PRIMUS GUARANTY LTD
Form 10-Q
November 09, 2004

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

FORM 10-Q

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

For the period ended September 30, 2004

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 Number: 001-32307

Primus Guaranty, Ltd.

(Exact name of registrant as specified in its charter)

Bermuda	Not Required
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.

Clarendon House
2 Church Street
Hamilton HM 11, Bermuda
(Address of principal executive offices, including zip code)

441-296-0519
(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 (the registrant became subject to the filing requirements of Section 13 or 15(d) on September 29, 2004)

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act).

Yes No

As of November 8, 2004, the number of shares outstanding of the issuer's common stock, $0.08 par value, was 42,787,843.

Part I. Financial Information
Item 1. Financial Statements

Primus Guaranty, Ltd.
Consolidated Statements of Financial Condition

	September 30, 2004 (Unaudited)	December 31, 2003

		(Dollars in thousands except per share data)		
Assets				
Cash and cash equivalents	$	357,539	$	257,967
Short-term investments		3,429		3,968
Accrued interest receivable		392		129
Unrealized gain on credit swaps, at fair value		37,072		46,594
Premiums receivable on credit swaps		28		140
Premiums receivable on financial guarantees		800		1,201
Accrued premiums on credit swaps		3,468		3,642
Fixed assets, less accumulated depreciation of $428 in 2004; $259 in 2003		1,609		1,651
Internal use software costs, less accumulated amortization of $5,350 in 2004; $4,176 in 2003		4,628		5,473
Other receivables		272		269
Receivable from underwriters		114,797		—
Prepaid expenses		1,107		395
Debt issuance costs of subsidiary		958		—
Total assets	$	526,099	$	321,429
Liabilities and shareholders' equity				
Long-term debt of subsidiary	$	75,000	$	—
Compensation accrual		4,479		5,474
Unrealized loss on credit swaps, at fair value		958		68
Unrealized loss on sublease		—		39
Brokerage fee payable		35		50
Accounts payable		841		653
Deferred rent payable		460		473
Current state and local taxes payable		50		—
Deferred financial guarantee premiums		906		1,201
Deferred credit swap premiums		74		112
Interest payable on long-term debt of subsidiary		375		—
Other payables		530		—
Total liabilities		83,708		8,070
Preferred securities of subsidiary		98,521		98,521
Shareholders' equity:				
Common stock, $0.08 par value, 62,500,000 shares authorized, 42,787,843; 2,567,901shares issued and outstanding at September 30, 2004; December 31, 2003		3,470		230
Additional paid-in-capital		261,544		1,325
Convertible preferred stock		—		143,908
Warrants		612		1,070
Retained earnings		78,244		68,305
Total shareholders' equity		343,870		214,838
Total liabilities and shareholders' equity	$	526,099	$	321,429

See accompanying notes.

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Primus Guaranty, Ltd.
Consolidated Statements of Operations

	Three Months Ended September 30, 2004	Three Months Ended September 30, 2003	Nine Months Ended September 30, 2004	Nine Months Ended September 30, 2003
	(Unaudited)		(Unaudited)	
Revenues	(Dollars in thousands except per share data)			
Net credit swap revenue	$ 23,331	$ 21,804	$ 26,166	$ 79,550
Interest income earned	1,166	607	2,534	1,915
Other	102	26	338	80
Total net revenues	24,599	22,437	29,038	81,545
Expenses				
Employee compensation and benefits	3,858	3,112	11,142	8,144
Excess-of-loss insurance policy premium	—	—	—	727
Internal use software amortization	437	635	1,286	1,883
Legal fees	16	79	109	304
Professional fees	366	401	1,051	2,040
Rent	193	164	550	517
Data feeds	183	223	668	657
Bank fees	275	218	438	387
Fixed asset depreciation	57	54	167	175
Brokerage expense	151	37	515	319
Interest expense on long-term debt of subsidiary	375	—	375	—
Other	281	376	1,154	1,254
Total expenses	6,192	5,299	17,455	16,407
Distributions on preferred securities of subsidiary	(403)	(533)	(1,550)	(1,365)
Income before benefit (provision) for income taxes	18,004	16,605	10,033	63,773
Benefit (provision) for income taxes	22	(22)	(95)	(127)
Net Income	$ 18,026	$ 16,583	$ 9,938	$ 63,646
Earnings available to common shares	$ 18,026	$ 16,583	$ 9,938	$ 63,646
Earnings per common share:				
Basic	$ 4.23	$ 6.59	$ 2.57	$ 25.29
Diluted	$ 0.51	$ 0.49	$ 0.28	$ 1.87
Average common shares outstanding				
Basic	4,264	2,517	3,866	2,517
Diluted	35,219	33,965	35,081	33,965

See accompanying notes.

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Primus Guaranty, Ltd.
Consolidated Statements of Cash Flows

	Nine Months Ended September 30, 2004	Nine Months Ended September 30, 2003
	(Unaudited)	
Cash flows from operating activities		
Net Income	$ 9,938	$ 63,646
Adjustments to reconcile net income to net cash provided by operating activities:		
Non-cash items included in net income (loss):		
Depreciation of fixed assets	167	175
Amortization of internal use software costs	1,286	1,883
Stock compensation	2,095	853
Net unrealized (gain) loss on credit swap portfolio	10,412	(35,603)
Unrealized loss on sublease	(39)	(17)
Deferred rent payable	(13)	108
Distributions on preferred securities of subsidiary	1,550	1,365
Increase (decrease) in cash resulting from changes in:		
Premiums receivable on credit swaps	112	(344)
Accrued premiums on credit swaps	174	318
Interest payable for long-term debt of subsidiary	375	—
Deferred credit swap premium	(38)	122
Deferred financial guarantee premium	(295)	—
Brokerage fees payable	(14)	(57)
Accrued interest receivable	(263)	(38)
Prepaid excess-of-loss insurance policy premium	—	618
Premiums receivable on financial guarantees	401	—
Income tax receivable	—	(231)
Other prepaid expenses	(712)	(105)
Accounts payable	188	(665)
Compensation payable	(995)	(145)
Debt issuance costs	(958)	—
Other	527	(2)
Current state and local taxes payable.	50	—
Net cash flows provided by operating activities	23,948	31,881
Cash flows from investing activities		
Fixed asset purchases	(125)	(109)
Redemption (purchase) of short-term investments.	539	(3,002)
Development and purchase of internal use software	(440)	(397)
Net cash flows (used in) investing activities	(26)	(3,508)
Cash flows from financing activities (see Note 2)		
Proceeds from long term subordinated debt issuance of subsidiary	75,000	—
IPO costs	(3,300)	—
Exercise of warrants	5,500	—
Net preferred distributions of subsidiary	(1,550)	(1,365)
Net cash flows provided by (used in) financing activities	75,650	(1,365)
Net increase in cash	99,572	27,008
Cash and cash equivalents at beginning of period	257,967	220,975

Cash and cash equivalents at end of year	$	357,539	$	247,983
Supplemental disclosures				
Cash paid for income taxes	$	44	$	347

See accompanying notes

Primus Guaranty, Ltd.
Notes to Consolidated Financial Statements (continued)
(Information pertaining to the three and nine months ended
September 30, 2004 and 2003 is unaudited)

1. Basis of Presentation

The accompanying unaudited consolidated financial statements of Primus Guaranty, Ltd. ("Primus Guaranty" or the "Company") have been prepared in accordance with generally accepted accounting principles for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. Operating results for the three- and nine-month periods ended September 30, 2004, are not necessarily indicative of the results that may be expected for any other interim period or for the year ended December 31, 2004. The consolidated financial statements include the accounts of the Company and its wholly owned subsidiaries. All significant intercompany balances have been eliminated.

The consolidated financial statements represent a single reportable segment, as defined in Statement of Financial Accounting Standards ("SFAS") No. 131, Disclosures about Segments of an Enterprise and Related Information.

The consolidated financial statements are presented in U.S. dollar equivalents. At September 30, 2004, 2003 and December 31, 2003, Primus Financial Products, LLC's ("Primus Financial") credit swap activities were conducted in U.S. dollars and Euros.

Credit Swaps

Credit Swaps are over-the-counter ("OTC") derivative financial instruments and are recorded at fair value in accordance with SFAS No. 133, Accounting for Derivative Instruments and Hedging Activities. Obtaining the fair value (as such term is defined in SFAS No. 133) for such instruments requires the use of management judgment. These instruments are valued using pricing models based on the net present value of expected future cash flows and observed prices for other OTC transactions bearing similar risk characteristics. The fair value of these instruments appears on the consolidated statement of financial condition as unrealized gains or losses on Credit Swaps. The Company does not believe that its Credit Swaps fall outside the scope of the guidance of SFAS No. 133 paragraph 10d, as amended by SFAS No. 149, Amendment of Statement 133 on Derivative Instruments and Hedging Activities, because there is no contractual requirement that the protection purchaser be exposed to the underlying risk.

Net credit swap revenue includes realized and unrealized gains and losses on credit swaps and net premiums earned.

Premiums are taken into income as they are earned over a specified time period. Accrued Premiums on Credit Swaps represent premiums earned but not yet payable by Primus Financial's counterparty. Premiums Receivable on credit swaps represents premiums that are both earned by and payable to Primus Financial.

Financial Guarantee-Insurance Contracts

The Company has undertaken a limited amount of financial guarantee business through its subsidiary Primus Re, Ltd. ("Primus Re"), a Class 3 Bermuda insurer. Financial guarantees are insurance contracts that contingently require the guarantor to make payments to the guaranteed party. The Company designs its guarantee contracts to qualify as non-derivatives in accordance with the scope exception under paragraph 10d of SFAS 133 as amended by SFAS No. 149, Amendment of Statement 133 on Derivative Instruments and Hedging Activities. This scope exception requires that the guaranteed party be exposed to loss both at inception and over the life of the contract, and incurrence

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1. Basis of Presentation (Continued)

of loss must be preconditions for payment under the contract and that these losses are based on payments to be made solely to reimburse the guaranteed party for failure of the debtor to satisfy its required payment obligations under a nonderivative contract, either at pre-specified payment dates or accelerated payment dates as a result of the occurrence of an event of default (as defined in the financial obligation covered by the guarantee contract) or notice of acceleration being made to the debtor by the creditor. Thus, the Company accounts for its financial guarantee contracts in accordance with SFAS No. 60, Accounting and Reporting by Insurance Enterprises. This requires that premiums are deferred and recognized over the life of the contract and that losses are recorded in the period that they occur based on an estimate of the ultimate cost of losses incurred.

The Company does not actively offer financial guarantee insurance. Rather, it is an alternative the Company has available when a counterparty requests an insurance product instead of a credit swap. Generally, a counterparty's choice of a financial guarantee insurance contract versus a credit swap is determined by economic terms available in the marketplace as well as regulatory and accounting considerations. Also, the purchaser of an insurance contract cannot submit a claim for payment unless it has an insurable loss, whereas the purchaser of a credit swap need not have actual exposure to the underlying risk.

Insurance Premiums Earned and Receivable and Related Expenses

In exchange for providing financial guarantee protection to counterparties, Primus Re receives premiums over the life of the contract. The amount expected over the life of the policy is reflected in the statement of financial condition and will be reduced as payments are received quarterly in advance.

The accounts of Primus Re are not deemed to be separate accounts under SOP 03-01, Accounting & Reporting by Insurance Enterprises for Certain Nontraditional Long-Duration Contracts for Separate Accounts, since investment performance is not passed through to the contract holder.

Policy acquisition costs include only those expenses that relate primarily to, and vary with, premium production. Such costs generally include compensation of employees involved in underwriting and policy issuance functions, certain rating agency fees, state premium taxes and certain other underwriting expenses. No costs have been deferred by the Company to date as any such amounts have been immaterial.

Deferred Financial Guarantee Premium

Unearned premiums related to the financial guarantee protection provided are used to establish the liability at inception. This liability is reflected in income on a straight-line basis over the period the risk protection is provided.

Unpaid Losses and Loss Expenses on Financial Guarantees

Liabilities for unpaid losses and loss expenses include the accumulation of individual case estimates for claims reported as well as estimates of incurred but not reported claims and estimates of loss settlement expenses on the obligations it has insured. Estimates will be based upon historical industry loss experience modified for current trends as well as prevailing economic, legal and social conditions. Any changes in estimates are reflected in operating results in the period in which the estimates changed. At September 30, 2004, the unpaid losses and loss expenses were estimated to be zero. At December 31, 2003, this amount was zero as the only financial guarantee contracts written were as of the same date.

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1. Basis of Presentation (Continued)

Income Taxes

Income tax expense is computed in accordance with the requirements of SFAS No. 109, Accounting for Income Taxes, which prescribes the asset and liability approach to accounting for income taxes. The asset and liability approach requires the recognition of deferred tax liabilities and assets for the expected future tax consequences of temporary differences between the carrying amounts and the tax bases of assets and liabilities.

Employee Compensation Plans

In 2003, the Company adopted the fair value approach on a prospective basis for recording stock-based employee compensation in accordance with the fair value method prescribed by SFAS No. 123, Accounting for Stock-based Compensation, as amended by SFAS No. 148, Accounting for Stock Based Compensation—Transition and Disclosure. Compensation expense is recognized based on the fair value of stock options, restricted shares and restricted share units ("RSU") granted over the related vesting period. The fair value of the stock options granted is determined through the use of an option-pricing model.

Recently Issued Accounting Standards

In January 2003, the FASB issued Interpretation No. 46 ("FIN 46"), Consolidation of Variable Interest Entities, an Interpretation of ARB No. 51 ("VIEs"). The Interpretation defines "variable interests" and specifies the circumstances under which consolidation of special purpose entities will be dependent upon such interests. In December 2003, the FASB issued FASB Interpretation No. 46 (revised December 2003), ("FIN 46R"), which effectively modified and clarified certain provisions of FIN 46, as originally issued, and modified the effective date for certain entities.

FIN 46 was effective immediately for VIEs created after January 31, 2003. The provisions of FIN 46R were adopted as of December 31, 2003, for the Company's interests in all VIEs. The result was the derecognition of the Trust Preferred certificates issued by the Trust and the recognition of the Preferred Securities issued by PFP to the Trust. As encouraged by FIN 46R, the Company has restated its prior year's financial statements. The adoption of FIN 46R had no impact on the statement of financial condition or the results of operations of the Company.

2. Initial Public Offering

Primus Guaranty completed an initial public offering ("IPO") on October 5, 2004, listing its shares on the New York Stock Exchange. The Company issued 9,143,493 shares at a price $13.50. The Company has recorded a receivable of $114.8 million for the proceeds at September 30, 2004. The proceeds to the Company were $111.5 million, net of the underwriting discount and offering expenses. Primus Guaranty has subsequently contributed $60 million of the IPO proceeds to Primus Financial to support the growth of its credit swap business. Primus Guaranty has invested the remaining net proceeds in short-term money market instruments, pending utilization in businesses related to the credit markets. The completion of the IPO caused the Company to vest one-half of the remaining unvested stock, restricted stock units and options held by employees at the date of the IPO. The Company will recognize an expense of approximately $3.3 million in the final quarter of 2004 as a result of this accelerated vesting.

3. Cash and Cash Equivalents

Primus Guaranty restricts the instruments in which its subsidiaries, Primus Financial and Primus Asset Management, Inc. ("Primus Asset Management"), invest to include obligations of the United

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Primus Guaranty, Ltd.
Notes to Consolidated Financial Statements (continued)
(Information pertaining to the three and nine months ended
September 30, 2004 and 2003 is unaudited)

3. Cash and Cash Equivalents (Continued)

States of America or direct debt obligations of U.S. Agencies rated AAA and Aaa by the respective Rating Agencies (as defined below), and commercial paper rated A-1 and P-1 by the respective Rating Agencies.

As of September 30, 2004 and December 31, 2003, the Company's Cash and cash equivalents include U.S. government agency obligations and money market funds. All outstanding obligations mature within 90 days.

4. Short-Term Investments

Short-term investments included obligations of the United States of America or direct debt obligations of U.S. Agencies rated AAA and Aaa by Standard & Poor's and Moody's Investor Services (the "Rating Agencies"), respectively, and have original maturities between 91 days and two years.

As of September 30, 2004 and December 31, 2003, the Company's short-term investments consisted entirely of short-term U.S. government agency obligations, which mature within two years.

5. Credit Swap Revenues and Portfolio

Net credit swap revenue as presented in the consolidated statement of operations comprises changes in the fair value of credit swaps, realized gains or losses on the termination of credit swaps and premium income or expense. The realized gains and losses on credit swaps represent realized gains and losses on unwound or assigned credit swaps. The realization of gains or losses on credit swaps will generally result in a reduction in unrealized gains or losses and accrued premium at the point in time realization occurs.

In exchange for providing credit protection to its counterparties, Primus Financial receives premium payments as a series of fixed cash flows. Premiums are taken into income as they are earned over a specified time period. Accrued premiums on credit swaps represent premiums earned but not yet payable by Primus Financial's counterparty. Premiums receivable on credit swaps represents premiums that are both earned by and payable to Primus Financial. When Primus Financial purchases credit protection from its counterparties, Primus Financial pays premiums as a series of fixed cash flows. The premium expense is recognized ratably over the life of the transaction as a component of net credit swap revenue.

In accordance with accounting principles generally accepted in the United States, the Company carries its credit swaps on its balance sheet at their fair value. Changes in the fair value of the Company's credit swap portfolio are recorded as unrealized gains or losses in the Company's consolidated income statement. If a credit swap has an increase in fair value during a period, the increase will add to the Company's net credit swap revenues for that period. Conversely, if a credit swap has a decline in fair value during the period, the decline will subtract from the Company's net credit swap revenues for that period. Changes in the fair value of the Company's credit swap portfolio are a function of the notional amount and composition of the portfolio and prevailing market credit swap premiums for comparable credit swaps. The Company generally holds the credit swaps it sells to maturity, at which point, assuming no credit event has occurred, the cumulative unrealized gains and losses on each credit swap would equal zero. In general, fair values of individual credit swaps are aggregated by counterparty for presentation on the Company's statement of condition. If the aggregate total of fair values for a counterparty is a net gain, the total is recorded as a component of unrealized gains on credit swaps, at fair value in the statement of condition. If the aggregate total of fair values for a counterparty is a net loss, the total is recorded as a component of unrealized losses

5. Credit Swap Revenues and Portfolio (Continued)

on credit swaps, at fair value in the statement of condition. Aggregation by counterparty is applied where a valid ISDA master agreement is in place with the counterparty, in instances where the Company does not yet have a valid ISDA master agreement with the counterparty, the fair values of individual swap transactions are recorded as components unrealized gains or losses on credit swaps, at fair value, dependent upon whether the individual contract was at a gain or a loss.

At the time at which the Company enters into a credit swap and assumes the risk of default, it has no intention of terminating the transaction prior to maturity. However, the Company occasionally disposes of credit swaps prior to maturity, but only in circumstances where the Company believes that the underlying risk related to the credit swap has increased beyond its risk tolerance or where the Company would seek to rebalance the Company's portfolio of credit swaps and create greater capacity for other credit swaps. The Company cannot identify at the outset of any credit swap transaction, whether the credit swap will be terminated or otherwise disposed of prior to its maturity.

As a general rule, when the Company sells credit protection, it intends to maintain the transaction until maturity. However, there are two sets of circumstances in which the Company could elect to terminate transactions prior to maturity, and the Company monitors its portfolio on a continuing basis to assess whether those circumstances are present.

First, whenever the Company receives new information suggesting that the credit quality of the underlying risk has deteriorated to a material degree, the Company considers the possibility of terminating the transaction, usually at a loss, to avoid the larger loss that could result if the credit swap were to remain in place until a credit event occurs. The principal factor that governs the Company's decision regarding termination in these circumstances is whether the Company believes that the underlying risk has become substantially greater than the level of risk the Company would choose to assume in entering into a new sale of credit default protection. Over its two years of operating history, the Company has terminated less than 1% of the notional amount of credit swaps under which the Company sold credit default protection due to credit considerations.

Second, the Company may also elect to terminate a transaction in order to realize a gain. In making a decision to terminate a transaction for this purpose the Company considers a number of different factors, including the absolute amount of the unrealized gain the Company could realize, the likelihood of additional gains arising from the position, the Company's view as to whether the capital dedicated to the position could be profitably reallocated to other opportunities over a foreseeable horizon, the total size of the Company's portfolio in relation to its capital, and the total size of its swap positions and exposures with a particular counterparty. The Company refers to terminations effected under these circumstances as "resizing" or "rebalancing". The majority of the Company's resizing occurred during the second and third quarters of 2003, when market credit swap premium levels had dropped dramatically from their historic 2002 highs. Over its two years of operating history, the Company has terminated less than 10% of credit swaps under which it sold credit protection in order to realize gains.

The Company terminates (or offsets) a credit swap in any one of three ways. The Company may negotiate an agreed termination through the original counterparty (an unwind). The Company may negotiate an assignment and novation of its rights and obligations under the credit swap to a third party (an assignment). As an alternative to terminating a transaction, the Company may enter into an equal and opposite transaction with a third party under which the Company purchases credit default protection on terms that match the terms of the original transaction (an offset). In this last case, both sides of the position may subsequently be unwound or assigned.

In the event of an unwind or assignment, the Company pays or receives a cash settlement negotiated with the counterparty or assignee, based on the fair value of the credit swap contract and

Primus Guaranty, Ltd.
Notes to Consolidated Financial Statements (continued)
(Information pertaining to the three and nine months ended
September 30, 2004 and 2003 is unaudited)

5. Credit Swap Revenues and Portfolio (Continued)

the accrued premium on the swap contract at the time of negotiation. The amounts the Company pays or receives are recorded as a realization of fair value and as a realization of accrued premiums in the period in which the termination occurs.

The tables below present the components of credit swap revenues (losses) for the three and nine months ended September 30, 2004 and 2003. The Company distinguishes credit swaps sold, credit swaps purchased as short-term investments and credit swaps purchased to offset the credit risk on credit swaps previously sold.

Net credit swap revenues for the three months ended September 30, 2004 (in thousands)

	Premium income (expense)	Realized gains	Realized (losses)	Change in unrealized gains/(losses)	Totals
Credit swaps sold	$ 11,192	$ 3,251	$ (778)	$ 10,998	$ 24,663
Credit swaps purchased as short-term investments	(279)	346	(34)	(1,335)	(1,302)
Credit swaps purchased to offset credit risk on certain swaps sold	(23)	0	0	(7)	(30)
Totals	$ 10,890	$ 3,597	$ (812)	$ 9,656	$ 23,331

Net credit swap revenues for the three months ended September 30, 2003 (in thousands)

	Premium income (expense)	Realized gains	Realized (losses)	Change in unrealized gains/(losses)	Totals
Credit swaps sold	$ 10,303	$ 7,360	$ 0	$ 4,170	$ 21,833
Credit swaps purchased to offset credit risk on certain swaps sold	(23)	0	0	(6)	(29)
Totals	$ 10,280	$ 7,360	$ 0	$ 4,164	$ 21,804

Net credit swap revenues for the nine months ended September 30, 2004 (in thousands)

	Premium income (expense)	Realized gains	Realized (losses)	Change in unrealized gains/(losses)	Totals

Credit swaps sold	$	31,600	$	5,360	$	(791)	$	(9,254)	$	26,915
Credit swaps purchased as short-term investments		(527)		1,086		(81)		(1,198)		(720)
Credit swaps purchased to offset credit risk on certain swaps sold		(69)		0		0		40		(29)
Totals	$	31,004	$	6,446	$	(872)	$	(10,412)	$	26,166

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Primus Guaranty, Ltd.
Notes to Consolidated Financial Statements (continued)
(Information pertaining to the three and nine months ended
September 30, 2004 and 2003 is unaudited)

5. Credit Swap Revenues and Portfolio (Continued)

Net credit swap revenues for the nine months ended September 30, 2003 (in thousands)

		Premium income (expense)		Realized gains		Realized (losses)		Change in unrealized gains/(losses)		Totals
Credit swaps sold	$	29,627	$	15,089	$	(214)	$	35,542	$	80,044
Credit swaps purchased as short-term investments		0		0		0		0		0
Credit swaps purchased to offset credit risk on certain swaps sold		(107)		0		(448)		61		(494)
Totals	$	29,520	$	15,089	$	(662)	$	35,603	$	79,550

The notional amount, fair value and average fair value of open Credit Swap transactions entered into with third parties at September 30, 2004 and December 31, 2003, are as follows (in thousands):

		September 30, 2004 (Unaudited)		December 31, 2003
Credit Swaps Sold				
Gross notional amount	$	9,440,873	$	6,291,375
Fair value:				
Asset		36,286		46,571
Liability		172		68
Average fair value:				
Asset		30,610		11,193
Liability		511		635
Credit Swaps Bought				

Gross notional amount	$	372,886	$	130,000
Fair value:				
Asset		0		141
Liability		1,175		118
Average fair value:				
Asset		246		5
Liability		243		4

"Asset" in the above table represents unrealized gains on Credit Swaps while "Liability" represents unrealized losses on Credit Swaps. All Credit Swaps are subject to netting arrangements that have been contractually established with each counterparty under an ISDA Master Agreement. All counterparties must be rated A or better, or otherwise be approved by the Rating Agencies. The notional amounts of the Credit Swap contracts in the preceding table are presented on a gross basis and the fair values of such contracts are presented net by counterparty. The average fair value in the above table was calculated on a daily basis. At September 30, 2004 and December 31, 2003, Primus Financial had three derivative transactions with its affiliate, Primus Re , totaling $87 million in notional principal.

Under the terms of Primus Financial's Operating Guidelines, as agreed with the Rating Agencies, derivatives transactions can only include Credit Swaps. Credit Swaps are derivative transactions that obligate one party to the transaction (the "Seller") to pay an amount to the other party to the

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5. Credit Swap Revenues and Portfolio (Continued)

transaction (the "Buyer") should one of a specified group of events ("Credit Events") be incurred by an unrelated third party (the "Reference Entity") specified in the contract. The amount to be paid by the Seller will either be (a) the notional amount of the transaction, in exchange for which the Seller must be delivered a defined obligation of the Reference Entity (called physical settlement), or (b) the difference between the current market value of a defined obligation of the Reference Entity and the notional amount of the transaction (called cash settlement). In exchange for incurring the potential of a Credit Event-generated loss, the Seller will receive a fixed premium for the term of the contract (or until the occurrence of a Credit Event). The fixed premium is generally paid quarterly in arrears over the term of the transaction.

All transactions entered into between the Buyer and the Seller are subject to an ISDA Master Agreement executed by both parties. The Master Agreement allows for the consolidation of the market exposures and termination of all transactions between the Buyer and Seller in the event a Default (as defined by the Master Agreement) is incurred by either party.

Primus Financial is primarily a Seller of Credit Swaps, although it may also buy Credit Swaps to off-set the risks it has incurred as a Seller. Credit Swaps purchased to off-set risks do not qualify as hedges in accordance with SFAS No. 133. In addition, Primus Financial is permitted to purchase Credit Swaps as a limited percentage of its overall portfolio (represented as Credit Swaps Bought in the below tables). The company's Operating Guidelines permit up to five percent of the total notional of its sold Credit Swaps portfolio to be purchased Credit Swaps, allowing Primus Financial to seek short term market appreciation. The primary risks inherent in the Company's activities are (a) that Reference Entities specified in its Credit Swap transactions will incur Credit Events (Credit Events may include any or all of the following: bankruptcy, failure to pay, repudiation or moratorium, and modified or original restructuring) that will require Primus Financial to make payments to the Buyers of the transactions, (b) where Primus Financial is a Buyer of a Credit Swap and a Credit Event occurs, the Seller fails to make payment to the Company, and (c) that Buyers of the transactions from Primus Financial will default on their required premium payments at times when the fair value of the underlying transactions are positive to Primus Financial. During 2004 and 2003, no Credit Swaps sold by Primus Financial incurred a Credit Event and no buyers defaulted on premium payments to Primus Financial.

The tables below summarize the notional amounts and fair value at risk to performance by Reference Entities and Counterparties of Credit Swap transactions, which are recorded at fair value, (based on credit rating) as of September 30, 2004 and December 31, 2003. Risk off-set transactions are reflected in the below tables as part of Credit Swaps Sold. The total notional amount of risk off-set transactions was $5 million, in both the first nine months of 2004, and during 2003. Total fair value equaled $(220) thousand at September 30, 2004 and $(264) thousand in 2003. Fair Value is the fair value of all transactions after consideration of offsetting exposures under Master Agreements with counterparties (in thousands and U.S. dollar equivalent):

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5. Credit Swap Revenues and Portfolio (Continued)

	September 30, 2004 (Unaudited)		December 31 2003	
Moody's Rating Category	Notional Amount	Fair Value	Notional Amount	Fair Value
Reference Entity				
Credit Swaps Sold:				
Aaa	$ 547,372	$ 953	$ 405,500	$ 1,680
Aa	1,571,888	6,211	1,002,640	6,492
A	4,043,676	18,606	2,940,208	23,208
Baa	3,249,501	12,137	1,943,027	15,123
Ba	28,436	(617)	—	—
NR	—	—	—	—
Total	$ 9,440,873	$ 37,290	$ 6,291,375	$ 46,503
Credit Swaps Bought:				
Aaa	$ 34,872	$ (167)	$ 20,000	$ (51)
Aa	24,872	(67)	—	—
A	132,180	(326)	70,000	(16)
Baa	146,090	(478)	40,000	90

NR	34,872	(137)	—	—
Total	$ 372,886	$ (1,175)	$ 130,000	$ 23
Counterparty Buyer				
Credit Swaps Sold:				
Aaa	$ 5,000	$ 47	$ 12,000	$ 41
Aa	7,365,395	27,757	4,529,351	33,039
A	2,070,478	9,486	1,750,024	13,423
Total	$ 9,440,873	$ 37,290	$ 6,291,375	$ 46,503
Counterparty Seller				
Credit Swaps Bought:				
Aaa	$ —	$ —	$ —	$ —
Aa	298,014	(970)	75,000	41
A	74,872	(205)	55,000	