Return to Regular Format

Research:

Assured Guaranty Re Ltd.

Publication date: 09-Jun-2005
Primary Credit Analyst(s): Robert E Green, New York (1) 212-438-2013; robert_green@standardandpoors.com
Secondary Credit Analyst(s): Richard P Smith, New York (1) 212-438-2095; dick_smith@standardandpoors.com.

DOMICILE
Bermuda
LICENSED
None

Rationale

The 'AA' financial strength, financial enhancement, and counterparty credit ratings on Assured Guaranty Re Ltd. are based on the company's solid capital position and strategic relationship with sister company Assured Guaranty Corp. (AGC).

Assured Guaranty Re Ltd. (formerly Assured Guaranty Re International Ltd.) and its subsidiaries Assured Guaranty Re Overseas Ltd. and Assured Guaranty Mortgage Insurance Co. are collectively known as AG Re.

AG Re's strategic relationship with sister company AGC should provide it with a pipeline of diversified investment-grade reinsurance business. It is anticipated in AGC's business plan that about 30% of its gross par written will be ceded to AG Re. AG Re also benefits from technical and administrative assistance from AGC. The company's ability to offer facultative reinsurance capacity to the primary bond insurers will prove attractive from time to time, but third-party volume is less certain in view of sister company AGC competing with the other primaries. Statutory capital for the company totaled $596 million as of Dec. 31, 2004, and the company's margin of safety falls in the range of 1.2x-1.3x. The margin of safety represents the relationship of the company's ending capital position in the Standard & Poor's Ratings Services capital adequacy model to losses incurred. This margin of safety is above the 1.0x minimum requirement for 'AA' rated reinsurers. Underwriting is to investment-grade standards. Capital charges, which are proxies for the risk profile of the insurance portfolio, are 10.1% for the insured public finance book and 2.0% for the asset-backed book of business. These numbers are generally in line with 2003 industry averages. While the insured book of business exhibits some above-average concentrations by sector, these should improve with time. AGC and AG Re have reached an agreement with Financial Security Assurance Inc. (FSA), AG Re's largest customer, to allow the transfer of about $19.1 billion in FSA reinsurance from AGC to AG Re. This transaction, expected to close in the second quarter of 2005 pending regulatory approval, significantly hastens the conversion of AGC to a predominately direct insurer, and likewise hastens AG Re's conversion to the principal reinsurer in the group.

Outlook

The stable outlook is based on the company's conservative underwriting and investment policy and solid capital profile, coupled with the anticipated success of sister company AGC, a major source of business.

Management And Corporate Strategy

Providing monoline financial guaranty reinsurance capacity is the cornerstone of AG Re's business strategy. While the company has gone through some transitions, it has, going back to its predecessor corporate identity Capital Reinsurance Co., a 17-year track record of offering financial guaranty reinsurance. To accommodate this strategy, and in connection with the April 2004 initial public offering of parent company Assured Guaranty Ltd., business lines that were not consistent with the monoline bond insurance business were eliminated. These include the sale of the single-name credit default swap (CDS) book of business in 2005 and the transfer of auto residual value insurance, equity CDO, trade credit, and title business to affiliates of ACE Limited (ACE) in 2004. With its dedicated monoline reinsurance platform in place, AG Re is now positioned to offer reinsurance capacity to the industry. Correspondingly, sister company AGC is only writing reinsurance in a limited capacity and predominately operating as a direct primary company. AG Re benefits from operating flexibility in that it can offer facultative and treaty capacity to both the industry and to AGC. If some of the primary companies choose not to do business with AG Re because of its relationship with competitor AGC, revenue growth should still be consistent based on the business it can expect to receive from AGC. Also, with a combined statutory capital base of about $1.4 billion, AG Re/AGC offers the marketplace sizable single-risk capacity. Domiciled in Bermuda, the tax advantages of that location offset to some degree the disadvantageous economic effect of ceding commission costs and periodic potential adverse selection that afflicts third-party reinsurers.

AG Re also has a small, niche reinsurance business line of providing reinsurance capacity to the private mortgage insurance industry. This is not mortgage insurance capacity in the traditional sense, but represents transactions that are structured to provide AG Re with an investment-grade level of protection. Standard & Poor's, in its shadow rating process, has confirmed this, and the transactions have been capital charged accordingly.

The AG Re consolidated group includes Assured Guaranty Re Ltd. (formerly Assured Guaranty Re International Ltd.) and its subsidiaries Assured Guaranty Re Overseas Ltd. and Assured Guaranty Mortgage Insurance Co. Keepwell agreements from Assured Guaranty Re Ltd. for the benefit of Assured Guaranty Re Overseas Ltd. and from Assured Guaranty Re Overseas Ltd. for the benefit of Assured Guaranty Mortgage Insurance Co. allow the companies to be rated on a consolidated basis. The agreements provide that sufficient funds will be provided to each subsidiary to allow them to meet their obligations.

Pierre Samson is the president and COO of AG Re. Mr. Samson is a FCAS (Fellow of the Casualty Actuarial Society) and was previously with the ACE group of companies for nine years. He reports to Dominic Frederico, CEO of Assured Guaranty Ltd. Mr. Samson is supported by Dave Penchoff, chief underwriting officer. Mr. Penchoff was previously at MBIA Insurance Corp. for 10 years as a managing director and head of the public finance business. The company has a relatively small staff of eight professionals, but benefits from administrative and technological support from sister company AGC. All underwriting and management decisions are made by AG Re in Bermuda.

For part of 2004 there were elements of uncertainty with respect to management and the professional staff, which may have led to higher-than-expected turnover within the group. On March 31, 2004, Joseph W. Swain III, who until December 2003 had been the CEO of ACE's financial guaranty business and was thereafter the president of reinsurance for Assured Guaranty US Holdings Inc., resigned. In his resignation, Mr. Swain cited differences with management over the company's new business strategy and its ability to execute the strategy as a result of his concerns regarding the relevant experience of certain members of management, staffing levels, and corporate culture. Dominic Frederico, during a mid-2004 earnings call, likewise indicated that the staffing turnover situation was a concern for the company. However, he believed that this situation was in some ways to be expected based on the strategy shift and resulting downsizing and refocus of new management. This situation prompted board of director involvement in some areas, and that involvement had positive results. We believe internal communication and board/senior management communication have improved and the turnover situation has abated. Senior management, the staff, and the board all seem to be acting in unison with respect to their roles in implementing the business plan. In September 2004, Mr. Samson replaced Mr. Robbin Conner as the head of reinsurance operations, not withstanding the fact that Mr. Conner had participated in the IPO road show in the role of head of reinsurance.

The seven directors of the Assured Guaranty Ltd. Board are Walter Scott, non-executive chairman and former chairman, president, and CEO of ACE; Dominic Frederico; Neil Baron, former vice chairman and general counsel of Fitch IBCA Inc.; Lawrence Buhl, former insurance partner at Ernst & Young LLP; Stephen Cozen of the law firm Cozen O'Conner; John Heimann, former comptroller of the currency; and Patrick Kenny, former CFO of Aetna. It is likely that the size of the board will increase by one or two directors in 2005.

Table 1 Assured Guaranty Re Business Statistics

	—Year ended Dec. 31—	
(Mil $)	2004	2003
Net par exposure	21,590.0	9,125.0
Adjusted Gross Premiums Written*		
U.S. public finance	97.7	32.0
U.S. asset-backed and other	38.4	19.8
U.S. total	136.1	51.8
International public finance	18.7	9.5
International asset-backed and other	40.3	3.1
International total	59.1	12.6
Total adjusted gross premiums written	195.2	64.4
Net premiums written	17.8	232.9
Gross Par Written		
U.S. public finance	7,972.0	1,533.8
U.S. asset-backed and other	6,313.5	727.1
U.S. total	14,285.5	2,260.9
International public finance	878.9	281.4
International asset-backed and other	1,198.4	158.5
International total	2,077.2	439.9
Total gross par written	16,362.7	2,700.9
Net par written	15,478.5	2,700.9

*Adjusted gross premiums written include upfront and present value of installment premiums.

Table 2 Assured Guaranty Re Par Exposure By Source

As of Dec. 31, 2004

(Mil $)	Gross in-force	Gross written year
Direct	8,298	884
AGC	10,989	9,910
Ambac	4,008	2,359
FGIC	2,351	2,306
FSA	986	508
MBIA	822	0
Other	812	395
Total	28,266	16,363

Table 3 Assured Guaranty Re Insurance Portfolio Statistics

	—Year ended Dec. 31—			
(Mil $)	2004 industry average % of par	2004 % of par	2004 par	2003 par
Public Finance				
GO	21.5	12.7	2,745	1,073
Utility	10.1	12.1	2,615	2,015
Tax-backed	8.3	8.7	1,883	560
Health care	4.6	12.4	2,674	190
Transportation	5.4	4.2	906	631
Colleges and universities	3.1	0.7	148	52

Investor-owned utilities	1.6	0.8	180	46
Housing	1.8	0.8	176	82
Special revenue	0.7	0.6	126	8
Other	3.8	0.0	0	0
Total	60.8	53.0	11,454	4,658
Leases contained in above	4.6	4.1	877	195
Domestic Asset-Backed and Corporate Finance				
MBS	5.2	3.2	681	71
Home equity loan	3.4	9.3	2,010	158
Auto loan	1.8	1.5	318	77
Other consumer asset-backed	1.8	0.4	82	4
Commercial asset-backed	6.8	14.5	3,128	2,389
Bank/financial institutions	0.3	0.6	129	11
Other	5.2	5.2	1,120	544
Total	24.5	34.6	7,469	3,253
International				
Public finance	3.2	5.0	1,084	306
Asset-backed	10.9	3.5	754	866
Other	0.5	3.8	830	42
Total	14.7	12.4	2,668	1,214
Total net par outstanding	100.0	100.0	21,590	9,125
Mortgage guaranty risk in force	N/A	N/A	2,325	N/A
N/A—Not applicable.				

Business Review

The transfer of FSA business from AGC to AG Re will improve the diversity of AG Re's insured portfolio. As part of the transaction, FSA has agreed to reassume about $820 million in ceded health care business. Currently, AG Re's exposure to the health care sector is about 12.6%. After the transaction, the health care book will decline to about 8.5%, still more than the industry average of 4.9% but a significant improvement compared with the year-end. Health care exposure on a consolidated AGL basis will decline to 6.1% from about 6.9%.

Following the FSA transaction, insured par will increase from $21.6 billion as of Dec. 31, 2004, to about $39.9 billion on a pro forma basis. In addition to health care, other sector exposures will improve. For example, the GO sector will increase to 16.2% from 12.7% as of Dec. 31, 2004. This is still below the industry average of about 21%, but is moving in a positive direction. The underlying rating distribution of the post-FSA transaction book of business is 21.5% 'AAA', 25.7% 'AA', 38.5% 'A', 13.6% 'BBB', and 0.7% non-investment grade. Capital charges, which are proxies for the risk profile of the insurance portfolio, are 9.9% for the insured public finance book and 2.1% for the asset-backed book of business. These numbers are generally in line with 2003 industry averages.

The mortgage insurance reinsurance book of business totals $2.3 billion and has a capital charge of 2.47%. The shadow rating distribution of this book of business is 53.9% 'AAA', 20.1% 'AA', 11.6% 'A', 11.2% 'BBB', and 2.5% 'BB'.

The business challenge for a reinsurer with a sister company competing against primary company clients was made apparent when Ambac Assurance Corp. cancelled its quota share treaty with AGC effective July 1, 2006. Management at Ambac has indicated to Standard & Poor's that it is reluctant to give reinsurance business to an affiliate of a competitor. Ambac did, however, enter into a master facultative agreement with AG Re in March 2005, suggesting that facultative capacity and single-risk need may sometimes outweigh other business considerations.

Going forward, FSA will be AG Re's largest customer. FSA will have four quota share treaties in place with AG Re, as well as facultative relationships. FSA is expected to generate about 75% of AG Re's third-party gross written premium in 2005. AG Re also has facultative treaties with Ambac, FGIC, and XLFA.

Table 4 Assured Guaranty Re Financial Statistics

	—Year ended Dec. 31—	
(Mil $)	**2004**	**2003**
Insurance Company*		
Total assets	1,147.3	1,376.1
Cash + invested assets	892.4	1,015.9
Unearned premiums	195.5	240.4
Shareholder equity	693.0	632.3
Net premiums earned	64.0	133.5
Losses and LAE	(32.4)	89.6
Underwriting expense	40.2	45.2
Investment income, including gains	42.4	49.0
Net income	101.6	115.7
Loss ratio (%)	(50.6)	67.1
Underwriting profitability ratio (%)¶	87.8	(1.0)
Holding Company§		
Total assets	2,694.0	49,552.8
Stockholders' equity	1,527.6	8,834.8
Net income	182.8	1,417.5
Debt/capitalization (%)	11.4	21.2
Return on average equity (%)§	10.1	18.2

*Consolidated GAAP balance sheets. ¶(Net earned premiums - underwriting expenses and losses)/net earned premiums. §ACE Limited was the holding company from 1999-2003, Assured Guaranty Ltd for 2004.

Financial Review

Year-to-year comparisons are difficult for AG Re because of the company's transitional strategy and the elimination of several business lines. As a result, most asset and revenue categories declined in 2004 from 2003. There were also large swings in loss and loss adjustment expenses, from $89.6 million as of Dec. 31, 2003, to $(32.4) million as of Dec. 31, 2004. Net income for the company for the year-ended Dec. 31, 2004, was $101.6 million, down from $115.7 million for the year-ended Dec. 31, 2003. At the holding company level, net income for the year ended Dec. 31, 2004, was $182.8 million, generating a return on average equity of 10.1% for parent company Assured Guaranty Ltd.

More fundamentally, profitability indices for AG Re are indicative of pricing and underwriting standards consistent with industry averages. The profitability index divides average per period premium rates by average per period capital charges. The relationship of premiums to capital charges shows how much premium has been charged per unit of risk, which provides a basis for analysis of trends and company comparisons. For the 2004 book of business, the public finance weighted average premium rate was 0.77% and the weighted average capital charge was 9.99%, resulting in a profitability index of 7.7%. For the entire industry the profitability index for the 2003 book of public finance business was 7.59%. For the 2004 structured finance book of business, AG Re had a weighted average premium rate of 0.31% and a weighted average capital charge of 3.37%, for a profitability index of 9.2%. The industry average for the 2003 book of business was 12.8%, although preliminary reports indicate a decline for the 2004 book of business. The disparity is also somewhat offset to degree by the tax advantages of being located in Bermuda.

AG Re's $892.4 million investment portfolio generated $42.4 million in investment income returns in 2004, excluding net realized gains of $11.0 million. The pre-tax yield of the portfolio is 4.9% and the duration of the portfolio is 4.1 years. Because of Bermuda tax advantages, only $45.6 million of the portfolio is invested in tax-exempt paper. The rating distribution of the investment portfolio is 80.6% in the Treasury, agency, or 'AAA' category; 13.3% 'AA'; 5.9% 'A'; and 0.2% 'BBB'. BlackRock Inc. manages the portfolio with the goal of maximizing after-tax book income while generating a competitive total return, maintaining sufficient liquidity and preserving the company's 'AA' rating.

Table 5 Assured Guaranty Re Capital Statistics		
	—Year ended Dec. 31—	
(Mil $)	2004	2003
Portfolio Risk		
Municipal insurance weighted average capital charge (% of average annual debt service)	10.1	7.1
Asset-backed capital charge (% of par)	2.0	2.0
Claims-Paying Resources		
Statutory capital	596.0	560.0
Stop-loss treaty	0.0	0.0
Losses and LAE	103.0	390.0
Unearned premiums	186.0	233.0
Present value of annual premiums	132.1	90.0
Total	1,017.1	1,273.0
Capital Adequacy		
Capital remaining at end of depression test	150-200	N/A
Margin of safety (x)	1.2-1.3	N/A
Reliance on soft capital (%)	5.0	N/A
Notes: Claims-paying resources are AGR estimates of U.S. statutory accounting. The company files Bermuda statutory financial statements. N/A—Not applicable.		

Capitalization

AG Re has $1.0 billion in claims-paying resources as of Dec. 31, 2004. This is down from $1.3 billion as of Dec. 31, 2003, mostly due to the elimination of the aforementioned business lines in 2004. In particular, losses and loss adjustment expense reserves declined to $103 million as of Dec. 31, 2004, from $390 million at Dec. 31, 2003. Statutory capital increased to $596 million, a 6.4% increase from Dec. 31, 2003, due to the company earnings less dividends.

The company's margin of safety falls within a range of 1.2x-1.3x. This is the ratio of losses incurred in the Standard & Poor's capital adequacy model plus ending capital, divided by losses incurred. Determining the losses in the model are capital charges of 10.1% for the company's public finance book of business and 2.0% for the company's asset-backed book of business. The AG Re public finance capital charge was slightly below the 2003 industry average of 11.6%, while the asset-backed charge was slightly above the 2003 industry average of 1.9%. AG Re is currently neither a user of reinsurance or soft capital to manage its insured risk, but this could change modestly going forward.

The company has a very strong ratio of liquidity assets to theoretical claim payments coming due in the current year from each of the company's various sources of liquidity risk. With only a modest amount of tax-exempt investments, AG Re has a larger-than-average proportion of investments in corporate bonds and other more liquid financial assets that are readily availably to support reverse repurchase transactions. The company's two largest theoretical cash needs relate to AG Re's now-in-runoff single-name CDS business, where one individual obligor's theoretical claim payment this year would be $60 million (as of Dec. 31, 2004). The second largest cash need assumes the default AG Re's largest servicer of a reinsured transaction, and the assumption of 90 days worth of servicing payments.

Table 6 Assured Guaranty Re. Liquidity Margin Of Safety Analysis		
	Haircut (%)	Amount (mil $)
Assets/Resources as of Dec. 31, 2004		
Cash and short-term investments	0.0	106.7
Treasury and government agency fixed income securities	10.0	190.4
Corporate and ABS/MBS bonds	50.0	251.5
Bank lines of credit	0.0	100.0
Other	0.0	0.0
Adjusted cash totals after haircut		648.6
Municipal bonds (informational only)		43.8
Potential Uses (Occurring in the Full Year 2005)		
Largest net total payments in 2004 associated with a municipal obligor default		17.5
Largest net bullet maturity default (potentially includes IOUs, international, or "guaranteed" maturity bonds)		5.2
Largest debt service reserve draw		8.6
90 days of payments associated with the largest servicer default		50.8
Largest financial service obligations, such as largest unscheduled draw on a municipal investment contract		0.0
Largest individual "single name" credit default swap or single name in a defaulted synthetic structure		60.0
Holding company debt and dividend servicing needs		0.0
Other		0.0
Total usage		142.1
Net (assets - usage)		506.5
Margin of safety (x)		4.56