

PRIMUS GUARANTY LTD  
Form 10-Q  
May 10, 2007

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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 March 31, 2007

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 May 1, 2007, the number of shares outstanding of the issuer’s common stock, \$0.08 par value, was 45,023,823.

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Primus Guaranty, Ltd.  
Form 10-Q  
For the three months ended March 31, 2007

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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)

|  | March 31,<br>2007<br>(unaudited) | December<br>31,<br>2006 |
|--|----------------------------------|-------------------------|
| Assets   |                                  |                         |
| Cash and cash equivalents  | \$ 155,212                       | \$ 204,428              |
| Available-for-sale investments   | 644,315                          | 584,911                 |
| Trading account assets   | 12,952                           | 14,537                  |
| Accrued interest receivable  | 6,120                            | 6,374                   |
| Accrued premiums and receivables on credit and other swaps   | 4,409                            | 4,022                   |
| Unrealized gain on credit and other swaps, at fair value   | 58,577                           | 73,330                  |
| Deposit and warehouse loan agreements  | 5,089                            | —                       |
| Warehouse loans held for securitization  | 59,369                           | —                       |
| Fixed assets and software costs, net   | 5,360                            | 5,510                   |
| Debt issuance costs, net   | 7,198                            | 7,399                   |
| Other assets   | 4,390                            | 1,957                   |
| Total assets   | \$ 962,991                       | \$ 902,468              |
| Liabilities and shareholders' equity   |                                  |                         |
| Accounts payable and accrued expenses  | \$ 4,312                         | \$ 2,854                |
| Accrued compensation   | 2,031                            | 8,800                   |
| Interest payable   | 806                              | 625                     |
| Unrealized loss on credit and other swaps, at fair value   | 11,026                           | 2,931                   |
| Trading account liabilities  | 1,010                            | 1,002                   |
| Warehouse loan payable   | 59,369                           | —                       |
| Long-term debt   | 324,513                          | 325,000                 |
| Other liabilities  | 1,168                            | 644                     |
| Total liabilities  | 404,235                          | 341,856                 |
| Preferred securities of subsidiary   | 98,521                           | 98,521                  |
| Shareholders' equity   |                                  |                         |
| Common shares, \$0.08 par value, 62,500,000 shares authorized, 44,954,415 and 43,380,893 shares issued and outstanding at March 31, 2007 and December 31, 2006 | 3,583                            | 3,470                   |
| Additional paid-in-capital   | 277,130                          | 269,420                 |
| Warrants   | —                                | 612                     |
| Accumulated other comprehensive loss   | (1,724)                          | (2,375)                 |
| Retained earnings  | 181,246                          | 190,964                 |
| Total shareholders' equity   | 460,235                          | 462,091                 |

|  |            |            |
|--|------------|------------|
| Total liabilities, preferred securities of subsidiary and shareholders' equity | \$ 962,991 | \$ 902,468 |
|--|------------|------------|

See accompanying notes.

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

|   | Three months ended<br>March 31, |           |
|---|---------------------------------|-----------|
|   | 2007                            | 2006      |
|   | (unaudited)                     |           |
| Revenues  |                                 |           |
| Net credit swap revenue (loss)                      | \$ (4,877)                      | \$ 40,129 |
| Premiums earned on financial guarantees             | —                               | 100       |
| Asset management and advisory fees                  | 661                             | 49        |
| Interest income                                     | 9,977                           | 6,601     |
| Other trading revenue                               | 1,259                           | —         |
| Foreign currency revaluation gain (loss)            | 51                              | (6)       |
| Total net revenues                                  | 7,071                           | 46,873    |
| Expenses  |                                 |           |
| Compensation and employee benefits                  | 6,004                           | 4,891     |
| Professional and legal fees                         | 976                             | 1,215     |
| Depreciation and amortization                       | 577                             | 589       |
| Technology and data                                 | 877                             | 399       |
| Interest expense                                    | 4,862                           | 2,449     |
| Other   | 1,535                           | 1,039     |
| Total expenses                                      | 14,831                          | 10,582    |
| Distributions on preferred securities of subsidiary | 1,902                           | 1,131     |
| Income (loss) before provision for income taxes     | (9,662)                         | 35,160    |
| Provision for income taxes                          | 56                              | 55        |
| Net income (loss) available to common shares        | \$ (9,718)                      | 35,105    |
| Income (loss) per common share:                     |                                 |           |
| Basic   | \$ (0.22)                       | \$ 0.81   |
| Diluted   | \$ (0.22)                       | \$ 0.79   |
| Average common shares outstanding:                  |                                 |           |
| Basic   | 44,164                          | 43,246    |
| Diluted   | 44,164                          | 44,287    |

See accompanying notes.

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

|  | Three months ended<br>March 31, |           |
|--|---------------------------------|-----------|
|  | 2007                            | 2006      |
|  | (unaudited)                     |           |
| Cash flows from operating activities   |                                 |           |
| Net income (loss)  | \$ (9,718)                      | \$ 35,105 |
| Adjustments to reconcile net income (loss) to net cash provided by operating activities: |                                 |           |
| Non-cash items included in net income (loss):  |                                 |           |
| Depreciation and amortization  | 577                             | 589       |
| Share compensation   | 1,007                           | 1,046     |
| Net unrealized (gain) loss on credit swap portfolio                                      | 22,848                          | (24,332)  |
| Net amortization of premium and discount on securities                                   | (2,223)                         | (904)     |
| Amortization of debt issuance costs  | 78                              | 43        |
| Distributions on preferred securities of subsidiary                                      | 1,902                           | 1,131     |
| Increase (decrease) in cash resulting from changes in:                                   |                                 |           |
| Accrued interest receivable  | 254                             | (154)     |
| Accrued premiums and interest receivable on credit and other swaps                       | (387)                           | (101)     |
| Deposit and warehouse loan agreement   | (5,089)                         | —         |
| Warehouse loans held for securitization  | (59,369)                        | —         |
| Other assets   | (2,433)                         | 279       |
| Trading account assets   | 1,585                           | —         |
| Accounts payable and accrued expenses  | 1,581                           | (1,263)   |
| Accrued compensation   | (6,769)                         | (3,206)   |
| Trading account liabilities  | 8                               | —         |
| Interest payable   | 181                             | 160       |
| Other liabilities  | 37                              | (27)      |
| Net cash (used in) provided by operating activities                                      | (55,930)                        | 8,366     |
| Cash flows from investing activities   |                                 |           |
| Fixed asset purchases and capitalized software costs                                     | (427)                           | (1,017)   |
| Purchases of available-for-sale investments  | (267,249)                       | (10,375)  |
| Maturities and sales of available-for-sale investments                                   | 210,714                         | —         |
| Net cash used in investing activities  | (56,962)                        | (11,392)  |
| Cash flows from financing activities   |                                 |           |
| Repurchase and retirement of common shares   | (1,131)                         | (507)     |
| Proceeds from exercise of options and issue of shares                                    | —                               | 206       |
| Proceeds from exercise of warrants   | 7,335                           | —         |
| Warehouse loan payable   | 59,369                          | —         |
| Debt issuance costs  | —                               | (13)      |
| Net preferred distributions of subsidiary  | (1,902)                         | (1,131)   |

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|   |            |           |
|---|------------|-----------|
| Net cash provided by (used in) financing activities | 63,671     | (1,445)   |
| Net effect of exchange rate changes on cash         | 5          | —         |
| Net decrease in cash                                | (49,216)   | (4,471)   |
| Cash and cash equivalents at beginning of period    | 204,428    | 69,355    |
| Cash and cash equivalents at end of period          | \$ 155,212 | \$ 64,884 |
| Supplemental disclosures                            |            |           |
| Cash paid for interest                              | \$ 4,603   | \$ 2,246  |
| Cash paid for taxes                                 | \$ 11      | \$ 44     |

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 that conducts business through several operating subsidiaries, including Primus Financial Products, LLC (“Primus Financial”), Primus Asset Management, Inc. (“Primus Asset Management”) and PRS Trading Strategies, LLC (“PRS Trading Strategies”).

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 Financial recently received the rating agencies’ approval to sell credit swaps referencing residential mortgage-backed securities and commercial mortgage-backed securities, which are referred to as ABS. Primus Financial has begun selling credit swaps against ABS having an assigned rating of “BBB/Baa” (or the equivalent thereof) or better from a recognized rating agency, referencing residential mortgage-backed securities.

Primus Asset Management, a Delaware services company, acts as an investment manager to affiliated companies and third party entities. It currently manages the investment portfolios of its affiliates Primus Financial and PRS Trading Strategies, LLC (“PRS Trading Strategies”). In addition, Primus Asset Management manages three investment grade synthetic collateralized debt obligations, or synthetic CDO’s, on behalf of third parties. The synthetic CDO’s issue securities backed by one or more credit swaps sold against unaffiliated clients’ debt obligations. Primus Asset Management has commenced acting as asset manager with respect to collateralized loan obligation, or CLO, transactions. Primus Asset Management receives fees for its investment management services. Primus Asset Management’s business plan includes the expansion of its assets under management and coverage of additional financial products and asset classes including, among others, mortgage-backed and other asset-backed securities and speculative grade investments.

Primus Re, Ltd. (“Primus Re”), is a Bermuda company that operates as a financial guaranty insurance company and is licensed as a Class 3 Insurer under the Bermuda Insurance Act of 1978. Primus Re’s business is to act as a conduit, or transformer, between parties interested in buying or selling protection in insurance form and other parties interested in assuming the opposite risk position in the form of credit swaps.

PRS Trading Strategies commenced operations in January 2006 with \$50 million of capital contributed by Primus Guaranty from the proceeds of our initial public offering. PRS Trading Strategies trades in a broad range of fixed income products, including credit default swaps, leveraged loans and investment grade and speculative grade securities. Unlike Primus Financial, PRS Trading Strategies has no counterparty ratings from rating agencies and, accordingly, may post collateral with its counterparties to support its contractual obligations. PRS Trading Strategies does not engage in trading activity with Primus Financial.

Primus Guaranty (UK), Ltd. (“PGUK”) was incorporated in England to expand the Company’s presence and further develop its business and relationships across Europe.

The accompanying unaudited condensed consolidated financial statements of Primus Guaranty, Ltd. 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, 2007. The condensed consolidated financial statements include the accounts of the Company and its wholly owned subsidiaries. All significant intercompany balances have been eliminated.

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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 March 31, 2007 and December 31, 2006, 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.

## 2. Recent Accounting Pronouncements

In April 2006, the FASB issued FASB Staff Position FIN 46(R)-6, Determining the Variability to Be Considered in Applying FASB Interpretation No. 46(R) (“FSP FIN 46(R)-6”). FSP FIN 46(R)-6 addresses how variability should be considered when applying FIN 46(R). Variability affects the determination of whether an entity is a variable interest entity (VIE), which interests are variable interests, and which party, if any, is the primary beneficiary of the VIE required to consolidate. FSP FIN 46(R)-6 clarifies that the design of the entity also should be considered when identifying which interests are variable interests. The Company adopted FSP FIN 46(R)-6 during the third quarter of 2006 and applied it prospectively to all entities in which the Company first became involved with. The adoption of FSP FIN 46(R)-6 did not have a material effect on the Company’s 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. Effective January 1, 2007, the Company adopted FIN 48. The adoption did not have a material effect on the Company's consolidated financial statements. See note 10 for further discussion.

In September 2006, the FASB issued SFAS No. 157, Fair Value Measurements (SFAS No. 157). SFAS No. 157 defines fair value, establishes a framework for measuring fair value in 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.

In February 2007, the FASB issued SFAS No. 159, The Fair Value Option for Financial Assets and Liabilities ("SFAS No. 159"). SFAS No. 159 provides a fair value option election that allows companies to irrevocably elect fair value as the initial and subsequent measurement attribute for certain financial assets and liabilities, with changes in fair value recognized in earnings as they occur. SFAS No. 159 permits the fair value option election on an instrument by instrument basis at initial recognition of an asset or liability or upon an event that gives rise to a new basis of accounting for that instrument. SFAS No. 159 is effective as of the beginning of an entity's first fiscal year that begins after November 15, 2007. The Company is currently evaluating the impact that adoption of SFAS No. 159 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, commercial paper rated A-1 and P-1 by the respective rating agencies and the Company's equity investment in a CLO. 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 March 31, 2007 and December 31, 2006 (in thousands):

|                                      | March 31, 2007    |            |            |            |
|--------------------------------------|-------------------|------------|------------|------------|
|                                      | Amortized         | Unrealized | Unrealized | Estimated  |
|                                      | Cost              | Gains      | Losses     | Fair Value |
| U.S government agency obligations    | \$ 613,482        | \$ 127     | \$ (1,673) | \$ 611,936 |
| Commercial paper                     | 25,979            | 4          | —          | 25,983     |
| Collateralized loan obligation (CLO) | 6,786             | —          | (390)      | 6,396      |
| Total                                | \$ 646,247        | \$ 131     | \$ (2,063) | \$ 644,315 |
|                                      | December 31, 2006 |            |            |            |
|                                      | Amortized         | Unrealized | Unrealized | Estimated  |
|                                      | Cost              | Gains      | Losses     | Fair Value |



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|                                      |            |       |            |            |
|--------------------------------------|------------|-------|------------|------------|
| U.S government agency obligations    | \$ 554,691 | \$ 89 | \$ (2,551) | \$ 552,229 |
| Commercial paper                     | 26,275     | 1     | —          | 26,276     |
| Collateralized loan obligation (CLO) | 6,536      | —     | (130)      | 6,406      |
| Total                                | \$ 587,502 | \$ 90 | \$ (2,681) | \$ 584,911 |

The following table summarizes the fair value of investments that have been in a continuous unrealized loss position for less than 12 months and for 12 months or more at March 31, 2007 and December 31, 2006 (in thousands):

|                                      | March 31, 2007                    |                         |                   |                         |            |                         |
|--------------------------------------|-----------------------------------|-------------------------|-------------------|-------------------------|------------|-------------------------|
|                                      | Securities with Unrealized Losses |                         |                   |                         |            |                         |
|                                      | Less than 12 months               |                         | 12 months or more |                         | Total      |                         |
|                                      | Fair Value                        | Gross Unrealized Losses | Fair Value        | Gross Unrealized Losses | Fair Value | Gross Unrealized Losses |
| U.S. government agency obligations   | \$ 40,703                         | \$ (26)                 | \$ 227,575        | \$ (1,647)              | \$ 268,278 | \$ (1,673)              |
| Collateralized loan obligation (CLO) | 6,396                             | (390)                   | —                 | —                       | 6,396      | (390)                   |
| Total                                | \$ 47,099                         | \$ (416)                | \$ 227,575        | \$ (1,647)              | \$ 274,674 | \$ (2,063)              |

|                                      | December 31, 2007                 |                         |                   |                         |            |                         |
|--------------------------------------|-----------------------------------|-------------------------|-------------------|-------------------------|------------|-------------------------|
|                                      | Securities with Unrealized Losses |                         |                   |                         |            |                         |
|                                      | Less than 12 months               |                         | 12 months or more |                         | Total      |                         |
|                                      | Fair Value                        | Gross Unrealized Losses | Fair Value        | Gross Unrealized Losses | Fair Value | Gross Unrealized Losses |
| U.S. government agency obligations   | \$ 19,978                         | \$ (90)                 | \$ 331,709        | \$ (2,461)              | \$ 351,687 | \$ (2,551)              |
| Collateralized loan obligation (CLO) | 6,406                             | (130)                   | —                 | —                       | 6,406      | (130)                   |
| Total                                | \$ 26,384                         | \$ (220)                | \$ 331,709        | \$ (2,461)              | \$ 358,093 | \$ (2,681)              |

The unrealized losses on the Company's investments in U.S. government agency obligations were the result of an increase in short-term interest rates. 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 March 31, 2007 and December 31, 2006. The U.S. government agency obligations mature within two years and the CLO matures in 2019, although the maturity may be sooner.

4. Net Credit Swap Revenues and Portfolio

Overview

Net credit swap revenue as presented in the 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.

All credit swap transactions entered into between the Buyer and the Seller are, or will shortly be, subject to an International Swaps and Derivatives Association, Inc. Master Agreement or (“ISDA Master Agreement”) executed by both parties. The ISDA Master Agreement allows for the aggregation of the market exposures and termination of all transactions between the Buyer and Seller in the event a default (as defined by the ISDA 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. The Company has not experienced any of these events since its inception.

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). 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 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 or decline in fair value during a period, the increase will add to the Company’s net credit swap revenue and the decline will subtract from the Company’s net credit swap revenue for that period, respectively. 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 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 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 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. Primus Financial and PRS Trading Strategies each enter into a valid ISDA Master Agreement with each of their counterparties.

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

#### Primus Financial

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

Primus Financial is primarily a Seller of credit swaps. 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 could 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.

#### PRS Trading Strategies

PRS Trading Strategies commenced operations in January 2006 with \$50 million of capital contributed by Primus Guaranty from the proceeds of our initial public offering. PRS Trading Strategies trades in a broad range of fixed income products, including credit default swaps, leveraged loans and investment grade and speculative grade

securities, among others. Unlike Primus Financial, PRS Trading Strategies has no counterparty ratings from rating agencies and, accordingly, may post collateral with its counterparties to support its contractual obligations. PRS Trading Strategies does not engage in trading activity with Primus Financial. Credit swaps purchased to off-set risks do not

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qualify as hedges in accordance with SFAS No. 133. PRS Trading Strategies 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.

#### Revenue and Portfolio Information

The table below presents the components of consolidated net credit swap revenue (loss) for the three months ended March 31, 2007 and 2006 (in thousands).

|                                      | Three months ended<br>March 31, |           |
|--------------------------------------|---------------------------------|-----------|
|                                      | 2007                            | 2006      |
| Net premium income                   | \$ 18,524                       | \$ 15,943 |
| Realized gains                       | 2,796                           | 658       |
| Realized losses                      | (3,169)                         | (804)     |
| Change in unrealized gains (losses)  | (23,028)                        | 24,332    |
| Total net credit swap revenue (loss) | \$ (4,877)                      | \$ 40,129 |

The Company’s consolidated notional amount, fair value and average fair value of open credit swap transactions (excluding a \$1.2 million and a \$25 thousand net fair value associated with the CDS index, CDS on ABS and total return swaps) entered into with third parties at March 31, 2007 and December 31, 2006 are as follows (in thousands):

|                                    | March 31,<br>2007 | December 31,<br>2006 |
|------------------------------------|-------------------|----------------------|
| Gross Notional Amounts:            |                   |                      |
| Credit swaps sold-single name      | \$ 15,695,106     | \$ 15,485,145        |
| Credit swaps sold-tranche          | 1,100,000         | 500,000              |
| Credit swaps purchased-single name | (266,719)         | (147,597)            |
| Fair value:                        |                   |                      |
| Asset                              | 59,414            | 73,305               |
| Liability                          | 10,691            | 2,931                |
| Average fair value:                |                   |                      |
| Asset                              | 70,525            | 57,435               |
| Liability                          | 6,320             | 1,990                |

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“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 Strategies 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.

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The tables that follow summarize, by credit rating of Reference Entities and of counterparties, the notional amounts and fair values of credit swap transactions outstanding (excluding a \$1.2 million and a \$25 thousand net fair value associated with the CDS index, CDS on ABS and total return swaps) for the Company as of March 31, 2007 and December 31, 2006 (in thousands).

| Moody's Rating Category<br>Reference Entity/Tranche | March 31, 2007     |               | December 31, 2006  |               |
|---|--------------------|---------------|--------------------|---------------|
|   | Notional<br>Amount | Fair<br>Value | Notional<br>Amount | Fair<br>Value |
| Credit Swaps Sold – Single Name:                    |                    |               |                    |               |
| Aaa   | \$ 828,469         | \$ 2,132      | \$ 761,211         | \$ 1,483      |
| Aa  | 2,723,048          | 5,928         | 2,690,166          | 9,364         |
| A   | 5,891,596          | 22,874        | 6,075,786          | 29,501        |
| Baa   | 5,652,293          | 33,056        | 5,427,937          | 32,786        |
| Ba  | 535,670            | 812           | 470,842            | 1,467         |
| B   | 64,030             | (1,436)       | 59,203             | (706)         |
| Total   | \$ 15,695,106      | \$ 63,366     | \$ 15,485,145      | \$ 73,895     |
| Credit Swaps Sold – Tranche:                        |                    |               |                    |               |
| Aa  | \$ 850,000         | \$ (13,789)   | \$ 300,000         | \$ (2,494)    |
| A   | 250,000            | (1,402)       | 200,000            | (534)         |
| Total   | \$ 1,100,000       | \$ (15,191)   | \$ 500,000         | \$ (3,028)    |
| Credit Swaps Purchased – Single Name:               |                    |               |                    |               |
| Aa  | \$ (25,000)        | \$ 79         | \$ (15,000)        | \$ (15)       |
| A   | (98,774)           | 121           | (36,000)           | (10)          |
| Baa   | (135,445)          | 374           | (83,636)           | (484)         |
| Ba  | (5,000)            | (67)          | (6,961)            | 235           |
| B   | (2,500)            | 40            | (6,000)            | (219)         |
| Total   | \$ (266,719)       | \$ 547        | \$ (147,597)       | \$ (493)      |
| Counterparty Buyer/(Seller)                         |                    |               |                    |               |
| Credit Swaps Sold – Single Name:                    |                    |               |                    |               |
| Aaa   | \$ 3,007,523       | \$ 13,277     | \$ 982,194         | \$ 5,003      |
| Aa  | 10,172,439         | 39,908        | 12,037,591         | 57,175        |
| A   | 2,515,144          | 10,181        | 2,465,360          | 11,717        |
| Total   | \$ 15,695,106      | \$ 63,366     | \$ 15,485,145      | \$ 73,895     |
| Credit Swaps Sold – Tranche:                        |                    |               |                    |               |
| Aaa   | \$ 50,000          | \$ 842        | \$ —               | \$ —          |

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|                                       |              |             |              |            |
|---------------------------------------|--------------|-------------|--------------|------------|
| Aa                                    | 1,050,000    | (16,033)    | 500,000      | (3,028)    |
| Total                                 | \$ 1,100,000 | \$ (15,191) | \$ 500,000   | \$ (3,028) |
| Credit Swaps Purchased – Single Name: |              |             |              |            |
| Aaa                                   | \$ (37,752)  | \$ (131)    | \$ (9,961)   | \$ (120)   |
| Aa                                    | (228,967)    | 678         | (137,636)    | (373)      |
| Total                                 | \$ (266,719) | \$ 547      | \$ (147,597) | \$ (493)   |

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| S&P Rating Category<br>Reference Entity/Tranche | March 31, 2007     |               | December 31, 2006  |               |
|---|--------------------|---------------|--------------------|---------------|
|   | Notional<br>Amount | Fair<br>Value | Notional<br>Amount | Fair<br>Value |
| Credit Swaps Sold – Single Name:                |                    |               |                    |               |
| AAA   | \$ 936,580         | \$ 1,267      | \$ 940,031         | \$ 1,721      |
| AA  | 2,546,801          | 7,161         | 2,275,564          | 8,845         |
| A   | 6,148,166          | 23,048        | 6,490,958          | 30,644        |
| BBB   | 5,465,889          | 31,861        | 5,271,390          | 32,958        |
| BB  | 520,633            | 1,635         | 438,499            | 1,060         |
| B   | 77,037             | (1,606)       | 68,703             | (1,333)       |
| Total   | \$ 15,695,106      | \$ 63,366     | \$ 15,485,145      | \$ 73,895     |
| Credit Swaps Sold – Tranche:                    |                    |               |                    |               |
| AAA   | \$ 350,000         | \$ (6,055)    | \$ 150,000         | \$ (2,010)    |
| AA  | 600,000            | (8,673)       | 200,000            | (1,613)       |
| A   | 150,000            | (463)         | 150,000            | 595           |
| Total   | \$ 1,100,000       | \$ (15,191)   | \$ 500,000         | \$ (3,028)    |
| Credit Swaps Purchased – Single Name:           |                    |               |                    |               |
| AA  | \$ (25,000)        | \$ 78         | \$ (15,000)        | \$ (15)       |
| A   | (103,774)          | 245           | (56,000)           | (10)          |
| BBB   | (125,445)          | 341           | (58,636)           | (473)         |
| BB  | (10,000)           | (157)         | (13,961)           | 214           |
| B   | (2,500)            | 40            | (4,000)            | (209)         |
| Total   | \$ (266,719)       | \$ 547        | \$ (147,597)       | \$ (493)      |
| Counterparty Buyer/(Seller)                     |                    |               |                    |               |
| Credit Swaps Sold – Single Name:                |                    |               |                    |               |
| AAA   | \$ 5,000           | \$ 20         | \$ 31,406          | \$ 104        |
| AA  | 11,902,496         | 50,120        | 11,732,030         | 58,698        |
| A   | 3,787,610          | 13,226        | 3,721,709          | 15,093        |
| Total   | \$ 15,695,106      | \$ 63,366     | \$ 15,485,145      | \$ 73,895     |
| Credit Swaps Sold – Tranche:                    |                    |               |                    |               |
| AAA   | \$ —               | \$ —          | \$ 100,000         | \$ (1,335)    |
| AA  | 1,100,000          | (15,191)      | 400,000            | (1,693)       |
| Total   | \$ 1,100,000       | \$ (15,191)   | \$ 500,000         | \$ (3,028)    |
| Credit Swaps Purchased – Single Name:           |                    |               |                    |               |
| AA  | \$ (142,828)       | \$ 792        | \$ (127,995)       | \$ (665)      |
| A   | (123,891)          | (245)         | (19,602)           | 172           |
| Total   | \$ (266,719)       | \$ 547        | \$ (147,597)       | \$ (493)      |

Primus Financial's and PRS Trading's counterparties are generally financial institutions with whom it has entered into Master Agreements that consolidate the counterparty risk to one office of that counterparty. For the three months ended March 31, 2007 and 2006, respectively, one and two counterparties each generated greater than ten percent of the Company's total net premium revenue.

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The table below shows the geographical distribution of the Company's credit swap portfolio by domicile of the Reference Entity and domicile of the counterparty as of March 31, 2007 and December 31, 2006 (in thousands):

| Country of Domicile                  | March 31, 2007  |             | December 31, 2006 |            |
|--------------------------------------|-----------------|-------------|-------------------|------------|
|                                      | Notional Amount | Fair Value  | Notional Amount   | Fair Value |
| Credit Swaps Sold – Single Name      |                 |             |                   |            |
| By Reference Entity:                 |                 |             |                   |            |
| North America                        | \$ 9,293,722    | \$ 34,388   | \$ 9,133,328      | \$ 46,286  |
| Europe                               | 5,667,384       | 26,560      | 5,612,817         | 25,097     |
| Pacific                              | 565,000         | 1,557       | 570,000           | 1,351      |
| Others                               | 169,000         | 861         | 169,000           | 1,161      |
| Total                                | \$ 15,695,106   | \$ 63,366   | \$ 15,485,145     | \$ 73,895  |
| By Counterparty:                     |                 |             |                   |            |
| North America                        | \$ 8,072,890    | \$ 30,754   | \$ 7,904,024      | \$ 36,321  |
| Europe                               | 7,527,216       | 32,487      | 7,486,121         | 37,502     |
| Pacific                              | 75,000          | 40          | 75,000            | (17)       |
| Others                               | 20,000          | 85          | 20,000            | 89         |
| Total                                | \$ 15,695,106   | \$ 63,366   | \$ 15,485,145     | \$ 73,895  |
| Credit Swaps Sold – Tranche          |                 |             |                   |            |
| By Counterparty:                     |                 |             |                   |            |
| North America                        | \$ 50,000       | \$ 842      | \$ 50,000         | \$ 851     |
| Europe                               | 1,050,000       | (16,033)    | 450,000           | (3,879)    |
| Total                                | \$ 1,100,000    | \$ (15,191) | \$ 500,000        | \$ (3,028) |
| Credit Swaps Purchased – Single Name |                 |             |                   |            |
| By Reference Entity:                 |                 |             |                   |            |
| North America                        | \$ (206,835)    | \$ 727      | \$ (127,000)      | \$ (491)   |
| Europe                               | (45,284)        | (87)        | (20,597)          | (2)        |
| Pacific                              | (14,600)        | (93)        | —                 | —          |
| Total                                | \$ (266,719)    | \$ 547      | \$ (147,597)      | \$ (493)   |
| By Counterparty:                     |                 |             |                   |            |
| North America                        | \$ (161,643)    | \$ (377)    | \$ (65,563)       | \$ (362)   |
| Europe                               | (105,076)       | 924         | (82,034)          | (131)      |
| Total                                | \$ (266,719)    | \$ 547      | \$ (147,597)      | \$ (493)   |

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The table below shows the distribution of the Company's credit swap portfolio by year of maturity as of March 31, 2007 and December 31, 2006 (in thousands):

|                                      | March 31, 2007  |             | December 31, 2006 |            |
|--------------------------------------|-----------------|-------------|-------------------|------------|
|                                      | Notional Amount | Fair Value  | Notional Amount   | Fair Value |
| Credit Swaps Sold – Single Name      |                 |             |                   |            |
| Year of Maturity                     |                 |             |                   |            |
| 2007                                 | \$ 1,991,432    | \$ 3,975    | \$ 2,432,827      | \$ 6,589   |
| 2008                                 | 1,133,247       | 5,580       | 1,127,551         | 6,509      |
| 2009                                 | 2,724,970       | 15,458      | 2,739,561         | 16,964     |
| 2010                                 | 6,096,947       | 30,655      | 6,132,240         | 33,056     |
| 2011                                 | 2,945,893       | 9,470       | 3,004,357         | 10,842     |
| 2012                                 | 791,617         | (1,465)     | 44,609            | (41)       |
| 2013                                 | —               | —           | 4,000             | (24)       |
| 2014                                 | 3,000           | (13)        | —                 | —          |
| 2017                                 | 8,000           | (294)       | —                 | —          |
| Total                                | \$ 15,695,106   | \$ 63,366   | \$ 15,485,145     | \$ 73,895  |
| Credit Swaps Sold – Tranche          |                 |             |                   |            |
| Year of Maturity                     |                 |             |                   |            |
| 2010                                 | \$ 50,000       | \$ 842      | \$ 50,000         | \$ 851     |
| 2013                                 | 350,000         | (4,801)     | 350,000           | (2,544)    |
| 2014                                 | 700,000         | (11,232)    | 100,000           | (1,335)    |
| Total                                | \$ 1,100,000    | \$ (15,191) | \$ 500,000        | \$ (3,028) |
| Credit Swaps Purchased – Single Name |                 |             |                   |            |
| Year of Maturity                     |                 |             |                   |            |
| 2011                                 | \$ (40,000)     | \$ 16       | \$ (96,961)       | \$ (255)   |
| 2012                                 | (145,872)       | (223)       | (16,602)          | (16)       |
| 2013                                 | (12,000)        | 230         | (34,034)          | (222)      |
| 2014                                 | (68,847)        | 524         | —                 | —          |
| Total                                | \$ (266,719)    | \$ 547      | \$ (147,597)      | \$ (493)   |

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## 5. Earnings per Share

Basic earnings per share ("EPS") is calculated by dividing earnings available to common shareholders 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 |           |
|--|--------------------|-----------|
|  | March 31,          |           |
|  | 2007               | 2006      |
| Net earnings (loss) available to common shareholders | \$ (9,718)         | \$ 35,105 |
| Weighted-average basic shares outstanding            | 44,164             | 43,246    |
| Effect of dilutive instruments                       |                    |           |
| Employee options                                     | —                  | 33        |
| Restricted share units                               | —                  | 173       |
| Warrants   | —                  | 835       |
| Dilutive potential shares                            | —                  | 1,041     |
| Diluted shares                                       | 44,164             | 44,287    |
| Basic EPS  | \$ (0.22)          | \$ 0.81   |
| Diluted EPS  | \$ (0.22)          | \$ 0.79   |

For the three months ended March 31, 2007 and 2006, approximately 1.5 million shares and 452 thousand shares, respectively, were not included in the computation of diluted EPS because to do so would have been anti-dilutive for the periods presented.

On February 14, 2007, XL Insurance (Bermuda) Ltd., a subsidiary of XL Capital Ltd., exercised its warrants to purchase 1,414,747 common shares of the Company at an exercise price of approximately \$5.18 per share, yielding proceeds to the Company of \$7.3 million.

## 6. Share 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 share-based payment awards made to employees and directors including employee options and other forms of equity compensation based on estimated fair values.

Compensation expense is recognized based on the fair value of 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 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 share 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 three months ended March 31, 2007 were:

|                         | Three months |
|-------------------------|--------------|
|                         | ended        |
|                         | March 31,    |
|                         | 2007         |
| Risk free interest rate | 5.30%        |

|                         |         |
|-------------------------|---------|
| Volatility              | 33.05%  |
| Expected dividend yield | 0.00%   |
| Expected option life    | 7 years |
| Fair value of option    | \$3.76  |

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The following table is a summary of option activity for the three months ended March 31, 2007:

|                                  | March 31, 2007   |                                 |
|----------------------------------|------------------|---------------------------------|
|                                  | Number of shares | Weighted average exercise price |
| Outstanding at December 31, 2006 | 858,158          | \$ 11.18                        |
| Granted                          | 775,000          | \$ 11.75                        |
| Exercised                        | —                | \$ —                            |
| Forfeited                        | (46,956)         | \$ 12.30                        |
| Outstanding at March 31, 2007    | 1,586,202        | \$ 11.43                        |
| Exercisable at March 31, 2007    | 434,449          | \$ 10.18                        |

The following table summarizes the status of the Company's options as of March 31, 2007:

| Range of Exercise Prices | Options Outstanding |  |                                 | Options Exercisable |                                 |
|--------------------------|---------------------|--|---------------------------------|---------------------|---------------------------------|
|                          | Number of Shares    | Average Remaining Contractual Life (Years) | Weighted Average Exercise Price | Number of Shares    | Weighted Average Exercise Price |
| \$0.00 – \$6.94          | 128,125             | 5.9  | \$ 6.94                         | 128,125             | \$ 6.94                         |
| \$6.95 – \$9.76          | 168,593             | 6.9  | \$ 9.76                         | 134,062             | \$ 9.76                         |
| \$9.77 – \$13.50         | 1,289,484           | 6.3  | \$ 12.09                        | 172,262             | \$ 12.91                        |
| Total                    | 1,586,202           |  |                                 | 434,449             |                                 |

The Company recorded share compensation expense of approximately \$1.0 million during each of the three months ended March 31, 2007 and 2006, respectively. Share compensation expense is included in compensation and employee benefits in the consolidated statements of operations.

As of March 31, 2007, total unrecognized share-based compensation expense related to nonvested share awards was \$10.8 million. This expense is expected to be recognized over a weighted average period of 2.3 years.

## 7. Comprehensive Income (Loss)

Comprehensive income (loss) for the three months ended March 31, 2007 and 2006 is as follows (in thousands):

|   | Three months ended |           |
|---|--------------------|-----------|
|   | March 31,          |           |
|   | 2007               | 2006      |
| Net income (loss)   | \$ (9,718)         | \$ 35,105 |
| Foreign currency translation adjustments                                  | 5                  | —         |
| Change in net unrealized gains (losses) on available-for-sale investments | 646                | (1,445)   |
| Total comprehensive income (loss)   | \$ (9,067)         | \$ 33,660 |

#### 8. Interest Rate Swap Agreement

In February 2007, the Company entered into an interest rate swap agreement with a major financial institution that effectively converted a notional amount of \$75.0 million of the Company's \$125.0 million, 7% fixed rate senior notes due in December 2036, to floating rate debt based on the three month LIBOR rate plus a spread as defined in the agreement. The interest rate swap is designated as a fair value hedge on the fixed senior notes in accordance with SFAS No. 133. The fair value of the interest rate swap is included in other liabilities and the offsetting adjustment to the carrying value of the debt is included in long term debt in the accompanying consolidated statements of financial condition. Payments or receipts on the interest rate swap are recorded in the interest expense caption in the consolidated statements of operations.

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#### 9. Warehouse Loan Transaction

On February 7, 2007, the Company's subsidiaries, Primus Asset Management and PRS Trading Strategies entered into a master warehousing and participation agreement (together with certain other related agreements, hereafter referred to as the "warehouse loan agreements") with another major financial institution and a special purpose entity or SPE 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 SPE. Under the warehouse loan agreements, the SPE is able to finance the purchase and accumulation of loans to an amount up to \$400 million. In the interim period, while the SPE accumulates the loans and before the CLO securities are issued (the "warehouse period"), the major financial institution is funding the purchase of the loans. PRS Trading Strategies has deposited \$5 million in cash collateral with a trustee pursuant to this arrangement representing the first loss protection on the underlying loans. PRS Trading Strategies' potential loss is limited to \$5 million. Under the warehouse loan agreements, PRS Trading Strategies is entitled to the net interest earned on the loans, after deduction of funding costs.

The Company has determined, pursuant to FASB Interpretation No. 46(R), Consolidation of Variable Interest Entities, that it is the primary beneficiary of the SPE and, accordingly, the warehouse loans and related funding are consolidated in the Company's financial statements. At March 31, 2007, the Company recorded warehouse loans held for securitization of \$59.4 million, which are held as trading assets and carried at cost, which approximates fair value and recorded a corresponding warehouse loan payable to the financial institution related to these loans.

Revenue generated from the warehouse loan agreements is recorded in other trading revenues, as presented in the condensed consolidated statements of operations, and comprises the Company's share under the warehouse loan transaction of net realized losses on the termination of individual loan positions and net interest earned on the warehouse loans.

## 10. Income Taxes

Effective January 1, 2007, the Company adopted FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes (FIN 48). The adoption did not have a material effect on the Company's consolidated financial statements.

As of March 31, 2007, and January 1, 2007, the Company did not have any unrecognized tax benefits. The Company's accounting policy with respect to interest and penalties, if any, would be to recognize them in the provision for income taxes in the statements of operations. The Company did not incur any income tax related interest income, interest expense or penalties for the three months ended March 31, 2007 and 2006.

The Company and certain subsidiaries file income tax returns in the U.S. federal jurisdiction and various state, local and foreign jurisdictions, which are no longer subject to U.S. federal, state, local and foreign income tax examinations by tax authorities for years before 2003.

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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."

#### Business Overview

Primus Guaranty, Ltd. is a holding company that was incorporated in Bermuda in 1998 and conducts business through several operating subsidiaries. Our principal business is acting as a seller of credit swaps through Primus Financial Products, LLC, a limited liability company with "AAA/Aaa" counterparty ratings by Standard & Poor's Ratings Group, or S&P, and Moody's Investors Service, Inc., or Moody's, respectively. Primus Asset Management, Inc., or Primus Asset Management, one of our other principal operating subsidiaries, acts as an investment manager to affiliated companies and third party entities. PRS Trading Strategies, LLC, or PRS Trading Strategies, another of our principal operating subsidiaries, trades in a broad range of fixed income products, including credit default swaps, leveraged loans and investment grade and speculative grade securities.

#### Primus Financial

Primus Financial Products, LLC, or Primus Financial, is a "AAA/Aaa" rated seller of credit swaps against credit obligations of corporate and sovereign issuers. In exchange for a fixed quarterly premium we agree, upon the

occurrence of a default or other credit event (e.g., bankruptcy, failure to pay or restructuring) affecting a designated issuer, which we refer to as a Reference Entity, to pay our counterparty an agreed amount, which are referred to as “single name credit swaps.” To date, we have not experienced a credit event on any Reference Entity in our portfolio. We seek to minimize the risk inherent in our credit swap portfolio by maintaining a high quality, highly diversified credit swap portfolio across Reference Entities, industries and countries. Primus Financial is also permitted to sell credit swaps referencing portfolios containing obligations of multiple Reference Entities, which we refer to as “tranches”. Primus Financial recently received the rating agencies’ approval to sell credit swaps referencing residential mortgage-backed securities and commercial mortgage-backed securities, which we refer to as ABS. Primus Financial has begun selling credit swaps against ABS having an assigned rating of “BBB/Baa” (or the equivalent thereof) or better from a recognized rating agency referencing residential mortgage-backed securities.

#### Primus Asset Management

Primus Asset Management, Inc., or Primus Asset Management, acts as an investment manager to affiliated companies and third party entities. It currently manages the investment portfolios of its affiliates Primus Financial and PRS Trading Strategies, LLC. Primus Asset Management manages three investment grade synthetic collateralized debt obligations, or synthetic CDO’s, on behalf of third parties. The synthetic CDO’s issue securities backed by one or more credit swaps sold against unaffiliated clients’ debt obligations. In addition, Primus Asset Management has commenced acting as asset manager with respect to collateralized loan obligation, or CLO, transactions. A CLO is a debt security backed by a pool of commercial loans. Primus Asset Management receives fees for its investment management services.

Primus Asset Management’s business plan is to expand its assets under management, asset classes and strategies it manages.

Primus Asset Management is managed by an experienced team of professionals with expertise in credit analysis and structuring, investing, risk management and market analysis.

#### PRS Trading Strategies

PRS Trading Strategies, LLC, or PRS Trading Strategies, commenced operations in January 2006, with \$50 million of capital contributed by Primus Guaranty from the proceeds of our initial public

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offering. PRS Trading Strategies trades in a broad range of fixed income products, including credit default swaps, leveraged loans and investment grade and speculative grade securities. Unlike Primus Financial, PRS Trading Strategies has no counterparty ratings from rating agencies and, accordingly, may post collateral with its counterparties to support its contractual obligations. PRS Trading Strategies does not engage in trading activity with Primus Financial.

#### Net Credit Swap Revenues

Net credit swap revenue in our 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 both Primus Financial and PRS Trading Strategies. 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 tenor of the contract, generally five years, whereas PRS Trading Strategies 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 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 consolidated statements of operations. If a credit swap has an increase or decline in fair value during a period, the increase will add to our net credit swap revenue and 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 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 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 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 December 31, 2006, we had no outstanding credit swaps with any counterparties with whom we had not yet executed ISDA Master Agreements. Primus Financial and PRS Trading Strategies each enter into a valid ISDA Master Agreement with each of their counterparties.

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 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.

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).

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.

#### CLO Transaction

On December 19, 2006, the Company completed its first CLO offering through Primus CLO I, Ltd (a special purpose entity or SPE). Primus Asset Management is acting as collateral manager of the CLO. Under the terms of the collateral management agreement of the CLO, Primus Asset Management will receive management fees quarterly for managing the selection, acquisition and disposition of the underlying collateral and for monitoring the underlying collateral. The Company has invested \$6.5 million for a 25% of the equity interest in the CLO. The Company’s ultimate exposure to loss in the CLO is limited to the amount of its equity investment in the CLO.

Each time the Company is involved in a CLO transaction, the Company performs an analysis to determine whether it is the primary beneficiary and accordingly, would be required to consolidate the SPE in its consolidated financial statements. The Company has determined, that it is not the primary beneficiary of Primus CLO I, Ltd. and, accordingly, the SPE is not consolidated in the Company’s financial statements.

#### Warehouse Loan Transaction

On February 7, 2007, the Company’s subsidiaries, Primus Asset Management and PRS Trading Strategies entered into a master warehousing and participation agreement (together with certain other related agreements, hereafter referred to as the “warehouse loan agreements”) with another major financial institution and a special purpose entity or SPE 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 SPE. Under the warehouse loan agreements, the SPE is able to finance the purchase and accumulation of loans to an amount up to \$400 million. In the interim period, while the SPE accumulates the loans and before the CLO securities are issued (the “warehouse period”), the major financial institution is funding the purchase of the loans. PRS Trading Strategies has deposited \$5 million in cash collateral with a trustee pursuant to this arrangement representing the first loss protection on the underlying loans. PRS Trading Strategies’ potential loss is limited to \$5 million. Under the warehouse loan agreements, PRS Trading Strategies is entitled to the net interest earned on the loans, after deduction of funding costs.

The Company has determined, pursuant to FASB Interpretation No. 46(R), Consolidation of Variable Interest Entities, that it is the primary beneficiary of the SPE and, accordingly, the warehouse loans and related funding are consolidated in the Company’s financial statements. At March 31, 2007, the Company recorded warehouse loans held for securitization of \$59.4 million, which are held as trading assets and carried at cost, which approximates fair value and recorded a corresponding warehouse loan payable to the financial institution related to these loans.

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Revenue generated from the warehouse loan agreements is recorded in other trading revenues, as presented in the condensed consolidated statements of operations, and comprises the Company's share under the warehouse loan transaction of net realized losses on the termination of individual loan positions and net interest earned on the warehouse loans.

### Income Taxes

Primus Guaranty, PRS Trading Strategies, Primus Bermuda and Primus Financial are not expected to be engaged in the active conduct of a trade or business in the United States and as a result are not expected to be subject to United States federal, state or local income tax. Primus Asset Management is a United States domiciled corporation and is subject to United States federal, state and local income tax on its income, including on fees received from Primus Financial. Primus Re may be subject to United States federal, state or local income tax, or Primus Asset Management may be required to include all or part of Primus Re's income in calculating its liability for United States federal, state or local income tax, depending on the manner in which Primus Re conducts its business and the tax elections it makes. The maximum combined rate of United States corporate federal, state and local income tax that could apply to Primus Financial or Primus Bermuda, were they found to be engaged in a United States business in New York City and subject to income tax, is approximately 46% (not including United States branch profits tax that would be imposed on Primus Bermuda were Primus Financial deemed to be making distributions to Primus Bermuda). For United States federal income tax purposes, Primus Guaranty and Primus Bermuda are likely to be treated as PFICs.

### 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 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.

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### Share-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 share-based payment awards made to employees and directors including employee options and other forms of equity compensation based on estimated fair values.

Compensation expense is recognized based on the fair value of 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 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 share 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 March 31, 2007 Compared With Three Months Ended March 31, 2006

##### Overview

Our net income (loss) for the first quarter of 2007 was \$(9.7) million compared with \$35.1 million for the first quarter of 2006. The net loss during the first quarter of 2007 was primarily due to mark-to-market unrealized losses on credit swaps from the portfolio of credit swaps sold as compared with mark-to-market unrealized gains on credit swaps during the first quarter of 2006. Net credit swap premiums earned were \$18.5 million in the first quarter of 2007, compared with \$15.9 million in the first quarter of 2006. The increase in net premiums is attributable to the growth in our portfolio of credit swaps sold.

Interest income on our portfolio of investments was \$10.0 million in the first quarter of 2007, compared with \$6.6 million in the first quarter of 2006. 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 million senior notes offering by Primus Guaranty in December 2006.

Interest expense and distributions on preferred securities issued by Primus Financial were \$6.8 million in the first quarter of 2007, compared with \$3.6 million in the first quarter of 2006. The increase is due to higher short-term market interest rates, together with higher debt balances associated with the \$125 million senior notes offering by Primus Guaranty in December 2006 and a change in the frequency of distribution payments on the Series B preferred

securities.

Our operating expenses were \$10.0 million in the first quarter of 2007, compared with \$8.1 million in the first quarter of 2006. The increase was primarily due to higher compensation and employee benefits as a result of increased headcount, higher technology and data costs attributable to the expansion of our technology platform to accommodate new trading strategies associated with our asset management build-out and higher debt and investment management fees.

#### Net Credit Swap Revenue (Loss)

Consolidated net credit swap revenue (loss) was \$(4.9) million and \$40.1 million for the three months ended March 31, 2007 and 2006, respectively.

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The table below shows the Company's consolidated net credit swap revenue (loss), which is generated by Primus Financial and PRS Trading Strategies for the three months ended March 31, 2007 and 2006 (in thousands):

|   | Three months ended<br>March 31, |           |
|---|---------------------------------|-----------|
|   | 2007                            | 2006      |
| Primus Financial                                  | \$ (3,680)                      | \$ 40,361 |
| PRS Trading                                       | (1,197)                         | (232)     |
| Total consolidated net credit swap revenue (loss) | \$ (4,877)                      | \$ 40,129 |

Net credit swap loss for PRS Trading Strategies primarily consisted of mark-to-market unrealized losses on its credit swap portfolio during the period. See other trading revenues for further discussion of PRS Trading Strategies activities during the period.

Net credit swap revenue (loss) for Primus Financial is discussed below.

#### Net Credit Swap Revenue – Primus Financial

Net credit swap revenue (loss) was \$(3.7) million and \$40.4 million for the three months ended March 31, 2007 and 2006, respectively. Net credit swap revenue for Primus Financial excludes \$77 thousand for the three months ended March 31, 2006 of net revenue earned on three credit swap transactions with its affiliate, Primus Re, as this amount is eliminated in consolidation.

Net credit swap revenue (loss) includes:

- Net premiums earned;
- 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 three months ended March 31, 2007 and 2006 (in thousands):

|   | Three months ended<br>March 31, |           |
|---|---------------------------------|-----------|
|   | 2007                            | 2006      |
| Net premiums earned                           | \$ 18,401                       | \$ 15,925 |
| Net realized losses on credit swaps           | (749)                           | (275)     |
| Net unrealized gains (losses) on credit swaps | (21,332)                        | 24,711    |
| Total net credit swap revenue (loss)          | \$ (3,680)                      | \$ 40,361 |

Net Premiums Earned – Primus Financial

Net premiums earned were \$18.4 million and \$15.9 million for the three months ended March 31, 2007 and 2006, respectively. Net premiums earned include:

- Premium income on single name credit swaps sold;
- Premium income on tranches sold;
- Premium income on credit swaps sold on asset backed securities (ABS);

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The table below shows the components of net premiums earned for the three months ended March 31, 2007 and 2006 (in thousands).

|   | Three months ended<br>March 31, |           |
|---|---------------------------------|-----------|
|   | 2007                            | 2006      |
| Premium income on single name credit swaps sold | \$ 16,993                       | \$ 15,717 |
| Premium income on tranches sold                 | 1,368                           | 208       |
| Premium income on credit swaps sold on ABS      | 40                              | —         |
| Total net premiums earned                       | \$ 18,401                       | \$ 15,925 |

Premium income on single name credit swaps sold was \$17.0 million and \$15.7 million during the three months ended March 31, 2007 and 2006, respectively. The increase was primarily due to the expansion of our credit swap portfolio. The average notional amounts outstanding of credit swaps sold were \$15.4 billion and \$14.2 billion for the three months ended March 31, 2007 and 2006, respectively.

Premium income from tranches sold was \$1.4 million and \$208 thousand for the three months ended March 31, 2007 and 2006, respectively. The average notional amount of tranches outstanding was \$833.3 million and \$116.7 million for the three months ended March 31, 2007 and 2006, respectively.

During the fourth quarter of 2006, we received rating agency approval to sell credit protection on asset-backed securities (ABS). Premium income on credit swaps sold on ABS was \$40 thousand during the three months ended March 31, 2007. The average notional amount of credit swaps sold on ABS outstanding was \$26.7 million for the three months ended March 31, 2007.

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

Net realized gains (losses) for the three months ended March 31, 2007 and 2006 are summarized below (in thousands):

|   | Three months ended<br>March 31, |          |
|---|---------------------------------|----------|
|   | 2007                            | 2006     |
| Realized gains on terminated credit swaps sold  | \$ 244                          | \$ 502   |
| Realized losses on terminated credit swaps sold | (993)                           | (777)    |
| Total net realized losses on credit swaps       | \$ (749)                        | \$ (275) |

Net realized losses on the early termination of credit swaps sold were \$749 thousand and \$275 thousand for the three months ended March 31, 2007 and 2006, respectively. We terminated \$101.6 million and \$115 million notional amount of credit swaps sold during the three months ended March 31, 2007 and 2006, respectively. The realized losses incurred during the three months ended March 31, 2007 and 2006 were primarily the result of our decision to reduce our exposure to a limited number of reference entities against which we had sold credit protection.

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

The unrealized gains (losses) on credit swaps sold for the three months ended March 31, 2007 and 2006 are summarized below (in thousands):

|   | Three months ended<br>March 31, |           |
|---|---------------------------------|-----------|
|   | 2007                            | 2006      |
| Net unrealized gains (losses) on credit swaps sold  | \$ (8,042)                      | \$ 25,250 |
| Net unrealized losses on tranches sold              | (12,163)                        | (539)     |
| Net unrealized losses on credit swaps sold on ABS   | (1,127)                         | —         |
| Total net unrealized gains (losses) on credit swaps | \$ (21,332)                     | \$ 24,711 |

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Net unrealized gains (losses) on credit swaps were \$(21.3) million and \$24.7 million for the three months ended March 31, 2007 and 2006, respectively. The change in unrealized losses on credit swaps reflects the change in the fair value of our credit swap portfolio during these periods. The unrealized loss on credit swaps for the first quarter of 2007 is primarily due to rising credit market premiums on the portfolio of credit swaps compared with the prior

period. The unrealized gain in the first quarter 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 quarter.

#### Asset Management and Advisory Fees

We recognized \$661 thousand and \$49 thousand of asset management and advisory fees for the three months ended March 31, 2007 and 2006, respectively. The increase was primarily due to asset management fees related to our first CLO offering in December 2006. On December 19, 2006, the Company completed its first CLO offering of Primus CLO I, Ltd. Primus Asset Management acts as collateral manager of the CLO. Under the terms of the collateral management agreement of the CLO, Primus Asset Management receives management fees quarterly for managing the selection, acquisition and disposition of the underlying collateral and for monitoring the underlying collateral. Some of our synthetic CDO asset management contracts also provide for the receipt of contingent performance fees at the maturity of the contracts, none of which has been earned or accrued at March 31, 2007 or 2006, respectively.

#### Interest Income

We earned interest income of \$10.0 million and \$6.6 million for the three months ended March 31, 2007 and 2006, respectively. The increase in interest income is attributable to higher average invested balances resulting from the December 2006 senior notes offering of \$125 million by Primus Guaranty and retained cash earnings, and higher yields on our investment portfolio. The increase in yields is attributable to generally higher short-term market rates of interest during 2006 and 2007.

Weighted average yields on our cash, cash equivalents and investments were 4.95% in the three months ended March 31, 2007 compared with 4.20% for the three months ended March 31, 2006.

The table below summarizes our interest income for the three months ended March 31, 2007 and 2006 and our total cash, cash equivalents, available-for-sale and trading account securities at March 31, 2007 and 2006 (in thousands).

|   | Three months ended<br>March 31, |            |
|---|---------------------------------|------------|
|   | 2007                            | 2006       |
| Interest income   | \$ 9,977                        | \$ 6,601   |
| Cash and cash equivalents   | \$ 155,212                      | \$ 64,884  |
| Available-for-sale and trading account securities                               | 657,267                         | 569,981    |
| Total cash, cash equivalents, available-for-sale and trading account securities | \$ 812,479                      | \$ 634,865 |

#### Other Trading Revenue

During the three months ended March 31, 2007, PRS Trading Strategies recorded other trading revenues of \$1.3 million, which excludes PRS Trading Strategies' net credit swap loss of \$(1.2) million as discussed under net credit swap revenue (loss) caption. PRS Trading Strategies did not record other trading revenues during the three months ended March 31, 2006. Other trading revenues comprises the net trading gains from PRS Trading Strategies' total return swaps, loan warehousing and bond trading activities.

#### Foreign currency revaluation

We transact credit swaps denominated in U.S. dollars and euros. Euro-denominated credit swaps comprised 30% of the notional amount of our Primus Financial credit swaps sold portfolio at

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March 31, 2007. We 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 three months ended March 31, 2007 and 2006, we recorded \$51 thousand and \$(6) thousand, respectively, in foreign currency revaluation gains (losses).

## Operating Expenses

Our operating expenses were \$10.0 million and \$8.1 million for the three months ending March 31, 2007 and 2006, respectively, as summarized below (in thousands):

|   | Three months ended<br>March 31, |          |
|---|---------------------------------|----------|
|   | 2007                            | 2006     |
| Compensation and employee benefits              | \$ 6,004                        | \$ 4,891 |
| Professional and legal fees                     | 976                             | 1,215    |
| Depreciation and amortization                   | 577                             | 589      |
| Technology and data                             | 877                             | 399      |
| Other   | 1,535                           | 1,039    |
| Total operating expenses                        | \$ 9,969                        | \$ 8,133 |
| Number of full-time employees, at end of period | 55                              | 41       |

Compensation expense for the three months ended March 31, 2007 increased \$1.1 million over the comparable prior period. Overall, the 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 \$2.0 million for the three months ended March 31, 2007, compared with an accrued expense of \$1.6 million for the corresponding prior period. Share compensation expense was approximately \$1.0 million in each of the three months ended March 31, 2007 and 2006, respectively.

Professional and legal fees expense includes audit and tax advisor fees, legal costs, recruitment fees and director and officer insurance expense. The decrease in professional fees is primarily due to lower employee recruiting costs.

Depreciation and amortization expense remained consistent with the prior period. 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 debt and investment management fees.

## Interest Expense and Preferred Distributions

For the three months ended March 31, 2007 and 2006, we recorded \$4.9 million and \$2.4 million of interest expense, respectively. The increase in interest expense was primarily the result of higher debt balances as a result of the senior

note offering of \$125 million by Primus Guaranty in December 2006 along with increased short-term interest rates.

In February 2007, the Company entered into an interest rate swap agreement with a major financial institution that effectively converted a notional amount of \$75.0 million of the Company's \$125.0 million, 7% fixed rate senior notes due in December 2036, to floating rate debt based on the three month LIBOR rate plus a spread as defined in the agreement.

Primus Financial also made net distributions of \$1.9 million and \$1.1 million during the three months ended March 31, 2007 and 2006, respectively, on the Primus Financial Cumulative Preferred Securities issued in December 2002. The increase in net distributions was primarily due to increased short-term interest rates and a change in the frequency of distribution payments of the Series B preferred securities, which was approximately \$400 thousand.

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### Income Taxes

Provision for income taxes was \$56 thousand and \$55 thousand for the three months ended March 31, 2007 and 2006, respectively. Primus Guaranty had a net deferred tax asset, fully offset by a valuation allowance, of \$9.2 million and \$9.5 million as of March 31, 2007 and December 31, 2006, 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 or loss, then its income tax expense or (benefit), excluding interest and penalties, would have been approximately \$(3.5) million and \$17.5 million for the three months ended March 31, 2007 and 2006, 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.

### Off-Balance Sheet Arrangements

We do not have any off-balance sheet arrangements (as such term is defined in Item 303 of Regulation S-K) that are reasonably likely to have a current or future material effect on our financial condition, changes in financial condition, revenues or expenses, results of operations, liquidity, capital expenditures or capital resources.

### Contractual Obligations

The following table summarizes our contractual obligations at March 31, 2007 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 | \$ 10,859 | \$ 1,254              | \$ 2,507  | \$ 2,528  | \$ 4,570             |

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|  |            |           |           |           |            |
|--|------------|-----------|-----------|-----------|------------|
| Senior notes                           | 125,000    | —         | —         | —         | 125,000    |
| Interest on senior notes(b)            | 260,215    | 8,750     | 17,500    | 17,500    | 216,465    |
| Subordinated deferrable interest notes | 200,000    | —(a)      | —(a)      | —(a)      | 200,000    |
| Total                                  | \$ 596,074 | \$ 10,004 | \$ 20,007 | \$ 20,028 | \$ 546,035 |

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

(b) Net interest payments on the 7% fixed senior notes will vary due to the interest rate swap agreement, as previously discussed.

Property leases: Primus Financial currently occupies approximately 17,500 square feet of office space at 360 Madison Avenue, New York, New York at a fixed yearly rental (subject to certain escalations specified in the lease). In 2006, Primus Financial amended the original lease to extend its term to 2016 and add 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

Our consolidated cash, cash equivalents, available-for-sale and trading account securities were \$812.5 million and \$803.9 million as of March 31, 2007 and December 31, 2006, respectively. Since its

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inception, Primus Guaranty has raised both debt and equity capital and has contributed capital to its operating subsidiaries. Primus Guaranty is a holding company with no direct operations of its own, and as such, it is largely dependent upon the ability of its operating subsidiaries to generate cash to service its debt obligations and working capital needs.

On December 27, 2006, Primus Guaranty completed an offering of \$125 million of 7% senior notes, which mature in December 2036. The senior notes are senior unsecured obligations and rank equally with all of our other unsecured and unsubordinated indebtedness. The senior notes are also structurally subordinated to all liabilities of Primus Guaranty's subsidiaries. The senior notes are redeemable at the option of Primus Guaranty, in whole or in part, at any time on or after December 27, 2011, at redemption price equal to 100% of the principal amount to be redeemed, plus any accrued and unpaid interest thereon to the redemption date. Interest on the senior notes is payable quarterly, beginning on March 27, 2007. The senior notes are rated BBB+/Baa1 by S&P and Moody's, respectively.

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. At March 31, 2007 and December 31, 2006, Primus Financial had cash, cash equivalents and investments of \$640.6 million and



\$624.5 million, which management believes is sufficient to operate its credit swap business.

Primus Financial receives 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 operating and administrative expenses, premiums on credit swaps purchased, realized losses from the early termination of credit swaps, interest on debt and preferred share distributions.

PRS Trading Strategies commenced operations in January 2006 with \$50.0 million of capital contributed by Primus Guaranty from the proceeds of our initial public offering. The capital contribution will allow PRS Trading Strategies to trade in a broad range of fixed income products, including credit default swaps, leveraged loans and investment grade and speculative grade securities, among others. Unlike Primus Financial, PRS Trading Strategies has no counterparty ratings from rating agencies and, accordingly, may post collateral with its counterparties to support its contractual obligations.

#### Cash Flows

Cash flows from operating activities – Net cash (used in) provided by operating activities were \$(55.9) million and \$8.4 million for the three months ended March 31, 2007 and 2006, respectively. This decrease is primarily attributable to our consolidation of the SPE warehouse loans held for securitization, as discussed previously and higher working capital needs during the first quarter of 2007 compared with the first quarter of 2006.

Cash flows from investing activities – Net cash used in investing activities was \$57.0 million and \$11.4 million for the three months ended March 31, 2007 and 2006, respectively. This increase was primarily due to higher net purchases of available-for-sale-investments in 2007 compared with 2006.

Cash flows from financing activities – Net cash provided by (used in) financing activities was \$63.7 million and \$(1.4) million for the three months ended March 31, 2007 and 2006, respectively. This increase is primarily due to our consolidation of the SPE warehouse loan funding, as previously discussed and proceeds received from the exercise of warrants by XL Insurance (Bermuda) Ltd., partially offset by an increase in preferred distributions of our subsidiary.

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 debt service obligations (including preferred distributions) over at least the next twelve months.

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##### Recent Accounting Pronouncements

In April 2006, the FASB issued FASB Staff Position FIN 46(R)-6, Determining the Variability to Be Considered in Applying FASB Interpretation No. 46(R) (“FSP FIN 46(R)-6”). FSP FIN 46(R)-6 addresses how variability should be considered when applying FIN 46(R). Variability affects the determination of whether an entity is a variable interest entity (VIE), which interests are variable interests, and which party, if any, is the primary beneficiary of the VIE required to consolidate. FSP FIN 46(R)-6 clarifies that the design of the entity also should be considered when identifying which interests are variable interests. The Company adopted FSP FIN 46(R)-6 during the third quarter of 2006 and applied it prospectively to all entities in which the Company first became involved with. The adoption of FSP FIN 46(R)-6 did not have a material effect on the Company’s 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. Effective January 1, 2007, the Company adopted FIN 48. The adoption did not have a material effect on the Company's consolidated financial statements.

In September 2006, the FASB issued SFAS No. 157, Fair Value Measurements (SFAS No. 157). SFAS No.157 defines fair value, establishes a framework for measuring fair value in 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.

In February 2007, the FASB issued SFAS No. 159, The Fair Value Option for Financial Assets and Liabilities ("SFAS No. 159"). SFAS No. 159 provides a fair value option election that allows companies to irrevocably elect fair value as the initial and subsequent measurement attribute for certain financial assets and liabilities, with changes in fair value recognized in earnings as they occur. SFAS No. 159 permits the fair value option election on an instrument by instrument basis at initial recognition of an asset or liability or upon an event that gives rise to a new basis of accounting for that instrument. SFAS No. 159 is effective as of the beginning of an entity's first fiscal year that begins after November 15, 2007. The Company is currently evaluating the impact that adoption of SFAS No. 159 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;
- the level of activity in the leveraged buyout and private equity markets;
- competitive conditions and pricing levels;

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- legislative and regulatory developments;
- 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.

### 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 March 31, 2007, 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 \$6.3 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 Shares 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 Shares 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. 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.

In February 2007, the Company entered into an interest rate swap agreement with a major financial institution that effectively converted a notional amount of \$75.0 million of the Company's \$125.0 million, 7% fixed rate senior notes due in December 2036, to floating rate debt based on the three month LIBOR rate plus a spread as defined in the agreement. Assuming a 25 basis point increase or decrease in the three month LIBOR rate, our interest expense would increase or decrease by \$187,500 annually.

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.

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### 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 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, 2006.

### Item 6. Exhibits

- 12 Ratio of Earnings to Combined Fixed Charges and Preferred Share Dividend Requirements
- 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

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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: May 10, 2007

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