common stock and additional paid-in capital with an offset in unearned stock grant compensation as a separate component of shareholders' equity. In accordance with the provisions of FAS 123R, on January 1, 2006, the Company reclassified the balance in unearned stock grant compensation to common stock and additional paid-in capital in shareholders' equity. The following table summarizes restricted stock award activity for the three months ended March 31, 2006:

Nonvested Shares	Number of Shares	Weighted Average Grant-Date Fair Value	
Nonvested at December 31, 2005	1,021,124	\$	18.12
Granted	444,533	\$	25.50
Vested	(82,168)	\$	18.03
Forfeited	(3,549)	\$	18.01
Nonvested at March 31, 2006	1,379,940	\$	20.50

The Company recorded \$2.3 million (\$1.8 million after tax) in share-based compensation, related to restricted stock awards, during First Quarter 2006. Restricted stock awards are expensed on a straight-line basis over the vesting period. As of March 31, 2006 the total unrecognized compensation cost related to outstanding nonvested restricted stock awards was \$23.4 million, which the Company expects to recognize over the

weighted-average remaining service period of 2.6 years.

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**Restricted Stock Units**

The Company has granted restricted stock units to directors of the Company. Restricted stock units vest over a one-year period. The following table summarizes restricted stock unit activity (excluding dividend equivalents) for the three months ended March 31, 2006:

Nonvested Stock Units	Number of Stock Units	Weighted Average Grant-Date Fair Value	
Nonvested at December 31, 2005	36,301	\$	20.25
Granted		\$	
Vested		\$	
Forfeited		\$	
Nonvested at March 31, 2006	36,301	\$	20.25

The Company recorded \$0.2 million (\$0.2 million after tax) in share-based compensation during First Quarter 2006. The compensation for restricted stock units is expensed on a straight-line basis over the vesting period. As of March 31, 2006, the total unrecognized compensation cost related to outstanding nonvested restricted stock units was \$0.1 million, which the Company expects to recognize over the weighted-average remaining service period of 0.1 years.

**Employee Stock Purchase Plan**

Participation in the Stock Purchase Plan is available to all eligible employees. Maximum annual purchases by participants are limited to the number of whole shares that can be purchased by an amount equal to 10 percent of the participant's compensation or, if less, shares having a value of \$25,000. Participants may purchase shares at a purchase price equal to 85 percent of the lesser of the fair market value of the stock on the first day or the last day of the subscription period. The Company recorded \$32,000 (\$23,000 after tax) in share-based compensation during First Quarter 2006.

**8. Earnings Per Share**

The following table sets forth the computation of basic and diluted earnings per share ( EPS ):

	Three Months Ended March 31,	
	2006	2005
	(in thousands of U.S. dollars except per share amounts)	
Net income	\$ 34,882	\$ 44,348
Basic shares	73,768	74,458
Effect of dilutive securities:		
Stock awards	1,085	445
Diluted shares	74,853	74,903
Basic EPS	\$ 0.47	\$ 0.60
Diluted EPS	\$ 0.47	\$ 0.59

**9. Segment Reporting**

The Company has four principal business segments: (1) financial guaranty direct, which includes transactions whereby the Company provides an unconditional and irrevocable guaranty that indemnifies the holder of a financial obligation against non-payment of principal and interest when due, and could take the form of a credit derivative; (2) financial guaranty reinsurance, which includes agreements whereby the Company is a reinsurer and agrees to indemnify a primary insurance company against part or all of the loss which the latter may sustain under a policy it has issued; (3) mortgage guaranty, which includes mortgage guaranty insurance and reinsurance whereby the Company provides protection against the default of borrowers on mortgage loans; and (4) other, which includes several lines of business in which the Company is no longer active, including, but not limited to equity layer credit protection, trade credit reinsurance and title reinsurance.

The Company does not segregate assets and liabilities at a segment level since management reviews and controls these assets and liabilities on a consolidated basis. The Company allocates operating expenses to each segment based on a comprehensive cost study. During 2006, the Company implemented a new operating expense methodology to more closely apply expenses to the individual operating segments. This new methodology was based on a comprehensive study and is based on departmental time estimates and headcount. 2005 amounts have been restated to show this new methodology on a comparative basis. Management uses underwriting gains as the primary measure of each segment's financial performance.

The following table summarizes the components of underwriting gain for each reporting segment:

	Three Months Ended March 31, 2006				
	Financial Guaranty Direct	Financial Guaranty Reinsurance	Mortgage Guaranty	Other	Total
	(in millions of U.S. dollars)				
Gross written premiums	\$ 30.2	\$ 18.8	\$ 2.6	\$ 3.8	\$ 55.4
Net written premiums	29.7	18.5	2.6		50.8
Net earned premiums	20.7	23.3	4.2		48.1
Loss and loss adjustment expenses	(1.8)	2.8	(0.2)	(1.2)	(0.4)
Profit commission expense		0.4	0.9		1.3
Acquisition costs	1.8	8.7	0.3		10.8
Other operating expenses	13.4	3.4	0.3		17.2
Underwriting gain	\$ 7.2	\$ 8.0	\$ 2.8	\$ 1.2	\$ 19.2





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	Three Months Ended March 31, 2005				
	Financial Guaranty Direct	Financial Guaranty Reinsurance	Mortgage Guaranty	Other	Total
	(in millions of U.S. dollars)				
Gross written premiums	\$ 23.8	\$ 34.0	\$ 19.4	\$ 0.9	\$ 78.1
Net written premiums	23.1	34.0	19.4		76.5
Net earned premiums	20.4	23.0	4.6		48.1
Loss and loss adjustment expenses	(1.5 )	(7.1 )	0.2	(1.1 )	(9.4 )
Profit commission expense			1.0		1.0
Acquisition costs	1.5	8.1	0.5		10.2
Other operating expenses	11.4	2.8	0.3		14.5
Underwriting gain	\$ 9.0	\$ 19.2	\$ 2.6	\$ 1.1	\$ 31.9

The following is a reconciliation of total underwriting gain to income before provision for income taxes for the periods ended:

	Three Months Ended March 31,	
	2006	2005
	(in millions of U.S. dollars)	
Total underwriting gain	\$ 19.2	\$ 31.9
Net investment income	26.2	23.1
Net realized investment (losses) gains	(1.0 )	1.8
Unrealized gains on derivative financial instruments		3.1
Other income		0.3
Interest expense	(3.4 )	(3.3 )
Other expense	(0.6 )	
Income before provision for income taxes	\$ 40.5	\$ 56.8

The following table provides the lines of businesses from which each of the Company's segments derive their net earned premiums:

	Three Months Ended March 31,	
	2006	2005
	(in millions of U.S. dollars)	
<b>Financial guaranty direct:</b>		
Public finance	\$ 1.1	\$ 0.1
Structured finance	19.6	20.3
Total	20.7	20.4
<b>Financial guaranty reinsurance:</b>		
Public finance	15.6	11.0
Structured finance	7.7	12.0
Total	23.3	23.0
<b>Mortgage guaranty:</b>		

Mortgage guaranty		4.2		4.6	
<b>Total net earned premiums</b>		<b>\$ 48.1</b>		<b>\$ 48.1</b>	

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The other segment had an underwriting gain of \$1.2 million and \$1.1 million for First Quarter 2006 and First Quarter 2005, respectively, as the equity layer credit protection business recorded loss recoveries in both periods.

### 10. Subsidiary Information

The following tables present the unaudited condensed consolidated financial information for Assured Guaranty Ltd., Assured Guaranty US Holdings Inc., of which AGC is a subsidiary and other subsidiaries of Assured Guaranty Ltd. as of March 31, 2006 and December 31, 2005 and for the three months ended March 31, 2006 and 2005.

#### CONDENSED CONSOLIDATING BALANCE SHEET

AS OF MARCH 31, 2006

(in thousands of U. S. dollars)

	Assured Guaranty Ltd. (Parent Company)	Assured Guaranty US Holdings Inc.	AG Re and Other Subsidiaries	Consolidating Adjustments	Assured Guaranty Ltd. (Consolidated)
<b>Assets</b>					
Total investments and cash	\$ 76	\$ 1,132,042	\$ 1,120,724	\$	\$ 2,252,842
Investment in subsidiaries	1,687,289			(1,687,289)	
Deferred acquisition costs		75,660	120,237		195,897
Reinsurance recoverable		11,504	4,147	(3,493)	12,158
Goodwill		85,417			85,417
Premiums receivable		18,306	14,491	(5,813)	26,984
Other	744	95,705	49,764	(41,518)	104,695
<b>Total assets</b>	<b>\$ 1,688,109</b>	<b>\$ 1,418,634</b>	<b>\$ 1,309,363</b>	<b>\$ (1,738,113)</b>	<b>\$ 2,677,993</b>
<b>Liabilities and shareholders equity</b>					
<b>Liabilities</b>					
Unearned premium reserves	\$	\$ 196,391	\$ 368,650	\$ (24,297)	\$ 540,744
Reserves for losses and loss adjustment expenses		64,822	55,842	(3,493)	117,171
Profit commissions payable		3,790	24,258		28,048
Deferred income taxes		33,020	(7,630)		25,390
Long-term debt		197,352			197,352
Other	14,692	48,653	55,560	(23,034)	95,871
<b>Total liabilities</b>	<b>14,692</b>	<b>544,028</b>	<b>496,680</b>	<b>(50,824)</b>	<b>1,004,576</b>
<b>Total shareholders equity</b>	<b>1,673,417</b>	<b>874,606</b>	<b>812,683</b>	<b>(1,687,289)</b>	<b>1,673,417</b>
<b>Total liabilities and shareholders equity</b>	<b>\$ 1,688,109</b>	<b>\$ 1,418,634</b>	<b>\$ 1,309,363</b>	<b>\$ (1,738,113)</b>	<b>\$ 2,677,993</b>

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CONDENSED CONSOLIDATING BALANCE SHEET

AS OF DECEMBER 31, 2005

(in thousands of U. S. dollars)

	Assured Guaranty Ltd. (Parent Company)	Assured Guaranty US Holdings Inc.	AG Re and Other Subsidiaries	Consolidating Adjustments	Assured Guaranty Ltd. (Consolidated)
<b>Assets</b>					
Total investments and cash	\$ 163	\$ 1,116,387	\$ 1,139,463	\$	\$ 2,256,013
Investment in subsidiaries	1,665,392			(1,665,392)	
Deferred acquisition costs		73,803	119,639		193,442
Reinsurance recoverable		11,410	4,108	(3,168)	12,350
Goodwill		85,417			85,417
Premiums receivable		17,168	17,278	(1,435)	33,011
Other	1,172	107,211	27,121	(26,614)	108,890
Total assets	\$ 1,666,727	\$ 1,411,396	\$ 1,307,609	\$ (1,696,609)	\$ 2,689,123
<b>Liabilities and shareholders equity</b>					
<b>Liabilities</b>					
Unearned premium reserves	\$	\$ 196,435	\$ 362,273	\$ (21,559)	\$ 537,149
Reserves for losses and loss adjustment expenses		63,491	60,896	(3,168)	121,219
Profit commissions payable		4,237	48,756		52,993
Deferred income taxes		35,997	(9,368)		26,629
Long-term debt		197,344			197,344
Other	5,214	55,384	38,168	(6,490)	92,276
Total liabilities	5,214	552,888	500,725	(31,217)	1,027,610
Total shareholders equity	1,661,513	858,508	806,884	(1,665,392)	1,661,513
Total liabilities and shareholders equity	\$ 1,666,727	\$ 1,411,396	\$ 1,307,609	\$ (1,696,609)	\$ 2,689,123

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CONDENSED CONSOLIDATING STATEMENT OF OPERATIONS

FOR THE THREE MONTHS ENDED MARCH 31, 2006

(in thousands of U. S. dollars)

	Assured Guaranty Ltd. (Parent Company)	Assured Guaranty US Holdings Inc.	AG Re and Other Subsidiaries	Consolidating Adjustments *	Assured Guaranty Ltd. (Consolidated)
<b>Revenues</b>					
Net premiums written	\$	\$ 25,117	\$ 25,667	\$	\$ 50,784
Net premiums earned		26,729	21,326		48,055
Net investment income		12,829	13,421	(12)	26,238
Net realized investment (losses) gains		(1,146)	140		(1,006)
Unrealized gains (losses) on derivative financial instruments		720	(691)		29
Equity in earnings of subsidiaries	38,342			(38,342)	
Other revenues					
<b>Total revenues</b>	<b>38,342</b>	<b>39,132</b>	<b>34,196</b>	<b>(38,354)</b>	<b>73,316</b>
<b>Expenses</b>					
Loss and loss adjustment expenses		2,045	(2,427)		(382)
Acquisition costs and other operating expenses	3,450	15,294	10,499		29,243
Other	10	3,978	1		3,989
<b>Total expenses</b>	<b>3,460</b>	<b>21,317</b>	<b>8,073</b>		<b>32,850</b>
Income before provision for income taxes	34,882	17,815	26,123	(38,354)	40,466
Total provision for income taxes		3,505	2,059	20	5,584
<b>Net income</b>	<b>\$ 34,882</b>	<b>\$ 14,310</b>	<b>\$ 24,064</b>	<b>\$ (38,374)</b>	<b>\$ 34,882</b>

\* The net income in the consolidating adjustment column will not equal parent company equity in earnings of subsidiaries, due to the residual effects of the 2005 reinsurance agreement with FSA.

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CONDENSED CONSOLIDATING STATEMENT OF OPERATIONS

FOR THE THREE MONTHS ENDED MARCH 31, 2005

(in thousands of U. S. dollars)

	Assured Guaranty Ltd. (Parent Company)	Assured Guaranty US Holdings Inc.	AG Re and Other Subsidiaries	Consolidating Adjustments	Assured Guaranty Ltd. (Consolidated)
<b>Revenues</b>					
Net premiums written	\$	\$ 25,929	\$ 50,540	\$	\$ 76,469
Net premiums earned		31,087	17,003		48,090
Net investment income		13,280	9,852		23,132
Net realized investment gains		162	1,629		1,791
Unrealized gains (losses) on derivative financial instruments		4,923	(1,851 )		3,072
Equity in earnings of subsidiaries	47,944			(47,944 )	
Other revenues			283		283
Total revenues	47,944	49,452	26,916	(47,944 )	76,368
<b>Expenses</b>					
Loss and loss adjustment expenses		(1,828 )	(7,568 )		(9,396 )
Acquisition costs and other operating expenses	3,596	16,631	5,484		25,711
Other		3,326	(30 )		3,296
Total expenses	3,596	18,129	(2,114 )		19,611
Income before provision for income taxes	44,348	31,323	29,030	(47,944 )	56,757
Total provision for income taxes		8,205	4,204		12,409
Net income	\$ 44,348	\$ 23,118	\$ 24,826	\$ (47,944 )	\$ 44,348

## CONDENSED CONSOLIDATING STATEMENT OF CASH FLOWS

FOR THE THREE MONTHS ENDED MARCH 31, 2006

(in thousands of U. S. dollars)

	Assured Guaranty Ltd. (Parent Company)	Assured Guaranty US Holdings Inc.	AG Re and Other Subsidiaries	Consolidating Adjustments	Assured Guaranty Ltd. (Consolidated)
<b>Net cash flows provided by (used in) operating activities</b>	\$ 2,981	\$ 26,948	\$ (9,519 )	\$	\$ 20,410
<b>Cash flows from investing activities</b>					
Fixed maturity securities:					
Purchases		(144,847 )	(115,675 )		(260,522 )
Sales		144,257	115,695		259,952
Maturities					
Sales (purchases) of short-term investments, net	87	(27,398 )	8,073		(19,238 )
<b>Net cash flows (used in) provided by investing activities</b>	<b>87</b>	<b>(27,988 )</b>	<b>8,093</b>		<b>(19,808 )</b>
<b>Cash flows from financing activities</b>					
Dividends paid	(2,632 )				(2,632 )
Share activity under option and incentive plans	(436 )				(436 )
<b>Net cash flows used in financing activities</b>	<b>(3,068 )</b>				<b>(3,068 )</b>
Effect of exchange rate changes		17	5		22
Decrease in cash and cash equivalents		(1,023 )	(1,421 )		(2,444 )
Cash and cash equivalents at beginning of period		2,923	3,267		6,190
<b>Cash and cash equivalents at end of period</b>	<b>\$</b>	<b>\$ 1,900</b>	<b>\$ 1,846</b>	<b>\$</b>	<b>\$ 3,746</b>

## CONDENSED CONSOLIDATING STATEMENT OF CASH FLOWS

FOR THE THREE MONTHS ENDED MARCH 31, 2005

(in thousands of U. S. dollars)

	Assured Guaranty Ltd. (Parent Company)	Assured Guaranty US Holdings Inc.	AG Re and Other Subsidiaries	Consolidating Adjustments	Assured Guaranty Ltd. (Consolidated)
<b>Net cash flows provided by (used in) operating activities</b>	\$ 17,147	\$ (10,949 )	\$ 50,983	\$	\$ 57,181
<b>Cash flows from investing activities</b>					
Fixed maturity securities:					
Purchases		(59,545 )	(257,650 )		(317,195 )
Sales		41,823	127,692		169,515
Maturities					
Sales (purchases) of short-term investments, net	(133 )	32,531	79,911		112,309
<b>Net cash flows (used in) provided by investing activities</b>	<b>(133 )</b>	<b>14,809</b>	<b>(50,047 )</b>		<b>(35,371 )</b>
<b>Cash flows from financing activities</b>					
Repurchases of common stock	(14,740 )				(14,740 )
Dividends paid	(2,274 )				(2,274 )
<b>Net cash flows used in financing activities</b>	<b>(17,014 )</b>				<b>(17,014 )</b>
Effect of exchange rate changes		(26 )	(25 )		(51 )
Increase in cash and cash equivalents		3,834	911		4,745
Cash and cash equivalents at beginning of period		12,096	4,882		16,978
<b>Cash and cash equivalents at end of period</b>	<b>\$</b>	<b>\$ 15,930</b>	<b>\$ 5,793</b>	<b>\$</b>	<b>\$ 21,723</b>



## Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

### Forward-Looking Statements

This Form 10-Q contains information that includes or is based upon forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. Forward-looking statements give Assured Guaranty Ltd. (hereafter Assured Guaranty, we, our or the Company) expectations or forecasts of future events. You can identify these statements by the fact that they do not relate strictly to historical or current facts and relate to future operating or financial performance.

Any or all of Assured Guaranty's forward-looking statements herein may turn out to be wrong and are based on current expectations and the current economic environment. Assured Guaranty's actual results may vary materially. Among factors that could cause actual results to differ materially are: (1) downgrades of the financial strength ratings assigned by the major rating agencies to any of our insurance subsidiaries at any time, which has occurred in the past; (2) our inability to execute our business strategy; (3) reduction in the amount of reinsurance ceded by one or more of our principal ceding companies; (4) contract cancellations; (5) developments in the world's financial and capital markets that adversely affect our loss experience, the demand for our products or our investment returns; (6) more severe or frequent losses associated with our insurance products; (7) changes in regulation or tax laws applicable to us, our subsidiaries or customers; (8) governmental action; (9) natural catastrophes; (10) dependence on customers; (11) decreased demand for our insurance or reinsurance products or increased competition in our markets; (12) loss of key personnel; (13) technological developments; (14) the effects of mergers, acquisitions and divestitures; (15) changes in accounting policies or practices; (16) changes in general economic conditions, including interest rates and other factors; (17) other risks and uncertainties that have not been identified at this time; and (18) management's response to these factors. Assured Guaranty is not obligated to publicly correct or update any forward-looking statement if we later become aware that it is not likely to be achieved, except as required by law. You are advised, however, to consult any further disclosures we make on related subjects in our periodic reports filed with the Securities and Exchange Commission.

### Executive Summary

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. We apply our credit expertise, risk management skills and capital markets experience to develop insurance, reinsurance and credit derivative products that meet the credit enhancement needs of our customers. We market our products directly and through financial institutions. We serve the U.S. and international markets.

Our financial results include four principal business segments: financial guaranty direct, financial guaranty reinsurance, mortgage guaranty and other. The other segment consists of a number of businesses that we exited in connection with the IPO.

We derive our revenues principally from premiums from our insurance, reinsurance and credit derivative businesses, net investment income, net realized gains and losses from our investment portfolio and unrealized gains and losses on derivative financial instruments. Our premiums are a function of the amount and type of contracts we write as well as prevailing market prices. We receive premiums on an upfront basis when the policy is issued or the contract is executed and/or on an installment basis over the life of the applicable transaction.

Investment income is a function of invested assets and the yield that we earn on those assets. The investment yield is a function of market interest rates at the time of investment as well as the type, credit quality and maturity of our invested assets. In addition, we could realize capital losses on securities in our investment portfolio from other than temporary declines in market value as a result of changing market conditions, including changes in market interest rates, and changes in the credit quality of our invested assets.

Unrealized gains and losses on derivative financial instruments are a function of changes in the estimated fair value of our credit derivative contracts. We expect these unrealized gains and losses to fluctuate primarily based on changes in credit spreads and the credit quality of the referenced entities. We generally hold these derivative contracts to maturity. Where we hold a derivative contract to maturity, the cumulative unrealized gains and losses will net to zero if we incur no credit losses on that contract.

Our expenses consist primarily of losses and loss adjustment expenses ( LAE ), profit commission expense, acquisition costs, operating expenses, interest expense and income taxes. Losses and LAE are a function of the amount and types of business we write. Losses and LAE are based upon estimates of the ultimate aggregate losses inherent in the portfolio. The risks we take have a low expected frequency of loss and are investment grade at the time we accept the risk. Prior to the initial public offering ( IPO ), the majority of the risks we underwrote were investment grade, however some risks accepted were below investment grade. Profit commission expense represents payments made to ceding companies generally based on the profitability of the business reinsured by us. Acquisition costs are related to the production of new business. Certain acquisition costs that vary with and are directly attributable to the production of new business are deferred and recognized over the period in which the related premiums are earned. Operating expenses consist primarily of salaries and other employee-related costs, various outside service providers, rent and related costs and other expenses related to maintaining a holding company structure. These costs do not vary with the amount of premiums written. Interest expense is a function of outstanding debt and the contractual interest rate related to that debt. Income taxes are a function of our profitability and the applicable tax rate in the various jurisdictions in which we do business.

### **Critical Accounting Estimates**

Our unaudited interim consolidated financial statements include amounts that, either by their nature or due to requirements of accounting principles generally accepted in the United States of America ( GAAP ), are determined using estimates and assumptions. The actual amounts realized could ultimately be materially different from the amounts currently provided for in our unaudited interim consolidated financial statements. We believe the items requiring the most inherently subjective and complex estimates to be reserves for losses and LAE, valuation of derivative financial instruments, valuation of investments, other than temporary impairments of investments, premium revenue recognition, deferred acquisition costs and deferred income taxes. An understanding of our accounting policies for these items is of critical importance to understanding our unaudited interim consolidated financial statements. The following discussion provides more information regarding the estimates and assumptions used for these items and should be read in conjunction with the notes to our unaudited interim consolidated financial statements.

#### ***Reserves for Losses and Loss Adjustment Expenses***

Reserves for losses and loss adjustment expenses for non-derivative transactions in our financial guaranty direct, financial guaranty assumed reinsurance and mortgage guaranty business include case reserves and portfolio reserves. See the Valuation of Derivative Financial Instruments of the Critical Accounting Estimates section for more information on our derivative transactions. 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 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 incurred but not reported ( IBNR ) reserves 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, are discounted at 6%, which is the approximate taxable equivalent yield on our investment portfolio in all periods presented.

We record portfolio reserves in our financial guaranty direct, financial guaranty assumed reinsurance and mortgage guaranty business. Portfolio reserves are established with respect to the portion of our business for which case reserves have not been established. Portfolio reserves are not established for quota share mortgage insurance contract types, all of which are in run-off, rather IBNR reserves have been established for these contracts.

Portfolio reserves are not established based on a specific event, rather they are calculated by aggregating the portfolio reserve calculated for each individual transaction. Individual transaction reserves are 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 is defined as the frequency of loss multiplied by the severity of loss, where the frequency is defined as the probability of default for each individual issue. The earning factor is inception to date earned premium divided by the estimated ultimate written premium for each transaction. The probability of default is estimated from historical rating agency data and is based on the transaction's credit rating, industry sector

and time until maturity. The severity is defined as the complement of historical recovery/salvage rates gathered by the rating agencies of defaulting issues and is based on the industry sector.

Portfolio reserves are recorded gross of reinsurance. To date our reinsurance programs have been made up of excess of loss contracts. We have not ceded any amounts under these contracts, as our recorded portfolio reserves have not exceeded our contractual retentions.

The Company records an incurred loss that is reflected in the statement of operations upon the establishment of portfolio reserves. When we initially record a case reserve, we reclassify 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 is recorded as a charge in our statement of operations. It would be a remote occurrence when the case reserve is not greater than the reclassified portfolio reserve. Any subsequent change in portfolio reserves or the initial case reserves are recorded quarterly as a charge or credit in our statement of operations in the period such estimates change. Due to the inherent uncertainties of estimating loss and LAE reserves, actual experience may differ from the estimates reflected in our unaudited interim consolidated financial statements, and the differences may be material.

The chart below demonstrates the portfolio reserve's sensitivity to frequency and severity assumptions. The change in these estimates represent management's estimate of reasonably possible material changes and are based upon our analysis of historical experience. Portfolio reserves were recalculated with changes made to the default and severity assumptions. In all scenarios, the starting point used to test the portfolio reserve's sensitivity to the changes in the frequency and severity assumptions was the weighted average frequency and severity by rating and asset class of our insured portfolio. Overall the weighted average default frequency was 0.79% and the weighted average severity was 19.4% at March 31, 2006. For example, in the first scenario where the frequency was increased by 5.0%, each transaction's contribution to the portfolio reserve was recalculated by adding 0.04% (i.e. 5.0% multiplied by 0.79%) to the individual transaction's default frequency.

(in thousands of U.S. dollars)	Portfolio Reserve	Reserve Increase	Percentage Change	
Portfolio reserve as of March 31, 2006	\$ 62,504	\$		
5% Frequency Increase	66,124	3,620	5.79	%
10% Frequency Increase	69,743	7,239	11.58	%
5% Severity Increase	65,516	3,012	4.82	%
10% Severity Increase	68,528	6,024	9.64	%
5% Frequency and Severity Increase	69,327	6,823	10.91	%

In addition to analyzing the sensitivity of our portfolio reserves to possible changes in frequency and severity, we have also performed a sensitivity analysis on our financial guaranty and mortgage guaranty case reserves. Case reserves may change from our original estimate due to changes in severity factors. An actuarial analysis of the historical development of our case reserves shows that it is reasonably possible that our case reserves could develop by as much as ten percent. This analysis was performed by separately evaluating the historical development by comparing the initial case reserve established to the subsequent development in that case reserve, excluding the effects of discounting, for each sector in which we currently have significant case reserves, and estimating the possible future development. Based on this analysis, it is reasonably possible that our current financial guaranty and mortgage guaranty case reserves of \$35.9 million could reasonably increase by approximately \$3.0 million to \$4.0 million in the future. This would cause an increase in incurred losses on our statement of operations and comprehensive income.

A sensitivity analysis is not appropriate for our other segment reserves and our mortgage guaranty IBNR, since the amounts are fully reserved or reinsured.

We also record IBNR reserves for our mortgage guaranty and other segments. IBNR is an estimate of losses for which the insured event has occurred but the claim has not yet been reported to us. In establishing IBNR, we use traditional actuarial methods to estimate the reporting lag of such claims based on historical experience, claim reviews and information reported by ceding companies.

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We record IBNR for mortgage guaranty quota-share reinsurance contracts, all of which are in run-off, within our mortgage guaranty segment. We also record IBNR for title reinsurance, auto residual value reinsurance and trade credit reinsurance within our other segment. The other segment represents lines of business we have exited or sold prior to the IPO.

For all other mortgage guaranty transactions we record portfolio reserves in a manner consistent with our financial guaranty business. While other mortgage guaranty insurance companies do not record portfolio reserves, rather just case and IBNR reserves, we record portfolio reserves because we write business on an excess of loss basis, while other industry participants write quota share or first layer loss business. We manage and underwrite this business in the same manner as our financial guaranty insurance and reinsurance business because they have similar characteristics as insured obligations of mortgage-backed securities.

Statement of Financial Accounting Standards ( FAS ) No. 60, Accounting and Reporting by Insurance Enterprises ( FAS 60 ) is the authoritative guidance for an insurance enterprise. FAS 60 prescribes differing reserving methodologies depending on whether a contract fits within its definition of a short-duration contract or a long-duration contract. Financial guaranty contracts have elements of long-duration insurance contracts in that they are irrevocable and extend over a period that may exceed 30 years or more, but for regulatory purposes are reported as property and liability insurance, which are normally considered short-duration contracts. The short-duration and long-duration classifications have different methods of accounting for premium revenue and contract liability recognition. Additionally, the accounting for deferred acquisition costs ( DAC ) could be different under the two methods.

We believe the guidance of FAS 60 does not expressly address the distinctive characteristics of financial guaranty insurance, so we also apply the analogous guidance of Emerging Issues Task Force ( EITF ) Issue No. 85-20, Recognition of Fees for Guaranteeing a Loan ( EITF 85-20 ), which provides guidance relating to the recognition of fees for guaranteeing a loan, which has similarities to financial guaranty insurance contracts. Under the guidance in EITF 85-20, the guarantor should assess the probability of loss on an ongoing basis to determine if a liability should be recognized under FAS No. 5, Accounting for Contingencies ( FAS 5 ). FAS 5 requires that a loss be recognized where it is probable that one or more future events will occur confirming that a liability has been incurred at the date of the financial statements and the amount of loss can be reasonably estimated.

The following tables summarize our reserves for losses and LAE by segment, by type of reserve and by segment and type of reserve as of the dates presented. For an explanation of changes in these reserves see Consolidated Results of Operations.

	March 31, 2006	December 31, 2005
	(in millions of U.S. dollars)	
<i>By segment:</i>		
Financial guaranty direct	\$ 8.0	\$ 13.1
Financial guaranty reinsurance	87.8	86.3
Mortgage guaranty	6.7	7.0
Other	14.7	14.8
Total	\$ 117.2	\$ 121.2

	March 31, 2006	December 31, 2005
	(in millions of U.S. dollars)	
<i>By type of reserve:</i>		
Case	\$ 43.1	\$ 45.9
IBNR	11.6	11.6
Portfolio	62.5	63.7
Total	\$ 117.2	\$ 121.2

	As of March 31, 2006					
	Financial Guaranty Direct	Financial Guaranty Reinsurance	Mortgage Guaranty	Other	Total	
	(in millions of U.S. dollars)					
<i>By segment and type of reserve:</i>						
Case	\$ (0.7)	\$ 36.4	\$ 0.2	\$ 7.2	\$ 43.1	
IBNR			4.1	7.5	11.6	
Portfolio	8.7	51.4	2.4		62.5	
Total	\$ 8.0	\$ 87.8	\$ 6.7	\$ 14.7	\$ 117.2	

	As of December 31, 2005					
	Financial Guaranty Direct	Financial Guaranty Reinsurance	Mortgage Guaranty	Other	Total	
	(in millions of U.S. dollars)					
<i>By segment and type of reserve:</i>						
Case	\$ 4.5	\$ 33.8	\$ 0.3	\$ 7.3	\$ 45.9	
IBNR			4.1	7.5	11.6	
Portfolio	8.6	52.5	2.6		63.7	
Total	\$ 13.1	\$ 86.3	\$ 7.0	\$ 14.8	\$ 121.2	

The following table sets forth the financial guaranty in-force portfolio by underlying rating:

Ratings(1)	As of March 31, 2006			As of December 31, 2005		
	Net par outstanding	% of Net par outstanding		Net par outstanding	% of Net par outstanding	
	(in billions of U.S. dollars)					
AAA	\$ 37.6	35.2	%	\$ 34.5	33.7	%
AA	20.8	19.5	%	20.0	19.5	%
A	30.8	28.9	%	30.3	29.5	%
BBB	16.3	15.3	%	16.4	16.0	%
Below investment grade	1.3	1.2	%	1.2	1.3	%
Total exposures	\$ 106.9	100.0	%	\$ 102.5	100.0	%

(1) These ratings represent the Company's internal assessment of the underlying credit quality of the insured obligations. Our scale is comparable to that of the nationally recognized rating agencies.

Our surveillance department is responsible for monitoring our portfolio of credits and maintains a list of closely monitored credits. The closely monitored credits are divided into four categories: Category 1 (low priority; fundamentally sound, greater than normal risk); Category 2 (medium priority; weakening credit profile, may result in loss); Category 3 (high priority; claim/default probable, case reserve established); Category 4 (claim paid, case reserve established for future payments). The closely monitored credits include all below investment grade (BIG) exposures where there is a material amount of exposure (generally greater than \$10.0 million) or a material risk of the Company incurring a loss greater than \$0.5 million. The closely monitored credits also include investment grade (IG) risks where credit quality is deteriorating and where, in the view of the Company, there is significant potential that the risk quality will fall below investment grade. The closely monitored credits include approximately 97% of our BIG exposure, and the remaining BIG exposure of \$45.5 million is distributed across 80 different credits, as of March 31, 2006. As of December 31, 2005, the closely monitored credits include approximately 96% of our BIG exposure, and the remaining BIG exposure of \$55.2 million is distributed across 103 different credits. Other than those excluded BIG credits, credits that are not included in the closely monitored credit list are categorized as fundamentally sound risks.



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The following table provides financial guaranty net par outstanding by credit monitoring category as of March 31, 2006 and December 31, 2005:

Description:	As of March 31, 2006					
	Net Par Outstanding	% of Net Par Outstanding	# of Credits in Category	Case Reserves		
(\$ in millions)						
Fundamentally sound risk(1)	\$ 105,480	98.7	%			
Closely monitored:						
Category 1	786	0.7	%	35	\$	
Category 2	369	0.4	%	20		
Category 3	213	0.2	%	19		23
Category 4	23			11		16
Sub total	1,391	1.3	%	85		39
Other below investment grade risk	46			80		
Total	\$ 106,917	100.0	%		\$	39

(1) As of March 31, 2006, Category 1 contains 3 credits with net par outstanding of \$59.7 million and Category 2 contains 6 credits with net par outstanding of \$51.0 million related to Hurricane Katrina.

Description:	As of December 31, 2005					
	Net Par Outstanding	% of Net Par Outstanding	# of Credits in Category	Case Reserves		
(\$ in millions)						
Fundamentally sound risk(1)	\$ 100,951	98.6	%			
Closely monitored:						
Category 1	872	0.9	%	36	\$	
Category 2	433	0.4	%	22		
Category 3	131	0.1	%	15		16
Category 4	23			11		15
Sub total	1,459	1.4	%	84		31
Other below investment grade risk	55			103		
Total	\$ 102,465	100.0	%		\$	31

(1) As of December 31, 2005, Category 1 contains 4 credits with net par outstanding of \$44.8 million and Category 2 contains 7 credits with net par outstanding of \$80.6 million related to Hurricane Katrina.

The following chart summarizes movements in CMC exposure by risk category:

Net Par Outstanding	Category 1	Category 2	Category 3	Category 4	Total CMC
	(\$ in millions)				
Balance, December 31, 2005	\$ 872	\$ 433	\$ 131	\$ 23	\$ 1,459
Less: Amortization	77	(22 )	7		62
Add: Additions From:					
First time on CMC	14		16		30
Upgrades	37	16			53
Downgrades		24	89		113
Less: Deletions From:					
Upgrades	36	37	16		89
Downgrades	24	89			113
Net Change	(86 )	(64 )	82		(68 )
Balance, March 31, 2006	\$ 786	\$ 369	\$ 213	\$ 23	\$ 1,391

### Industry Methodology

The Company is aware that there are certain differences regarding the measurement of portfolio loss liabilities among companies in the financial guaranty industry. In January and February 2005, the Securities and Exchange Commission ( SEC ) staff had discussions concerning these differences with a number of industry participants. Based on those discussions, in June 2005, the Financial Accounting Standards Board ( FASB ) staff decided additional guidance is necessary regarding financial guaranty contracts. When the FASB staff reaches a conclusion on this issue, which is expected during the first half of 2006, the Company and the rest of the financial guaranty industry may be required to change some aspects of their loss reserving policies, but the Company cannot currently assess how the FASB or SEC staffs ultimate resolution of this issue will impact our reserving policy or other balances, i.e., premiums and DAC. Until the issue is resolved, the Company intends to continue to apply its existing policy with respect to the establishment of both case and portfolio reserves.

### Valuation of Derivative Financial Instruments

The Company follows FAS No. 133, Accounting for Derivative Instruments and Hedging Activities ( FAS 133 ) and FAS No. 149, Amendment of Statement 133 on Derivative Instruments and Hedging Activities ( FAS 149 ), which establishes accounting and reporting standards for derivative instruments. FAS 133 and FAS 149 require recognition of all derivatives on the balance sheet at fair value.

We issue credit derivative financial instruments, which prior to 2004 included a few index-based derivative financial instruments, that we view as an extension of our financial guaranty business but which do not qualify for the financial guaranty insurance scope exception under FAS 133 and FAS 149 and therefore are reported at fair value, with changes in fair value included in our earnings.

Since we view these derivative contracts as an extension of our financial guaranty business, we believe that the most meaningful presentation of these derivatives is to reflect revenue as earned premium, to record estimates of losses and LAE on specific credit events as incurred and to record changes in fair value as incurred. Reserves for losses and LAE are established on a similar basis as our insurance policies. Other changes in fair value are included in unrealized gains and losses on derivative financial instruments. We generally hold derivative contracts to maturity. However, in certain circumstances such as for risk management purposes or as a result of a decision to exit a line of business, we may decide to terminate a derivative contract prior to maturity. Where we hold a derivative to maturity, the cumulative unrealized gains and losses will net to zero if we incur no credit losses on that contract. However, in the event that we terminate a derivative contract prior to maturity the unrealized gain or loss will be realized through premiums earned and losses incurred.

The fair value of these instruments depends on a number of factors including credit spreads, changes in interest rates, recovery rates and the credit ratings of referenced entities. Where available, we use quoted market





prices to determine the fair value of these credit derivatives. If the quoted prices are not available, particularly for senior layer CDOs and equity layer credit protection, the fair value is estimated using valuation models for each type of credit protection. These models may be developed by third parties, such as rating agencies, or developed internally based on market conventions for similar transactions, depending on the circumstances. These models and the related assumptions are continuously reevaluated by management and enhanced, as appropriate, based upon improvements in modeling techniques and availability of more timely market information. The majority of our single name credit derivatives were valued using third-party market quotes. These exposures were substantially liquidated in the first quarter of 2005 as we are no longer involved in the single name credit derivatives business. Our exposures to CDOs are typically valued using a combination of rating agency models and internally developed models.

Valuation models include the use of management estimates and current market information. Management is also required to make assumptions on how the fair value of derivative instruments are affected by current market conditions. Management considers factors such as current prices charged for similar agreements, performance of underlying assets, and our ability to obtain reinsurance for our insured obligations. Due to the inherent uncertainties of the assumptions used in the valuation models to determine the fair value of these derivative products, actual experience may differ from the estimates reflected in our unaudited interim consolidated financial statements, and the differences may be material.

During the first quarter 2005 review of its valuation models, management identified a limitation in its valuation models highlighted by the then widening credit spread environment. Management adjusted its valuation models for this limitation in the first quarter 2005 resulting in an adjustment to unrealized gains on derivative financial instruments of \$4.3 million, net of income taxes. Management continues to perform additional analysis, as necessary, to address market anomalies and its effect on its valuation models.

The fair value adjustment recognized in our statements of operations for the three months ended March 31, 2006 ( First Quarter 2006 ) was a \$29,000 gain compared with a \$3.1 million gain for the three months ended March 31, 2005 ( First Quarter 2005 ). The change in fair value is related to many factors but primarily due to widening in credit spreads.

#### *Valuation of Investments*

As of March 31, 2006 and December 31, 2005, we had total investments of \$2.2 billion. The fair values of all of our investments are calculated from independent market quotations.

As of March 31, 2006, approximately 94% of our investments were long-term fixed maturity securities, and our portfolio had an average duration of 4.4 years, compared with 95% and 4.4 years as of December 31, 2005. Changes in interest rates affect the value of our fixed maturity portfolio. As interest rates fall, the fair value of fixed maturity securities increases and as interest rates rise, the fair value of fixed maturity securities decreases.

#### *Other than Temporary Impairments*

We have a formal review process for all securities in our investment portfolio, including a review for impairment losses. Factors considered when assessing impairment include:

- a decline in the market value of a security by 20% or more below amortized cost for a continuous period of at least six months;
- a decline in the market value of a security for a continuous period of 12 months;
- recent credit downgrades of the applicable security or the issuer by rating agencies;
- the financial condition of the applicable issuer;
- whether scheduled interest payments are past due; and

- whether we have the ability and intent to hold the security for a sufficient period of time to allow for anticipated recoveries in fair value.

If we believe a decline in the value of a particular investment is temporary, we record the decline as an unrealized loss on our balance sheet in accumulated other comprehensive income in shareholders' equity. If we believe the decline is other than temporary, we write down the carrying value of the investment and record a realized loss in our statement of operations. Our assessment of a decline in value includes management's current assessment of the factors noted above. If that assessment changes in the future, we may ultimately record a loss after having originally concluded that the decline in value was temporary.

The Company had no write downs of investments for other than temporary impairment losses for the three-month periods ended March 31, 2006 and 2005.

The following table summarizes the unrealized losses in our investment portfolio by type of security and the length of time such securities have been in a continuous unrealized loss position as of the dates indicated:

Length of Time in Continuous Unrealized Loss	As of March 31, 2006		As of December 31, 2005	
	Estimated Fair Value	Gross Unrealized Losses	Estimated Fair Value	Gross Unrealized Losses
	(\$ in millions)			
<b>Municipal securities</b>				
0-6 months	\$ 104.5	\$ (0.9 )	\$ 103.2	\$ (0.9 )
7-12 months	59.1	(1.5 )	11.9	(0.3 )
Greater than 12 months	14.0	(0.5 )	13.1	(0.4 )
	177.6	(2.9 )	128.2	(1.6 )
<b>Corporate securities</b>				
0-6 months	17.8	(0.3 )	21.4	(0.4 )
7-12 months	17.4	(0.6 )	13.4	(0.2 )
Greater than 12 months	29.8	(1.2 )	16.8	(0.7 )
	65.0	(2.1 )	51.6	(1.3 )
<b>U.S. Government obligations</b>				
0-6 months	128.0	(2.2 )	160.5	(0.8 )
7-12 months	85.7	(1.1 )	8.7	(0.2 )
Greater than 12 months	21.7	(0.6 )	13.2	(0.4 )
	235.4	(3.9 )	182.4	(1.4 )
<b>Mortgage and asset-backed securities</b>				
0-6 months	171.8	(2.0 )	318.8	(4.7 )
7-12 months	305.3	(9.0 )	136.8	(2.6 )
Greater than 12 months	164.3	(6.8 )	89.7	(2.9 )
	641.4	(17.8 )	545.3	(10.2 )
Total	\$ 1,119.4	\$ (26.7 )	\$ 907.5	\$ (14.5 )

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The following table summarizes the unrealized losses in our investment portfolio by type of security and remaining time to maturity as of the dates indicated:

Remaining Time to Maturity	As of March 31, 2006		As of December 31, 2005	
	Estimated Fair Value	Gross Unrealized Losses	Estimated Fair Value	Gross Unrealized Losses
	(\$ in millions)			
<b>Municipal securities</b>				
Due in one year or less	\$	\$	\$	\$
Due after one year through five years	0.9		0.3	
Due after five years through ten years	56.2	(1.6 )	60.1	(1.2 )
Due after ten years	120.5	(1.3 )	67.8	(0.4 )
	177.6	(2.9 )	128.2	(1.6 )
<b>Corporate securities</b>				
Due in one year or less	4.0	(0.1 )		
Due after one year through five years	48.7	(1.4 )	44.3	(1.0 )
Due after five years through ten years	4.3	(0.1 )	4.2	
Due after ten years	8.0	(0.5 )	3.1	(0.3 )
	65.0	(2.1 )	51.6	(1.3 )
<b>U.S. Government obligations</b>				
Due in one year or less	38.8	(0.1 )	57.8	(0.2 )
Due after one year through five years	47.7	(0.4 )	39.5	(0.3 )
Due after five years through ten years	54.5	(1.2 )	45.2	(0.6 )
Due after ten years	94.4	(2.2 )	39.9	(0.3 )
	235.4	(3.9 )	182.4	(1.4 )
<b>Mortgage and asset-backed securities</b>	641.4	(17.8 )	545.3	(10.2 )
<b>Total</b>	\$ 1,119.4			