

PRIMUS GUARANTY LTD  
Form 10-Q  
November 08, 2006

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

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FORM 10-Q

(Mark One)

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

For the quarterly period ended September 30, 2006

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

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Primus Guaranty, Ltd.

(Exact name of registrant as specified in its charter)

Bermuda  
(State or other jurisdiction of  
incorporation or organization)

Not Required  
(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)

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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

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required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No

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

Large accelerated filer Accelerated filer Non-accelerated filer

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

As of November 1, 2006, the number of shares outstanding of the issuer's common stock, \$0.08 par value, was 43,356,274.

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Primus Guaranty, Ltd.  
Form 10-Q  
For the three months ended September 30, 2006

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## Part I. Financial Information

## Item 1. Financial Statements

Primus Guaranty, Ltd.

Condensed Consolidated Statements of Financial Condition

(in thousands except per share amounts)

|   | September<br>30,<br>2006<br>(unaudited) | December<br>31,<br>2005 |
|---|---|-------------------------|
| Assets  |   |                         |
| Cash and cash equivalents   | \$ 58,701                               | \$ 69,355               |
| Available-for-sale investments  | 599,932                                 | 560,147                 |
| Trading investments   | 1,257                                   | —                       |
| Accrued interest receivable   | 5,900                                   | 5,127                   |
| Accrued premiums and interest receivable on credit and other swaps  | 3,813                                   | 3,461                   |
| Premiums receivable on financial guarantees   | 100                                     | 300                     |
| Unrealized gain on credit and other swaps, at fair value  | 59,930                                  | 25,342                  |
| Deposit and warehouse loan agreements   | 4,116                                   | —                       |
| Fixed assets and software costs, net  | 5,753                                   | 4,993                   |
| Debt issuance costs, net  | 3,032                                   | 3,147                   |
| Other assets  | 1,597                                   | 1,210                   |
| Total assets  | \$ 744,131                              | \$ 673,082              |
| Liabilities and stockholders' equity  |   |                         |
| Accounts payable and accrued expenses   | \$ 2,236                                | \$ 3,035                |
| Accrued compensation  | 5,974                                   | 4,833                   |
| Interest payable  | 339                                     | 404                     |
| Accrued premiums on credit and other swaps  | 42                                      | —                       |
| Taxes payable   | 19                                      | 54                      |
| Unrealized loss on credit and other swaps, at fair value  | 1,350                                   | 3,521                   |
| Deferred credit swap premiums   | 29                                      | 46                      |
| Deferred financial guarantee premiums   | 100                                     | 401                     |
| Deferred rent payable   | 586                                     | 416                     |
| Long-term debt  | 200,000                                 | 200,000                 |
| Total liabilities   | 210,675                                 | 212,710                 |
| Preferred securities of subsidiary  | 98,521                                  | 98,521                  |
| Stockholders' equity:   |   |                         |
| Common stock, \$0.08 par value, 62,500,000 shares authorized, 43,341,973 and 43,176,511 shares issued and outstanding at September 30, 2006 and | 3,572                                   | 3,572                   |

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December 31, 2005

|  |            |            |
|--|------------|------------|
| Additional paid-in-capital   | 268,365    | 265,848    |
| Warrants   | 612        | 612        |
| Accumulated other comprehensive loss   | (3,182)    | (4,254)    |
| Retained earnings  | 165,568    | 96,073     |
| Total stockholders' equity   | 434,935    | 361,851    |
| Total liabilities, preferred securities of subsidiary and stockholders' equity | \$ 744,131 | \$ 673,082 |

See accompanying notes.

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Primus Guaranty, Ltd.  
Condensed Consolidated Statements of Operations  
(in thousands except per share amounts)

|   | Three Months Ended |           | Nine Months Ended |           |
|---|--------------------|-----------|-------------------|-----------|
|   | September 30,      |           | September 30,     |           |
|   | 2006               | 2005      | 2006              | 2005      |
|   | (unaudited)        |           | (unaudited)       |           |
| Revenues  |                    |           |                   |           |
| Net credit swap revenue                             | \$ 28,905          | \$ 27,449 | \$ 85,865         | \$ 15,672 |
| Net total return swap revenue                       | 313                | —         | 437               | —         |
| Net warehouse loan revenue                          | 76                 | —         | 76                | —         |
| Premiums earned on financial guarantees             | 100                | 101       | 300               | 300       |
| Asset management and advisory fees                  | 542                | 49        | 709               | 140       |
| Interest income                                     | 7,143              | 4,483     | 20,530            | 10,969    |
| Investment portfolio realized gains (losses)        | —                  | (3)       | —                 | 20        |
| Foreign currency revaluation gain (loss)            | (32)               | 55        | (56)              | (1,464)   |
| Total net revenues                                  | 37,047             | 32,134    | 107,861           | 25,637    |
| Expenses  |                    |           |                   |           |
| Compensation and employee benefits                  | 5,023              | 3,537     | 15,517            | 12,139    |
| Professional and legal fees                         | 1,361              | 981       | 3,645             | 2,731     |
| Depreciation and amortization                       | 649                | 533       | 1,846             | 1,574     |
| Technology and data                                 | 726                | 535       | 1,546             | 1,250     |
| Interest expense                                    | 2,831              | 649       | 7,933             | 1,640     |
| Other   | 1,302              | 805       | 3,632             | 2,423     |
| Total expenses                                      | 11,892             | 7,040     | 34,119            | 21,757    |
| Distributions on preferred securities of subsidiary | (1,437)            | (1,022)   | (4,206)           | (2,797)   |
| Income before provision for income taxes            | 23,718             | 24,072    | 69,536            | 1,083     |
| (Provision) benefit for income taxes                | 14                 | (63)      | (41)              | (108)     |
| Net income available to common shares               | \$ 23,732          | \$ 24,009 | \$ 69,495         | \$ 975    |
| Income per common share:                            |                    |           |                   |           |
| Basic   | \$ 0.55            | \$ 0.56   | \$ 1.61           | \$ 0.02   |

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|                                    |         |         |         |         |
|------------------------------------|---------|---------|---------|---------|
| Diluted                            | \$ 0.54 | \$ 0.54 | \$ 1.56 | \$ 0.02 |
| Average common shares outstanding: |         |         |         |         |
| Basic                              | 43,314  | 43,120  | 43,285  | 43,147  |
| Diluted                            | 44,341  | 44,543  | 44,410  | 44,673  |

See accompanying notes.

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Primus Guaranty, Ltd.  
Condensed Consolidated Statements of Cash Flows  
(in thousands except per share amounts)

|   | Nine months ended<br>September 30,<br>2006                      2005<br>(unaudited) |         |
|---|---|---------|
| Cash flows from operating activities  |   |         |
| Net income  | \$ 69,495   | \$ 975  |
| Adjustments to reconcile net income to net cash provided by operating activities: |   |         |
| Non-cash items included in net income:  |   |         |
| Depreciation and amortization   | 1,846   | 1,574   |
| Stock compensation  | 2,747   | 2,149   |
| Net unrealized (gain) loss on swap portfolio                                      | (36,759)  | 18,837  |
| Net amortization of premium and discount on securities                            | (2,669)   | —       |
| Deferred rent   | 170   | (20)    |
| Loss on disposal of assets  | 25  | —       |
| Amortization of debt issuance costs   | 128   | 31      |
| Distributions on preferred securities of subsidiary                               | 4,206   | 2,798   |
| Increase (decrease) in cash resulting from changes in:                            |   |         |
| Accrued interest receivable   | (773)   | (2,754) |
| Accrued premiums and interest receivable on credit and other swaps                | (352)   | 188     |
| Premiums receivable on financial guarantees                                       | 200   | 400     |
| Deposit and warehouse loan agreement  | (4,116)   | —       |
| Other assets  | (387)   | 356     |
| Purchase of trading investments   | (1,257)   | —       |
| Accounts payable and accrued expenses   | (799)   | 881     |
| Accrued compensation  | 1,141   | (1,400) |
| Interest payable  | (65)  | (269)   |
| Accrued premiums payable on credit swaps  | 42  | —       |
| Taxes payable   | (35)  | 208     |
| Deferred credit swap premiums   | (17)  | (17)    |
| Deferred financial guarantee premiums   | (301)   | (299)   |

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|   |           |           |
|---|-----------|-----------|
| Net cash provided by operating activities                                     | 32,470    | 23,638    |
| Cash flows from investing activities  |           |           |
| Fixed asset purchases and capitalized software costs                          | (2,631)   | (519)     |
| Purchases of available-for-sale investments                                   | (103,129) | (258,165) |
| Maturities of available-for-sale investments                                  | 67,000    | —         |
| Net cash used in investing activities   | (38,760)  | (258,684) |
| Cash flows from financing activities  |           |           |
| Repurchase and retirement of common stock                                     | (684)     | (2,397)   |
| Proceeds from employee exercise of stock options and issuance of common stock | 454       | 234       |
| Debt issuance costs   | (13)      | (31)      |
| Net preferred distributions of subsidiary                                     | (4,206)   | (2,798)   |
| Net cash used in financing activities   | (4,449)   | (4,992)   |
| Net effect of exchange rate changes on cash                                   | 85        | —         |
| Net decrease in cash  | (10,654)  | (240,038) |
| Cash and cash equivalents at beginning of period                              | 69,355    | 320,989   |
| Cash and cash equivalents at end of period                                    | \$ 58,701 | \$ 80,951 |
| Supplemental disclosures  |           |           |
| Cash paid for interest  | \$ 7,870  | \$ 1,879  |
| Cash paid for taxes   | \$ 76     | \$ 4      |

See accompanying notes.

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1. Organization and Basis of Presentation

Primus Guaranty, Ltd., together with its consolidated subsidiaries (“Primus Guaranty” or “the Company”), is a Bermuda holding company, and the 100% owner of Primus Bermuda, Ltd. (“Primus Bermuda”), a Bermuda holding company and PRS Trading Strategies, LLC. Primus Bermuda is the 100% owner of Primus Group Holdings, LLC (“Primus Group Holdings”), a Delaware limited liability company. Primus Group Holdings has two principal operating subsidiaries, Primus Financial Products, LLC (“Primus Financial”), and Primus Asset Management, Inc. (“Primus Asset Management”). Primus Financial is a Delaware financial products limited liability company that maintains a long-term counterparty credit rating of AAA from Standard & Poor’s (“S&P”) and Aaa from Moody’s Investors Service, Inc. (“Moody’s” and, together with S&P, the “Rating Agencies”). Primus Financial is primarily a seller of credit swaps against investment grade credit obligations of corporate and sovereign reference entities. Primus Financial also sells credit swaps referencing portfolios containing obligations of multiple reference entities. Primus Asset Management, a Delaware services company, is an asset manager for Primus Financial and unrelated third parties.

Primus Financial and Primus Asset Management function as separate entities from Primus Group Holdings. Additionally, the obligations of Primus Guaranty are not the obligations of Primus Bermuda, Primus Group Holdings, or any other of its affiliates, and vice versa. Primus Asset Management is the 100% owner of Primus Re, Ltd. (“Primus Re”), a Bermuda company that operates as a financial guaranty insurance company and is licensed as a Class 3 Insurer under the Insurance Act of 1978 of Bermuda.

In July 2005, PRS Trading Strategies, LLC (PRS Trading), a Delaware limited liability company, was formed. PRS Trading engages in relative value trading and other strategies involving buying and selling of credit swaps and other financial instruments in pursuit of financial returns. These trading strategies generally have a short-term investment

horizon and are subject to tight risk controls and liquidity management. PRS Trading commenced operations in January 2006. PRS Trading does not engage in trading activity with Primus Financial. PRS Trading has no rating from the rating agencies and, accordingly generally provides its swap counterparties with collateral to support its contractual obligations. More recently, PRS Trading has entered into total return swaps and a loan warehouse financing arrangement.

In November 2005, Primus Guaranty (UK), Ltd. (PGUK) was incorporated in England to expand the Company's presence and further develop its business and relationships across Europe. Primus Bermuda is the 100% owner of PGUK.

The accompanying unaudited condensed consolidated financial statements of Primus Guaranty have been prepared in accordance with U.S. 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 periods presented are not necessarily indicative of the results that may be expected for any other interim period or for the year ended December 31, 2006. The condensed consolidated financial statements include the accounts of the Company and its wholly owned subsidiaries. All significant intercompany balances have been eliminated.

The condensed 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 condensed consolidated financial statements are presented in U.S. dollar equivalents. At September 30, 2006 and December 31, 2005, the Company's credit swap activities were conducted in U.S. dollars and euros.

Certain prior year amounts have been reclassified to conform to current year presentation.

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### 2. Recent Accounting Pronouncements

In December 2004, the Financial Accounting Standards Board ("FASB") issued SFAS No. 123 (R), Share-Based Payment. SFAS No. 123(R) is a revision of SFAS No. 123 and supersedes Accounting Principles Board ("APB") Opinion No. 25, Accounting for Stock Issued to Employees, and amends SFAS No. 95, Statement of Cash Flows. SFAS No. 123(R) eliminates the ability to account for share-based compensation transactions using APB Opinion No. 25 and requires all share-based payments to employees, including grants of employee stock options, to be recognized in the financial statements using a fair value-based method. In April 2005, the Securities and Exchange Commission ("SEC") amended the effective date of SFAS No. 123(R) until the first fiscal year beginning after June 15, 2005 to provide additional time for companies to comply with the reporting requirements. Effective January 1, 2006, the Company adopted SFAS No. 123(R). See note 9 of notes to condensed consolidated financial statements for further detail.

In March 2005, the SEC staff issued Staff Accounting Bulletin No. 107 ("SAB No. 107") to provide supplemental implementation guidance on SFAS No. 123(R). The Company applied the relevant provisions of SAB No. 107 in its adoption of SFAS No. 123(R).

In May 2005, the FASB issued SFAS 154, Accounting Changes and Error Corrections – a replacement of APB Opinion No. 20 and FASB Statement No. 3. This statement requires retrospective application to prior periods' financial statements of changes in accounting principle. SFAS 154 is effective for accounting changes and corrections of errors made in fiscal years beginning after December 15, 2005. The Company will apply SFAS 154 in future periods, if applicable.

In November 2005, the FASB issued FASB Staff Position FSP 115-1, The Meaning of Other-Than Temporary Impairment and Its Application to Certain Investments (FSP 115-1), which addresses the determination as to when an investment is considered impaired, whether that impairment is other-than-temporary, and the measurement of an impairment loss. FSP 115-1 also includes accounting considerations subsequent to the recognition of an other-than-temporary impairment and requires certain disclosures about unrealized losses that have not been recognized as other-than-temporary impairments. The guidance in FSP 115-1 is required to be applied to reporting periods beginning after December 15, 2005. The adoption did not have any effect on the condensed consolidated financial statements.

In June 2006, the FASB issued Interpretation No. 48, Accounting for Uncertainty in Income Taxes-an interpretation of FASB Statement No. 109 (FIN 48). FIN 48 prescribes a recognition threshold and measurement attributes for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. FIN 48 also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. FIN 48 is effective for fiscal years beginning after December 15, 2006. The Company is currently evaluating the impact that adoption of FIN 48 will have on its consolidated financial statements.

In September 2006, the FASB issued SFAS No. 157, Fair Value Measurements (SFAS No. 157). SFAS 157 defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles (GAAP), and expands disclosures about fair value measurements. SFAS No. 157 is effective for fiscal years beginning after November 15, 2007. The Company is currently evaluating the impact that adoption of SFAS No. 157 will have on its consolidated financial statements.

### 3. Available-for-Sale Investments

Available-for-sale investments included U.S. government agency obligations (including government-sponsored enterprises) rated AAA and Aaa by the respective rating agencies and commercial paper rated A-1 and P-1 by the respective rating agencies. Available-for-sale investments have original maturities or maturities at time of purchase greater than 90 days.

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The following table summarizes the composition of the Company's available-for-sale investments at September 30, 2006 and December 31, 2005 (in thousands):

|                                   | Amortized<br>Cost | September 30, 2006  |                      | Estimated<br>Fair Value |
|-----------------------------------|-------------------|---------------------|----------------------|-------------------------|
|                                   |                   | Unrealized<br>Gains | Unrealized<br>Losses |                         |
| U.S government agency obligations | \$ 572,411        | \$ —                | \$ (3,279)           | \$ 569,132              |



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|                  |         |    |         |         |
|------------------|---------|----|---------|---------|
| Commercial paper | 30,788  | 12 | —       | 30,800  |
| Total            | 603,199 | 12 | (3,279) | 599,932 |

|                                    | December 31, 2005 |                     |                      | Estimated<br>Fair Value |
|------------------------------------|-------------------|---------------------|----------------------|-------------------------|
|                                    | Amortized<br>Cost | Unrealized<br>Gains | Unrealized<br>Losses |                         |
| U.S. government agency obligations | \$ 544,824        | \$ —                | \$ (4,259)           | \$ 540,565              |
| Commercial paper                   | 19,577            | 5                   | —                    | 19,582                  |
| Total                              | \$ 564,401        | \$ 5                | \$ (4,259)           | \$ 560,147              |

The unrealized losses on the Company's investments in U.S. government agency obligations were the result of an increase in interest rates during the first nine months of 2006 and during 2005. These securities have primarily been in a loss position for more than 12 months. Because the decline in market value is attributable to changes in interest rates and not credit quality, and the Company has the ability and intent to hold these investments until maturity, the Company does not consider these investments to be other-than-temporarily impaired at September 30, 2006 and December 31, 2005. These securities have maturities of less than 3 years.

#### 4. Trading Investments

During the end of the third quarter of 2006, PRS Trading purchased corporate bonds for trading purposes. Trading investments are carried at fair value, with unrealized gains or losses recorded in the condensed consolidated statements of operations. At September 30, 2006, the fair value of these trading investments was approximately \$1.3 million.

#### 5. Net Credit Swap Revenue and Credit Swap Portfolio

##### Overview

Net credit swap revenue as presented in the condensed consolidated statements 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 the termination of 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.

Credit swaps are derivative transactions that obligate one party to the transaction (the "Seller") to pay an amount to the other party to the transaction (the "Buyer") should an unrelated third party or portfolio of third parties (the "Reference Entity") specified in the contract be subject to one of a specified group of events ("Credit Events"). 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 taking the risk of the contract, 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. Premium income is recognized ratably over the life of the transaction as a component of net credit swap revenue. When the Company purchases credit swaps from its counterparties, the Company pays fixed premiums over the term of the contract. Premium expense is recognized ratably over the life of the transaction as a component of net credit swap revenue.

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All credit swap transactions entered into between the Buyer and the Seller, or will shortly be, are subject to an International Swaps and Derivatives Association, Inc. Master Agreement or (“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) occurs in respect of either party.

The primary risks inherent in the Company’s activities are (a) where the Company is a Seller that Reference Entities specified in its credit swap transactions will experience Credit Events that will require the Company to make payments to the Buyers of the transactions. Credit Events may include any or all of the following: bankruptcy, failure to pay, repudiation or moratorium, and modified or original restructuring, (b) where the Company 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 the Company will default on their required premium payments. During the three and nine months ended September 30, 2006 and 2005, none of these events have occurred.

The Company terminates a credit swap in one of two ways. The Company may negotiate an agreed termination with 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, in order to reduce its exposure, the Company may enter into an equal and opposite transaction with a third party under which the Company purchases credit swaps 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 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.

In accordance with accounting principles generally accepted in the United States, the Company carries its credit swaps on its condensed consolidated statements of financial condition at their fair value. Changes in the fair value of the Company’s credit swap portfolio are recorded as unrealized gains or losses as a component of net credit swap revenue in the Company’s consolidated statements of operations. If a credit swap has an increase in fair value during a period, the increase will add to the Company’s net credit swap revenue 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 revenue 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, the Company aggregates fair values of individual credit swaps by counterparty for presentation on the Company’s condensed consolidated statements of financial condition. If the aggregate total of fair values with a counterparty is a net gain, the total is recorded as a component of unrealized gains on credit swaps, at fair value in the condensed consolidated statements of financial condition. If the aggregate total of fair values with a counterparty is a net loss, the total is recorded as a component of unrealized losses on credit swaps, at fair value in the condensed consolidated statements of financial 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 of unrealized gains or losses on credit swaps, at fair value, dependent upon whether the individual contract was at a gain or a loss.

The Company's portfolio of credit swaps is generally held by Primus Financial and PRS Trading.

#### Primus Financial

Under the terms of Primus Financial's operating guidelines, derivatives transactions can only include credit swaps.

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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. As a general rule, when Primus Financial sells credit swaps, 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 Primus Financial 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.

Second, Primus Financial may elect to terminate a transaction for which it has an unrealized gain or loss based on one or more of the following considerations: the likelihood of further gains or losses arising from the position, its view as to whether the capital dedicated to the position would be profitably reallocated, its total exposure to a particular Reference Entity, the total size of its portfolio in relation to its capital and the total size of its swap positions and exposures with a particular counterparty which might be reduced so that the counterparty may enter into additional swaps with Primus Financial.

Primus Financial distinguishes among credit swaps sold-single name and credit swaps sold-tranche. Credit swaps sold-single name refers to credit swaps referencing a single entity. Credit swaps sold-tranche refers to credit swaps referencing portfolios containing obligations of multiple reference entities, which Primus Financial began selling during the second quarter of 2005.

#### PRS Trading

PRS Trading engages in relative value trading and other strategies involving buying and selling of credit swaps and other financial instruments in pursuit of financial returns. These trading strategies generally have a short-term investment horizon and are subject to tight risk controls and liquidity management. PRS Trading commenced operations in January 2006. PRS Trading does not engage in trading activity with Primus Financial. PRS Trading has no rating from the rating agencies and, accordingly generally provides its swap counterparties with collateral to support its contractual obligations. Credit swaps purchased to off-set risks do not qualify as hedges in accordance with SFAS No. 133. PRS Trading also transacts in credit default swap indices (CDS index), which are over-the-counter transactions based on the risk of credit defaults against a pool of sub-investment grade corporate reference entities.

#### Consolidated Net Credit Swap Revenue and Credit Swap Portfolio Information

The tables below present the components of consolidated net credit swap revenue for the three and nine months ended September 30, 2006 and 2005 (in thousands):

|                                     | Three Months Ended |           | Nine Months Ended |           |
|-------------------------------------|--------------------|-----------|-------------------|-----------|
|                                     | September 30,      |           | September 30,     |           |
|                                     | 2006               | 2005      | 2006              | 2005      |
| Net premium income                  | \$ 18,034          | \$ 13,962 | \$ 51,081         | \$ 37,561 |
| Realized gains                      | 101                | 216       | 1,043             | 1,461     |
| Realized losses                     | (1,927)            | (1,464)   | (3,141)           | (4,513)   |
| Change in unrealized gains (losses) | 12,697             | 14,735    | 36,882            | (18,837)  |
| Total net credit swap revenue       | \$ 28,905          | \$ 27,449 | \$ 85,865         | \$ 15,672 |

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The Company's consolidated notional amount, fair value and average fair value of open credit swap transactions (excluding the CDS index) entered into with third parties at September 30, 2006 and December 31, 2005 are as follows (in thousands):

|                                    | September 30,<br>2006 | December 31,<br>2005 |
|------------------------------------|-----------------------|----------------------|
| Gross Notional Amounts:            |                       |                      |
| Credit swaps sold-single name      | \$ 15,377,221         | \$ 13,374,031        |
| Credit swaps sold-tranche          | 350,000               | 50,000               |
| Credit swaps purchased-single name | (192,156)             | —                    |
| Fair value:                        |                       |                      |
| Asset                              | 59,930                | 25,342               |
| Liability                          | 1,110                 | 3,521                |
| Average fair value:                |                       |                      |
| Asset                              | 51,575                | 28,140               |
| Liability                          | 2,064                 | 3,545                |

“Asset” in the table above 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 independently by Primus Financial and PRS Trading with each counterparty under an ISDA Master Agreement. 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 netted by counterparty.

At September 30, 2006 and December 31, 2005, Primus Financial had three derivative transactions with its affiliate, Primus Re, totaling \$87 million in notional principal which are eliminated in consolidation.

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The tables that follow summarize, by credit rating of Reference Entities and of Counterparties, the consolidated notional amounts and fair values of credit swap transactions outstanding (excluding transactions with affiliates and a negative \$240 thousand net fair value associated with the CDS index and total return swaps, as discussed in note 6) for the Company as of September 30, 2006 and December 31, 2005 (in thousands):

(in thousands)

| Moody's Rating Category<br>Reference Entity/Tranche | September 30, 2006 |               | December 31, 2005  |               |
|---|--------------------|---------------|--------------------|---------------|
|   | Notional<br>Amount | Fair<br>Value | Notional<br>Amount | Fair<br>Value |
| Credit Swaps Sold – Single Name:                    |                    |               |                    |               |
| Aaa   | \$ 784,352         | \$ 1,492      | \$ 561,472         | \$ 1,118      |
| Aa  | 2,601,928          | 9,520         | 2,268,090          | 8,006         |
| A   | 5,851,422          | 24,711        | 5,270,706          | 15,008        |
| Baa   | 5,612,040          | 28,316        | 5,041,442          | 4,328         |
| Ba  | 467,807            | (895)         | 199,321            | (5,785)       |
| B   | 59,672             | (2,634)       | 33,000             | (1,539)       |
| Total   | \$ 15,377,221      | \$ 60,510     | \$ 13,374,031      | \$ 21,136     |
| Credit Swaps Sold – Tranche:                        |                    |               |                    |               |
| Aa  | \$ 150,000         | \$ 938        | \$ 50,000          | \$ 685        |
| A   | 200,000            | (2,076)       | —                  | —             |
| Total   | \$ 350,000         | \$ (1,138)    | \$ 50,000          | \$ 685        |
| Credit Swaps Purchased                              |                    |               |                    |               |
| A   | \$ (65,344)        | \$ (131)      | \$ —               | \$ —          |
| Baa   | (111,812)          | (361)         | —                  | —             |
| Ba  | (15,000)           | (60)          | —                  | —             |
| Total   | \$ (192,156)       | \$ (552)      | \$ —               | \$ —          |
| Counterparty Buyer                                  |                    |               |                    |               |
| Credit Swaps Sold – Single Name:                    |                    |               |                    |               |
| Aaa   | \$ 5,000           | \$ 16         | \$ 5,000           | \$ 37         |
| Aa  | 12,841,615         | 50,246        | 11,228,563         | 13,341        |
| A   | 2,530,606          | 10,248        | 2,140,468          | 7,758         |
| Total   | \$ 15,377,221      | \$ 60,510     | \$ 13,374,031      | \$ 21,136     |
| Credit Swaps Sold – Tranche:                        |                    |               |                    |               |
| Aa  | \$ 350,000         | \$ (1,138)    | \$ 50,000          | \$ 685        |
| Total   | \$ 350,000         | \$ (1,138)    | \$ 50,000          | \$ 685        |
| Counterparty Seller                                 |                    |               |                    |               |
| Credit Swaps Purchased:                             |                    |               |                    |               |
| Aa  | \$ (192,156)       | \$ (552)      | \$ —               | \$ —          |
| Total   | \$ (192,156)       | \$ (552)      | \$ —               | \$ —          |

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(in thousands)

| S&P Rating Category<br>Reference Entity/Tranche | September 30, 2006 |               | December 31, 2005  |               |
|---|--------------------|---------------|--------------------|---------------|
|   | Notional<br>Amount | Fair<br>Value | Notional<br>Amount | Fair<br>Value |
| Credit Swaps Sold – Single Name:                |                    |               |                    |               |
| AAA   | \$ 898,040         | \$ 1,773      | \$ 636,472         | \$ 1,222      |
| AA  | 2,230,264          | 8,243         | 1,862,713          | 6,026         |
| A   | 6,597,765          | 27,708        | 6,143,717          | 17,753        |
| BBB   | 5,234,559          | 26,243        | 4,513,356          | 4,803         |
| BB  | 354,921            | (760)         | 197,773            | (7,062)       |
| B   | 61,672             | (2,697)       | 20,000             | (1,606)       |
| Total   | \$ 15,377,221      | \$ 60,510     | \$ 13,374,031      | \$ 21,136     |
| Credit Swaps Sold – Tranche:                    |                    |               |                    |               |
| AAA   | \$ 150,000         | \$ (1,400)    | \$ —               | \$ —          |
| AA  | 200,000            | 262           | 50,000             | 685           |
| Total   | \$ 350,000         | \$ (1,138)    | \$ 50,000          | \$ 685        |
| Credit Swaps Purchased:                         |                    |               |                    |               |
| A   | \$ (40,000)        | \$ (80)       | \$ —               | \$ —          |
| BBB   | (152,156)          | (472)         | —                  | —             |
| BB  | —                  | —             | —                  | —             |
| Total   | \$ (192,156)       | \$ (552)      | \$ —               | \$ —          |
| Counterparty Buyer                              |                    |               |                    |               |
| Credit Swaps Sold – Single Name:                |                    |               |                    |               |
| AAA   | \$ 36,680          | \$ 70         | \$ 34,623          | \$ (57)       |
| AA  | 11,590,518         | 47,254        | 9,262,316          | 10,525        |
| A   | 3,750,023          | 13,186        | 4,077,092          | 10,668        |
| Total   | \$ 15,377,221      | \$ 60,510     | \$ 13,374,031      | \$ 21,136     |
| Credit Swaps Sold – Tranche:                    |                    |               |                    |               |
| AA  | \$ 350,000         | \$ (1,138)    | \$ 50,000          | \$ 685        |
| Total   | \$ 350,000         | \$ (1,138)    | \$ 50,000          | \$ 685        |
| Counterparty Seller                             |                    |               |                    |               |
| Credit Swaps Purchased:                         |                    |               |                    |               |
| AA  | \$ (121,812)       | \$ (517)      | \$ —               | \$ —          |
| A   | (70,344)           | (35)          | —                  | —             |
| Total   | \$ (192,156)       | \$ (552)      | \$ —               | \$ —          |

Primus Financial's and PRS Trading's counterparties are generally financial institutions with whom it has entered into Master Agreements. For the nine months ended September 30, 2006 and 2005, respectively, two counterparties and three counterparties, respectively, each generated greater than ten percent of the Company's total premium revenue. At September 30, 2006, the notional and fair value amount of credit swaps outstanding with respect to one non-rated counterparty was \$5.0 million and \$17 thousand, respectively. The premiums on these transactions were fully prepaid by the counterparty, and as such, they have been categorized as AAA/Aaa rating in our credit swap portfolio.

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The table below shows the geographical distribution of the Company's credit swap portfolio (excluding transactions with affiliates) by domicile of the Reference Entity and domicile of the counterparty (in thousands):

| Country of Domicile             | September 30, 2006 |            | December 31, 2005 |            |
|---------------------------------|--------------------|------------|-------------------|------------|
|                                 | Notional Amount    | Fair Value | Notional Amount   | Fair Value |
| Credit Swaps Sold – Single Name |                    |            |                   |            |
| By Reference Entity:            |                    |            |                   |            |
| North America                   | \$ 9,247,368       | \$ 38,217  | \$ 8,243,123      | \$ 12,268  |
| Europe                          | 5,380,853          | 20,088     | 4,561,908         | 7,412      |
| Pacific                         | 565,000            | 1,362      | 445,000           | 992        |
| Others                          | 184,000            | 843        | 124,000           | 464        |
| Total                           | \$ 15,377,221      | \$ 60,510  | \$ 13,374,031     | \$ 21,136  |
| By Counterparty:                |                    |            |                   |            |
| North America                   | \$ 7,971,447       | \$ 28,370  | \$ 6,878,892      | \$ 8,754   |
| Europe                          | 7,310,774          | 31,924     | 6,388,139         | 12,359     |
| Pacific                         | 75,000             | 127        | 65,000            | (37)       |
| Others                          | 20,000             | 89         | 42,000            | 60         |
| Total                           | \$ 15,377,221      | \$ 60,510  | \$ 13,374,031     | \$ 21,136  |
| Credit Swaps Sold – Tranche     |                    |            |                   |            |
| By Counterparty:                |                    |            |                   |            |
| North America                   | \$ 50,000          | \$ 805     | \$ 50,000         | \$ 685     |
| Europe                          | 300,000            | (1,943)    | —                 | —          |
| Total                           | \$ 350,000         | \$ (1,138) | \$ 50,000         | \$ 685     |
| Credit Swaps Purchased          |                    |            |                   |            |
| By Reference Entity:            |                    |            |                   |            |
| North America                   | \$ (138,000)       | \$ (418)   | \$ —              | \$ —       |
| Europe                          | (39,156)           | (79)       | —                 | —          |
| Others                          | (15,000)           | (55)       | —                 | —          |
| Total                           | \$ (192,156)       | \$ (552)   | \$ —              | \$ —       |
| By Counterparty:                |                    |            |                   |            |
| North America                   | \$ (153,820)       | \$ (459)   | \$ —              | \$ —       |
| Europe                          | (38,336)           | (93)       | —                 | —          |
| Total                           | \$ (192,156)       | \$ (552)   | \$ —              | \$ —       |

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The table below shows the distribution of the Company's credit swap portfolio (excluding related party transactions) by year of maturity as of September 30, 2006 and December 31, 2005 (in thousands):

|                                 | September 30, 2006 |               | December 31, 2005  |               |
|---------------------------------|--------------------|---------------|--------------------|---------------|
|                                 | Notional<br>Amount | Fair<br>Value | Notional<br>Amount | Fair<br>Value |
| Credit Swaps Sold – Single Name |                    |               |                    |               |
| Year of Maturity                |                    |               |                    |               |
| 2006                            | \$ 268,421         | \$ 64         | \$ 939,657         | \$ 588        |
| 2007                            | 2,435,048          | 8,645         | 2,469,188          | 12,637        |
| 2008                            | 1,140,798          | 7,116         | 1,129,811          | 7,948         |
| 2009                            | 2,696,410          | 15,169        | 2,684,704          | 5,980         |
| 2010                            | 6,171,800          | 24,014        | 6,122,897          | (5,963)       |
| 2011                            | 2,664,744          | 5,502         | 27,774             | (54)          |
| Total                           | \$ 15,377,221      | \$ 60,510     | \$ 13,374,031      | \$ 21,136     |
| Credit Swaps Sold – Tranche     |                    |               |                    |               |
| Year of Maturity                |                    |               |                    |               |
| 2010                            | \$ 50,000          | \$ 805        | \$ 50,000          | \$ 685        |
| 2011                            | 50,000             | 162           | —                  | —             |
| 2013                            | 250,000            | (2,105)       | —                  | —             |
| Total                           | \$ 350,000         | \$ (1,138)    | \$ 50,000          | \$ 685        |
| Credit Swaps Purchased          |                    |               |                    |               |
| Year of Maturity                |                    |               |                    |               |
| 2011                            | \$ (184,680)       | \$ (504)      | \$ —               | \$ —          |
| 2016                            | (7,476)            | (48)          | —                  | —             |
| Total                           | \$ (192,156)       | \$ (552)      | \$ —               | \$ —          |

#### 6. Net Total Return Swap Revenue

During the second quarter of 2006, the Company's subsidiary, PRS Trading entered into a master agreement for total return swap transactions with a counterparty, which expires in May 2008. Under the terms of the agreement, PRS Trading receives interest and other payments based on certain mutually agreed reference loans, and pays a financing interest expense based on the principal amount of such loans. PRS Trading takes the risk that the referenced loans deteriorate in value and conversely receives the benefit from any appreciation in the value of loans referenced in each total return swap. The net fair value of each swap is determined by the net fair value of the referenced loan. PRS Trading determines the fair value of the swaps based on the estimated cost to close-out the swap positions. PRS Trading places with the counterparty, initial margin cash collateral and ongoing mark-to-market cash collateral, which is determined by the fair value of the total return swaps. The total return swap with the counterparty is documented under an ISDA master agreement between PRS Trading and the counterparty. The net fair value of all total return swaps is netted with the fair values of any credit swaps outstanding between PRS Trading and the counterparty for presentation in the condensed consolidated statements of financial condition.

The total notional amount of loans outstanding under the total return swaps was \$22.5 million at September 30, 2006. The net fair value of the total return swaps was negative \$123 thousand at September 30, 2006.

Net total return swap revenue, as presented in the condensed consolidated statements of operations, comprises changes in the fair value of the total return swaps, realized gains or losses on the termination of the total return swaps, and the net interest earned on the total return swaps. The Company recorded net total return swap revenue of \$313 thousand and \$437 thousand for the three and nine month periods ended September 30, 2006, respectively.



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## 7. Deposit and Warehouse Loan Agreements

On July 13, 2006, the Company's subsidiaries, Primus Asset Management and PRS Trading entered into a credit agreement (together with certain other related agreements hereafter referred to as the "warehouse loan agreements") with a major financial institution and a special purpose entity ("CLO"), for the purpose of building a portfolio of loan assets, with the expectation of subsequently issuing securities in the form of a collateralized loan obligation. Primus Asset Management will act as interim collateral manager for the CLO. Under the warehouse loan agreements, the CLO is able to finance the purchase and accumulation of loans to an amount up to \$400 million. In the interim period, while the CLO accumulates the loans and before the securities are issued (the "warehouse period"), the major financial institution is funding the purchase of the loans. PRS Trading and the major financial institution have agreed to share equally in any gains or losses arising from the sale of loans during the warehouse period, although PRS Trading's potential loss is limited to an amount of \$4 million. PRS Trading has deposited \$4 million in cash collateral with a trustee pursuant to this arrangement. PRS Trading and the major financial institution have agreed to share equally in the net interest earned on the loans, after deduction of funding costs.

The total accumulated notional amount of loans outstanding under the warehouse loan agreements was approximately \$253 million at September 30, 2006. The Company has determined, pursuant to FASB Interpretation No. 46 (R), Consolidation of Variable Interest Entities, that it is not the primary beneficiary of the warehouse loan agreements and, accordingly, the warehouse loans are not consolidated in the Company's financial statements.

These agreements are being treated as derivatives for accounting purposes and are carried at fair value. Net warehouse loan revenue, as presented in the condensed consolidated statements of operations, comprises PRS Trading's share under the derivative transaction of net realized losses on the termination of individual loan positions and net interest earned on the warehouse loans. The Company recorded net warehouse loan revenue of \$76 thousand for each of the three and nine month periods ended September 30, 2006, respectively.

## 8. Earnings per Share

Basic earnings per share ("EPS") is calculated by dividing earnings available to common stockholders by the weighted average number of common shares outstanding. Diluted EPS is similar to basic EPS, but adjusts for the effect of the potential issuance of common shares. The following table presents the computations of basic and diluted EPS (in thousands, except per share data):

|   | Three months ended |           | Nine months ended |           |
|---|--------------------|-----------|-------------------|-----------|
|   | September 30,      |           | September 30,     |           |
|   | 2006               | 2005      | 2006              | 2005      |
| Net earnings available to common stockholders | \$ 23,732          | \$ 24,009 | \$ 69,495         | \$ 975    |
| Weighted-average basic shares outstanding     | 43,314             | 43,120    | 43,285            | 43,147    |
| Effect of dilutive instruments                |                    |           |                   |           |
| Employee stock options                        | 49                 | 88        | 59                | 142       |
| Restricted share units                        | 210                | 508       | 275               | 508       |
| Warrants                                      | 768                | 827       | 791               | 876       |
| Dilutive potential shares                     | 1,027              | 1,423     | 1,125             | 1,526     |
| Weighted-average diluted shares               | 44,341(a)          | 44,543(a) | 44,410(a)         | 44,673(a) |
| Basic EPS                                     | \$ 0.55            | \$ 0.56   | \$ 1.61           | \$ 0.02   |
| Diluted EPS                                   | \$ 0.54            | \$ 0.54   | \$ 1.56           | \$ 0.02   |

(a) For the three months ended September 30, 2006 and 2005, securities of approximately 510 thousand shares and 259 thousand shares, respectively, were excluded from the computation of diluted EPS because the effect was anti-dilutive for the periods presented. For the nine months ended September 30, 2006 and 2005, securities of approximately 611 thousand shares and zero shares, respectively, were excluded from the computation of diluted EPS because the effect was anti-dilutive for the periods presented.

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### 9. Stock Based Compensation

Effective January 1, 2006, the Company adopted SFAS No. 123(R), Share-Based Payment using the modified prospective transition method. SFAS No. 123(R) requires the measurement and recognition of compensation expense for all stock-based payment awards made to employees and directors including employee stock options and other forms of equity compensation based on estimated fair values.

Prior to the adoption of SFAS No. 123(R), the Company used the fair value approach 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. The approach to accounting for share-based payments in SFAS No. 123(R) is similar to the approach described in SFAS 123; therefore, there were no material changes made to our recognition method upon adoption of SFAS No. 123(R). Under the fair value method, stock-based compensation expense had been recognized in our results of operations in prior periods.

Compensation expense is recognized based on the fair value of stock options, performance shares, restricted shares and restricted share units (“RSU”) as determined on the date of grant and is being expensed over the related vesting period. The fair value of the stock options granted is determined using the Black-Scholes option-pricing model. Upon the adoption of SFAS No. 123(R), the Company continues to apply the Black-Scholes option pricing model for determining the estimated fair value for stock awards as it deems it to be the most appropriate model. The use of the Black-Scholes model requires certain estimates for values of variables used in the model, as noted in the table that follows.

The fair value of each option grant is estimated on the date of grant using the Black-Scholes option-pricing model. The weighted average fair value and assumptions used for options granted during the nine months ended September 30, 2006 were:

|  |   |
|--|---|
|  | Nine months<br>ended<br>September 30,<br>2006 |
| Risk free interest rate                | 5.16%   |
| Volatility                             | 33.80%  |
| Expected dividend yield                | 0.00%   |
| Expected option life                   | 7 years                                       |
| Weighted average fair value of options | \$4.02  |

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The following table is a summary of stock option activity as of and for the nine months ended September 30, 2006:

|                                   | September 30, 2006 |                                 |
|-----------------------------------|--------------------|---------------------------------|
|                                   | Number of shares   | Weighted average exercise price |
| Outstanding at December 31, 2005  | 710,860            | \$ 10.43                        |
| Granted                           | 422,122            | \$ 12.46                        |
| Exercised                         | (33,516)           | \$ 9.17                         |
| Forfeited                         | (182,636)          | \$ 12.18                        |
| Outstanding at September 30, 2006 | 916,830            | \$ 11.06                        |
| Exercisable at September 30, 2006 | 264,842            | \$ 9.30                         |

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The following table summarizes the status of the Company's stock options as of September 30, 2006:

|                          | Stock Options Outstanding |  |                                 | Stock Options Exercisable |                                 |
|--------------------------|---------------------------|--|---------------------------------|---------------------------|---------------------------------|
|                          | Number of Shares          | Average Remaining Contractual Life (Years) | Weighted Average Exercise Price | Number of Shares          | Weighted Average Exercise Price |
| Range of Exercise Prices |                           |  |                                 |                           |                                 |
| \$0.00 – \$6.94          | 148,125                   | 6.2  | \$ 6.94                         | 109,843                   | \$ 6.94                         |
| \$6.95 – \$9.76          | 209,999                   | 7.2  | \$ 9.76                         | 98,749                    | \$ 9.76                         |
| \$9.77 – \$13.50         | 558,706                   | 6.0  | \$ 12.64                        | 56,250                    | \$ 13.10                        |
| Total                    | 916,830                   |  | \$ 11.06                        | 264,842                   | \$ 9.30                         |

The Company recorded stock compensation expense of approximately \$2.7 million and \$2.1 million during the nine months ended September 30, 2006 and 2005, respectively. Stock compensation expense is included in compensation and employee benefits in the consolidated statements of operations.

As of September 30, 2006, total unrecognized stock-based compensation expense related to nonvested stock awards was approximately \$6.8 million. This expense is expected to be recognized over a weighted average period of 2.5 years.

10. Comprehensive Income (Loss)

Comprehensive income (loss) for the three and nine months ended September 30, 2006 and 2005 is as follows (in thousands):

|   | Three Months Ended |           | Nine months ended |            |
|---|--------------------|-----------|-------------------|------------|
|   | September 30,      |           | September 30,     |            |
|   | 2006               | 2005      | 2006              | 2005       |
| Net income  | \$ 23,732          | \$ 24,009 | \$ 69,495         | \$ 975     |
| Foreign currency translation adjustments                                  | 46                 | —         | 85                | —          |
| Change in net unrealized gains (losses) on available-for-sale investments | 3,155              | (2,675)   | 987               | (2,670)    |
| Total comprehensive income (loss)   | \$ 26,933          | \$ 21,334 | \$ 70,567         | \$ (1,695) |

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### Item 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following is a discussion and analysis of our financial condition and results of operations. This discussion should be read in conjunction with our consolidated financial statements and accompanying notes which appear in the Company's Annual Report on Form 10-K. It contains forward-looking statements that involve risks and uncertainties. Our actual results could differ materially from those anticipated in these forward-looking statements as a result of various factors, including those discussed below and in the Company's Annual Report on Form 10-K, particularly under Item 1A "Risk Factors" and the heading "Cautionary Note Regarding Forward-Looking Statements." Unless otherwise indicated or the context requires otherwise, references to "we," "us," "our", "company," or "Primus" refer to the consolidated operations of Primus Guaranty, Ltd., or Primus Guaranty and references to a company name refer solely to such company.

#### Business Overview

We, through Primus Financial, one of our principal subsidiaries, are primarily engaged in selling credit swaps against investment grade credit obligations of corporate and sovereign reference entities. Credit swaps are derivative transactions that obligate one party to the transaction (the "Seller") to pay an amount to the other party to the transaction (the "Buyer") should an unrelated third party or portfolio of third parties (the "Reference Entity") specified in the contract incur one of a specified group of events ("Credit Events"). 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 taking the risk of the contract, the Seller will receive a fixed premium for the term of the contract (or until the occurrence of a Credit Event). We seek to minimize the risk inherent in our credit swap portfolio by maintaining a high quality, broadly diversified credit swap portfolio across Reference Entities, industries and countries. Primus Financial also sells credit swaps referencing portfolios containing obligations of multiple reference entities, which we call "tranches". Primus Financial has the highest counterparty credit ratings offered by S&P (AAA) and Moody's (Aaa).

Primus Asset Management, our other principal operating subsidiary, has an experienced team of professionals who have expertise in credit analysis, investing, risk management and market analysis. Primus Asset Management provides credit risk investment advisory and asset management services to Primus Financial and unrelated third parties. For such services, Primus Asset Management receives management fees.

Primus Re operates as a financial guaranty insurance company, and generates revenue by charging a higher insurance premium for protection sold than the premium it pays for the offsetting protection it purchases.

PRS Trading engages in relative value trading and other strategies involving buying and selling of credit swaps and other financial instruments in pursuit of financial returns. These trading strategies generally have a short-term investment horizon and are subject to tight risk controls and liquidity management. PRS Trading commenced operations in January 2006. PRS Trading does not engage in trading activity with Primus Financial. PRS Trading has no rating from the rating agencies and, accordingly generally provides its swap counterparties with collateral to support its contractual obligations. More recently, PRS Trading has entered into total return swaps and a loan warehouse financing arrangement.

#### Net Credit Swap Revenue

Net credit swap revenue in our condensed consolidated statements of operations, comprises the premiums earned and expensed on credit swaps, gains or losses realized as a result of the termination of credit swaps and changes in the fair value of our credit swaps. Net credit swap revenue is earned by

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both Primus Financial and PRS Trading. Although both companies earn net credit swap revenue, the strategies of the two companies are different. Primus Financial generally sells credit swaps in order to earn premium income over the term of the contract, whereas PRS Trading engages in the active buying and selling of credit swaps and generally will only hold positions for a limited portion of the swap's full tenor.

We receive premium income from the credit swaps we sell. In general, premiums are received quarterly in arrears and are accrued daily into income. In accordance with U.S. GAAP, we carry our credit swaps on our condensed consolidated statements of financial condition at their fair value. Changes in the fair value of our credit swap portfolio are included as a component of net credit swap revenue in our condensed consolidated statements of operations. If a credit swap has an increase in fair value during a period, the increase will add to our net credit swap revenue for that period. Conversely, if a credit swap has a decline in fair value during the period, the decline will subtract from our net credit swap revenue for that period. Changes in the fair value of our 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. In our experience, considerable fluctuations may occur in the fair values of credit swaps from period to period and, as a result, the reader of our financial statements should not infer future results from historical net credit swap revenues or losses.

In general, the fair values of individual credit swaps are aggregated by counterparty for presentation in our condensed consolidated statements of financial 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 our condensed consolidated statements of financial 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 on credit swaps, at fair value, in our condensed consolidated statements of financial condition. Aggregation by counterparty is applied where an executed ISDA master agreement is in place with the counterparty. In instances where we do not yet have an executed ISDA master agreement with the counterparty, the fair values of individual swap transactions are recorded as components of unrealized gains or losses on credit swaps, at fair value, dependent upon whether the individual contract was at a gain or a loss. As of September 30, 2006, we had no outstanding credit swaps with any counterparties with whom we had not yet executed ISDA

master agreements.

As a general rule, when Primus Financial sells credit swaps, it is our intention to maintain the transaction until maturity. However, there are two sets of circumstances in which we could elect to terminate transactions prior to maturity, and we monitor our portfolio on a continuing basis to assess whether those circumstances are present.

First, whenever we receive new information suggesting that the credit quality of the underlying risk has deteriorated to a material degree, we consider the possibility of terminating the transaction, usually at a loss, to avoid a larger loss that could result if the credit swap were to remain in place until a credit event occurs. The principal factor that governs our decision regarding termination in these circumstances is whether we believe that the underlying risk has become substantially greater than the level of risk we would choose to assume in entering into a new sale of credit swaps. Since inception, we have terminated due to credit considerations approximately 1.2% of the notional amount of credit swaps sold.

Second, we may elect to terminate a transaction for reasons other than credit considerations. Terminations of this type may generate gains or losses. In making a decision to terminate a transaction for reasons other than credit considerations, we consider a number of different factors, including the absolute amount of the unrealized gain or loss we could realize, the likelihood of additional gains or losses arising from the position, our 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 our portfolio in relation to our capital and the total size of our swap positions and exposures with a particular counterparty. We refer to terminations effected under these circumstances as “resizing” or “rebalancing”. Since inception, we have terminated approximately 10% of credit swaps under which we sold credit swaps based on resizing or rebalancing considerations.

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We may terminate a credit swap in one of two ways. We may negotiate an agreed termination through the original counterparty (an unwind). We may negotiate an assignment and novation of our rights and obligations under the credit swap to a third party (an assignment). As an alternative to terminating a transaction, we may enter into an equal and opposite transaction with a third party under which we purchase credit swaps 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, we pay or receive a cash settlement negotiated with the counterparty or assignee, based on the fair value of the credit swap contract and the accrued premium on the swap contract at the time of negotiation. The amounts we pay or receive are recorded as a realization of fair value and as a realization of accrued premiums in the period in which the termination occurs.

In the past, Primus Financial purchased a limited amount of credit swaps as short-term investments, and incurred the cost of paying premiums until the purchased swaps were terminated. Primus Financial undertook these transactions with the expectation that the market credit swap premium level for the Reference Entity would rise subsequent to our purchase of swaps and that we would be able to terminate the swap at a realized net gain. We did not achieve the results we expected from this strategy and wound down the portfolio to zero during the last quarter of 2005.

PRS Trading both sold and purchased credit swaps during the nine months ended September 30, 2006 pursuant to its predominantly relative value strategy.

## Net Total Return Swap Revenue

During the second quarter of 2006, the Company's subsidiary, PRS Trading entered into a master agreement for total return swap transactions with a counterparty, which expires in May 2008. Under the terms of the agreement, PRS Trading receives interest and other payments based on certain mutually agreed reference loans, and pays a financing interest expense based on the principal amount of such loans. PRS Trading takes the risk that the referenced loans deteriorate in value and conversely receives the benefit from any appreciation in the value of loans referenced in each total return swap. The net fair value of each swap is determined by the net fair value of the referenced loan. PRS Trading determines the fair value of the swaps based on the estimated cost to close-out the swap positions. PRS Trading places with the counterparty, initial margin cash collateral and ongoing mark-to-market cash collateral, which is determined by the fair value of the total return swaps. The total return swap with the counterparty is documented under an ISDA master agreement between PRS Trading and the counterparty. The net fair value of all total return swaps is netted with the fair values of any credit swaps outstanding between PRS Trading and the counterparty for presentation in the condensed consolidated statements of financial condition.

## Deposit and Warehouse Loan Agreements

On July 13, 2006, the Company's subsidiaries, Primus Asset Management and PRS Trading entered into a credit agreement (together with certain other related agreements hereafter referred to as the "warehouse loan agreements") with a major financial institution and a special purpose entity ("CLO"), for the purpose of building a portfolio of loan assets, with the expectation of subsequently issuing securities in the form of a collateralized loan obligation. Primus Asset Management will act as interim collateral manager for the CLO. Under the warehouse loan agreements, the CLO is able to finance the purchase and accumulation of loans to an amount up to \$400 million. In the interim period, while the CLO accumulates the loans and before the securities are issued (the "warehouse period"), the major financial institution is funding the purchase of the loans. PRS Trading and the major financial institution have agreed to share equally in any gains or losses arising from the sale of loans during the warehouse period, although PRS Trading's potential loss is limited to an amount of \$4 million. PRS Trading has deposited \$4 million in cash collateral with a trustee pursuant to this arrangement. PRS Trading and the major financial institution have agreed to share equally in the net interest earned on the loans, after deduction of funding costs.

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Critical Accounting Policies

Valuation of Credit Swaps

From the inception of our business, we have applied Statement of Financial Accounting Standards, or SFAS, 133, Accounting for Derivative Instruments and Hedging Activities, which established accounting and reporting standards for derivative instruments. SFAS 133 requires recognition of all credit swaps on the condensed consolidated statements of financial condition at fair value.

The fair value of the credit swaps depends on a number of factors, primarily the market level of credit swap premiums associated with individual Reference Entities. Credit swaps are valued using market-standard pricing models which calculate the net present value of differences between future premiums on currently quoted market credit swaps and the contractual future credit swap premiums on contracts we have undertaken. Our pricing model has been internally developed but is benchmarked against a market-standard model. Generally, our model uses quoted market credit swap

premium data that we purchase from an independent pricing service. This service takes pricing information from a number of prominent dealers and brokers in the credit swap market across a range of standard maturities and restructuring terms, and creates average mid-market credit swap premium quotes on specific Reference Entities. We adjust the mid-market pricing we receive from the pricing service to reflect an estimate of the cost to close the position.

We believe there are a variety of factors that may influence market credit swap premium levels. The principal factor is the market's view of the probability that a Reference Entity will default over the multi-year horizon typical for a credit swap contract. Those views in turn are influenced by the state of the economy, the outlook for corporate financial health in general as well as the outlook for particular industries and companies. Additional factors include the magnitude of debt outstanding and debt paying capacity within those same industries and companies. One factor specific to the credit swap market is the capacity of credit swap market participants to sell credit swaps. If, for example, commercial banks are actively buying protection to manage their regulatory capital, this will tend, other factors being equal, to absorb the capacity of protection sellers and cause an increase in market credit swap premiums. Conversely, creation of special purpose vehicles that sell protection create additional protection seller capacity and, absent additional demand, can cause a decrease in market premiums. Absent rapid and steep changes, interest rates have, at most, a limited effect on market credit swap premium levels.

#### Stock-Based Employee Compensation Plans

Effective January 1, 2006, the Company adopted SFAS No. 123(R), Share-Based Payment using the modified prospective transition method. SFAS No. 123(R) requires the measurement and recognition of compensation expense for all stock-based payment awards made to employees and directors including employee stock options and other forms of equity compensation based on estimated fair values.

Prior to the adoption of SFAS No. 123(R), the Company used the fair value approach 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. The approach to accounting for share-based payments in SFAS No. 123(R) is similar to the approach described in SFAS 123, therefore, there were no material changes made to our recognition method upon adoption of SFAS No. 123(R). Under the fair value method, stock-based compensation expense had been recognized in our results of operations in prior periods.

Compensation expense is recognized based on the fair value of stock options, performance shares, restricted shares and restricted share units ("RSU") as determined on the date of grant and is being expensed over the related vesting period. The fair value of the stock options granted is determined using the Black-Scholes option-pricing model. Upon the adoption of SFAS No. 123(R), the Company

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continues to apply the Black-Scholes option pricing model for determining the estimated fair value for stock awards as it deems it to be the most appropriate model. The use of the Black-Scholes model requires certain estimates for values of variables used in the model.

#### Results of Operations



Three months ended September 30, 2006 compared with three months ended September 30, 2005

#### Overview

Our net income for the three months ended September 30, 2006 was \$23.7 million compared with \$24.0 million for the three months ended September 30, 2005. Net credit swap revenues were \$28.9 million in the third quarter of 2006, compared with \$27.4 million in the third quarter of 2005. The improvement in net credit swap revenues were primarily the result of an increase in net credit swap premiums partly offset by lower unrealized gains on our portfolio of credit swaps sold in the third quarter of 2006, compared with the third quarter of 2005.

Interest income on our portfolio of investments was \$7.1 million in the third quarter of 2006, compared with \$4.5 million in the third quarter of 2005. The increase is due to higher market interest rates, together with increased invested balances, mainly arising from the investment of the proceeds of the \$125.0 million debt issuance by Primus Financial in December 2005.

Interest expense and distributions on preferred stock issued by Primus Financial were \$4.3 million in the third quarter of 2006, compared with \$1.7 million in the third quarter of 2005. The increase is due to higher market interest rates in 2006, together with the interest expense associated with the \$125.0 million debt issuance in December 2005.

Our operating expenses were \$9.1 million in the third quarter of 2006, compared with \$6.4 million in the third quarter of 2005, primarily due to higher compensation and employee benefits as a result of increased headcount and higher professional fees, including employee recruiting costs. Included in the third quarter of 2006, was a credit of approximately \$500 thousand related to a reduction in stock compensation expense as a result of employee departures.

#### Consolidated Net Credit Swap Revenue

Consolidated net credit swap revenue was \$28.9 million and \$27.4 million for the three months ended September 30, 2006 and 2005, respectively. Net credit swap revenue for Primus Financial excludes \$72 thousand of net revenue earned on three credit swap transactions with its affiliate, Primus Re, as this amount is eliminated in consolidation.

The table below shows the Company's consolidated net credit swap revenues, which are generated by Primus Financial and PRS Trading for the three months ended September 30, 2006 and 2005 (in thousands):

|  | Three months ended |           |
|--|--------------------|-----------|
|  | September 30,      |           |
|  | 2006               | 2005      |
| Primus Financial                           | \$ 29,366          | \$ 27,449 |
| PRS Trading                                | (461)              | —         |
| Total consolidated net credit swap revenue | \$ 28,905          | \$ 27,449 |

Net credit swap revenues are discussed separately below for Primus Financial and PRS Trading.

## Net Credit Swap Revenue – Primus Financial

Net credit swap revenue was \$29.4 million and \$27.4 million for the three months ended September 30, 2006 and 2005, respectively.

Net credit swap revenue includes:

- Net premiums earned;
- Net realized gains (losses) on credit swaps; and
- Net unrealized gains (losses) on credit swaps.

The table below shows the components of net credit swap revenue for the three months ended September 30, 2006 and 2005 (in thousands):

|                                      | Three months ended<br>September 30, |           |
|--------------------------------------|-------------------------------------|-----------|
|                                      | 2006                                | 2005      |
| Net premiums earned                  | \$ 18,129                           | \$ 13,962 |
| Net realized losses on credit swaps  | (1,539)                             | (1,248)   |
| Net unrealized gains on credit swaps | 12,776                              | 14,735    |
| Total net credit swap revenue        | \$ 29,366                           | \$ 27,449 |

## Net Premiums Earned – Primus Financial

Net premiums earned were \$18.1 million and \$14.0 million for the three months ended September 30, 2006 and 2005, respectively. Net premiums earned include:

- Premium income on credit swaps sold;
- Premium income on tranches sold;
- Premium expense on credit swaps purchased as short-term investments; and
- Premium expense on credit swaps purchased to offset credit risk on certain credit swaps sold.

The table below shows the components of net premiums earned for the three months ended September 30, 2006 and 2005 (in thousands):

|   | Three months ended<br>September 30, |           |
|---|-------------------------------------|-----------|
|   | 2006                                | 2005      |
| Premium income on credit swaps sold   | \$ 17,175                           | \$ 14,177 |
| Premium income on tranches sold   | 954                                 | 114       |
| Premium expense on credit swaps purchased as short-term investments                   | —                                   | (308)     |
| Premium expense on credit swaps purchased to offset credit risk on certain swaps sold | —                                   | (21)      |
| Total net premiums earned   | \$ 18,129                           | \$ 13,962 |

Premium income on credit swaps sold was \$17.2 million and \$14.2 million during the three months ended September 30, 2006 and 2005, respectively. The increase was primarily as a result of the expansion in our credit swap portfolio. The average notional amounts outstanding of credit swaps sold were \$15.2 billion and \$13.0 billion for the three

months ended September 30, 2006 and 2005, respectively.

We began to sell credit swaps in tranche format during the second quarter of 2005, whereby we sell credit swaps referencing portfolios containing obligations of multiple reference entities. Premium income from the tranches sold was \$954 thousand and \$114 thousand for the three months ended September 30, 2006 and 2005, respectively. The average notional amount outstanding was \$350.0 million and \$50.0 million for the three months ended September 30, 2006 and 2005, respectively.

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The portfolio of credit swaps purchased for short-term investment purposes was wound down to zero during 2005 and there was no premium expense for swaps of this type in 2006.

#### Net Realized Gains (Losses) on Credit Swaps – Primus Financial

Net realized gains (losses) for the three months ended September 30, 2006 and 2005 are summarized below (in thousands):

|  | Three months ended<br>September 30, |            |
|--|-------------------------------------|------------|
|  | 2006                                | 2005       |
| Realized gains on terminated credit swaps sold   | \$ 12                               | \$ 201     |
| Realized losses on terminated credit swaps sold  | (1,551)                             | (1,264)    |
| Realized gains on terminated credit swaps purchased as short-term investments                    | —                                   | 15         |
| Realized losses on terminated credit swaps purchased as short-term investments                   | —                                   | (26)       |
| Realized losses on terminated credit swaps purchased to offset credit risk on certain swaps sold | —                                   | (174)      |
| Total net realized losses on credit swaps  | \$ (1,539)                          | \$ (1,248) |

We terminated \$134.4 million and \$106.2 million notional amount of credit swaps sold during the three months ended September 30, 2006 and 2005, respectively. We received \$12 thousand and \$201 thousand from the early termination of swaps at a realized gain during the three months ended September 30, 2006 and 2005, respectively, due to portfolio rebalancing. We incurred realized losses of \$1.6 million and \$1.3 million during the three months ended September 30, 2006 and 2005, respectively, due to the early termination of swaps in order to mitigate credit risk.

During the third quarter of 2005, we terminated our position where we had purchased credit swaps to offset credit risk on certain swaps sold and we realized a loss of \$174 thousand.

#### Net Unrealized Gains (Losses) on Credit Swaps – Primus Financial

The unrealized gains (losses) on credit swaps sold and credit swaps purchased as short-term investments and for credit risk offset purposes for the three months ended September 30, 2006 and 2005 are summarized below (in thousands):

|   | Three months ended<br>September 30, |           |
|---|-------------------------------------|-----------|
|   | 2006                                | 2005      |
| Net unrealized gains on credit swaps sold   | \$ 12,776                           | \$ 15,047 |
| Net unrealized losses on credit swaps purchased as short-term investments                         | —                                   | (455)     |
| Net unrealized gains on credit swaps purchased to offset credit risk on certain credit swaps sold | —                                   | 143       |
| Total net unrealized gains on credit swaps  | \$ 12,776                           | \$ 14,735 |

Net unrealized gains on Primus Financial's credit swaps were \$12.8 million and \$14.7 million for the three months ended September 30, 2006 and 2005, respectively. The change in unrealized gains on credit swaps reflects the change in the fair value of our credit swap portfolio during these periods. The smaller unrealized gain on credit swaps for the three months ended September 30, 2006 is primarily due to smaller decreases in market credit swap premium levels compared to the comparable prior period.

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### PRS Trading Activity

During the three months ended September 30, 2006, PRS Trading recorded net trading losses of \$72 thousand; which comprised of net credit swap losses of \$461 thousand, net total return swap revenue of \$313 thousand and net warehouse loan revenue of \$76 thousand. See below for a more detailed discussion.

### Net Credit Swap Revenue – PRS Trading

PRS Trading commenced operations in January 2006 and therefore prior year comparison information is not available. In the third quarter of 2006, PRS Trading sold new credit swaps in notional principal of \$113.4 million and purchased new credit swaps in notional principal of \$84.2 million. Net credit swap revenue (loss) for PRS Trading was (\$461) thousand for the three months ended September 30, 2006. Net credit swap revenue includes:

- Net premium income (expense);
- Net realized gains (losses) on credit swaps; and
- Net unrealized gains (losses) on credit swaps.

The table below shows the components of net credit swap revenue (loss) for the three months ended September 30, 2006 (in thousands):

|                     | Three months<br>ended<br>September 30,<br>2006 |
|---------------------|--|
| Net premium expense | \$ (94)  |

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|                                       |          |
|---------------------------------------|----------|
| Net realized losses on credit swaps   | (288)    |
| Net unrealized losses on credit swaps | (79)     |
| Total net credit swap revenue (loss)  | \$ (461) |

Net Premium Income (Expense) – PRS Trading

Net premium expense was \$(94) thousand for the three months ended September 30, 2006. Net premiums include premiums on credit swaps sold and purchased. The table below shows the components of net premiums by PRS Trading for the three months ended September 30, 2006 (in thousands):

|   |  |
|---|--|
|   | Three months<br>ended<br>September 30,<br>2006 |
| Premium income on credit swaps sold       | \$ 214   |
| Premium expense on credit swaps purchased | (308)  |
| Total net premium expense                 | \$ (94)  |

Net Realized Gains (Losses) on Credit Swaps – PRS Trading

Net realized gains (losses) for the three months ended September 30, 2006 are summarized below (in thousands):

|  |  |
|--|--|
|  | Three months<br>ended<br>September 30,<br>2006 |
| Net realized losses on terminated credit swaps sold      | \$ (229)                                       |
| Net realized losses on terminated credit swaps purchased | (59)   |
| Total net realized losses on credit swaps                | \$ (288)                                       |

We terminated \$54.2 million notional amount of credit swaps sold during the three months ended September 30, 2006, resulting in net realized losses of \$229 thousand. We terminated \$34.5 million notional amount of credit swaps purchased during the three months ended September 30, 2006, resulting in net realized losses of \$59 thousand.

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Net Unrealized Gains (Losses) on Credit Swaps – PRS Trading

The unrealized gains and losses on credit swaps sold and purchased for the three months ended September 30, 2006 are summarized below:

|   | Three months<br>ended<br>September 30,<br>2006 |
|---|--|
| Net unrealized gains on credit swaps sold       | \$ 419   |
| Net unrealized losses on credit swaps purchased | (498)  |
| Net unrealized losses on credit swaps           | \$ (79)  |

Net unrealized losses on PRS Trading credit swaps were \$79 thousand for the three months ended September 30, 2006. The change in unrealized losses on credit swaps reflects the change in the fair value of our credit swap portfolio during the period. The fair value of the portfolio reflects the mid-market value with an adjustment for the estimated cost to close the position.

#### Net Total Return Swap Revenue – PRS Trading

As previously discussed, we entered into a master agreement for total return swap transactions with a counterparty in the second quarter of 2006. The total return swap is based on the returns on certain mutually agreed reference loans.

Net total return swap revenue, as presented in the condensed consolidated statements of operations, comprises changes in the fair value of total return swaps, realized gains or losses on the termination of total return swaps and the net interest earned on the total return swaps.

During the three months ended September 30, 2006, net total return swap revenue was \$313 thousand. PRS Trading earned net interest of \$253 thousand, realized a gain of \$267 thousand on the termination of total return swaps and recorded a net unrealized loss of \$207 thousand under the total return swaps.

#### Net Warehouse Loan Revenue – PRS Trading

As previously discussed, on July 13, 2006, we entered into warehouse loan agreements with a major financial institution.

Net warehouse loan revenue, as presented in the condensed consolidated statements of operations, comprises of PRS Trading's share under the derivative transaction of net realized losses on the termination of individual loan positions and the net interest earned on the warehouse loans. During the three months ended September 30, 2006, net warehouse loan revenue was \$76 thousand.

#### Asset Management and Advisory Fees

We recognized \$542 thousand and \$49 thousand of asset management and advisory fees for the three months ended September 30, 2006 and 2005, respectively. During the third quarter of 2006, on behalf of an outside third party, we received an advisory fee of \$400 thousand for the arrangement of a credit swap tranche transaction. Some of our asset management contracts also provide for the receipt of contingent performance fees at maturity, none of which has been earned or accrued at September 30, 2006 or 2005, respectively.

#### Interest Income

We earned interest income of \$7.1 million and \$4.5 million for the three months ended September 30, 2006 and 2005, respectively. The increase in interest income is attributable to higher average invested balances resulting from the December 2005 issuance of \$125.0 million of subordinated debt by Primus Financial and retained cash earnings, together with higher yields on our investment portfolio. The increase in yields is attributable to generally increasing market rates of interest during 2005 and 2006.

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Weighted average yields on the cash equivalents and available-for-sale investments were 4.40% in the three months ended September 30, 2006 compared with 3.64% for the three months ended September 30, 2005.

The table below summarizes our interest income for the three months ended September 30, 2006 and 2005 and our total cash, cash equivalents and available-for-sale and trading investments at September 30, 2006 and 2005, respectively (in thousands):

|   | Three months ended |            |
|---|--------------------|------------|
|   | September 30,      |            |
|   | 2006               | 2005       |
| Interest income   | \$ 7,143           | \$ 4,483   |
| Cash and cash equivalents   | \$ 58,701          | \$ 80,951  |
| Available-for-sale and trading investments                                  | 601,189            | 416,597    |
| Total cash, cash equivalents and available-for-sale and trading investments | \$ 659,890         | \$ 497,548 |

## Foreign Currency Revaluation

We transact credit swaps denominated in U.S. dollars and euros. Euro-denominated credit swaps comprised 28% of the notional amount of our Primus Financial credit swaps sold portfolio at September 30, 2006. Until the fourth quarter of 2005, net premiums received from swaps denominated in euros were retained in euros. We now sell the majority of our euro premium receipts as they are received for U.S. dollars, retaining only a small working cash balance in euros. We recorded a currency revaluation loss of \$32 thousand and a currency revaluation gain of \$55 thousand on our holdings of euros, during the three months ended September 30, 2006 and 2005, respectively.

## Operating Expenses

Our operating expenses were \$9.1 million and \$6.4 million for the three months ending September 30, 2006 and 2005, respectively, as summarized below (in thousands):

|   | Three months ended |          |
|---|--------------------|----------|
|   | September 30,      |          |
|   | 2006               | 2005     |
| Compensation and employee benefits              | \$ 5,023           | \$ 3,537 |
| Professional and legal fees                     | 1,361              | 981      |
| Depreciation and amortization                   | 649                | 533      |
| Technology and data                             | 726                | 535      |
| Other   | 1,302              | 805      |
| Total operating expenses                        | \$ 9,061           | \$ 6,391 |
| Number of full-time employees, at end of period | 46                 | 33       |

Compensation expense for the three months ended September 30, 2006 increased approximately \$1.5 million over the comparable prior period. This increase was primarily the result of an increase in headcount as we expand our business operations and higher performance based incentives. Included in the third quarter of 2006, was a credit of approximately \$500 thousand related to a reduction in stock compensation expense as a result of employee departures. Our accrued cash incentive compensation expense was \$2.1 million in the third quarter of 2006, compared with an accrued expense of \$1.3 million for the third quarter of 2005. Stock compensation expense was approximately \$0.6 million for both the three months ended September 30, 2006 and 2005, respectively.

Professional and legal fees expense includes audit and tax advisor expenses, legal costs, employee recruiting costs and director and officer insurance expense. The increase in professional fees is primarily related to higher employee recruiting costs associated with the increase in headcount in the

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third quarter of 2006. Depreciation and amortization principally relate to the depreciation of our computer equipment and furniture and fixtures, and the amortization of our internally developed software. The increase in depreciation and amortization expense is due to the increase in purchases of fixed assets and higher capitalized software costs. The increase in technology and data expense was primarily attributable to the expansion of our technology platform to accommodate new trading strategies associated with our asset management build out. Other operating expenses include rent, bank fees, rating agency fees, brokerage expense, travel and entertainment, exchange fees and other administrative expenses. The increase in other expenses was primarily due to higher travel related costs and occupancy expenses associated with the additional office space in New York and in London.

### Interest Expense and Preferred Distributions

For the three months ended September 30, 2006 and 2005, we incurred \$2.8 million and \$649 thousand of interest expense, respectively. The interest expense was incurred on the \$75.0 million 30-year subordinated debt and the \$125.0 million of 15.5 year subordinated deferrable interest notes that were issued by Primus Financial in July 2004 and December 2005, respectively. The interest rate for the 30-year subordinated debt averaged 5.47% and 2.57% for the three months ended September 30, 2006 and 2005, respectively.

On December 19, 2005, Primus Financial issued \$125.0 million of subordinated deferrable interest notes, which mature in June 2021. The average interest rate on these notes was 5.59% for the three months ended September 30, 2006.

Primus Financial also made net distributions of \$1.4 million and \$1.0 million during the three months ended September 30, 2006 and 2005, respectively, on the Primus Financial Cumulative Preferred Stock issued in December 2002. The average rate on these securities was 6.10% and 4.29% during the three months ended September 30, 2006 and 2005, respectively.

### Income Taxes

Provision (benefit) for income taxes was \$(14) thousand and \$63 thousand for the three months ended September 30, 2006 and 2005, respectively. Primus Guaranty had a net deferred tax asset, fully offset by a valuation allowance, of \$5.6 million and \$4.8 million as of September 30, 2006 and December 31, 2005, respectively. The change in the



deferred tax asset and valuation allowance resulted primarily from Primus Asset Management's estimated net operating loss. It is expected that only the income of Primus Asset Management and its subsidiary, Primus Re, are likely to be subject to United States federal and local income taxes. However, were Primus Bermuda to be subject to income tax, at a combined United States federal, New York State and New York City income tax rate of 46%, on its United States GAAP income, then its income tax expense (excluding interest and penalties) would have been approximately \$12.4 million and \$10.5 million for the three months ended September 30, 2006 and 2005, respectively. These figures assume that Primus Financial is not deemed to be making distributions to Primus Bermuda; such distributions would subject Primus Bermuda to an additional United States federal branch profits tax.

Nine months ended September 30, 2006 compared with nine months ended September 30, 2005

#### Overview

On a U.S. GAAP basis, we reported net income of \$69.5 million and \$975 thousand for the nine months ended September 30, 2006 and 2005, respectively. The increase in net income was primarily due to the mark-to-market unrealized gains on credit swaps from the portfolio of credit swaps sold by Primus Financial in the 2006 period, compared with unrealized losses in the portfolio in the corresponding period of 2005.

#### Consolidated Net Credit Swap Revenue

Consolidated net credit swap revenue was \$85.9 million and \$15.7 million for the nine months ended September 30, 2006 and 2005, respectively. Net credit swap revenue for Primus Financial

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excludes \$233 thousand of net revenue earned on three credit swap transactions with its affiliate, Primus Re, as this amount is eliminated in consolidation.

The table below shows the Company's consolidated net credit swap revenues, which are generated by Primus Financial and PRS Trading for the nine months ended September 30, 2006 and 2005 (in thousands):

|  | Nine months ended<br>September 30, |           |
|--|------------------------------------|-----------|
|  | 2006                               | 2005      |
| Primus Financial                           | \$ 86,587                          | \$ 15,672 |
| PRS Trading                                | (722)                              | —         |
| Total consolidated net credit swap revenue | \$ 85,865                          | \$ 15,672 |

Net credit swap revenues are discussed separately below for Primus Financial and PRS Trading.

#### Net credit swap revenue – Primus Financial

Net credit swap revenue was \$86.6 million and \$15.7 million for the nine months ended September 30, 2006 and 2005, respectively.

Net credit swap revenue includes:

- Net premiums earned;
- Net realized gains (losses) on credit swaps; and
- Net unrealized gains (losses) on credit swaps.

The table below shows the components of net credit swap revenue for the nine months ended September 30, 2006 and 2005 (in thousands):

|   | Nine months ended<br>September 30, |           |
|---|------------------------------------|-----------|
|   | 2006                               | 2005      |
| Net premiums earned                           | \$ 51,143                          | \$ 37,561 |
| Net realized losses on credit swaps           | (1,922)                            | (3,052)   |
| Net unrealized gains (losses) on credit swaps | 37,366                             | (18,837)  |
| Total net credit swap revenue                 | \$ 86,587                          | \$ 15,672 |

The components of net credit swap revenue are discussed further below:

#### Net Premiums Earned – Primus Financial

Net premiums earned were \$51.1 million and \$37.6 million for the nine months ended September 30, 2006 and 2005, respectively. Net premiums earned include:

- Premium income on credit swaps sold;
- Premium income on tranches sold;
- Premium expense on credit swaps purchased as short-term investments; and
- Premium expense on credit swaps purchased to offset credit risk on certain credit swaps sold.

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The table below shows the components of net premiums earned for the nine months ended September 30, 2006 and 2005 (in thousands):

|   | Nine months ended<br>September 30, |           |
|---|------------------------------------|-----------|
|   | 2006                               | 2005      |
| Premium income on credit swaps sold   | \$ 49,529                          | \$ 38,458 |
| Premium income on tranches sold   | 1,614                              | 210       |
| Premium expense on credit swaps purchased as short-term investments                   | —                                  | (1,040)   |
| Premium expense on credit swaps purchased to offset credit risk on certain swaps sold | —                                  | (67)      |

|                           |           |           |
|---------------------------|-----------|-----------|
| Total net premiums earned | \$ 51,143 | \$ 37,561 |
|---------------------------|-----------|-----------|

Premium income on credit swaps sold was \$49.5 million and \$38.5 million during the nine months ended September 30, 2006 and 2005, respectively. The increase was primarily as a result of the expansion in our credit swap portfolio. The average notional amounts outstanding of credit swaps sold were \$14.8 billion and \$11.8 billion for the nine months ended September 30, 2006 and 2005, respectively.

We began to sell credit swaps in tranche format during the second quarter of 2005, whereby we sell credit swaps referencing portfolios containing obligations of multiple reference entities. Premium income from the tranches sold was \$1.6 million and \$210 thousand for the nine months ended September 30, 2006. The average notional amount outstanding was \$233.3 million and \$33.3 million for the nine months ended September 30, 2006 and 2005, respectively.

The portfolio of credit swaps purchased for short-term investment purposes was wound down to zero during 2005 and there was no premium expense for swaps of this type in 2006.

#### Net Realized Gains (Losses) on Credit Swaps – Primus Financial

Net realized gains (losses) for the nine months ended September 30, 2006 and 2005 are summarized below (in thousands):

|  | Nine months ended<br>September 30, |            |
|--|------------------------------------|------------|
|  | 2006                               | 2005       |
| Realized gains on terminated credit swaps sold   | \$ 625                             | \$ 790     |
| Realized losses on terminated credit swaps sold  | (2,547)                            | (4,283)    |
| Realized gains on terminated credit swaps purchased as short-term investments                    | —                                  | 671        |
| Realized losses on terminated credit swaps purchased as short-term investments                   | —                                  | (56)       |
| Realized losses on terminated credit swaps purchased to offset credit risk on certain swaps sold | —                                  | (174)      |
| Total net realized losses on credit swaps  | \$ (1,922)                         | \$ (3,052) |

Net realized losses on the early termination of credit swaps sold were \$1.9 million and \$3.1 million for the nine months ended September 30, 2006 and 2005, respectively. We terminated \$271.9 million and \$356.3 million notional amount of credit swaps sold during the nine months ended September 30, 2006 and 2005, respectively. We received \$625 thousand and \$790 thousand from the early termination of swaps at a realized gain during the nine months ended September 30, 2006 and 2005, respectively. We incurred realized losses of \$2.5 million during the nine months ended September 30, 2006 from the early termination of swaps in order to mitigate credit risk. We incurred \$4.3 million of realized losses which was due to the mitigation of our credit risk during the nine months ended September 30, 2005.

We terminated \$123.0 million notional amount of credit swaps purchased during the nine months ended September 30, 2005 resulting in a net realized gain of \$615 thousand. During the course of 2005 we wound down our portfolio of credit swaps purchased and, as a consequence, there were no realized gains or losses on this portfolio in 2006.

During the third quarter of 2005, we terminated our position where we had purchased credit swaps to offset credit risk on certain swaps sold and we realized a loss of \$174 thousand.

#### Net Unrealized Gains (Losses) on Credit Swaps – Primus Financial

The unrealized gains (losses) on credit swaps sold and credit swaps purchased as short-term investments and for credit risk offset purposes for the nine months ended September 30, 2006 and 2005 are summarized below (in thousands):

|   | Nine months ended<br>September 30, |             |
|---|------------------------------------|-------------|
|   | 2006                               | 2005        |
| Net unrealized gains (losses) on credit swaps sold  | \$ 37,366                          | \$ (19,214) |
| Net unrealized gains on credit swaps purchased as short-term investments                          | —                                  | 171         |
| Net unrealized gains on credit swaps purchased to offset credit risk on certain credit swaps sold | —                                  | 206         |
| Total net unrealized gains (losses) on credit swaps   | \$ 37,366                          | \$ (18,837) |

Net unrealized gains (losses) on Primus Financial's credit swaps were \$37.4 million and \$(18.8) million for the nine months ended September 30, 2006 and 2005, respectively. The change in unrealized gains (losses) on credit swaps reflects the change in the fair value of our credit swap portfolio during these periods. The gain during the first nine months of 2006 on credit swaps sold is primarily attributable to the increase in the fair value of the portfolio as market premiums fell during that period. Market premium levels at September 30, 2005 were higher than those prevailing at December 31, 2004, which resulted in the unrealized loss in the nine months ended September 30, 2005.

#### PRS Trading Activity

During the nine months ended September 30, 2006, PRS Trading recorded net trading losses of \$209 thousand; which comprised of net credit swap losses of \$722 thousand, net total return swap revenue of \$437 thousand and net warehouse loan revenue of \$76 thousand. See below for a more detailed discussion.

#### Net Credit Swap Revenue – PRS Trading

PRS Trading commenced operations in January 2006 and therefore prior year comparison information is not available. During the first nine months of 2006, PRS Trading sold new credit swaps in notional principal of \$291.4 million of and purchased new credit swaps in notional principal of \$288.7 million. Net credit swap revenue (loss) for PRS Trading was \$(722) thousand for the nine months ended September 30, 2006. Net credit swap revenue (loss) includes:

- Net premium income (expense);
- Net realized gains (losses) on credit swaps; and
- Net unrealized gains (losses) on credit swaps.

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The table below shows the components of net credit swap revenue (loss) for the nine months ended September 30, 2006 (in thousands):

|                                       | Nine months<br>ended<br>September 30,<br>2006 |
|---------------------------------------|---|
| Net premium expense                   | \$ (62)                                       |
| Net realized losses on credit swaps   | (176)   |
| Net unrealized losses on credit swaps | (484)   |
| Total net credit swap revenue (loss)  | \$ (722)                                      |

## Net Premiums Earned – PRS Trading

Net premium expense was \$62 thousand for the nine months ended September 30, 2006. Net premiums include premiums on credit swaps sold and purchased. The table below shows the components of net premiums by PRS Trading for the nine months ended September 30, 2006 (in thousands):

|   | Nine months<br>ended<br>September 30,<br>2006 |
|---|---|
| Premium income on credit swaps sold       | \$ 449  |
| Premium expense on credit swaps purchased | (511)   |
| Total net premium expense                 | \$ (62)                                       |

## Net Realized Gains (Losses) on Credit Swaps – PRS Trading

Net realized gains (losses) for the nine months ended September 30, 2006 are summarized below (in thousands):

|  | Nine months<br>ended<br>September 30,<br>2006 |
|--|---|
| Net realized losses on terminated credit swaps sold      | \$ (170)                                      |
| Net realized losses on terminated credit swaps purchased | (15)  |
| Realized gains on credit swap index                      | 9   |
| Total net realized losses on credit swaps                | \$ (176)                                      |

We terminated \$103.7 million notional amount of credit swaps sold during the nine months ended September 30, 2006, resulting in net realized losses of \$170 thousand. We terminated \$86.5 million notional amount of credit swaps purchased during the nine months ended September 30, 2006, resulting in net realized losses of \$15 thousand.

Net Unrealized Gains (Losses) on Credit Swaps – PRS Trading

The unrealized gains and losses on credit swaps sold and purchased for the nine months ended September 30, 2006 are summarized below:

|   | Nine months<br>ended<br>September 30,<br>2006 |
|---|---|
| Net unrealized gains on credit swaps sold       | \$ 185  |
| Net unrealized losses on credit swaps purchased | (669)   |
| Net unrealized losses on credit swaps           | \$ (484)                                      |

Net unrealized losses on PRS Trading credit swaps were \$484 thousand for the nine months ended September 30, 2006. The change in unrealized losses on credit swaps reflects the change in the fair value of our credit swap portfolio during the period. The fair value of the portfolio reflects the mid-market value with an adjustment for the estimated cost to close the position.

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Net Total Return Swap Revenue – PRS Trading

As previously discussed, we entered into a master agreement for total return swap transactions with a counterparty in the second quarter of 2006. The total return swap is based on the returns on certain mutually agreed reference loans.

Net total return swap revenue, as presented in the condensed consolidated statements of operations, comprises changes in the fair value of total return swap, realized gains or losses on the termination of total return swaps and the net interest earned on the total return swaps.

During the nine months ended September 30, 2006, net total return swap revenue was \$437 thousand. PRS Trading earned net interest of \$283 thousand, realized a gain of \$277 thousand on the termination of total return swaps and recorded a net unrealized loss of \$123 thousand under the total return swap.

Net Warehouse Loan Revenue – PRS Trading

As previously discussed, on July 13, 2006, we entered into warehouse loan agreements with a major financial institution.

Net warehouse loan revenue, as presented in the condensed consolidated statements of operations, comprises of PRS Trading's share under the derivative transaction of net realized losses on the termination of individual loan positions and the net interest earned on the warehouse loans. During the nine months ended September 30, 2006, net warehouse loan revenue was \$76 thousand.

Asset Management and Advisory Fees

During the second quarter of 2006, we closed on our third credit swap asset management transaction, in which we manage a portfolio of credit swaps on behalf of third parties in exchange for management fees. We recognized \$709 thousand and \$140 thousand of asset management and advisory fees for the nine months ended September 30, 2006 and 2005, respectively. During the third quarter of 2006, on behalf of an outside third party, we received an advisory fee of \$400 thousand for the arrangement of a credit swap tranche transaction. Some of our asset management contracts also provide for the receipt of contingent performance fees at maturity, none of which has been earned or accrued at September 30, 2006 or 2005, respectively.

### Interest Income

We earned interest income of \$20.5 million and \$11.0 million for the nine months ended September 30, 2006 and 2005, respectively. The increase in interest income is attributable to higher average invested balances resulting from the December 2005 issuance of \$125.0 million of subordinated debt by Primus Financial and retained cash earnings, together with higher yields on our investment portfolio. The increase in yields is attributable to generally increasing market rates of interest during 2005 and 2006.

Weighted average yields on the cash equivalents and available-for-sale investments were 4.29% during the nine months ended September 30, 2006 compared with 2.99% for the nine months ended September 30, 2005.

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The table below summarizes our interest income for the nine months ended September 30, 2006 and 2005 and our total cash, cash equivalents and available-for-sale and trading investments at September 30, 2006 and 2005, respectively (in thousands):

|   | Nine months ended<br>September 30, |            |
|---|------------------------------------|------------|
|   | 2006                               | 2005       |
| Interest income   | \$ 20,530                          | \$ 10,969  |
| Cash and cash equivalents   | \$ 58,701                          | \$ 80,951  |
| Available-for-sale and trading investments                                  | 601,189                            | 416,597    |
| Total cash, cash equivalents and available-for-sale and trading investments | \$ 659,890                         | \$ 497,548 |

### Foreign Currency Revaluation

We transact credit swaps denominated in U.S. dollars and euros. Euro-denominated credit swaps comprised 28% of the notional amount of our Primus Financial credit swaps sold portfolio at September 30, 2006. Until the fourth quarter of 2005, net premiums received from swaps denominated in euros were retained in euros. We now sell the majority of our euro premium receipts as they are received for U.S. dollars, retaining only a small working cash balance in euros. During the nine months ended September 30, 2005, the euro lost value against the U.S. dollar resulting in currency revaluation losses of \$1.5 million on our holdings of euro compared to a revaluation loss of \$56 thousand, on significantly reduced holdings of euros, for the nine months ended September 30, 2006.

## Operating Expenses

Our operating expenses were \$26.2 million and \$20.1 million for the nine months ending September 30, 2006 and 2005, respectively, as summarized below (in thousands):

|   | Nine months ended<br>September 30, |           |
|---|------------------------------------|-----------|
|   | 2006                               | 2005      |
| Compensation and employee benefits              | \$ 15,517                          | \$ 12,139 |
| Professional and legal fees                     | 3,645                              | 2,731     |
| Depreciation and amortization                   | 1,846                              | 1,574     |
| Technology and data                             | 1,546                              | 1,250     |
| Other   | 3,632                              | 2,423     |
| Total operating expenses                        | \$ 26,186                          | \$ 20,117 |
| Number of full-time employees, at end of period | 46                                 | 33        |

Compensation expense for the nine months ended September 30, 2006 increased \$3.4 million over the comparable prior period. Included in the nine months ended September 30, 2006, was a credit of approximately \$500 thousand related to a reduction in stock compensation expense as a result of employee departures. Compensation expense for the nine months ended September 30, 2005 included approximately \$800 thousand related to the accelerated compensation expenses and accelerated vesting of stock related to the departure of former employees. This increase was primarily the result of an increase in headcount as we expand our business operations and higher performance based incentives. Our accrued cash incentive compensation expense was \$6.0 million for the nine months ended September 30, 2006, compared with an accrued expense of \$3.9 million in the corresponding period of 2005. Stock compensation expense was approximately \$2.7 million and \$2.1 million for the nine months ended September 30, 2006 and 2005, respectively.

The increase in professional fees is primarily related to increased provisions for legal and audit fees and employee recruiting costs. The increase in depreciation and amortization expense is due to the increase in purchases of fixed assets and higher capitalized software costs. The increase in

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technology and data expense was primarily attributable to the expansion of our technology platform to accommodate new trading strategies associated with our asset management build out. The increase in other expenses was primarily due to travel related costs and occupancy expenses associated with the additional office space in New York and London.

## Interest Expense and Preferred Distributions

For the nine months ended September 30, 2006 and 2005, we incurred \$7.9 million and \$1.6 million of interest expense, respectively. The interest expense was incurred on the \$75.0 million 30-year subordinated debt and the \$125.0 million of 15.5 year subordinated deferrable interest notes that were issued by Primus Financial in July 2004 and December 2005, respectively. The interest rate for the 30-year subordinated debt averaged 5.00% and 2.57% for



the nine months ended September 30, 2006 and 2005, respectively.

On December 19, 2005, Primus Financial issued \$125.0 million of subordinated deferrable interest notes, which mature in June 2021. The average interest rate on these notes was 5.35% during the nine months ended September 30, 2006.

Primus Financial also made net distributions of \$4.2 million and \$2.8 million during the nine months ended September 30, 2006 and 2005, respectively, on the Primus Financial Cumulative Preferred Stock issued in December 2002. The average rate on these securities was 5.60% and 3.77% during the nine months ended September 30, 2006 and 2005, respectively.

#### Income Taxes

Provision for income taxes was \$41 thousand and \$108 thousand for the nine months ended September 30, 2006 and 2005, respectively. Primus Guaranty had a net deferred tax asset, fully offset by a valuation allowance, of \$5.6 million and \$4.8 million as of September 30, 2006 and December 31, 2005, respectively. The change in the deferred tax asset and valuation allowance resulted primarily from Primus Asset Management's estimated net operating loss. It is expected that only the income of Primus Asset Management and its subsidiary, Primus Re, are likely to be subject to United States federal and local income taxes. However, were Primus Bermuda to be subject to income tax, at a combined United States federal, New York State and New York City income tax rate of 46%, on its United States GAAP income, then its income tax expense (excluding interest and penalties) would have been approximately \$36.2 million and approximately \$1.1 million for the nine months ended September 30, 2006 and 2005, respectively. These figures assume that Primus Financial is not deemed to be making distributions to Primus Bermuda; such distributions would subject Primus Bermuda to an additional United States federal branch profits tax.

#### Contractual Obligations

The following table summarizes our contractual obligations at September 30, 2006 and the effect that those obligations are expected to have on our liquidity and cash flows in future periods (in thousands):

|  | Total      | Payment due by period |           |           | More than<br>5 years |
|--|------------|-----------------------|-----------|-----------|----------------------|
|  |            | Less than<br>1 year   | 1-3 years | 3-5 years |                      |
| Property leases                        | \$ 9,160   | \$ 1,252              | \$ 2,679  | \$ 2,732  | \$ 2,497             |
| Subordinated deferrable interest notes | 200,000    | — (a)                 | — (a)     | — (a)     | 200,000              |
| Total                                  | \$ 209,160 | \$ 1,252              | \$ 2,679  | \$ 2,732  | \$ 202,497           |

(a) Payments on the subordinated deferrable interest notes for the next five years cannot be determined, as the notes are auction rate obligations.

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Property lease: Primus Financial has leased its premises at 360 Madison Avenue, New York, New York from Madison 45 LLC at a fixed yearly rental (subject to certain escalations specified in the lease) until August 1, 2012. We

have agreed to an amendment to the lease that extends its term to 2016 and adds approximately 5,500 square feet of additional space. In addition, in 2006, we leased approximately 2,900 square feet of office space in London under a lease that expires in 2012. There are no material restrictions imposed by our lease agreements and the leases are categorized as operating leases.

We have no other material long-term contractual obligations.

## Liquidity and Capital Resources

### Capital Strategy

Primus Financial, in order to support its AAA/Aaa ratings, is required to maintain capital in an amount determined by the capital models it has agreed upon with S&P and Moody's. The capital required is primarily a function of Primus Financial's credit swap portfolio characteristics, operating expenses and tax position. Retained cash flow and proceeds from financings are utilized to increase our capital resources to support our credit swap business.

We receive cash from the receipt of credit swap premiums, realized gains from the early termination of credit swaps, interest income earned on our investment portfolio and capital raising activities. Cash is used to pay our operating expenses, administrative expenses, premiums on credit swaps we have purchased, realized losses from the early termination of credit swaps, interest on debt and preferred share distributions. Our cash, cash equivalents and available-for-sale and trading investments were \$659.9 million and \$629.5 million as of September 30, 2006 and December 31, 2005, respectively.

### Cash Flows

Cash flows from operating activities – Net cash provided by operating activities were \$32.5 million and \$23.6 million for the nine months ended September 30, 2006 and 2005, respectively. This increase is primarily attributable to higher premium income on a larger credit swap portfolio during 2006 compared with 2005, as a result of the continued growth of our credit swap portfolio.

Cash flows from investing activities – Net cash used in investing activities were \$38.8 million and \$258.7 million for the nine months ended September 30, 2006 and 2005, respectively. The decrease was primarily due to reduced purchases of available-for-sale-investments in 2006 compared with 2005 and securities maturing in 2006.

Cash flows from financing activities – Net cash used in financing activities were \$4.4 million and \$5.0 million for the nine months ended September 30, 2006 and 2005, respectively. This decrease is primarily due to lower repurchase and retirement of our common stock, partly offset by an increase in preferred distributions of our subsidiary during 2006 compared with 2005.

With our current capital resources and anticipated future credit swap premium receipts and interest income, we believe we have sufficient liquidity to pay our operating expenses and preferred distributions over at least the next twelve months.

### Recent Accounting Pronouncements

In December 2004, the Financial Accounting Standards Board ("FASB") issued SFAS No. 123(R), Share-Based Payment. SFAS No. 123(R) is a revision of SFAS No. 123 and supersedes Accounting Principles Board ("APB") Opinion No. 25, Accounting for Stock Issued to Employees, and amends SFAS No. 95, Statement of Cash Flows. SFAS No. 123(R) eliminates the ability to account for share-based compensation transactions using APB Opinion No. 25 and requires all share-based payments to employees, including grants of employee stock options, to be recognized in the financial statements using a fair value-based method. In April 2005, the Securities and Exchange Commission

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(“SEC”) amended the effective date of SFAS No. 123(R) until the first fiscal year beginning after June 15, 2005 to provide additional time for companies to comply with the reporting requirements. Effective January 1, 2006, the Company adopted SFAS No. 123 (R). See note 9 of notes to condensed consolidated financial statements for further detail.

In March 2005, the SEC staff issued Staff Accounting Bulletin No. 107 (“SAB No. 107”) to provide supplemental implementation guidance on SFAS No. 123(R). The Company applied the relevant provisions of SAB No. 107 in its adoption of SFAS No. 123(R).

In May 2005, the FASB issued SFAS 154, Accounting Changes and Error Corrections – a replacement of APB Opinion No. 20 and FASB Statement No. 3. This statement requires retrospective application to prior periods’ financial statements of changes in accounting principle. SFAS 154 is effective for accounting changes and corrections of errors made in fiscal years beginning after December 15, 2005. The Company will apply SFAS 154 in future periods, if applicable.

In November 2005, the FASB issued FASB Staff Position FSP 115-1, The Meaning of Other-Than Temporary Impairment and Its Application to Certain Investments (FSP 115-1), which addresses the determination as to when an investment is considered impaired, whether that impairment is other-than-temporary, and the measurement of an impairment loss. FSP 115-1 also includes accounting considerations subsequent to the recognition of an other-than-temporary impairment and requires certain disclosures about unrealized losses that have not been recognized as other-than-temporary impairments. The guidance in FSP 115-1 is required to be applied to reporting periods beginning after December 15, 2005. The adoption did not have any effect on the condensed consolidated financial statements.

In June 2006, the FASB issued Interpretation No. 48, Accounting for Uncertainty in Income Taxes-an interpretation of FASB Statement No. 109 (FIN 48). FIN 48 prescribes a recognition threshold and measurement attributes for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. FIN 48 also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. FIN 48 is effective for fiscal years beginning after December 15, 2006. The Company is currently evaluating the impact that adoption of FIN 48 will have on its consolidated financial statements.

In September 2006, the FASB issued SFAS No. 157, Fair Value Measurements (SFAS No. 157). SFAS 157 defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles (GAAP), and expands disclosures about fair value measurements. SFAS No. 157 is effective for fiscal years beginning after November 15, 2007. The Company is currently evaluating the impact that adoption of SFAS No. 157 will have on its consolidated financial statements.

## Cautionary Note Regarding Forward-Looking Statements

This quarterly report of Primus Guaranty includes statements that are not historical or current facts and are “forward-looking statements” made pursuant to the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. The words “believe,” “anticipate,” “project,” “plan,” “expect,” “intend,” “will likely result,” “looking for,” “continue,” and similar expressions identify forward-looking statements. These statements are subject to certain risks and uncertainties that could cause actual results to differ materially from historical earnings and those presently

anticipated or projected. Primus Guaranty cautions readers not to place undue reliance on any such forward-looking statements, which speak only to their respective dates. The following are some of the factors that could affect financial performance or could cause actual results to differ materially from estimates contained in or underlying the Company's forward-looking statements:

- fluctuations in the economic, credit, interest rate or foreign currency environment in the United States (U.S.) and abroad;
- the level of activity within the national and international credit markets;
- competitive conditions and pricing levels;
- legislative and regulatory developments;

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- technological developments;
- changes in tax laws;
- changes in international or national political or economic conditions, including any terrorist attacks;
- uncertainties that have not been identified at this time.

The Company undertakes no obligation to publicly correct or update any forward-looking statement if it later becomes aware that such results are not likely to be achieved.

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##### Item 3. Quantitative and Qualitative Disclosures about Market Risk

Market risk represents the potential for gains or losses that may result from changes in the value of a financial instrument as a consequence of changes in market conditions. Our primary market risk is changes in market credit swap premium levels, which increase or decrease the fair value of our credit swap portfolio. Market credit swap premium levels change as a result of specific events or news related to a Reference Entity, such as a change in a credit rating by any of the rating agencies. Additionally, market credit swap premium levels can vary as a result of changes in market sentiment. As a general matter, given our strategy of holding credit swaps sold until maturity, we do not seek to manage our overall exposure to market credit swap premium levels, and we expect fluctuations in the fair value of our credit swap portfolio as a result of these changes. As of September 30, 2006, each one basis point increase or decrease in market credit swap premiums would decrease or increase the fair value of our credit swap portfolio by approximately \$5.4 million. We face other market risks, which are likely to have a lesser impact upon our net income than those associated with market credit swap premium level risk. These other risks include interest rate risk associated with market interest rate movements. These movements may affect the value of our credit swap portfolio as our pricing model includes an interest rate component, which is used to discount future expected cash flows. Interest rate movements may also affect the carrying value of and yield on our investments. The Primus Financial Cumulative Preferred Stock pays distributions that are based upon the auction rate preferred market. A difference between the rates we pay in the auction rate preferred market and the interest rates we receive on our investments may result in an additional cost to our company. Assuming that auction results with respect to the Primus Financial Cumulative Preferred Stock reflect prevailing short-term interest rates, each 25 basis point increase or decrease in the level of those rates would increase or decrease Primus Financial's annual distribution cost by

approximately \$125,000 for each of the Series A and Series B MMP Receipts, but would not affect distributions on the Series B MMP Receipts as the interest and auction rate for such MMP Receipts were set for a one year period on January 20, 2006. In addition, interest rate movements may increase or decrease the interest expense we incur on our \$200 million of subordinated deferrable interest notes. A 25 basis point increase in the level of those rates would increase Primus Financial's interest expense by \$500,000 annually; however, at December 31, 2005, the interest rate on the \$50 million Series B subordinated deferrable interest notes was set for a one year period.

Counterparty risk represents the potential for loss should one or more of our counterparties be unable to meet its obligations due to bankruptcy or a similar event, which could adversely affect our results of operations. Our counterparties generally have investment grade credit ratings. At September 30, 2006, the notional and fair value amount of credit swaps outstanding with respect to one non-rated counterparty were \$5.0 million and \$17 thousand, respectively. The premiums on these transactions were fully prepaid by the counterparty, and as such, they have been categorized as AAA/Aaa rating in our credit swap portfolio.

#### Item 4. Controls and Procedures

The company has carried out an evaluation, under the supervision and with the participation of the company's management, including the Chief Executive Officer and Chief Financial Officer, of the effectiveness of disclosure controls and procedures pursuant to rules 13a-15 and 15-15d promulgated under the Securities and Exchange Act of 1934 as of the end of the period covered by this report. Based on that evaluation, the Chief Executive Officer and the Chief Financial Officer concluded that the disclosure controls and procedures are effective to provide reasonable assurance that all material information relating to the company required to be filed in this report have been made known to them in a timely fashion. There have been no changes in internal control over financial reporting that occurred during the most recent fiscal quarter that have materially affected, or are reasonably likely to affect, internal control over financial reporting.

The company's management, including the Chief Executive Officer and the Chief Financial Officer, does not expect that the company's disclosure controls or its internal controls can prevent all errors and all fraud. Further, the design of a control system must reflect the fact that there are resource constraints, and the benefits of controls must be considered relative to their costs. As a result

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of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, within the company have been detected. These inherent limitations include the realities that judgments in decision-making are faulty, and that breakdowns can occur because of simple error or mistake. As a result of the inherent limitations in a cost-effective control system, misstatements due to error or fraud may occur and not be detected. Accordingly, the company's disclosure controls and procedures are designed to provide reasonable, not absolute, assurance that the disclosure controls and procedures are met.

#### Part II. Other Information

##### Item 1. Legal Proceedings

In the ordinary course of operating our business, we may encounter a significant risk of litigation from time to time. However, we are not party to or currently aware of any material pending litigation.

Item 1A. Risk Factors

There have not been any material changes from the risk factors previously disclosed in our Annual Report on Form 10-K for the year ended December 31, 2005.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds  
None.

Item 3. Defaults upon Senior Securities  
None.

Item 4. Submission of Matters to a Vote of Security Holders  
None.

Item 5. Other Information  
None.

Item 6. Exhibits

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31.1 Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002

31.2 Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002

32 Certification of Chief Executive Officer and Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted by Section 906 of the Sarbanes-Oxley Act of 2002

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SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this Report to be signed on its behalf by the undersigned, thereunto duly authorized.

PRIMUS GUARANTY, LTD.

/s/ Richard Claiden

Richard Claiden

Chief Financial Officer

(Duly Authorized Officer and Principal Financial Officer)

Date: November 8, 2006

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