

ASSURED GUARANTY LTD
Form 10-Q
November 09, 2012
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 10-Q
(Mark One)

QUARTERLY REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the Quarterly Period Ended September 30, 2012
or
 TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT
OF 1934

For the 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 offices)
(441) 279-5700
(Registrant's 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 has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

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

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

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 November 1, 2012 was 194,076,724 (includes 88,549 unvested restricted shares).

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PART I. Financial Information

ITEM 1. Financial Statements

Assured Guaranty Ltd.

Consolidated Balance Sheets (unaudited)

(dollars in millions except per share and share amounts)

	As of September 30, 2012	As of December 31, 2011
Assets		
Investment portfolio:		
Fixed maturity securities, available-for-sale, at fair value (amortized cost of \$9,589 and \$9,638)	\$10,318	\$10,142
Short term investments, at fair value	564	734
Other invested assets	205	223
Total investment portfolio	11,087	11,099
Cash	133	215
Premiums receivable, net of ceding commissions payable	944	1,003
Ceded unearned premium reserve	550	709
Deferred acquisition costs	127	132
Reinsurance recoverable on unpaid losses	56	69
Salvage and subrogation recoverable	430	368
Credit derivative assets	450	469
Deferred tax asset, net	729	804
Current income tax receivable	78	76
Financial guaranty variable interest entities' assets, at fair value	2,693	2,819
Other assets	286	262
Total assets	\$17,563	\$18,025
Liabilities and shareholders' equity		
Unearned premium reserve	\$5,332	\$5,963
Loss and loss adjustment expense reserve	594	679
Reinsurance balances payable, net	185	171
Long-term debt	840	1,038
Credit derivative liabilities	2,151	1,773
Financial guaranty variable interest entities' liabilities with recourse, at fair value	2,169	2,397
Financial guaranty variable interest entities' liabilities without recourse, at fair value	1,018	1,061
Other liabilities	322	291
Total liabilities	12,611	13,373
Commitments and contingencies (See Note 12)		
Common stock (\$0.01 par value, 500,000,000 shares authorized; 193,988,878 and 182,235,798 shares issued and outstanding in 2012 and 2011)	2	2
Additional paid-in capital	2,722	2,570
Retained earnings	1,693	1,708
Accumulated other comprehensive income, net of tax of \$200 and \$135	531	368
Deferred equity compensation (320,193 shares in 2012 and 2011)	4	4
Total shareholders' equity	4,952	4,652

Total liabilities and shareholders' equity	\$17,563	\$18,025
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The accompanying notes are an integral part of these consolidated financial statements.

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Assured Guaranty Ltd.

Consolidated Statements of Operations (unaudited)

(dollars in millions except per share amounts)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
Revenues				
Net earned premiums	\$222	\$211	\$635	\$695
Net investment income	102	95	301	295
Net realized investment gains (losses):				
Other-than-temporary impairment losses	(4	) (33	) (41	) (67
Less: portion of other-than-temporary impairment loss recognized in other comprehensive income	0	(17	) (30	) (35
Other net realized investment gains (losses)	6	5	11	19
Net realized investment gains (losses)	2	(11	) 0	(13
Net change in fair value of credit derivatives:				
Realized gains (losses) and other settlements	2	0	(78	) 25
Net unrealized gains (losses)	(38	) 1,156	(388	) 830
Net change in fair value of credit derivatives	(36	) 1,156	(466	) 855
Fair value gain (loss) on committed capital securities	(2	) 2	(12	) 3
Fair value gains (losses) on financial guaranty variable interest entities	38	(99	) 174	(154
Other income	16	(9	) 112	59
Total revenues	342	1,345	744	1,740
Expenses				
Loss and loss adjustment expenses	90	215	459	313
Amortization of deferred acquisition costs	4	4	14	13
Interest expense	21	25	71	74
Other operating expenses	48	46	163	163
Total expenses	163	290	707	563
Income (loss) before income taxes	179	1,055	37	1,177
Provision (benefit) for income taxes				
Current	(9	) (13	) (9	) (200
Deferred	46	307	10	520
Total provision (benefit) for income taxes	37	294	1	320
Net income (loss)	\$142	\$761	\$36	\$857
Earnings per share:				
Basic	\$0.73	\$4.15	\$0.19	\$4.66
Diluted	\$0.73	\$4.13	\$0.19	\$4.60
Dividends per share	\$0.09	\$0.045	\$0.27	\$0.135

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

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Assured Guaranty Ltd.

Consolidated Statements of Comprehensive Income (unaudited)

(in millions)

	Three Months Ended		Nine Months Ended September	
	September 30,		30,	
	2012	2011	2012	2011
Net income (loss)	\$142	\$761	\$36	\$857
Unrealized holding gains (losses) arising during the period on:				
Investments with no other-than-temporary impairment, net of tax provision (benefit) of \$34, \$52, \$61 and \$94	95	129	169	210
Investments with other-than-temporary impairment, net of tax provision (benefit) of \$4, \$(7), \$(4) and \$(3)	5	(14	) (13	) (6
Unrealized holding gains (losses) arising during the period, net of tax	100	115	156	204
Less: reclassification adjustment for gains (losses) included in net income (loss), net of tax provision (benefit) of \$(1), \$(4), \$(6), and \$(5)	—	(9	) (5	) (12
Change in net unrealized gains on investments	100	124	161	216
Other, net of tax provision	1	(3	) 2	(1
Other comprehensive income (loss)	\$101	\$121	\$163	\$215
Comprehensive income (loss)	\$243	\$882	\$199	\$1,072

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

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Assured Guaranty Ltd.

Consolidated Statement of Shareholders' Equity (unaudited)

For the Nine Months Ended September 30, 2012

(dollars in millions, except share data)

	Common Stock		Additional Paid-in Capital	Retained Earnings	Accumulated Other Comprehensive Income	Deferred Equity Compensation	Total Shareholders' Equity
	Shares	Amount					
Balance at December 31, 2011	182,235,798	\$2	\$2,570	\$1,708	\$ 368	\$ 4	\$4,652
Net income	—	—	—	36	—	—	36
Dividends (\$0.27 per share)	—	—	—	(51)	—	—	(51)
Dividends on restricted stock units	—	—	0	0	—	—	—
Common stock issuance, net	13,428,770	0	173	—	—	—	173
Common stock repurchases	(2,066,759)	0	(24)	—	—	—	(24)
Share-based compensation and other	391,069	0	3	—	—	—	3
Other comprehensive income	—	—	—	—	163	—	163
Balance at September 30, 2012	193,988,878	\$2	\$2,722	\$1,693	\$ 531	\$ 4	\$4,952

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

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Assured Guaranty Ltd.

Consolidated Statements of Cash Flows (unaudited)

(in millions)

	Nine Months Ended September	
	30,	
	2012	2011
Net cash flows provided by (used in) operating activities	\$(223	) \$601
Investing activities		
Fixed maturity securities:		
Purchases	(1,322	) (1,788
Sales	683	849
Maturities	758	503
Net sales (purchases) of short-term investments	282	182
Net proceeds from paydowns on financial guaranty variable interest entities' assets	407	598
Acquisition of MIAC, net of cash acquired	(91) —
Other	85	14
Net cash flows provided by (used in) investing activities	802	358
Financing activities		
Proceeds from issuances of common stock	173	—
Dividends paid	(51	) (25
Repurchases of common stock	(24	) (23
Share activity under option and incentive plans	(3	) (3
Net paydowns of financial guaranty variable interest entities' liabilities	(553	) (830
Repayment of long-term debt	(204	) (17
Net cash flows provided by (used in) financing activities	(662	) (898
Effect of exchange rate changes	1	4
Increase (decrease) in cash	(82	) 65
Cash at beginning of period	215	108
Cash at end of period	\$133	\$173
Supplemental cash flow information		
Cash paid (received) during the period for:		
Income taxes	\$(11	) \$89
Interest	\$56	\$58

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

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Assured Guaranty Ltd.

Notes to Consolidated Financial Statements (unaudited)

September 30, 2012

1. Business and Basis of Presentation

Business

Assured Guaranty Ltd. (“AGL” and, together with its subsidiaries, “Assured Guaranty” or the “Company”) is a Bermuda-based holding company that provides, through its operating subsidiaries, credit protection products to the United States (“U.S.”) and international public finance (including infrastructure) and structured finance markets. The Company has applied its credit underwriting judgment, risk management skills and capital markets experience to offer insurance that protects holders of debt instruments and other monetary obligations from defaults in scheduled payments, including scheduled interest and principal payments. The Company markets its credit protection products directly to issuers and underwriters of public finance and structured finance securities as well as to investors in such obligations. The Company guarantees obligations issued in many countries, although its principal focus is on the U.S., Europe and Australia.

Financial guaranty insurance policies provide an unconditional and irrevocable guaranty that protects the holder of a financial obligation against non-payment of principal and interest (“Debt Service”) when due. Upon an obligor’s default on scheduled principal or interest payments due on the obligation, the Company is required under the financial guaranty policy to pay the principal or interest shortfall. The Company has issued financial guaranty insurance policies on public finance obligations and structured finance obligations. Public finance obligations insured by the Company consist primarily of general obligation bonds supported by the taxing powers of U.S. state or municipal governmental authorities, as well as tax-supported bonds, revenue bonds and other obligations supported by covenants from state or municipal governmental authorities or other municipal obligors to impose and collect fees and charges for public services or specific infrastructure projects. The Company also includes within public finance obligations those obligations backed by the cash flow from leases or other revenues from projects serving substantial public purposes, including utilities, toll roads, health care facilities and government office buildings. Structured finance obligations insured by the Company are generally issued by special purpose entities and backed by pools of assets such as residential or commercial mortgage loans, consumer or trade receivables, securities or other assets having an ascertainable cash flow or market value. The Company also includes within structured finance obligations other specialized financial obligations.

In the past, the Company had sold credit protection by issuing policies that guaranteed payment obligations under credit derivatives. Financial guaranty contracts accounted for as credit derivatives are generally structured such that the circumstances giving rise to the Company’s obligation to make loss payments are similar to those for financial guaranty insurance contracts and only occurs upon one or more defined credit events such as failure to pay or bankruptcy, in each case, as defined within the transaction documents, with respect to one or more third party referenced securities or loans. Financial guaranty contracts accounted for as credit derivatives are primarily comprised of credit default swaps (“CDS”). The Company’s credit derivative transactions are governed by International Swaps and Derivative Association, Inc. (“ISDA”) documentation.

The Company has not entered into any new CDS in order to sell credit protection since the beginning of 2009, when regulatory guidelines were issued that limited the terms under which such protection could be sold. The capital and margin requirements applicable under the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”) also contributed to the decision of the Company not to enter into such new CDS in the foreseeable

future. The Company actively pursues opportunities to terminate existing CDS and, in certain cases, has converted existing CDS exposure into a financial guaranty insurance contract. These actions have the effect of reducing future fair value volatility in income and/or reducing rating agency capital charges.

The Company has historically entered into ceded reinsurance contracts in order to obtain greater business diversification and reduce the net potential loss from large risks. In January 2012, two of AGL's operating subsidiaries, Assured Guaranty Municipal Corp. ("AGM") and Assured Guaranty Corp. ("AGC"), entered into a \$435 million excess of loss reinsurance facility with third-party reinsurers, which reduced rating agency capital charges. The Company also has been reassuming previously ceded business from reinsurers. In the three-month period ended March 31, 2012 ("First Quarter 2012"), the Company reassumed a total of \$19.1 billion in par from two reinsurers and in the three-month period ended September 30, 2012, the Company reassumed \$9 million in par from one reinsurer. See Note 11, Reinsurance and Other Monoline Exposures.

When a rating agency assigns a public rating to a financial obligation guaranteed by one of AGL's insurance company

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subsidiaries, it generally awards that obligation the same rating it has assigned to the financial strength of the AGL subsidiary that provides the guaranty. Investors in products insured by AGL's insurance company subsidiaries frequently rely on ratings published by nationally recognized statistical rating organizations ("NRSROs") because such ratings influence the trading value of securities and form the basis for many institutions' investment guidelines as well as individuals' bond purchase decisions. Therefore, the Company manages its business with the goal of achieving high financial strength ratings. However, the models used by NRSROs differ, presenting conflicting goals that may make it inefficient or impractical to reach the highest rating level. The models are not fully transparent, contain subjective data (such as assumptions about future market demand for the Company's products) and change frequently. Ratings reflect only the views of the respective NRSROs and are subject to continuous review and revision or withdrawal at any time.

Unless otherwise noted, ratings disclosed herein on Assured Guaranty's insured portfolio reflect Assured Guaranty's internal ratings. Assured Guaranty's ratings scale is similar to that used by the NRSROs; however, the ratings in these financial statements may not be the same as those assigned by any such rating agency. For example, the super senior category, which is not generally used by rating agencies, is used by Assured Guaranty in instances where Assured Guaranty's AAA-rated exposure on its internal rating scale (which does not take into account Assured Guaranty's financial guaranty) has additional credit enhancement due to either (1) the existence of another security rated AAA that is subordinated to Assured Guaranty's exposure or (2) Assured Guaranty's exposure benefiting from a different form of credit enhancement that would pay any claims first in the event that any of the exposures incurs a loss, and such credit enhancement, in management's opinion, causes Assured Guaranty's attachment point to be materially above the AAA attachment point.

Basis of Presentation

The unaudited interim consolidated financial statements 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 that are of a normal recurring nature, necessary for a fair statement of the financial condition, results of operations and cash flows of the Company and its consolidated financial guaranty variable interest entities ("FG VIEs") 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 are as of September 30, 2012 and cover the three-month period ended September 30, 2012 ("Third Quarter 2012"), the three-month period ended September 30, 2011 ("Third Quarter 2011"), the nine-month period ended September 30, 2012 ("Nine Months 2012") and the nine-month period ended September 30, 2011 ("Nine Months 2011"). The year-end balance sheet data was derived from audited financial statements, but does not include all disclosures required by GAAP.

The unaudited interim consolidated financial statements include the accounts of AGL and its direct and indirect subsidiaries (collectively, the "Subsidiaries") and its consolidated FG VIEs. Intercompany accounts and transactions between and among all consolidated entities have been eliminated. Certain prior year balances have been reclassified to conform to the current year's presentation.

These unaudited interim consolidated financial statements should be read in conjunction with the consolidated financial statements included in AGL's Annual Report on Form 10-K for the year ended December 31, 2011, filed with the U.S. Securities and Exchange Commission (the "SEC").

AGL's principal insurance company subsidiaries are AGC, domiciled in Maryland; AGM, domiciled in New York; and Assured Guaranty Re Ltd. ("AG Re"), domiciled in Bermuda. In addition, the Company has another U.S. and another Bermuda insurance company subsidiary that participate in a pooling agreement with AGM, two insurance subsidiaries

organized in the United Kingdom, and a mortgage insurance company domiciled in New York. On May 31, 2012, the Company also completed the purchase of Municipal and Infrastructure Assurance Corporation ("MIAC"), which is domiciled in New York. See Note 2, Business Changes, Risks, Uncertainties and Accounting Developments. The Company's organizational structure includes various holdings companies, two of which—Assured Guaranty US Holdings Inc. ("AGUS") and Assured Guaranty Municipal Holdings Inc. ("AGMH")—have public debt outstanding. See Note 13, Long Term Debt and Credit Facilities.

2. Business Changes, Risks, Uncertainties and Accounting Developments

Summarized below are updates of the most significant recent events that have had, or may have in the future, a material effect on the financial position, results of operations or business prospects of the Company.

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Rating Actions

In the last several years, Standard and Poor's Ratings Services ("S&P") and Moody's Investors Service, Inc. ("Moody's") have downgraded the financial strength ratings of all the Company's insurance subsidiaries that they rate. On March 20, 2012, Moody's placed the ratings of AGL and its Subsidiaries, including the insurance financial strength rating of the Company's insurance subsidiaries, on review for possible downgrade. On October 30, 2012, Moody's indicated that it anticipates resolving its review during the first half of November 2012. There can be no assurance as to the actions that Moody's may take on the Company's ratings or that S&P will not take further action on the Company's ratings. For a discussion of the effect of rating actions by S&P or Moody's on the Company as of September 30, 2012, see the following:

• Note 4, Financial Guaranty Insurance Contracts

• Note 6, Financial Guaranty Contracts Accounted for as Credit Derivatives

• Note 11, Reinsurance and Other Monoline Exposures

• Note 13, Long Term Debt and Credit Facilities (regarding the impact on the Company's insured leveraged lease transactions)

Another situation in which the Company is exposed to downgrade risk is AGM may be required to pay claims in respect of AGMH's former financial products business if Dexia SA and its affiliates do not comply with their obligations following a downgrade of the financial strength rating of AGM. Most of the guaranteed investment contracts ("GICs") insured by AGM allow for the withdrawal of GIC funds in the event of a downgrade of AGM, unless the relevant GIC issuer posts collateral or otherwise enhances its credit. Most GICs insured by AGM allow for the termination of the GIC contract and a withdrawal of GIC funds at the option of the GIC holder in the event of a downgrade of AGM below a specified threshold, generally below A- by S&P or A3 by Moody's, with no right of the GIC issuer to avoid such withdrawal by posting collateral or otherwise enhancing its credit. Each GIC contract stipulates the thresholds below which the GIC issuer must post eligible collateral, along with the types of securities eligible for posting and the collateralization percentage applicable to each security type. These collateralization percentages range from 100% of the GIC balance for cash posted as collateral to, typically, 108% for asset-backed securities. At September 30, 2012, a downgrade of AGM to below AA- by S&P and Aa3 by Moody's would result in withdrawal of \$358 million of GIC funds and the need to post collateral on GICs with a balance of \$2.9 billion. In the event of such a downgrade, assuming an average margin of 105%, the market value as of September 30, 2012 that the GIC issuers would be required to post in order to avoid withdrawal of any GIC funds would be \$3.1 billion.

The insurance subsidiaries' financial strength ratings are an important competitive factor in the financial guaranty insurance and reinsurance markets. If the financial strength or financial enhancement ratings of the Company's insurance subsidiaries were reduced below current levels, the Company expects it could have adverse effects on its future business opportunities as well as the premiums it could charge for its insurance policies and consequently, a downgrade could harm the Company's new business production and results of operations in a material respect.

Accounting Changes

There has recently been significant GAAP rule making activity which has affected the accounting policies and presentation of the Company's financial information beginning on January 1, 2012, particularly:

• Adoption of new guidance that restricted the types and amounts of financial guaranty insurance acquisition costs that may be deferred. See Note 4, Financial Guaranty Insurance Contracts.

• Adoption of guidance that changed the presentation of other comprehensive income ("OCI"). See "Consolidated Statements of Comprehensive Income."

• Adoption of guidance requiring additional fair value disclosures. See Note 5, Fair Value Measurement.

In July 2012, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") 2012-02, "Intangibles-Goodwill and Other (Topic 350): Testing Indefinite-Lived Intangible Assets for Impairment" ("ASU 2012-02"). ASU 2012-02 amends prior indefinite-lived intangible asset impairment testing guidance. Under ASU 2012-02, the Company has the option to first assess qualitative factors to determine whether it is more likely than not (a likelihood of more than 50%) that an indefinite-lived intangible asset is impaired. If, after considering the totality of events and circumstances, an entity determines it is more likely than not that an indefinite-lived intangible asset is not impaired, then calculating the fair value of such asset is unnecessary. ASU 2012-02 is effective for interim and annual periods beginning after September 15, 2012 and the Company will adopt ASU 2012-02 at December 31, 2012. There will be no cumulative effect upon the adoption of ASU 2012-02 on the Company's consolidated financial position, results of operations or cash flows.

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Deutsche Bank Agreement

On May 8, 2012, Assured Guaranty reached a settlement with Deutsche Bank AG and certain of its affiliates (collectively, "Deutsche Bank"), resolving claims related to certain residential mortgage-backed securities ("RMBS") transactions issued, underwritten or sponsored by Deutsche Bank that were insured by Assured Guaranty under financial guaranty insurance policies and to certain RMBS exposures in re-securitization transactions as to which Assured Guaranty provides credit protection through CDS. As part of the settlement agreement (the "Deutsche Bank Agreement"), Assured Guaranty settled its litigation against Deutsche Bank on three RMBS transactions.

Assured Guaranty received a cash payment of \$166 million from Deutsche Bank upon signing of the Deutsche Bank Agreement, a portion of which partially reimbursed Assured Guaranty for past losses on certain transactions. Assured Guaranty and Deutsche Bank also entered into loss sharing arrangements covering future RMBS related losses, which are described below. Under the Deutsche Bank Agreement, Deutsche Bank AG placed eligible assets in trust in order to collateralize the obligations of a reinsurance affiliate under the loss-sharing arrangements. The Deutsche Bank reinsurance affiliate may be required to post additional collateral in the future to satisfy rating agency requirements. As of September 30, 2012 the balance of the assets held in trust of \$282 million was sufficient to fully collateralize Deutsche Bank's obligations, based on the Company's estimate of expected loss for the transactions covered under the agreement.

The settlement includes eight RMBS transactions ("Covered Transactions") that Assured Guaranty has insured through financial guaranty insurance policies. The Covered Transactions are backed by first lien and second lien mortgage loans. Under the Deutsche Bank Agreement, the Deutsche Bank reinsurance affiliate will reimburse 80% of Assured Guaranty's future losses on the Covered Transactions until Assured Guaranty's aggregate losses (including those to date that are partially reimbursed by the \$166 million cash payment) reach \$319 million. Assured Guaranty currently projects that in the base case the Covered Transactions will not generate aggregate losses in excess of \$319 million. In the event aggregate losses exceed \$389 million, the Deutsche Bank reinsurance affiliate is required to resume reimbursement at the rate of 85% of Assured Guaranty's losses in excess of \$389 million until such losses reach \$600 million. The Covered Transactions represented \$548 million of gross par outstanding (\$472 million on a net basis) as of September 30, 2012.

Certain uninsured tranches ("Uninsured Tranches") of three of the Covered Transactions are included as collateral in RMBS re-securitization transactions as to which Assured Guaranty provides credit protection through CDS. Under the Deutsche Bank Agreement, the Deutsche Bank reinsurance affiliate will reimburse losses on the CDS in an amount equal to 60% of losses in these Uninsured Tranches until the aggregate losses in the Uninsured Tranches reach \$141 million. In the event aggregate losses exceed \$161 million, reimbursement resumes at the rate of 60% until the aggregate losses reach \$185 million. The Deutsche Bank reinsurance affiliate is required to reimburse any losses in excess of \$185 million at the rate of 100% until the aggregate losses reach \$248 million. The Uninsured Tranches represent \$317 million of par outstanding as of September 30, 2012. As of September 30, 2012, lifetime losses in the base case are expected to exceed \$141 million (on a discounted basis).

Except for the Uninsured Tranches, the settlement does not include Assured Guaranty's CDS with Deutsche Bank. The parties have agreed to continue efforts to resolve CDS-related claims.

Reinsurance Agreements

As discussed in Note 11, Reinsurance and Other Monoline Exposures, the Company has entered into several agreements with reinsurers, including assumption and re-assumption agreements with Radian Asset Assurance Inc. ("Radian"), a re-assumption agreement with Tokio Marine & Nichido Fire Insurance Co., Ltd. ("Tokio") and a \$435 million excess of loss reinsurance facility.

MIAC Acquisition

On May 31, 2012, the Company purchased 100% of the outstanding common stock of MIAC from Radian for \$91 million in cash, resulting in \$16 million in indefinite-lived intangible assets which represents the value of MIAC's licenses. The other assets acquired consisted primarily of short-term investments. MIAC is licensed to provide financial guaranty insurance and reinsurance in 38 U.S. jurisdictions including the District of Columbia. The acquisition of MIAC enhances the Company's flexibility to respond to changes in the financial guaranty industry.

Remarketing of Senior Notes and Redemption of Equity Units

On June 1, 2012, the Company completed the remarketing of the \$173 million aggregate principal amount of 8.50%

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Senior Notes issued by AGUS in 2009 that were components of the Company's Equity Units. AGUS purchased all of the Senior Notes in the remarketing at a price of 100% of the aggregate principal amount thereof, and retired all of such notes on June 1, 2012. The proceeds from the remarketing were used to satisfy the obligations of the holders of the Equity Units to purchase AGL common shares pursuant to the forward purchase contracts that were also components of the Equity Units. Accordingly, on June 1, 2012, AGL issued 3.8924 common shares to holders of each \$50 Equity Unit, which represented a settlement rate of 3.8685 common shares plus certain anti-dilution adjustments, or an aggregate of 13,428,770 common shares. The Equity Units ceased to exist when the forward purchase contracts were settled on June 1, 2012.

3. Outstanding Exposure

The Company's financial guaranty contracts are written in different forms, but collectively are considered financial guaranty contracts. The Company seeks to limit its exposure to losses by underwriting obligations that are investment grade at inception, diversifying its insured portfolio and maintaining rigorous subordination or collateralization requirements on structured finance obligations. The Company also has utilized reinsurance by ceding business to third-party reinsurers. The Company provides financial guaranties with respect to debt obligations of special purpose entities, including VIEs. Some of these VIEs are consolidated as described in Note 7, Consolidation of Variable Interest Entities. The outstanding par and Debt Service amounts presented below include outstanding exposures on VIEs whether or not they are consolidated.

Debt Service Outstanding

	Gross Debt Service Outstanding		Net Debt Service Outstanding	
	September 30, 2012	December 31, 2011	September 30, 2012	December 31, 2011
	(in millions)			
Public finance	\$746,703	\$798,471	\$699,938	\$716,890
Structured finance	117,105	137,661	109,790	128,775
Total financial guaranty	\$863,808	\$936,132	\$809,728	\$845,665

In addition to the amounts shown in the table above, the Company's net mortgage guaranty insurance in force was approximately \$150 million as of September 30, 2012. The net mortgage guaranty insurance in force is assumed excess of loss business and comprises \$135 million covering loans originated in Ireland and \$15 million covering loans originated in the UK.

Financial Guaranty Portfolio by Internal Rating

Rating Category	As of September 30, 2012																	
	Public Finance U.S.				Public Finance Non-U.S.				Structured Finance U.S.				Structured Finance Non-U.S.				Total	
	Net Par Outstanding	%	Net Par Outstanding	%	Net Par Outstanding	%	Net Par Outstanding	%	Net Par Outstanding	%	Net Par Outstanding	%	Net Par Outstanding	%	Net Par Outstanding	%		
	(dollars in millions)																	
Super senior	\$—	—	\$1,119	2.9	\$13,714	17.5	\$4,818	24.1	\$19,651	3.7								
AAA	4,575	1.2	1,392	3.6	30,745	39.2	8,504	42.5	45,216	8.4								
AA	131,488	32.9	950	2.4	9,996	12.7	725	3.6	143,159	26.7								
A	215,989	54.1	10,281	26.5	4,500	5.7	1,476	7.4	232,246	43.3								
BBB	42,353	10.6	22,712	58.7	4,093	5.2	2,594	13.0	71,752	13.4								
Below-investment-grade ("BIG")	4,771	1.2	2,266	5.9	15,456	19.7	1,876	9.4	24,369	4.5								

Total net par
outstanding

\$399,176 100.0% \$38,720 100.0% \$78,504 100.0% \$19,993 100.0% \$536,393 100.0%

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Rating Category	As of December 31, 2011														
	Public Finance U.S.			Public Finance Non-U.S.			Structured Finance U.S			Structured Finance Non-U.S			Total		
	Net Par Outstanding	%		Net Par Outstanding	%		Net Par Outstanding	%		Net Par Outstanding	%		Net Par Outstanding	%	
	(dollars in millions)														
Super senior	\$—	—	%	\$1,138	2.9	%	\$16,756	18.2	%	\$5,660	23.9	%	\$23,554	4.2	%
AAA	5,074	1.3		1,381	3.5		35,736	38.7		10,231	43.2		52,422	9.4	
AA	139,693	34.6		1,056	2.7		12,575	13.6		976	4.1		154,300	27.7	
A	213,164	52.9		11,744	30.1		4,115	4.5		1,518	6.4		230,541	41.3	
BBB	40,635	10.1		21,399	54.8		5,044	5.5		3,391	14.3		70,469	12.6	
BIG	4,507	1.1		2,328	6.0		18,008	19.5		1,919	8.1		26,762	4.8	
Total net par outstanding	\$403,073	100.0%		\$39,046	100.0%		\$92,234	100.0%		\$23,695	100.0%		\$558,048	100.0%	

Beginning in First Quarter 2012, the Company decided to classify those portions of risks benefiting from reimbursement obligations collateralized by eligible assets held in trust in acceptable reimbursement structures as the higher of 'AA' or their current internal rating. As of Third Quarter 2012, the Company applied this policy to the Bank of America Agreement and the Deutsche Bank Agreement (see Note 4, Financial Guaranty Insurance Contracts). The Bank of America Agreement was entered into in April 2011 and the reclassification in First Quarter 2012 resulted in a decrease in BIG net par outstanding as of December 31, 2011 of \$1,452 million from that previously reported.

In addition to amounts shown in the tables above, the Company had outstanding commitments to provide guaranties of \$1.7 billion for structured finance and \$0.9 billion for public finance obligations at September 30, 2012. The structured finance commitments include the unfunded component of pooled corporate and other transactions. Public finance commitments typically relate to primary and secondary public finance debt issuances. The expiration dates for the public finance commitments range between October 1, 2012 and February 25, 2017, with \$0.5 billion expiring prior to December 31, 2012. The commitments are contingent on the satisfaction of all conditions set forth in them and may expire unused or be canceled at the counterparty's request. Therefore, the total commitment amount does not necessarily reflect actual future guaranteed amounts.

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Economic Exposure to the Selected European Countries

Several European countries are experiencing significant economic, fiscal and/or political strains such that the likelihood of default on obligations with a nexus to those countries may be higher than the Company anticipated when such factors did not exist. The Company is closely monitoring its exposures in European countries where it believes heightened uncertainties exist, specifically, Greece, Hungary, Ireland, Italy, Portugal and Spain (the “Selected European Countries”). Published reports have identified countries that may be experiencing reduced demand for their sovereign debt in the current environment. The Company selected these European countries based on these reports and its view that their credit fundamentals are deteriorating. The Company’s economic exposure to the Selected European Countries (based on par for financial guaranty contracts and notional amount for financial guaranty contracts accounted for as derivatives) is shown in the following table net of ceded reinsurance.

Net Economic Exposure to Selected European Countries(1)
September 30, 2012

	Greece (in millions)	Hungary	Ireland	Italy	Portugal	Spain (2)	Total
Sovereign and sub-sovereign exposure:							
Public finance	\$—	\$—	\$—	\$992	\$108	\$260	\$1,360
Infrastructure finance	—	423	23	326	99	167	1,038
Sub-total	—	423	23	1,318	207	427	2,398
Non-sovereign exposure:							
Regulated utilities	—	—	—	228	—	9	237
RMBS	—	219	135	491	—	—	845
Commercial receivables	—	1	18	26	14	17	76
Pooled corporate	25	—	187	227	14	527	980
Sub-total	25	220	340	972	28	553	2,138
Total	\$25	\$643	\$363	\$2,290	\$235	\$980	\$4,536
Total BIG	\$—	\$511	\$8	\$242	\$125	\$410	\$1,296

(1) While the Company’s exposures are shown in U.S. dollars, the obligations the Company insures are in various currencies, including U.S. dollars, Euros and British pounds sterling. Included in the table above is \$135 million of reinsurance assumed on a 2004 - 2006 pool of Irish residential mortgages that is part of the Company’s remaining legacy mortgage reinsurance business. One of the residential mortgage-backed securities included in the table above includes residential mortgages in both Italy and Germany, and only the portion of the transaction equal to the portion of the original mortgage pool in Italian mortgages is shown in the table.

(2) See Note 4, Financial Guaranty Insurance Contracts.

The Company no longer guarantees any sovereign bonds of the Selected European Countries. The exposure shown in the “Public Finance Category” is from transactions backed by receivable payments from sub-sovereigns in Italy, Spain and Portugal. Sub-sovereign debt is debt issued by a governmental entity or government backed entity, or supported by such an entity, that is other than direct sovereign debt of the ultimate governing body of the country. The Company understands that Moody’s recently had undertaken a review of redenomination risk in selected countries in the Eurozone, including some of the Selected European Countries. No redenomination from the Euro to another currency has yet occurred and it may never occur. Therefore, it is not possible to be certain at this point how a redenomination of an issuer’s obligations might be implemented in the future and, in particular, whether any redenomination would extend to the Company’s obligations under a related financial guarantee. As of June 30, 2012, the Company had €218 million of net exposure to the sovereign debt of Greece. The Company accelerated claims under its guarantees during

the second quarter 2012, paying off in full its liabilities with respect to the Greek sovereign bonds it guaranteed. As of September 30, 2012, the Company no longer had any direct exposure to Greece.

Surveillance Categories

The Company segregates its insured portfolio into investment grade and BIG surveillance categories to facilitate the appropriate allocation of resources to monitoring and loss mitigation efforts and to aid in establishing the appropriate cycle for

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periodic review for each exposure. BIG exposures include all exposures with internal credit ratings below BBB-. The Company's internal credit ratings are based on internal assessments of the likelihood of default and loss severity in the event of default. Internal credit ratings are expressed on a ratings scale similar to that used by the rating agencies and are generally reflective of an approach similar to that employed by the rating agencies.

The Company monitors its investment grade credits to determine whether any new credits need to be internally downgraded to BIG. The Company refreshes its internal credit ratings on individual credits in quarterly, semi-annual or annual cycles based on the Company's view of the credit's quality, loss potential, volatility and sector. Ratings on credits in sectors identified as under the most stress or with the most potential volatility are reviewed every quarter. The Company's insured credit ratings on assumed credits are based on the Company's reviews of low-rated credits or credits in volatile sectors, unless such information is not available, in which case, the ceding company's credit rating of the transactions are used. The Company models most assumed RMBS credits with par above \$1 million, as well as certain RMBS credits below that amount.

Credits identified as BIG are subjected to further review to determine the probability of a loss (see Note 4, Financial Guaranty Insurance Contracts). Surveillance personnel then assign each BIG transaction to the appropriate BIG surveillance category based upon whether a lifetime loss is expected and whether a claim has been paid. The Company expects "lifetime losses" on a transaction when the Company believes there is at least a 50% chance that, on a present value basis, it will pay more claims over the life of that transaction than it ultimately will have been reimbursed. For surveillance purposes, the Company calculates present value using a constant discount rate of 5%. (A risk-free rate is used for recording of reserves for financial statement purposes.)

Intense monitoring and intervention is employed for all BIG surveillance categories, with internal credit ratings reviewed quarterly. The three BIG categories are:

BIG Category 1: Below-investment-grade transactions showing sufficient deterioration to make lifetime losses possible, but for which none are currently expected. Transactions on which claims have been paid but are expected to be fully reimbursed (other than investment grade transactions on which only liquidity claims have been paid) are in this category.

BIG Category 2: Below-investment-grade transactions for which lifetime losses are expected but for which no claims (other than liquidity claims which is a claim that the Company expects to be reimbursed within one year) have yet been paid.

BIG Category 3: Below-investment-grade transactions for which lifetime losses are expected and on which claims (other than liquidity claims) have been paid. Transactions remain in this category when claims have been paid and only a recoverable remains.

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Financial Guaranty Exposures

(Insurance and Credit Derivative Form)

As of September 30, 2012

	BIG Net Par Outstanding				Net Par Outstanding	BIG Net Par as a % of Net Par Outstanding	
	BIG 1	BIG 2	BIG 3 (in millions)	Total BIG			
First lien U.S. RMBS:							
Prime first lien	\$27	\$461	\$3	\$491	\$663	0.1	%
Alt-A first lien	120	2,146	1,442	3,708	4,760	0.7	
Option ARM	60	425	734	1,219	1,753	0.2	
Subprime	116	1,350	854	2,320	7,541	0.4	
Second lien U.S. RMBS:							
Closed end second lien	—	451	412	863	985	0.2	
Home equity lines of credit (“HELOCs”)	96	—	2,755	2,851	3,358	0.5	
Total U.S. RMBS	419	4,833	6,200	11,452	19,060	2.1	
Trust preferred securities (“TruPS”)	2,026	—	951	2,977	5,863	0.6	
Other structured finance	1,156	377	1,370	2,903	73,574	0.5	
U.S. public finance	3,288	665	818	4,771	399,176	0.9	
Non-U.S. public finance	2,266	—	—	2,266	38,720	0.4	
Total	\$9,155	\$5,875	\$9,339	\$24,369	\$536,393	4.5	%

As of December 31, 2011

	BIG Net Par Outstanding				Net Par Outstanding	BIG Net Par as a % of Net Par Outstanding	
	BIG 1	BIG 2	BIG 3 (in millions)	Total BIG			
First lien U.S. RMBS:							
Prime first lien	\$77	\$465	\$—	\$542	\$739	0.1	%
Alt-A first lien	1,695	1,028	1,540	4,263	5,329	0.8	
Option ARM	25	689	882	1,596	2,433	0.3	
Subprime (including net interest margin securities)	795	1,200	513	2,508	8,136	0.4	
Second lien U.S. RMBS:							
Closed end second lien	—	495	520	1,015	1,040	0.2	
HELOCs	421	—	2,858	3,279	3,890	0.6	
Total U.S. RMBS	3,013	3,877	6,313	13,203	21,567	2.4	
TruPS	2,501	—	951	3,452	6,334	0.6	
Other structured finance	1,295	548	1,429	3,272	88,028	0.6	
U.S. public finance	3,395	274	838	4,507	403,073	0.8	
Non-U.S. public finance (1)	2,046	282	—	2,328	39,046	0.4	
Total	\$12,250	\$4,981	\$9,531	\$26,762	\$558,048	4.8	%

(1) Includes \$282 million in net par as of December 31, 2011, for bonds of the Hellenic Republic of Greece. See Note 4, Financial Guaranty Insurance Contracts.

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Below-Investment-Grade Credits

By Category

Description	As of September 30, 2012			Number of Risks(2)		
	Net Par Outstanding					
	Financial Guaranty Insurance(1)	Credit Derivative	Total	Financial Guaranty Insurance(1)	Credit Derivative	Total
	(dollars in millions)					
BIG:						
Category 1	\$6,943	\$2,212	\$9,155	148	31	179
Category 2	3,233	2,642	5,875	90	30	120
Category 3	7,299	2,040	9,339	136	31	167
Total BIG	\$17,475	\$6,894	\$24,369	374	92	466

Description	As of December 31, 2011			Number of Risks(2)		
	Net Par Outstanding					
	Financial Guaranty Insurance(1)	Credit Derivative	Total	Financial Guaranty Insurance(1)	Credit Derivative	Total
	(dollars in millions)					
BIG:						
Category 1	\$8,297	\$3,953	\$12,250	171	40	211
Category 2	3,458	1,523	4,981	71	33	104
Category 3	7,204	2,327	9,531	126	26	152
Total BIG	\$18,959	\$7,803	\$26,762	368	99	467

(1) Includes net par outstanding for FG VIEs.

(2) A risk represents the aggregate of the financial guaranty policies that share the same revenue source for purposes of making Debt Service payments.

Hurricane Sandy

On October 29, 2012, Hurricane Sandy made landfall in New Jersey and caused significant loss of life and property damage in New Jersey, New York and Connecticut. While the Company is continuing to evaluate the effects of Hurricane Sandy on its insured portfolio, it does not expect any significant losses as a result of the hurricane at this time.

4. Financial Guaranty Insurance Contracts

Change in accounting for deferred acquisition costs

In October 2010, the FASB adopted Accounting Standards Update (“Update”) No. 2010-26. The Company adopted this guidance January 1, 2012, with retrospective application. The Update specifies that certain costs incurred in the successful acquisition of new and renewal insurance contracts should be capitalized. These costs include direct costs of contract acquisition that result directly from and are essential to the contract transaction. These costs include expenses such as ceding commissions and the cost of underwriting personnel. Management uses its judgment in determining the type and amount of cost to be deferred. The Company conducts an annual study to determine which operating costs qualify for deferral. Ceding commission income on business ceded to third party reinsurers reduces

policy acquisition costs and is deferred. Costs incurred by the insurer for soliciting potential customers, market research, training, administration, unsuccessful acquisition efforts, and product development as well as all overhead type costs are charged to expense as incurred.

Expected losses, which include loss adjustment expenses (“LAE”), investment income, and the remaining costs of servicing the insured or reinsured business are considered in determining the recoverability of deferred acquisition costs. When an insured issue is retired early, the remaining related deferred acquisition cost is expensed at that time. Ceding commission expense and income associated with future installment premiums on assumed and ceded business, respectively,

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are calculated at their contractually defined rates and recorded in deferred acquisition costs on the consolidated balance sheets with a corresponding offset to net premium receivable or reinsurance balances payable.

As of January 1, 2011, the effect of retrospective application of the new guidance was a reduction to deferred acquisition costs of \$94 million and a reduction to retained earnings of \$64 million.

Effect of Retrospective Application of New Deferred Acquisition Cost Guidance
On Consolidated Statements of Operations

	As Reported Third Quarter 2011	Retroactive Application Adjustment	As Revised Third Quarter 2011
	(in millions except per share amounts)		
Amortization of deferred acquisition costs	\$7	\$(3)	\$4
Other operating expenses	42	4	46
Net income (loss)	761	0	761
Earnings per share:			
Basic	\$4.15	\$—	\$4.15
Diluted	4.13	—	4.13

	As Reported Nine Months 2011	Retroactive Application Adjustment	As Revised Nine Months 2011
	(in millions except per share amounts)		
Amortization of deferred acquisition costs	\$24	\$(11)	\$13
Other operating expenses	147	16	163
Net income (loss)	859	(2)	857
Earnings per share:			
Basic	4.67	(0.01)	4.66
Diluted	4.61	(0.01)	4.60

The portfolio of outstanding exposures discussed in Note 3, Outstanding Exposure, includes financial guaranty contracts that meet the definition of insurance contracts as well as those that meet the definition of derivative contracts. Amounts presented in this note relate only to financial guaranty insurance contracts. See Note 6, Financial Guaranty Contracts Accounted for as Credit Derivatives. Tables presented herein also present reconciliations to financial statement line items for other less significant types of insurance.

Net Earned Premiums

	Third Quarter 2012	2011	Nine Months 2012	2011
	(in millions)			
Scheduled net earned premiums	\$144	\$178	\$441	\$596
Acceleration of premium earnings	73	27	178	77
Accretion of discount on net premiums receivable	4	6	15	21
Total financial guaranty	221	211	634	694
Other	1	0	1	1
Total net earned premiums(1)	\$222	\$211	\$635	\$695

(1) Excludes \$17 million and \$20 million in Third Quarter 2012 and 2011, respectively, and \$50 million and \$57 million for Nine Months 2012 and 2011, respectively, related to consolidated FG VIEs.

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Gross Premium Receivable, Net of Ceding Commissions Roll Forward

	Nine Months	
	2012	2011
	(in millions)	
Balance beginning of period	\$1,003	\$1,168
Premium written, net	134	153
Premium payments received, net	(225	) (228
Adjustments to the premium receivable:		
Changes in the expected term of financial guaranty insurance contracts	12	(117
Accretion of discount	19	23
Foreign exchange translation	10	(3
Consolidation of FG VIEs	(5	) (10
Other adjustments	(4	) 1
Balance, end of period (1)	\$944	\$987

(1) Excludes \$30 million and \$29 million as of September 30, 2012 and 2011, respectively, related to consolidated FG VIEs.

Gains or losses due to foreign exchange rate changes relate to installment premium receivables denominated in currencies other than the U.S. dollar. Approximately 50%, 47% and 49% of installment premiums at September 30, 2012, December 31, 2011 and September 30, 2011, respectively, are denominated in currencies other than the U.S. dollar, primarily in Euro and British Pound Sterling.

Actual collections may differ from expected collections in the tables below due to factors such as foreign exchange rate fluctuations, counterparty collectability issues, accelerations, commutations and changes in expected lives.

Expected Collections of Gross Premiums Receivable,
Net of Ceding Commissions (Undiscounted)

	September 30, 2012
	(in millions)
2012 (October 1 – December 31)	\$65
2013	112
2014	93
2015	83
2016	77
2017-2021	305
2022-2026	206
2027-2031	152
After 2031	190
Total(1)	\$1,283

(1) Excludes expected cash collections on FG VIEs of \$35 million.

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Components of Unearned Premium Reserve

	As of September 30, 2012			As of December 31, 2011			
	Gross (in millions)	Ceded	Net(1)	Gross	Ceded	Net(1)	
Deferred premium revenue	\$5,476	\$576	\$4,900	\$6,046	\$728	\$5,318	
Contra-paid	(152) (26) (126) (92) (19) (73)
Total financial guaranty	5,324	550	4,774	5,954	709	5,245	
Other	8	0	8	9	0	9	
Total	\$5,332	\$550	\$4,782	\$5,963	\$709	\$5,254	

(1) Total net unearned premium reserve excludes \$226 million and \$274 million related to FG VIEs as of September 30, 2012 and December 31, 2011, respectively.

The following table provides a schedule of the expected timing of the income statement recognition of pre-tax financial guaranty insurance net deferred premium revenue and the present value of net expected losses to be expensed. The amount and timing of actual premium earnings and loss and LAE may differ from the estimates shown below due to factors such as refundings, accelerations, commutations, changes in expected lives and updates to loss estimates. A loss and LAE reserve is only recorded for the amount by which net expected loss to be expensed exceeds deferred premium revenue determined on a contract-by-contract basis. This table excludes amounts related to consolidated FG VIEs.

Expected Timing of Premium and Loss Recognition

	As of September 30, 2012		
	Scheduled Net Earned Premium (in millions)	Net Expected Loss to be Expensed	Net
2012 (October 1–December 31)	\$141	\$25	\$116
Subtotal 2012	141	25	116
2013	490	75	415
2014	433	49	384
2015	379	38	341
2016	343	35	308
2017 - 2021	1,294	124	1,170
2022 - 2026	814	66	748
2027 - 2031	498	34	464
After 2031	508	30	478
Total present value basis(1)(2)	4,900	476	4,424
Discount	270	235	35
Total future value	\$5,170	\$711	\$4,459

(1) Balances represent discounted amounts.

(2) Consolidation of FG VIEs resulted in reductions of \$364 million in future scheduled net earned premium and \$195 million in net expected loss to be expensed.

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Selected Information for Policies Paid in Installments

	As of September 30, 2012	As of December 31, 2011		
	(dollars in millions)			
Premiums receivable, net of ceding commission payable	\$944	\$1,003		
Gross deferred premium revenue	1,920	2,193		
Weighted-average risk-free rate used to discount premiums	3.6	%	3.4	%
Weighted-average period of premiums receivable (in years)	9.9		9.8	

Loss Estimation Process

The Company's loss reserve committees estimate expected loss to be paid (including any loss adjustment expenses). Surveillance personnel present analyses related to potential losses to the Company's loss reserve committees for consideration in estimating the expected loss to be paid. Such analyses include the consideration of various scenarios with potential probabilities assigned to them. Depending upon the nature of the risk, the Company's view of the potential size of any loss and the information available to the Company, that analysis may be based upon individually developed cash flow models, internal credit rating assessments and sector-driven loss severity assumptions or judgmental assessments. In the case of its assumed business, the Company may conduct its own analysis as just described or, depending on the Company's view of the potential size of any loss and the information available to the Company, the Company may use loss estimates provided by ceding insurers. The Company's loss reserve committees review and refresh the estimate of expected loss to be paid each quarter. The Company's estimate of ultimate loss on a policy is subject to significant uncertainty over the life of the insured transaction due to the potential for significant variability in credit performance as a result of economic, fiscal and financial market variability over the long duration of most contracts. The determination of expected loss to be paid is an inherently subjective process involving numerous estimates, assumptions and judgments by management.

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The following table presents a roll forward of the present value of net expected loss to be paid for financial guaranty insurance contracts by sector. Net expected loss to be paid is the estimate of the present value of future claim payments, net of reinsurance and net of salvage and subrogation, which includes the present value benefit of estimated recoveries for breaches of representations and warranties (“R&W”). The Company used weighted average risk-free rates for U.S. dollar denominated obligations, which ranged from 0.0% to 3.19% as of September 30, 2012 and 0.0% to 3.27% as of December 31, 2011.

Present Value of Net Expected Loss to be Paid
Roll Forward by Sector(1)

	Net Expected Loss to be Paid as of June 30, 2012 (in millions)	Economic Loss Development(2)	(Paid) Recovered Losses(3)	Net Expected Loss to be Paid as of September 30, 2012(4)
U.S. RMBS:				
First lien:				
Prime first lien	\$3	\$1	\$—	\$4
Alt-A first lien	192	4	(8	) 188
Option ARM	(36	) 7	(88	) (117
Subprime	159	11	(5	) 165
Total first lien	318	23	(101	) 240
Second lien:				
Closed-end second lien	(17	) (1	) (3	) (21
HELOCs	(63	) (14	) (30	) (107
Total second lien	(80	) (15	) (33	) (128
Total U.S. RMBS	238	8	(134	) 112
TruPS	7	3	(1	) 9
Other structured finance	221	1	(1	) 221
U.S. public finance	58	8	(56	) 10
Non-U.S. public finance	302	33	(289) 46
Total financial guaranty	826	53	(481) 398
Other	(4) —	—	(4
Total	\$822	\$53	\$(481) \$394

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	Net Expected Loss to be Paid as of June 30, 2011 (in millions)	Economic Loss Development(2)	(Paid) Recovered Losses(3)	Net Expected Loss to be Paid as of September 30, 2011
U.S. RMBS:				
First lien:				
Prime first lien	\$3	\$ (1	) \$—	\$ 2
Alt-A first lien	167	(3	) (16	) 148
Option ARM	267	51	(75	) 243
Subprime	162	36	(1	) 197
Total first lien	599	83	(92	) 590
Second lien:				
Closed-end second lien	(95	) 47	(1	) (49
HELOCs	(38	) (8	) (24	) (70
Total second lien	(133	) 39	(25	) (119
Total U.S. RMBS	466	122	(117	) 471
TruPS	4	8	1	13
Other structured finance	177	75	(6	) 246
U.S. public finance	60	1	(30	) 31
Non-U.S. public finance	6	6	—	12
Total financial guaranty	713	212	(152	) 773
Other	2	—	—	2
Total	\$715	\$212	\$(152	) \$ 775

	Net Expected Loss to be Paid as of December 31, 2011(4) (in millions)	Economic Loss Development(2)	(Paid) Recovered Losses(3)	Net Expected Loss to be Paid as of September 30, 2012(4)
U.S. RMBS:				
First lien:				
Prime first lien	\$2	\$2	\$—	\$ 4
Alt-A first lien	135	18	35	188
Option ARM	153	6	(276	) (117
Subprime	140	33	(8	) 165
Total first lien	430	59	(249	) 240
Second lien:				
Closed-end second lien	(80	) (5	) 64	(21
HELOCs	(31	) 9	(85	) (107
Total second lien	(111	) 4	(21	) (128
Total U.S. RMBS	319	63	(270	) 112
TruPS	13	(3	) (1	) 9
Other structured finance	240	12	(31	) 221
U.S. public finance	16	66	(72	) 10
Non-U.S. public finance	50	216	(220) 46
Total financial guaranty	638	354	(594) 398
Other	2	(6) —	(4

Total	\$640	\$348	\$(594) \$ 394
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	Net Expected Loss to be Paid as of December 31, 2010 (in millions)	Economic Loss Development(2)	(Paid) Recovered Losses(3)	Expected Loss to be Paid as of September 30, 2011
U.S. RMBS:				
First lien:				
Prime first lien	\$ 1	\$ 1	\$—	\$ 2
Alt-A first lien	184	19	(55	) 148
Option ARM	524	(38	) (243	) 243
Subprime	201	13	(17	) 197
Total first lien	910	(5	) (315	) 590
Second lien:				
Closed-end second lien	57	(63	) (43	) (49
HELOCs	(806	) 97	639	(70
Total second lien	(749	) 34	596	(119
Total U.S. RMBS	161	29	281	471
TruPS	(1	) 15	(1	) 13
Other structured finance	160	93	(7	) 246
U.S. public finance	82	(12	) (39	) 31
Non-U.S public finance	7	5	—	12
Total financial guaranty	409	130	234	773
Other	2	—	—	2
Total	\$411	\$130	\$234	\$ 775

(1) Amounts include all expected payments whether or not the insured VIE is consolidated.

(2) Economic loss development includes the effects of changes in assumptions based on observed market trends, changes in discount rates, accretion of discount and the economic effects of loss mitigation efforts.

Net of ceded paid losses, whether or not such amounts have been settled with reinsurers. Ceded paid losses are (3) typically settled 45 days after the end of the reporting period. Such amounts are recorded in reinsurance recoverable on paid losses included in other assets.

(4) Includes expected LAE to be paid for mitigating claim liabilities of \$26 million as of September 30, 2012 and \$36 million as of December 31, 2011.

The table below provides a reconciliation of expected loss to be paid to expected loss to be expensed. Expected loss to be paid differs from expected loss to be expensed due to: (1) the contra-paid which represent the payments that have been made but have not yet been expensed, (2) for transactions with a net expected recovery, the addition of claim payments that have been made (and therefore are not included in expected loss to be paid) that are expected to be recovered in the future (and therefore have also reduced expected loss to be paid), and (3) loss reserves that have already been established (and therefore expensed but not yet paid).

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Reconciliation of Financial Guaranty Insurance Present Value of Net Expected Loss to be Paid and Net Present Value of Net Expected Loss to be Expensed

	As of September 30, 2012 (in millions)
Net expected loss to be paid	\$398
Less: net expected loss to be paid for FG VIEs	(81)
Total	479
Contra-paid, net	126
Other recoveries (1)	30
Salvage and subrogation recoverable	424
Ceded salvage and subrogation recoverable(2)	(47)
Loss and LAE reserve	(591)
Reinsurance recoverable on unpaid losses	55
Net expected loss to be expensed(3)	\$476

(1) R&W recoveries recorded in other assets on the consolidated balance sheet.

(2) Recorded in reinsurance balances payable on the consolidated balance sheet.

(3) Excludes \$195 million related to consolidated FG VIEs.

The Company's Approach to Projecting Losses in U.S. RMBS

The Company projects losses on its insured U.S. RMBS on a transaction-by-transaction basis by projecting the performance of the underlying pool of mortgages over time and then applying the structural features (i.e., payment priorities and tranching) of the RMBS to the projected performance of the collateral over time. The resulting projected claim payments or reimbursements are then discounted using risk-free rates. For transactions where the Company projects it will receive recoveries from providers of R&W, it projects the amount of recoveries and either establishes a recovery for claims already paid or reduces its projected claim payments accordingly.

The further behind a mortgage borrower falls in making payments, the more likely it is that he or she will default. The rate at which borrowers from a particular delinquency category (number of monthly payments behind) eventually default is referred to as the "liquidation rate." Liquidation rates may be derived from observed roll rates, which are the rates at which loans progress from one delinquency category to the next and eventually to default and liquidation. The Company applies liquidation rates to the mortgage loan collateral in each delinquency category and makes certain timing assumptions to project near-term mortgage collateral defaults from loans that are currently delinquent.

Mortgage borrowers that are not more than one payment behind (generally considered performing borrowers) have demonstrated an ability and willingness to pay throughout the recession and mortgage crisis, and as a result are viewed as less likely to default than delinquent borrowers. Performing borrowers that eventually default will also need to progress through delinquency categories before any defaults occur. The Company projects how many of the currently performing loans will default and when they will default, by first converting the projected near term defaults of delinquent borrowers derived from liquidation rates into a vector of conditional default rates ("CDR"), then projecting how the conditional default rates will develop over time. Loans that are defaulted pursuant to the conditional default rate after the liquidation of currently delinquent loans represent defaults of currently performing loans. A conditional default rate is the outstanding principal amount of defaulted loans liquidated in the current month

divided by the remaining outstanding amount of the whole pool of loans (or “collateral pool balance”). The collateral pool balance decreases over time as a result of scheduled principal payments, partial and whole principal prepayments, and defaults.

In order to derive collateral pool losses from the collateral pool defaults it has projected, the Company applies a loss severity. The loss severity is the amount of loss the transaction experiences on a defaulted loan after the application of net proceeds from the disposal of the underlying property. The Company projects loss severities by sector based on its experience to date. Further detail regarding the assumptions and variables the Company used to project collateral losses in its U.S. RMBS portfolio may be found below in the sections “U.S. Second Lien RMBS Loss Projections: HELOCs and Closed-End Second

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Lien” and “U.S. First Lien RMBS Loss Projections: Alt-A First Lien, Option ARM, Subprime and Prime.”

The Company is in the process of enforcing claims for breaches of R&W regarding the characteristics of the loans included in the collateral pools. The Company calculates a credit from the RMBS issuer for such recoveries where the R&W were provided by an entity the Company believes to be financially viable and where the Company already has access or

believes it will attain access to the underlying mortgage loan files. Where the Company has an agreement with an R&W provider (e.g., the the Bank of America Agreement or the Deutsche Bank Agreement) or where it is in advanced discussions on a potential agreement, that credit is based on the agreement or potential agreement. In second lien RMBS transactions where there is no agreement or advanced discussions, this credit is based on a percentage of actual repurchase rates achieved across those transactions where material repurchases have been made. In first lien RMBS transactions where there is no agreement or advanced discussions, this credit is estimated by reducing collateral losses projected by the Company to reflect a percentage of the recoveries the Company believes it will achieve, based on a percentage of actual repurchase rates achieved or based on the amounts the Company was able to negotiate under the Bank of America Agreement and Deutsche Bank Agreement. The first lien approach is different from the second lien approach because the Company’s first lien transactions have multiple tranches and a more complicated method is required to correctly allocate credit to each tranche. In each case, the credit is a function of the projected lifetime collateral losses in the collateral pool, so an increase in projected collateral losses generally increases the R&W credit calculated by the Company for the RMBS issuer. Further detail regarding how the Company calculates these credits may be found under “Breaches of Representations and Warranties” below.

The Company projects the overall future cash flow from a collateral pool by adjusting the payment stream from the principal and interest contractually due on the underlying mortgages for (a) the collateral losses it projects as described above, (b) assumed voluntary prepayments and (c) recoveries for breaches of R&W as described above. The Company then applies an individual model of the structure of the transaction to the projected future cash flow from that transaction’s collateral pool to project the Company’s future claims and claim reimbursements for that individual transaction. Finally, the projected claims and reimbursements are discounted using risk-free rates. As noted above, the Company runs several sets of assumptions regarding mortgage collateral performance, or scenarios, and probability weights them.

Third Quarter-End 2012 U.S. RMBS Loss Projections

The Company's RMBS loss projection methodology assumes that the housing and mortgage markets will eventually improve. Each quarter the Company makes a judgment as to whether to change its assumptions used to make RMBS loss projections based on its observation during the quarter of the performance of its insured transactions (including early stage delinquencies, late stage delinquencies and, for first liens, loss severity) as well as the residential property market and economy in general, and, to the extent it observes changes, it makes a judgment as whether those changes are normal fluctuations or part of a trend. Based on such observations, the Company chose to use essentially the same methodology and scenarios to project RMBS loss as of September 30, 2012 as it used as of June 30, 2012. The methodology and scenarios used as of September 30, 2012 were also essentially the same as those it used as of December 31, 2011, except that as compared to December 31, 2011 (i) in its most optimistic scenario, it reduced by three months the period it assumed it would take the mortgage market to recover and (ii) in its most pessimistic scenario, it increased by three months the period it assumed it would take the mortgage market to recover. The methodology the Company uses to project RMBS losses and the scenarios it employs are described in more detail below under "-- U.S. Second Lien RMBS Loss Projections: HELOCs and Closed-End Second Lien" and "-- U.S. First Lien RMBS Loss Projections: Alt A First Lien, Option ARM, Subprime and Prime".

U.S. Second Lien RMBS Loss Projections: HELOCs and Closed-End Second Lien

The Company insures two types of second lien RMBS: those secured by HELOCs and those secured by closed end second lien mortgages. HELOCs are revolving lines of credit generally secured by a second lien on a one to four family home. A mortgage for a fixed amount secured by a second lien on a one to four family home is generally referred to as a closed end second lien. Second lien RMBS sometimes include a portion of loan collateral with a different priority than the majority of the collateral. The Company has material exposure to second lien mortgage loans originated and serviced by a number of parties, but the Company's most significant second lien exposure is to HELOCs originated and serviced by Countrywide, a subsidiary of Bank of America. See “—Breaches of Representations and Warranties.”

The delinquency performance of HELOC and closed end second lien exposures included in transactions insured by the Company began to deteriorate in 2007, and such transactions, continue to perform below the Company's original underwriting expectations. While insured securities benefit from structural protections within the transactions designed to absorb collateral losses in excess of previous historically high levels, in many second lien RMBS projected losses now exceed those structural protections.

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The Company believes the primary variables affecting its expected losses in second lien RMBS transactions are the amount and timing of future losses in the collateral pool supporting the transactions and the amount of loans repurchased for breaches of R&W (or agreements with R&W providers related to such obligations). Expected losses are also a function of the structure of the transaction; the voluntary prepayment rate (typically also referred to as conditional prepayment rate ("CPR") of the collateral); the interest rate environment; and assumptions about the draw rate and loss severity. These variables are interrelated, difficult to predict and subject to considerable volatility. If actual experience differs from the Company's assumptions, the losses incurred could be materially different from the estimate. The Company continues to update its evaluation of these exposures as new information becomes available.

The following table shows the range of key assumptions for the calculation of expected loss to be paid for individual transactions for direct vintage 2004 - 2008 second lien U.S. RMBS.

Key Assumptions in Base Case Expected Loss Estimates
Second Lien RMBS(1)

HELOC key assumptions	As of September 30, 2012		As of June 30, 2012		As of December 31, 2011	
Plateau CDR	2.2	%– 12.9%	2.9	%– 20.9%	4.0	%– 27.4%
Final CDR trended down to	0.4	%– 3.2%	0.4	%– 3.2%	0.4	%– 3.2%
Expected period until final CDR	36 months		36 months		36 months	
Initial CPR	3.7	%– 17.5%	2.7	%– 16.4%	1.4	%– 25.8%
Final CPR	10%		10%		10%	
Loss severity	98%		98%		98%	
Initial draw rate	0.0	%– 3.5%	0.0	%– 4.1%	0.0	%– 15.3%
Closed-end second lien key assumptions	As of September 30, 2012		As of June 30, 2012		As of December 31, 2011	
Plateau CDR	6.2	%– 19.0%	4.3	%– 20.7%	6.9	%– 24.8%
Final CDR trended down to	3.3	%– 9.1%	3.3	%– 9.1%	3.5	%– 9.2%
Expected period until final CDR	36 months		36 months		36 months	
Initial CPR	1.8	%– 10.1%	1.1	%– 11.0%	0.9	%– 14.7%
Final CPR	10%		10%		10%	
Loss severity	98%		98%		98%	

(1) Represents variables for most heavily weighted scenario (the "base case").

In second lien transactions the projection of near-term defaults from currently delinquent loans is relatively straightforward because loans in second lien transactions are generally "charged off" (treated as defaulted) by the securitization's servicer once the loan is 180 days past due. Most second lien transactions report the amount of loans in five monthly delinquency categories (i.e., 30-59 days past due, 60-89 days past due, 90-119 days past due, 120-149 days past due and 150-179 days past due). The Company estimates the amount of loans that will default over the next five months by calculating current representative liquidation rates (the percent of loans in a given delinquency status that are assumed to ultimately default) from selected representative transactions and then applying an average of the preceding twelve months' liquidation rates to the amount of loans in the delinquency categories. The amount of loans projected to default in the first through fifth months is expressed as a CDR. The first four months' CDR is

calculated by applying the liquidation rates to the current period past due balances (i.e., the 150-179 day balance is liquidated in the first projected month, the 120-149 day balance is liquidated in the second projected month, the 90-119 day balance is liquidated in the third projected month and the 60-89 day balance is liquidated in the fourth projected month). For the fifth month the CDR is calculated using the average 30-59 day past due balances for the prior three months. An average of the third, fourth and fifth month CDR is then used as the basis for the plateau period that follows the embedded five months of losses.

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As of September 30, 2012, for the base case scenario, the CDR (the “plateau CDR”) was held constant for one month. Once the plateau period has ended, the CDR is assumed to gradually trend down in uniform increments to its final long-term steady state CDR. In the base case scenario, the time over which the CDR trends down to its final CDR is 30 months. Therefore, the total stress period for second lien transactions is 36 months, comprising five months of delinquent data, a one month plateau period and 30 months of decrease to the steady state CDR. This is the same as June 30, 2012 and December 31, 2011. The long-term steady state CDR is calculated as the constant CDR that would have yielded the amount of losses originally expected at underwriting. When a second lien loan defaults, there is generally a very low recovery. Based on current expectations of future performance, the Company assumes that it will only recover 2% of the collateral, the same as June 30, 2012 and December 31, 2011.

The rate at which the principal amount of loans is prepaid may impact both the amount of losses projected (which is a function of the CDR and the loan balance over time) as well as the amount of excess spread (which is the excess of the interest paid by the borrowers on the underlying loan over the amount of interest and expenses owed on the insured obligations). In the base case, the current CPR (based on an average of the most recent three months) is assumed to continue until the end of the plateau before gradually increasing to the final CPR over the same period the CDR decreases. For transactions where the initial CPR is higher than the final CPR, the initial CPR is held constant. The final CPR is assumed to be 10% for both HELOC and closed-end second lien transactions. This level is much higher than current rates for most transactions, but lower than the historical average, which reflects the Company’s continued uncertainty about the projected performance of the borrowers in these transactions. This pattern is consistent with how the Company modeled the CPR at June 30, 2012 and December 31, 2011. To the extent that prepayments differ from projected levels it could materially change the Company’s projected excess spread and losses.

The Company uses a number of other variables in its second lien loss projections, including the spread between relevant interest rate indices, and HELOC draw rates (the amount of new advances provided on existing HELOCs expressed as a percentage of current outstanding advances). For HELOC transactions, the draw rate is assumed to decline from the current level to a final draw rate over a period of three months. The final draw rates were assumed to range from 0.0% to 1.8%.

In estimating expected losses, the Company modeled and probability weighted three possible CDR curves applicable to the period preceding the return to the long-term steady state CDR. The Company believes that the level of the elevated CDR and the length of time it will persist is the primary driver behind the likely amount of losses the collateral will suffer (before considering the effects of repurchases of ineligible loans). The Company continues to evaluate the assumptions affecting its modeling results.

As of September 30, 2012, the Company’s base case assumed a one month CDR plateau and a 30 month ramp-down (for a total stress period of 36 months), the same as June 30, 2012 and December 31, 2011. The Company also modeled a scenario with a longer period of elevated defaults and another with a shorter period of elevated defaults and weighted them the same as of June 30, 2012 and December 31, 2011. The length of the ramp-downs the Company used as of September 30, 2012 and June 30, 2012 were three months shorter in the optimistic cases and three months longer in the pessimistic cases than the Company used as of December 31, 2011 reflecting both positive and negative developments observed by the Company in the market. Increasing the CDR plateau to four months and increasing the ramp-down by three months to 33-months (rather than 30 months as of December 31, 2011, for a total stress period of 42 months rather than 39 months as of December 31, 2011) would increase the expected loss by approximately \$53 million for HELOC transactions and \$4 million for closed-end second lien transactions. On the other hand, keeping the CDR plateau at one month but decreasing the length of the CDR ramp-down to a 21 months (rather than 24 months as of December 31, 2011, for a total stress period of 27 months rather than 30 months as of December 31, 2011) would decrease the expected loss by approximately \$52 million for HELOC transactions and \$3 million for closed-end second lien transactions.

U.S. First Lien RMBS Loss Projections: Alt-A First Lien, Option ARM, Subprime and Prime

First lien RMBS are generally categorized in accordance with the characteristics of the first lien mortgage loans on one-to-four family homes supporting the transactions. The collateral supporting “subprime RMBS” transactions consists of first-lien residential mortgage loans made to subprime borrowers. A “subprime borrower” is one considered to be a higher risk credit based on credit scores or other risk characteristics. Another type of RMBS transaction is generally referred to as “Alt-A first lien.” The collateral supporting such transactions consists of first-lien residential mortgage loans made to “prime” quality borrowers who lack certain ancillary characteristics that would make them prime. When more than 66% of the loans originally included in the pool are mortgage loans with an option to make a minimum payment that has the potential to amortize the loan negatively (i.e., increase the amount of principal owed), the transaction is referred to as an “Option ARM.” Finally, transactions may be composed primarily of loans made to prime borrowers. First lien RMBS sometimes include a portion of

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loan collateral that differs in priority from the majority of the collateral.

The performance of the Company's first lien RMBS exposures began to deteriorate in 2007 and such transactions, continue to perform below the Company's original underwriting expectations. The Company currently projects first lien collateral losses many times those expected at the time of underwriting. While insured securities benefited from structural protections within the transactions designed to absorb some of the collateral losses, in many first lien RMBS transactions, projected losses exceed those structural protections.

The majority of projected losses in first lien RMBS transactions are expected to come from non-performing mortgage loans (those that are delinquent or in foreclosure or where the loan has been foreclosed and the RMBS issuer owns the underlying real estate). Changes in the amount of non-performing loans from the amount projected in the previous period are one of the primary drivers of loss development in this portfolio. In order to determine the number of defaults resulting from these delinquent and foreclosed loans, the Company applies a liquidation rate assumption to loans in each of various delinquency categories. The Company arrived at its liquidation rates based on data purchased from a third party, and assumptions about how delays in the foreclosure process may ultimately affect the rate at which loans are liquidated. The liquidation rate is a standard industry measure that is used to estimate the number of loans in a given aging category that will default within a specified time period. The Company projects these liquidations to occur over two years. The Company used the same liquidation rates for September 30, 2012 as it did for June 30, 2012 and December 31, 2011. The following table shows liquidation assumptions for various delinquency categories.

First Lien Liquidation Rates
as of September 30, 2012

30 – 59 Days Delinquent	
Alt A and Prime	35%
Option ARM	50
Subprime	30
60 – 89 Days Delinquent	
Alt A and Prime	55
Option ARM	65
Subprime	45
90+ Days Delinquent	
Alt A and Prime	65
Option ARM	75
Subprime	60
Bankruptcy	
Alt A and Prime	55
Option ARM	70
Subprime	50
Foreclosure	
Alt A and Prime	85
Option ARM	85
Subprime	80
Real Estate Owned ("REO")	
All	100

While the Company uses liquidation rates as described above to project defaults of non-performing loans, it projects defaults on presently current loans by applying a CDR trend. The start of that CDR trend is based on the defaults the

Company projects will emerge from currently nonperforming loans. The total amount of expected defaults from the non-performing loans is translated into a constant CDR (i.e., the CDR plateau), which, if applied for each of the next 24 months, would be sufficient to produce approximately the amount of defaults that were calculated to emerge from the various delinquency categories. The CDR thus calculated individually on the delinquent collateral pool for each RMBS is then used as the starting point for the CDR curve used to project defaults of the presently performing loans.

In the base case, after the initial 24-month CDR plateau period, each transaction's CDR is projected to improve over

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12 months to an intermediate CDR (calculated as 20% of its CDR plateau); that intermediate CDR is held constant for 36 months and then trails off in steps to a final CDR of 5% of the CDR plateau. Under the Company's methodology, defaults projected to occur in the first 24 months represent defaults that can be attributed to loans that are currently delinquent or in foreclosure, while the defaults projected to occur using the projected CDR trend after the first 24 month period represent defaults attributable to borrowers that are currently performing.

Another important driver of loss projections is loss severity, which is the amount of loss the transaction incurs on a loan after the application of net proceeds from the disposal of the underlying property. Loss severities experienced in first lien transactions have reached historic high levels, and the Company is assuming that these high levels generally will continue for another year (in the case of subprime loans, the Company assumes the unprecedented 90% loss severity rate will continue for six months then drop to 80% for six months before following the ramp described below). The Company determines its initial loss severity based on actual recent experience. The Company's loss severity assumptions for September 30, 2012 were the same as it used for June 30, 2012 and December 31, 2011. The Company then assumes that loss severities begin returning to levels consistent with underwriting assumptions beginning in June 2013, and in the base case scenario, decline over two years to 40%.

The following table shows the range of key assumptions used in the calculation of expected loss to be paid for individual transactions for direct vintage 2004 - 2008 first lien U.S. RMBS.

Key Assumptions in Base Case Expected Loss Estimates
First Lien RMBS(1)

	As of September 30, 2012			As of June 30, 2012			As of December 31, 2011		
Alt-A First Lien									
Plateau CDR	3.5	%–	23.5%	3.3	%–	23.0%	2.8	%–	41.3%
Intermediate CDR	0.7	%–	4.7%	0.7	%–	4.6%	0.6	%–	8.3%
Final CDR	0.2	%–	1.2%	0.2	%–	1.2%	0.1	%–	2.1%
Initial loss severity	65%			65%			65%		
Initial CPR	0.0	%–	31.9%	0.0	%–	27.1%	0.0	%–	24.4%
Final CPR	15%			15%			15%		
Option ARM									
Plateau CDR	7.6	%–	27.7%	9.3	%–	30.2%	11.7	%–	31.5%
Intermediate CDR	1.5	%–	5.5%	1.9	%–	6.0%	2.3	%–	6.3%
Final CDR	0.4	%–	1.4%	0.5	%–	1.5%	0.6	%–	1.6%
Initial loss severity	65%			65%			65%		
Initial CPR	0.0	%–	4.0%	0.6	%–	4.9%	0.3	%–	10.8%
Final CPR	15%			15%			15%		
Subprime									
Plateau CDR	7.5	%–	28.4%	7.2	%–	29.2%	8.6	%–	29.9%
Intermediate CDR	1.5	%–	5.7%	1.4	%–	5.8%	1.7	%–	6.0%
Final CDR	0.4	%–	1.4%	0.4	%–	1.5%	0.4	%–	1.5%
Initial loss severity	90%			90%			90%		
Initial CPR	0.0	%–	7.4%	0.0	%–	8.8%	0.0	%–	16.3%
Final CPR	15%			15%			15%		

(1) Represents variables for most heavily weighted scenario (the "base case").

The rate at which the principal amount of loans is prepaid may impact both the amount of losses projected (since that amount is a function of the conditional default rate, the loss severity and the loan balance over time) as well as the amount of excess spread (the amount by which the interest paid by the borrowers on the underlying loan exceeds the amount of interest owed on the insured obligations). The assumption for the CPR follows a similar pattern to that of the conditional default rate.

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The current level of voluntary prepayments is assumed to continue for the plateau period before gradually increasing over 12 months to the final CPR, which is assumed to be either 10% or 15% depending on the scenario run. For transactions where the initial CPR is higher than the final CPR, the initial CPR is held constant.

The ultimate performance of the Company's first lien RMBS transactions remains highly uncertain and may be subject to considerable volatility due to the influence of many factors, including the level and timing of loan defaults, changes in housing prices and other variables. The Company will continue to monitor the performance of its RMBS exposures and will adjust the loss projections for those transactions based on actual performance and management's estimates of future performance.

In estimating expected losses, the Company modeled and probability weighted sensitivities for first lien transactions by varying its assumptions of how fast a recovery is expected to occur. One of the variables used to model sensitivities was how quickly the conditional default rate returned to its modeled equilibrium, which was defined as 5% of the current conditional default rate. The Company also stressed CPR and the speed of recovery of loss severity rates. The Company probability weighted a total of five scenarios (including its base case) as of September 30, 2012, the same number of scenarios as June 30, 2012 and December 31, 2011. For September 30, 2012 the Company used the same scenarios and weightings as it has for June 30, 2012, which were also the same as it used for December 31, 2011 except that for September 30, 2012 and June 30, 2012 it assumed in the most stressful scenario that the recovery would occur three months more slowly and in the most optimistic scenario that it would occur three months more quickly than it had for December 31, 2011. In a somewhat more stressful environment than that of the base case, where the conditional default rate plateau was extended three months (to be 27 months long) before the same more gradual conditional default rate recovery and loss severities were assumed to recover over four rather than two years (and subprime loss severities were assumed to recover only to 60%), expected loss to be paid would increase from current projections by approximately \$25 million for Alt-A first liens, \$23 million for Option ARM, \$108 million for subprime and \$1 million for prime transactions. In an even more stressful scenario where loss severities were assumed to rise and then recover over eight years and the initial ramp-down of the conditional default rate was assumed to occur over 15 months (rather than 12 months as of December 31, 2011) and other assumptions were the same as the other stress scenario, expected loss to be paid would increase from current projections by approximately \$71 million for Alt-A first liens, \$56 million for Option ARM, \$167 million for subprime and \$4 million for prime transactions. The Company also considered two scenarios where the recovery was faster than in its base case. In a scenario with a somewhat less stressful environment than the base case, where conditional default rate recovery was somewhat less gradual and the initial subprime loss severity rate was assumed to be 80% for 12 months and was assumed to recover to 40% over two years, expected loss to be paid would decrease from current projections by approximately \$4 million for Alt-A first lien, \$30 million for Option ARM, \$29 million for subprime and \$0 million for prime transactions. In an even less stressful scenario where the conditional default rate plateau was three months shorter (21 months, effectively assuming that liquidation rates would improve) and the conditional default rate recovery was more pronounced, (including an initial ramp-down of the conditional default rate over nine months rather than 12 months as at December 31, 2011), expected loss to be paid would decrease from current projections by approximately \$28 million for Alt-A first lien, \$68 million for Option ARM, \$56 million for subprime and \$1 million for prime transactions.

Breaches of Representations and Warranties

The Company is pursuing reimbursements for breaches of R&W regarding loan characteristics. Performance of the collateral underlying certain first and second lien securitizations has substantially differed from the Company's original expectations. The Company has employed several loan file diligence firms and law firms as well as devoted internal resources to review the mortgage files surrounding many of the defaulted loans. The Company's success in these efforts has resulted in three negotiated agreements in respect of the Company's R&W claims, including one on April 14, 2011 with Bank of America and one on May 8, 2012 with Deutsche Bank AG as described under "Deutsche

Bank Agreement” in Note 2, Business Changes, Risks, Uncertainties and Accounting Developments.

The Company has included in its net expected loss estimates as of September 30, 2012 an estimated benefit from loan repurchases related to breaches of R&W of \$1.1 billion, which includes \$471 million from Bank of America and Deutsche Bank under their respective agreements and \$660 million in transactions where the Company does not yet have such an agreement. Proceeds projected to be reimbursed to the Company on transactions where the Company has already paid claims are viewed as a recovery on paid losses. For transactions where the Company has not already paid claims, projected recoveries reduce projected loss estimates. In either case, projected recoveries have no effect on the amount of the Company's exposure. These amounts reflect payments made pursuant to the negotiated transaction agreements and not payments made pursuant to legal settlements. See “Recovery Litigation” below for a description of the related legal proceedings the Company has commenced.

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The Company's success in pursuing breaches of R&W is based upon a detailed review of loan files. The Company reviewed approximately 34,200 second lien and 6,800 first lien loan files (representing approximately \$2,593 million and \$2,357 million, respectively, of loans) in financial guaranty transactions as to which it eventually reached agreements, including the agreements with Bank of America and Deutsche Bank. For the RMBS transactions as to which the Company had not settled its claims for breaches of R&W as of September 30, 2012, the Company had performed a detailed review of approximately 11,000 second lien and 23,200 first lien loan files, representing approximately \$812 million in second lien and \$7,187 million in first lien outstanding par of loans underlying insured transactions. In the majority of its loan file reviews, the Company identified breaches of one or more R&W regarding the characteristics of the loans, such as misrepresentation of income or employment of the borrower, occupancy, undisclosed debt and non-compliance with underwriting guidelines at loan origination.

Through September 30, 2012 the Company has caused entities providing R&Ws to pay or agree to pay approximately \$2.7 billion (gross of reinsurance) in respect of their R&W liabilities for transactions in which the Company has provided a financial guaranty. Of this, \$2.1 billion are payments made or to be made directly to the Company pursuant to agreements with R&W providers (e.g. the Bank of America Agreement and Deutsche Bank Agreement) and approximately \$607 million are amounts paid (or committed to be paid) into the relevant RMBS financial guaranty transactions pursuant to the transaction documents.

The \$2.1 billion of payments made or to be made directly to the Company by R&W providers under agreements with the Company includes \$1,571 million that has already been received by the Company, as well as \$489 million the Company projects receiving in the future pursuant to such currently existing agreements. Because most of that \$489 million is projected to be received through loss-sharing arrangements, the exact amount the Company will receive will depend on actual losses experienced by the covered transactions. This amount is included in the Company's calculated credit for R&W recoveries, described below.

The \$607 million paid, or committed to be paid, by R&W providers are paid into the relevant RMBS transactions in accordance with the priority of payments set out in the relevant transaction documents. Because the Company may insure only a portion of the capital structure of a transaction, such payments will not necessarily directly benefit the Company dollar-for-dollar, especially in first lien transactions. However, such payments do reduce collateral pool losses and so usually reduce the Company's expected losses.

The Company did not incorporate any gain contingencies or damages paid from potential litigation in its estimated repurchases. The amount the Company will ultimately recover related to contractual R&W is uncertain and subject to a number of factors including the counterparty's ability to pay, the number and loss amount of loans determined to have breached R&W and, potentially, negotiated settlements or litigation recoveries. As such, the Company's estimate of recoveries is uncertain and actual amounts realized may differ significantly from these estimates. In arriving at the expected recovery from breaches of R&W, the Company considered the creditworthiness of the provider of the R&W, the number of breaches found on defaulted loans, the success rate in resolving these breaches across those transactions where material repurchases have been made and the potential amount of time until the recovery is realized.

The calculation of expected recovery from breaches of R&W involved a variety of scenarios which ranged from the Company recovering substantially all of the losses it incurred due to violations of R&W to the Company realizing limited recoveries. These scenarios were probability weighted in order to determine the recovery incorporated into the Company's estimate of expected losses. This approach was used for both loans that had already defaulted and those assumed to default in the future.

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Balance Sheet Classification of R&W Benefit, Net of Reinsurance

	As of September 30, 2012			As of December 31, 2011		
	For all Financial Guaranty Insurance Contracts (in millions)	Effect of Consolidating FG VIEs	Reported on Balance Sheet(1)	For all Financial Guaranty Insurance Contracts	Effect of Consolidating FG VIEs	Reported on Balance Sheet(1)
Salvage and subrogation recoverable	\$363	\$(130)	\$ 233	\$402	\$(197)	\$ 205
Loss and LAE reserve	630	(35)	595	858	(75)	783

(1) The remaining benefit for R&W is not recorded on the balance sheet until the expected loss, net of R&W, exceeds unearned premium reserve.

The following table represents the Company's total estimated R&W recoveries netted in expected loss to be paid, from defective mortgage loans included in certain first and second lien U.S. RMBS loan securitizations that it insures.

Roll Forward of Estimated Benefit from Recoveries from Representation and Warranty Breaches, Net of Reinsurance

	Future Net R&W Benefit as of December 31, 2011	R&W Development and Accretion of Discount During Nine Months 2012	R&W Recovered During Nine Months 2012(1)	Future Net R&W Benefit as of September 30, 2012
	(in millions)			
Prime first lien	\$3	\$ 1	\$—	\$ 4
Alt-A first lien	203	23	(67)	159
Option ARM	714	50	(157)	607
Subprime	101	3	—	104
Closed end second lien	224	—	(88)	136
HELOC	190	6	(76)	120
Total	\$1,435	\$ 83	\$(388)	\$ 1,130

	Future Net R&W Benefit as of December 31, 2011	R&W Development and Accretion of Discount During Nine Months 2011	R&W Recovered During Nine Months 2011(1)	Future Net R&W Benefit as of September 30, 2011
	(in millions)			
Prime first lien	\$1	\$ 2	\$—	\$ 3
Alt-A first lien	81	112	—	193
Option ARM	309	531	(68)	772
Subprime	27	81	—	108
Closed end second lien	179	37	(9)	207
HELOC	1,004	167	(903)	268
Total	\$1,601	\$ 930	\$(980)	\$ 1,551

(1) Gross amounts recovered were \$411 million and \$1,108 million in Nine Months 2012 and 2011, respectively.

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Financial Guaranty Insurance U.S. RMBS Risks with R&W Benefit

	Number of Risks (1) as of		Debt Service as of	
	September 30, 2012	December 31, 2011	September 30, 2012	December 31, 2011
	(dollars in millions)			
Prime first lien	1	1	\$36	\$42
Alt-A first lien	19	22	1,414	1,733
Option ARM	9	12	912	1,460
Subprime	5	5	813	906
Closed-end second lien	4	4	237	361
HELOC (2)	4	15	174	2,978
Total	42	59	\$3,586	\$7,480

(1) A risk represents the aggregate of the financial guaranty policies that share the same revenue source for purposes of making debt service payments.

(2) The decline in number of HELOC risks and debt service relates to the final payment from Bank of America for covered HELOC transactions and due to fundings from an R&W provider.

The following table provides a breakdown of the development and accretion amount in the roll forward of estimated recoveries associated with alleged breaches of R&W.

	Third Quarter		Nine Months	
	2012	2011	2012	2011
	(in millions)			
Inclusion or removal of deals with breaches of R&W during period	\$—	\$1	\$(5)	\$108
Change in recovery assumptions as the result of additional file review and recovery success	—	43	70	242
Estimated increase (decrease) in defaults that will result in additional (lower) breaches	10	(23)	10	11
Results of settlements	—	130	—	560
Accretion of discount on balance	2	8	8	9
Total	\$12	\$159	\$83	\$930

The Company assumes that recoveries on transactions backed by HELOC and closed-end second lien loans that were not subject to the Bank of America Agreement or Deutsche Bank Agreement will occur in two to four years from the balance sheet date depending on the scenarios, and that recoveries on transactions backed by Alt-A first lien, Option ARM and Subprime loans will occur as claims are paid over the life of the transactions. Recoveries on second lien transactions subject to the Bank of America Agreement were paid in full by March 31, 2012.

As of September 30, 2012, cumulative collateral losses on the first lien RMBS transactions subject to a comprehensive agreement with Bank of America Corporation and its subsidiaries, including Countrywide Financial Corporation and its subsidiaries (collectively, "Bank of America"), 20 of which were transactions as to which the Company issued financial guaranty insurance contracts and one of which was a transaction on which the Company sold protection through a CDS (the "Bank of America Agreement"), were approximately \$2.8 billion and \$0.1 billion, respectively. The Company estimates that cumulative projected collateral losses for the 20 financial guaranty insurance transactions and one CDS transaction will be \$4.9 billion and \$0.2 billion, respectively. The Bank of America Agreement covers cumulative collateral losses up to \$6.6 billion for all these transactions. Bank of America had placed approximately

\$1.0 billion of eligible assets in trust in order to collateralize the reimbursement obligation relating to these and one covered first lien CDS transaction. The amount of assets required to be posted may increase or decrease from time to time as determined by rating agency requirements.

On May 8, 2012, Assured Guaranty reached a settlement with Deutsche Bank AG and certain of its affiliates (collectively, "Deutsche Bank"), resolving claims related to certain RMBS transactions issued, underwritten or sponsored by Deutsche Bank that were insured by Assured Guaranty under financial guaranty insurance policies and to certain RMBS

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exposures in re-securitization transactions as to which Assured Guaranty provides credit protection through CDS. See Note 2, Business Changes, Risks, Uncertainties and Accounting Developments, for more information.

Student Loan Transactions

The Company has insured or reinsured \$2.6 billion net par of student loan securitizations, of which \$1.3 billion was issued by private issuers and classified as asset-backed and \$1.3 billion was issued by public authorities and classified as public finance. Of these amounts, \$150 million and \$445 million, respectively, are rated BIG. The Company is projecting approximately \$56 million of net expected loss to be paid in these portfolios. In general, the losses are due to: (i) the poor credit performance of private student loan collateral and high loss severities; (ii) high interest rates on auction rate securities with respect to which the auctions have failed or (iii) lower risk-free rates used for discounting, which result in higher present value losses on transactions where losses are payable at final maturity. The largest of these losses was approximately \$25 million and related to a transaction backed by a pool of private student loans ceded to AG Re by another monoline insurer. The guaranteed bonds were issued as auction rate securities that now bear a high rate of interest due to the downgrade of the primary insurer's financial strength rating. Further, the underlying loan collateral has performed below expectations. The overall decrease of approximately \$7 million in net expected loss during Third Quarter 2012 is primarily due to developments in loss mitigation efforts and the increase in risk-free rates used to discount losses.

Trust Preferred Securities Collateralized Debt Obligations

The Company has insured or reinsured \$1.6 billion of net par of collateralized debt obligations ("CDOs") backed by TruPS and similar debt instruments, or "TruPS CDOs." Of that amount, \$725 million is rated BIG. The underlying collateral in the TruPS CDOs consists of subordinated debt instruments such as TruPS issued by bank holding companies and similar instruments issued by insurance companies, real estate investment trusts ("REITs") and other real estate related issuers.

The Company projects losses for TruPS CDOs by projecting the performance of the asset pools across several scenarios (which it weights) and applying the CDO structures to the resulting cash flows. At September 30, 2012, the Company has projected expected losses to be paid for TruPS CDOs that are accounted for as financial guaranty insurance of \$9 million. The increase of approximately \$2 million in net expected loss during Third Quarter 2012 was driven primarily by changes in London Interbank Offered Rate ("LIBOR").

"XXX" Life Insurance Transactions

The Company's \$2.3 billion net par of XXX life insurance transactions as of September 30, 2012 include \$883 million rated BIG. The BIG "XXX" life insurance reserve securitizations are based on discrete blocks of individual life insurance business. In each such transaction the monies raised by the sale of the bonds insured by the Company were used to capitalize a special purpose vehicle that provides reinsurance to a life insurer or reinsurer. The monies are invested at inception in accounts managed by third-party investment managers.

The BIG "XXX" life insurance transactions consist of two transactions: Ballantyne Re p.l.c and Orkney Re II p.l.c. These transactions had material amounts of their assets invested in U.S. RMBS transactions. Based on its analysis of the information currently available, including estimates of future investment performance, and projected credit impairments on the invested assets and performance of the blocks of life insurance business at September 30, 2012, the Company's projected net expected loss to be paid is \$134 million.

U.S. Public Finance Transactions

U.S. municipalities and related entities have been under increasing pressure over the last few quarters, and a few have filed for protection under the U.S. Bankruptcy Code, entered into state processes designed to help municipalities in fiscal distress or otherwise indicated they may consider not meeting their obligations to make timely payments on their debts. The Company expects that bondholder rights will be enforced. However, due to the early stage of these developments, and the circumstances surrounding each instance, the ultimate outcome cannot be certain. The Company will continue to analyze developments in each of these matters closely. The municipalities whose obligations the Company has insured that have filed for protection under Chapter 9 of the U.S Bankruptcy Code are: Jefferson County, Alabama and Stockton, California. The City Council of Harrisburg, Pennsylvania had also filed a purported bankruptcy petition, which was later dismissed by the bankruptcy court; a receiver for the City of Harrisburg was appointed by the Commonwealth Court of Pennsylvania on December 2, 2011.

The Company has net exposure to Jefferson County, Alabama of \$708 million as of September 30, 2012. On

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November 9, 2011, Jefferson County filed for bankruptcy under Chapter 9 of the U.S. Bankruptcy Code. Most of the Company's net Jefferson County exposure relates to \$479 million in sewer revenue exposure, of which \$206 million is direct and