XL Insurance (Bermuda) Ltd

Consolidated Financial Statements

For The Years Ended

December 31, 2012 and 2011

April 30, 2013

Independent Auditor's Report

To the Shareholder of XL Insurance (Bermuda) Ltd:

We have audited the accompanying consolidated financial statements of XL Insurance (Bermuda) Ltd, which comprise the consolidated balance sheets as of December 31, 2012 and December 31, 2011, and the related consolidated statements of income, retained earnings and comprehensive income, shareholder's equity and cash flows for the years then ended.

Management's Responsibility for the Consolidated Financial Statements

Management is responsible for the preparation and fair presentation of the consolidated financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of consolidated financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

Our responsibility is to express an opinion on the consolidated financial statements based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on our judgment, including the assessment of the risks of material misstatement of the consolidated financial statements, whether due to fraud or error. In making those risk assessments, we consider internal control relevant to the Company's preparation and fair presentation of the consolidated financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

PricewaterhouseCoopers, Chartered Accountants, P.O. Box HM 1171, Hamilton HM EX, Bermuda
T: +1 (441) 295 2000, F:+1 (441) 295 1242, www.pwc.com/bermuda

Opinion

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of XL Insurance (Bermuda) Ltd at December 31, 2012 and December 31, 2011, and the results of its operations and its cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.

PricewaterhouseCoopers

Chartered Accountants

XL Insurance (Bermuda) Ltd

CONSOLIDATED BALANCE SHEETS AT DECEMBER 31, 2012 AND 2011

(U.S. dollars in thousands, except share data)	2012	2011
ASSETS		
Investments:		
Fixed maturities, at fair value (amortized cost: 2012: $25,429,463; 2011: $24,454,288)	$ 26,660,524	$ 24,927,808
Equity securities, at fair value (cost: 2012: $617,486; 2011: $480,685)	649,359	468,197
Short-term investments, at fair value (amortized cost: 2012: $322,561; 2011: $359,378)	322,703	359,064
Total investments available for sale	$ 27,632,586	$ 25,755,069
Fixed maturities, held to maturity at amortized cost (fair value: 2012: $3,262,804; 2011: $2,895,688)	2,814,447	2,668,978
Investments in affiliates	1,126,875	1,052,724
Other investments	1,212,102	977,602
Total investments	$ 32,786,010	$ 30,454,373
Cash and cash equivalents	2,388,342	3,080,019
Accrued investment income	334,071	324,348
Deferred acquisition costs	675,705	647,113
Ceded unearned premiums	587,909	596,895
Premiums receivable	2,568,861	2,411,611
Reinsurance balances receivable	58,428	220,017
Unpaid losses and loss expenses recoverable	3,382,101	3,654,948
Receivable from investments sold	16,002	59,727
Amount due from Parent and affiliates	1,200	330,600
Goodwill and other intangible assets	272,494	271,289
Deferred tax asset	162,188	111,647
Other assets	461,320	553,421
Total assets	$ 43,694,631	$ 42,716,008
LIABILITIES AND SHAREHOLDERS' EQUITY		
Liabilities:		
Unpaid losses and loss expenses	$ 20,484,121	$ 20,613,901
Deposit liabilities	1,551,398	1,608,108
Future policy benefit reserves	4,812,045	4,845,394
Unearned premiums	3,755,920	3,555,310
Notes payable and debt	-	599,971
Reinsurance balances payable	143,112	90,552
Payable for investments purchased	102,112	58,494
Deferred tax liability	141,803	91,104
Amount due to affiliates	44,953	3,406
Other liabilities	799,984	698,641
Total liabilities	$ 31,835,448	$ 32,164,881
Commitments and Contingencies		
Shareholders' Equity:		
Ordinary shares, 15,000,000 authorized, par value $0.10; issued and outstanding: (2012: 10,000,000; 2011: 10,000,000)	$ 1,000	$ 1,000
Additional paid in capital	9,204,182	8,995,334
Accumulated other comprehensive income	1,275,116	464,992
Retained earnings (deficit)	1,377,060	1,089,801
Shareholders' equity attributable to XL Group plc	$ 11,857,358	$ 10,551,127
Non-controlling interest in equity of consolidated subsidiaries	1,825	-
Total shareholders' equity	$ 11,859,183	$ 10,551,127
Total liabilities and shareholders' equity	$ 43,694,631	$ 42,716,008

See accompanying Notes to Consolidated Financial Statements

XL INSURANCE (BERMUDA) LTD

CONSOLIDATED STATEMENTS OF INCOME

FOR THE YEARS ENDED DECEMBER 31, 2012 AND 2011

(U.S. dollars in thousands)	2012	2011
Revenues:		
Net premiums earned	$ 6,090,441	$ 5,690,130
Net investment income	975,605	1,078,586
Realized investment gains (losses):		
Net realized gains (losses) on investments sold	146,931	(23,399)
Other-than-temporary impairments on investments	(34,004)	(118,712)
Other-than-temporary impairments on investments transferred to (from) other comprehensive income	(19,896)	11,726
Total net realized gains (losses) on investments	$ 93,031	$ (130,385)
Net realized and unrealized gains (losses) on derivative instruments	5,246	633
Income (loss) from investment fund affiliates	58,485	26,304
Fee income and other	50,034	47,199
Total revenues	$ 7,272,842	$ 6,712,467
Expenses:		
Net losses and loss expenses incurred	$ 3,765,482	$ 4,078,391
Claims and policy benefits	486,198	535,074
Acquisition costs	913,492	826,411
Operating expenses	1,139,453	973,669
Exchange (gains) losses	10,383	(40,129)
Interest expense	83,239	100,697
Impairment of goodwill	-	385,592
Total expenses	$ 6,398,247	$ 6,859,705
Income (loss) before income tax and income (loss) from operating affiliates	$ 874,595	$ (147,238)
Income (loss) from operating affiliates	55,810	76,786
Provision for income tax	(35,668)	(59,668)
Net income (loss)	$ 894,737	$ (130,120)
Non-controlling interests	(167)	(83)
Net income (loss) attributable to XL Insurance (Bermuda) Ltd	$ 894,570	$ (130,203)

See accompanying Notes to Consolidated Financial Statements

XL INSURANCE (BERMUDA) LTD

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

FOR THE YEARS ENDED DECEMBER 31, 2012 AND 2011

(U.S. dollars in thousands)	2012	2011
Net income (loss) attributable to XL Insurance (Bermuda) Ltd	$ 894,570	$ (130,203)
Change in net unrealized gains (losses) on investments, net of tax	715,196	429,566
Change in net unrealized gains (losses) on affiliate and other investments, net of tax	45,985	25,595
Change in OTTI losses recognized in other comprehensive income, net of tax	51,702	22,480
Change in underfunded pension liability	(9,986)	(2,622)
Foreign currency translation adjustments	7,227	(26,727)
Comprehensive income (loss)	$ 1,704,694	$ 318,089

See accompanying Notes to Consolidated Financial Statements

XL INSURANCE (BERMUDA) Ltd

CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY

FOR THE YEARS ENDED DECEMBER 31, 2012 AND 2011

(U.S. dollars in thousands)	2012	2011
Ordinary Shares:		
Balance - beginning of year	$ 1,000	$ 1,000
Balance - end of year	$ 1,000	$ 1,000
Additional Paid in Capital:		
Balance - beginning of year	$ 8,995,334	$ 8,995,334
Receipt of Capital	208,848	-
Balance - end of year	$ 9,204,182	$ 8,995,334
Accumulated Other Comprehensive Income (Loss):		
Balance - beginning of year	$ 464,992	$ 16,700
Change in net unrealized gains (losses) on investments, net of tax	715,196	429,566
Change in net unrealized gains (losses) on affiliate and other investments, net of tax	45,985	25,595
Change in OTTI losses recognized in other comprehensive income, net of tax	51,702	22,480
Change in underfunded pension liability	(9,986)	(2,622)
Foreign currency translation adjustments	7,227	(26,727)
Balance - end of year	$ 1,275,116	$ 464,992
Retained Earnings (Deficit):		
Balance - beginning of year	$ 1,089,801	$ 1,931,554
Net income attributable to XL Insurance (Bermuda) Ltd	894,570	(130,203)
Dividends on ordinary shares	(607,311)	(711,550)
Balance - end of year	$ 1,377,060	$ 1,089,801
Non-controlling Interest in Equity of Consolidated Subsidiaries:		
Balance - beginning of year	$ -	$ 2,296
Non-controlling interests	1,825	(83)
Non-controlling interest share in change in accumulated other comprehensive income (loss)	-	(2,213)
Balance - end of year	$ 1,825	$ -
Total Shareholders' Equity	$ 11,859,183	$ 10,551,127

See accompanying Notes to Consolidated Financial Statements

XL INSURANCE (BERMUDA) Ltd

CONSOLIDATED STATEMENTS OF CASH FLOWS

FOR THE YEARS ENDED DECEMBER 31, 2012 AND 2011

(U.S. dollars in thousands)	2012	2011
Cash flows provided by (used in) operating activities:		
Net income (loss)	$ 894,737	$ (130,120)
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:		
Net realized (gains) losses on investments	(93,031)	130,385
Net realized and unrealized (gains) losses on derivative instruments	(5,246)	(633)
Amortization of premiums (discounts) on fixed maturities	170,826	129,365
(Income) loss from investment and operating affiliates	(114,296)	(103,090)
Impairment of goodwill	-	385,592
Share based compensation	-	23,797
Depreciation	51,794	44,345
Accretion of deposit liabilities	81,269	82,799
Changes in:		
Unpaid losses and loss expenses	(287,972)	243,040
Future policy benefit reserves	(187,400)	(171,618)
Unearned premiums	182,963	95,393
Premiums receivable	(127,633)	(31,286)
Unpaid losses and loss expenses recoverable	305,675	(2,168)
Amounts due from parent and affiliates	470,953	(18,870)
Ceded unearned premiums	14,923	21,532
Reinsurance balances receivable	162,280	(49,286)
Deferred acquisition costs	(649)	(41,881)
Reinsurance balances payable	48,159	(31,846)
Deferred tax asset - net	(28,556)	(47,537)
Derivatives	7,252	93,796
Other assets	32,975	(6,051)
Other liabilities	51,720	(91,006)
Other	(57, 475)	(47,834)
Total adjustments	$ 678,531	$ 606,938
Net cash provided by (used in) operating activities	$ 1,573,268	$ 476,818
Cash flows provided by (used in) investing activities:		
Proceeds from sale of fixed maturities and short-term investments	$ 1,912,201	$ 4,251,792
Proceeds from redemption of fixed maturities and short-term investments	4,243,346	2,633,038
Proceeds from sale of equity securities	221,617	204,986
Purchases of fixed maturities and short-term investments	(7,363,361)	(6,160,046)
Purchases of equity securities	(362,021)	(630,520)
Investment affiliates, net	(4,652)	136,258
Other investments, net	(79,358)	(39,681)
Net cash provided by (used in) investing activities	$ (1,432,228)	$ 395,827

See accompanying Notes to Consolidated Financial Statements

XL INSURANCE (BERMUDA) Ltd

CONSOLIDATED STATEMENTS OF CASH FLOWS

FOR THE YEARS ENDED DECEMBER 31, 2012 AND 2011

(U.S. dollars in thousands)	2012	2011
Cash flows provided by (used in) financing activities:		
Dividends paid on ordinary shares	(232,608)	(711,550)
Contribution from non-controlling interest	1,500	-
Contribution from Parent Company	208,848	-
Repayment of loan to Parent Company	(100,000)	-
Repayment of debt	(600,000)	-
Deposit liabilities	(134,950)	(152,618)
Net cash provided by (used in) financing activities	$ (857,210)	$ (864,168)
Effects of exchange rate changes on foreign currency cash	24,493	1,668
Increase (decrease) in cash and cash equivalents	$ (691,677)	$ 10,145
Cash and cash equivalents - beginning of period	3,080,019	3,069,874
Cash and cash equivalents - end of period	$ 2,388,342	$ 3,080,019
Net taxes paid	$ 34,094	$ 106,439
Interest paid on notes payable and debt	$ 19,500	$ 39,000

See accompanying Notes to Consolidated Financial Statements

1. General

XL Insurance (Bermuda) Ltd and its operating subsidiaries (collectively the "Company" or "XL"), are leading providers of insurance and reinsurance coverages to industrial, commercial and professional firms, insurance companies and other enterprises on a worldwide basis. The Company and its various subsidiaries operate globally in 24 countries, through its three business segments: Insurance, Reinsurance and Life operations. These segments are further discussed in Note 4, "Segment Information."

Insurance Operations

The Company's insurance operations are organized into four business units: International Property and Casualty ("IPC"), North America Property and Casualty ("NAPC"), Global Professional ("Professional") and Global Specialty ("Specialty"). The insurance operations market and distribute coverage through a wide variety of local, national and international producers and provide customized insurance policies for complex corporate risks that may require large limits. Large deductibles and self-insured retentions are incorporated into these policies to further manage risk along with stringent underwriting guidelines. While the insurance segment is known for insuring large complex risk, certain of our products are targeted to small and midsize companies and organizations, such as our professional liability and program business. The Company focuses on those lines of business that it believes will provide the best return on capital over time.

The excess nature of many of the Company's insurance products, coupled with historically large policy limits, results in a book of business that can have losses characterized as low frequency and high severity. As a result, large losses, though infrequent, can have a significant impact on the Company's results of operations, financial condition and liquidity. The Company attempts to mitigate this risk by, among other things, using strict underwriting guidelines, effective risk management practices (e.g., monitoring of aggregate exposures) and various reinsurance arrangements, discussed below.

International Property and Casualty

IPC includes the following lines of business: property, primary and excess casualty and environmental liability.

Property and casualty products are typically written as global insurance programs for large and medium sized multinational companies and institutions and include property and liability coverages. Property and casualty products generally provide large capacity on a primary, quota share or excess of loss basis. The primary casualty programs generally require customers to take large deductibles or self-insured retentions. For the excess business, the Company's liability attaches after large deductibles, including self insurance or insurance layers provided by other companies. Policies are written on an occurrence, claims-made and occurrence reported basis. The Company's property business, which also includes construction projects, is short-tail by nature and written on both a primary and excess of loss basis. Property business includes exposures to man-made and natural disasters, and generally, loss experience is characterized as low frequency and high severity.

Environmental liability products include pollution and remediation legal liability, general and project-specific pollution and professional liability, and commercial general property redevelopment and contractor's pollution liability. Business is written for both single and multiple years on a primary or excess of loss, claims-made or, less frequently, occurrence basis.

North America Property and Casualty

NAPC includes the following lines of business: property, primary and excess casualty, environmental liability, excess and surplus lines, construction, surety and program business.

In addition to the property, casualty and environmental products described under IPC, the NAPC business unit also includes 100% property products for the large account risk engineered markets and general liability, U.S. workers compensation and auto liability for the risk management accounts which require customers to take large deductibles or self-insured retentions.

Excess and surplus lines products include general liability property, excess auto and excess liability coverages where most Insurance Services Office, Inc. ("ISO") products are written.

Construction products include property coverages (builders risk, contractors equipment, property and inland marine), general liability, U.S. workers compensation and commercial auto, as well as professional liability for contractors and owner, excess umbrella, subcontractor default insurance and primary casualty wrap ups.

Surety products include contract bonds, including bid, performance, payment, and contractor qualification bonds, as well as commercial surety bonds, including appeal, court and qualification bonds. Products in general provide large capacity and are written

1. General

on a sole surety, co-surety or shared surety basis.

The Company’s program business specializes in insurance coverages for distinct market segments in North America, including program administrators and managing general agents who operate in a specialized market niche and have unique industry backgrounds or specialized underwriting capabilities. Products encompass mostly property and casualty coverages.

Global Professional

Professional includes directors’ and officers’ liability, errors and omissions liability and employment practices liability and technology and cyber liability coverages. Policies are written on both a primary and excess of loss basis. Directors’ and officers’ coverage includes primary and excess directors’ and officers’ liability, employment practices liability and company securities and private company directors’ and officers’ liability. Employment practices liability is written primarily for very large corporations on an excess of loss basis and covers those firms for legal liability in regard to the treatment of employees. Errors and omissions coverage is written on a primary and excess basis.

Global Specialty Lines

Specialty includes the following lines of business: aviation and satellite, marine and offshore energy, fine art and specie, equine, product recall, political risk and trade credit and North America inland marine.

Aviation and satellite products include comprehensive airline hull and liability, airport liability, aviation manufacturers’ product liability, aviation ground handler liability, large aircraft hull and liability, corporate non-owned aircraft liability, space third party liability and satellite risk including damage or malfunction during ascent to orbit and continual operation, and aviation war. Aviation liability and physical damage coverage is offered for large aviation risks on a proportional basis, while smaller general aviation risks are offered on a primary basis. Satellite risks are generally written on a proportional basis.

Marine and offshore energy coverage includes marine hull and machinery, marine war, marine excess liability, cargo and offshore energy insurance. Fine art and specie coverages include fine art and other collections, jewelers block, cash in transit and related coverages for financial institutions. Equine products specialize in providing bloodstock and livestock insurance. Product recall coverages include product contamination for the food and beverage sector and end-product consumer goods and product guarantee aimed at component part manufacturers.

In 2011, the Company launched underwriting capabilities for political risk and trade credit as well as North America inland marine business.

Also included as part of the Insurance segment is XL Global Asset Protection Services (“XL GAPS”), a fee for service loss prevention consulting service that offers individually tailored risk management solutions to risk managers, insurance brokers and insurance company clients operating on a global basis. Services are offered on an “unbundled” (services not tied to an insurance contract) and “bundled” basis.

Reinsurance Ceded

In certain cases, the risks assumed by the Company in the Insurance segment are partially reinsured with third party reinsurers. Reinsurance ceded varies by location and line of business based on a number of factors, including market conditions.

The Company uses reinsurance to support the underwriting and retention guidelines of each of its subsidiaries as well as to control the aggregate exposure of the Company to a particular risk or class of risks. Reinsurance is purchased at several levels ranging from reinsurance of risks assumed on individual contracts to reinsurance covering the aggregate exposure on a portfolio of policies issued by groups of companies.

Reinsurance Operations

The Company's Reinsurance segment is structured geographically into Bermuda operations, North American operations, European/Asia Pacific operations and Latin American operations. The segment provides casualty, property risk, property catastrophe, marine, aviation, treaty and other specialty reinsurance on a global basis with business being written on both a proportional and non-proportional basis and also on a facultative basis.

1. General

Business written on a non-proportional basis generally provides for an indemnification by the Company to the ceding company for a portion of losses both individually and in the aggregate, on policies with limits in excess of a specified individual or aggregate loss deductible. For business written on a proportional bases including “quota share” or “surplus” basis, the Company receives an agreed percentage of the premium and is liable for the same percentage of each and all incurred loss. For proportional business, the ceding company normally receives a ceding commission for the premiums ceded and may also, under certain circumstances; receive a profit commission based on performance of the contract. Occasionally this commission could be on a sliding scale depending on the loss ratio performance of the contract. The Company’s casualty reinsurance includes general liability, professional liability, automobile and workers’ compensation. Professional liability includes directors’ and officers’, employment practices, medical malpractice, and environmental liability. Casualty lines are written as treaties or programs and on both a proportional and a non-proportional basis. The treaty business includes clash programs which cover a number of underlying policies involved in one occurrence or a judgment above an underlying policy’s limit, before suffering a loss.

The Company’s property business, primarily short-tail in nature, is written on both a portfolio/treaty and individual/facultative basis and includes property catastrophe, property risk excess of loss and property proportional. A significant portion of the property business underwritten consists of large aggregate exposures to man-made and natural disasters and, generally, loss experience is characterized as low frequency and high severity.

The Company seeks to manage its reinsurance exposures to catastrophic events by limiting the amount of exposure written in each geographic or peril zone worldwide, underwriting in excess of varying attachment points and requiring that contracts exposed to catastrophe loss include aggregate limits. The Company also seeks to protect its total aggregate exposures by peril and zone through the purchase of reinsurance programs.

The Company’s property catastrophe reinsurance account is generally “all risk” in nature. As a result, the Company is exposed to losses from sources as diverse as hurricanes and other windstorms, earthquakes, freezing, riots, floods, industrial explosions, fires, and many other potential natural or man-made disasters. In accordance with market practice, the Company’s policies generally exclude certain risks such as war, nuclear contamination or radiation. Following the terrorist attacks at the World Trade Center in New York City, in Washington, D.C. and in Pennsylvania on September 11, 2001 (collectively, “the September 11 event”), terrorism cover, including, nuclear, biological, radiological and chemical has been restricted or excluded in many territories and classes. Some U.S. states require some cover for “Fire Following” terrorism and some countries make terrorism coverage mandatory. The Company’s predominant exposure under such coverage is to property damage.

Property catastrophe reinsurance provides coverage on an excess of loss basis when aggregate losses and loss adjustment expenses from a single occurrence of a covered event exceed the attachment point specified in the policy. Some of the Company’s property catastrophe contracts limit coverage to one occurrence in any single policy year, but most contracts generally enable at least one reinstatement to be purchased by the reinsured.

The Company also writes property risk excess of loss reinsurance. Property risk excess of loss reinsurance covers a loss to the reinsured on a single risk of the type reinsured rather than to aggregate losses for all covered risks on a specific peril, as is the case with catastrophe reinsurance. The Company’s property proportional account includes reinsurance of direct property insurance. The Company seeks to limit the catastrophe exposure from its proportional and per risk excess business through extensive use of occurrence and cession limits.

Other specialty reinsurance products include energy, marine, aviation, space, engineering, fidelity, surety, trade credit and political risk. The Company underwrites a small portfolio of contracts covering political risk and trade credit. Exposure is assumed from a limited number of trade credit contracts.

Reinsurance Retroceded

The Company uses third party reinsurance to support the underwriting and retention guidelines of each reinsurance subsidiary as well as seeking to limit the aggregate exposure of the Company to a particular risk or class of risks. Reinsurance is purchased at several levels ranging from reinsurance of risks assumed on individual contracts to reinsurance covering the aggregate exposures. Reinsurance ceded varies by location and line of business based on factors including, among others, market conditions and the credit worthiness of the counterparty.

The Company’s traditional catastrophe retrocession program was renewed in 2012 to cover certain of the Company’s exposures. These protections, in various layers and in excess of varying attachment points according to the territory exposed, assist in managing the Company’s net retention to an acceptable level. The Company has co-reinsurance retentions within this program. The

1. General

Company continued to buy additional protection for the Company's marine and offshore energy exposures and in 2012 increased its retentions for these lines.

The Company continues to buy specific reinsurances on its property and aviation portfolios to manage its net exposures in these classes.

Life Operations

During 2009, the Company completed a strategic review of its life reinsurance business. In relation to this initiative, during 2009 the Company sold the renewal rights to certain of its businesses, sold its U.S. Life businesses and announced that it would run-off its existing book of U.K. and Irish traditional life and annuity business, and not accept new business. In addition, in 2010, the Company consummated various transactions to novate and recapture U.K. and Irish term assurance and critical illness treaties and U.S. mortality retrocession pools. In addition, during the fourth quarter of 2012, we entered into an agreement to recapture two small U.S. life reinsurance treaties.

The Life Operations segment provides life reinsurance on business written by life insurance companies, principally to help them manage mortality, morbidity, survivorship, investment and lapse risks.

Prior to the decision to run-off the U.K. and Irish business, products offered included a broad range of underlying lines of life insurance business, including term assurances, group life, critical illness cover, immediate annuities and disability income. In addition, prior to selling the renewal rights, the products offered included short-term life, accident and health business. Notwithstanding these sales, the segment still covers a range of geographic markets, with an emphasis on the U.K., U.S., Ireland and Continental Europe.

The portfolio has three particularly significant components:

1) The portfolio includes a small number of large contracts relating to closed blocks of U.K. and Irish fixed annuities in payment. In relation to certain of these contracts, the Company receives cash and investment assets at the inception of the reinsurance contract, relating to the future policy benefit reserves assumed. These contracts are long-term in nature, and the expected claims payout period can span up to 30 or 40 years with average duration of around 10 years. The Company is exposed to investment and survivorship risk over the life of these arrangements.

2) The second component of the portfolio relates to life risks (in the U.S., U.K. and Ireland), income protection risks (in the U.S.) and critical illness risks (in the U.K. and Ireland) where the Company is exposed to the mortality, morbidity and lapse experience from the underlying business, over the medium to long-term.

3) The third component relates to the annually renewable business covering life, accident and health risks written in Continental Europe. These contracts are short-term in nature and include both proportional and non-proportional reinsurance structures. While the renewal rights for this business have been sold, the existing business remains with the Company.

Reinsurance Retroceded

The Company purchases limited retrocession capacity on a "per-life" basis in the United States in order to cap the maximum claim arising from the death of a single individual. Cover is purchased from professional retrocessionaires that meet the Company's criteria for counterparty exposures. Limited retrocession of fixed annuity business has been arranged to manage aggregate longevity capacity on specific deals. Limited retrocession of life, accident and health business on specific treaties written in Continental Europe has also been arranged to manage mortality and morbidity risks

2. Significant Accounting Policies

(a) Basis of Preparation and Consolidation

These consolidated financial statements include the accounts of the Company and all of its subsidiaries. These consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America ("GAAP"). To facilitate period-to-period comparisons, certain reclassifications have been made to prior year consolidated financial statement amounts to conform to current year presentation. There was no effect on net income from this change in presentation.

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amount of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. The Company's most significant areas of estimation include:

- unpaid losses and loss expenses and unpaid losses and loss expenses recoverable;
- future policy benefit reserves;
- valuation and other-than-temporary impairments of investments;
- income taxes;
- reinsurance premium estimates; and
- goodwill carrying value.

While management believes that the amounts included in the consolidated financial statements reflect the Company's best estimates and assumptions, actual results could differ from these estimates.

(b) Fair Value Measurements

Financial Instruments Subject to Fair Value Measurements

Accounting guidance over fair value measurements requires that a fair value measurement reflect the assumptions market participants would use in pricing an asset or liability based on the best information available. Assumptions include the risks inherent in a particular valuation technique (such as a pricing model) and/or the risks inherent in the inputs to the model. The fair value of a financial instrument is the amount that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date (the "exit price"). Instruments that the Company owns ("long positions") are marked to bid prices and instruments that the Company has sold but not yet purchased ("short positions") are marked to offer prices. Fair value measurements are not adjusted for transaction costs.

Basis of Fair Value Measurement

Fair value measurements accounting guidance also establishes a fair value hierarchy that prioritizes the inputs to the respective valuation techniques used to measure fair value. The hierarchy gives the highest priority to unadjusted quoted prices in active markets for identical assets or liabilities (Level 1 measurements) and the lowest priority to unobservable inputs (Level 3 measurements). An asset or liability's classification within the fair value hierarchy is based on the lowest level of significant input to its valuation. The three levels of the fair value hierarchy are described further below:

- **Level 1**–Quoted prices in active markets for identical assets or liabilities (unadjusted); no blockage factors.
- **Level 2**–Other observable inputs (quoted prices in markets that are not active or inputs that are observable either directly or indirectly) – include quoted prices for similar assets/liabilities (adjusted) other than quoted prices in Level 1; quoted prices in markets that are not active; or other inputs that are observable or can be derived principally from or corroborated by observable market data for substantially the full term of the assets or liabilities.

2. Significant Accounting Policies

- **Level 3**–Unobservable inputs that are supported by little or no market activity and are significant to the fair value of the assets or liabilities. Unobservable inputs reflect the reporting entity's own assumptions about the assumptions that market participants would use in pricing the asset or liability. Level 3 assets and liabilities include financial instruments whose values are determined using pricing models, discounted cash flow methodologies, or similar techniques, as well as instruments for which the determination of fair value requires significant management judgment or estimation.

Details on assets and liabilities that have been included under the requirements of authoritative guidance on fair value measurements to illustrate the bases for determining the fair values of these items held by the Company are detailed in each respective significant accounting policy section of this note.

Fair values of investments and derivatives are based on published market values if available, estimates of fair values of similar issues, or estimates of fair values provided by independent pricing services and brokers. Fair values of financial instruments for which quoted market prices are not available or for which the company believes current trading conditions represent distressed markets are based on estimates using present value or other valuation techniques. The fair values estimated using such techniques are significantly affected by the assumptions used, including the discount rates and the estimated amounts and timing of future cash flows. In such instances, the derived fair value estimates cannot be substantiated by comparison to independent markets and are not necessarily indicative of the amounts that would be realized in a current market exchange.

(c) Total Investments

Investments Available For Sale

Investments that are considered available for sale (comprised of the Company's fixed maturities, equity securities and short-term investments) are carried at fair value. The fair values for available for sale investments are generally sourced from third parties. The fair values of fixed income securities are based upon quoted market values where available, "evaluated bid" prices provided by third party pricing services ("pricing services") where quoted market values are not available, or by reference to broker or underwriter bid indications where pricing services do not provide coverage for a particular security. To the extent the Company believes current trading conditions represent distressed transactions, the Company may elect to utilize internally generated models. The pricing services use market approaches to valuations using primarily Level 2 inputs in the vast majority of valuations, or some form of discounted cash flow analysis, to obtain investment values for a small percentage of fixed income securities for which they provide a price. Pricing services indicate that they will only produce an estimate of fair value if there is objectively verifiable information available to produce a valuation. Standard inputs to the valuations provided by the pricing services listed in approximate order of priority for use when available include: reported trades, benchmark yields, broker/dealer quotes, issuer spreads, two-sided markets, benchmark securities, bids, offers, and reference data. The pricing services may prioritize inputs differently on any given day for any security, and not all inputs listed are available for use in the evaluation process on any given day for each security evaluation; however, the pricing services also monitor market indicators, customer feedback through a price challenge process and industry and economic events. Information of this nature is a trigger to acquire further corroborating market data. When these inputs are not available, they identify "buckets" of similar securities (allocated by asset class types, sectors, sub-sectors, contractual cash flows/structure, and credit rating characteristics) and apply some form of matrix or other modeled pricing to determine an appropriate security value which represents their best estimate as to what a buyer in the marketplace would pay for a security in a current sale. While the Company receives values for the majority of the investment securities it holds from pricing services, it is ultimately management's responsibility to determine whether the values received and recorded in the financial statements are representative of appropriate fair value measurements. It is common industry practice to utilize pricing services as a source for determining the fair values of investments where the pricing services are able to obtain sufficient market corroborating information to allow them to produce a valuation at a reporting date. In addition, in the majority of cases, although a value may be obtained from a particular pricing service for a security or class of similar securities, these values are corroborated against values provided by other pricing services.

Broker/dealer quotations are used to value fixed maturities where prices are unavailable from pricing services due to factors specific to the security such as limited liquidity, lack of current transactions, or trades only taking place in privately negotiated transactions. These are considered Level 3 valuations, as significant inputs utilized by brokers may be difficult to corroborate with observable market data, or sufficient information regarding the specific inputs utilized by the broker was not available to support a Level 2 classification.

2. Significant Accounting Policies

Prices provided by independent pricing services and independent broker quotes can vary widely even for the same security. The use of different methodologies and assumptions may have a material effect on the estimated fair value amounts.

The net unrealized gain or loss on investments, net of tax, is included in "accumulated other comprehensive income (loss)."

Short-term investments include investments due to mature within one year from the date of purchase and are valued using the same external factors and in the same manner as fixed income securities.

Equity securities include investments in open end mutual funds and shares of publicly traded alternative funds. The fair value of equity securities is based upon quoted market values (Level 1), or monthly net asset value statements provided by the investment managers upon which subscriptions and redemptions can be executed (Level 2).

All investment transactions are recorded on a trade date basis. Realized gains and losses on sales of equities and fixed income investments are determined on a first-in, first-out basis. Investment income is recognized when earned and includes interest and dividend income together with the amortization of premium and discount on fixed maturities and short-term investments, and is recorded net of related investment expenses. Amortization of discounts on fixed maturities includes amortization to expected recovery values for investments that have previously been recorded as other than temporarily impaired. For mortgage-backed securities, and any other holdings for which there is a prepayment risk, prepayment assumptions are evaluated and revised as necessary. Prepayment fees or call premiums that are only payable to the Company when a security is called prior to its maturity are earned when received and reflected in net investment income.

Investments Held to Maturity

Investments classified as held to maturity include securities for which the Company has the ability and intent to hold to maturity and are carried at amortized cost. For details see Note 5, "Investments."

Investments In Affiliates

Investments in which the Company has significant influence over the operating and financial policies of the investee are classified as investments in affiliates on the Company's balance sheet and are accounted for under the equity method of accounting. Under this method, the Company records its proportionate share of income or loss from such investments in its results for the period as well as its portion of movements in certain of the investee shareholders' equity balances. When financial statements of the affiliate are not available on a timely basis to record the Company's share of income or loss for the same reporting periods as the Company, the most recently available financial statements are used. This lag in reporting is applied consistently.

The Company generally records its alternative and private equity fund affiliates on a one-month and three-month lag, respectively, and its operating affiliates on a three-month lag. Significant influence is generally deemed to exist where the Company has an investment of 20% or more in the common stock of a corporation or an investment of 3% or more in closed end funds, limited partnerships, LLCs or similar investment vehicles. Significant influence is considered for other strategic investments on a case-by-case basis. Investments in affiliates are not subject to fair value measurement guidance as they are not considered to be fair value measured investments under U.S. GAAP. However, impairments associated with investments in affiliates that are deemed to be other-than-temporary are calculated in accordance with fair value measurement guidance and appropriate disclosures included within the financial statements during the period the losses are recorded.

2. Significant Accounting Policies

Other Investments

Contained within this asset class are equity interests in investment funds, limited partnerships and unrated tranches of collateralized debt obligations for which the Company does not have sufficient rights or ownership interests to follow the equity method of accounting. The Company accounts for equity securities that do not have readily determinable market values at estimated fair value as it has no significant influence over these entities. Also included within other investments are structured transactions which are carried at amortized cost.

Fair values for other investments, principally other direct equity investments, investment funds and limited partnerships, are primarily based on the net asset value provided by the investment manager, the general partner or the respective entity, recent financial information, available market data and, in certain cases, management judgment may be required. These entities generally carry their trading positions and investments, the majority of which have underlying securities valued using Level 1 or Level 2 inputs, at fair value as determined by their respective investment managers; accordingly, these investments are generally classified as Level 2. Private equity investments are classified as Level 3. The net unrealized gain or loss on investments, net of tax, is included in "Accumulated other comprehensive income (loss)." Any unrealized loss in value considered by management to be other-than-temporary is charged to income in the period that it is determined.

Overseas deposits include investments in private funds related to Lloyd's syndicates in which the underlying instruments are primarily cash equivalents. The funds themselves do not trade on an exchange and therefore are not included within available for sale securities. Also included in overseas deposits are restricted cash and cash equivalent balances held by Lloyd's syndicates for solvency purposes. Given the restricted nature of these cash balances, they are not included within the cash and cash equivalents line in the balance sheet. Each of these investment types is considered a Level 2 valuation.

The Company historically participated in structured transactions that include cash loans supporting project finance transactions, providing liquidity facility financing to a structured project deal in 2009 and the Company also invested in a payment obligation with an insurance company. These transactions are carried at amortized cost. For further details see Note 3, "Fair Value Measurements," and Note 7, "Other Investments."

(d) Premiums and Acquisition Costs

Insurance premiums written are recorded in accordance with the terms of the underlying policies. Reinsurance premiums written are recorded at the inception of the policy and are estimated based upon information received from ceding companies and any subsequent differences arising on such estimates are recorded in the period they are determined.

Premiums are earned on a pro-rata basis over the period the coverage is provided. Unearned premiums represent the portion of premiums written applicable to the unexpired terms of policies in force. Net premiums earned are presented after deductions for reinsurance ceded, as applicable.

Mandatory reinstatement premiums are recognized and earned at the time a loss event occurs.

Life and annuity premiums from long duration contracts that transfer significant mortality or morbidity risks are recognized as revenue and earned when due from policyholders. Life and annuity premiums from long duration contracts that do not subject the Company to risks arising from policyholder mortality or morbidity are accounted for as investment contracts and presented within deposit liabilities.

The Company has periodically written retroactive loss portfolio transfer ("LPT") contracts. These contracts are evaluated to determine whether they meet the established criteria for reinsurance accounting, and, if so, at inception, written premiums are fully earned and corresponding losses and loss expense recognized. The contracts can cause significant variances in gross premiums written, net premiums written, net premiums earned, and net incurred losses in the years in which they are written. Reinsurance contracts sold not meeting the established criteria for reinsurance accounting are recorded using the deposit method.

2. Significant Accounting Policies

Acquisition costs, which vary with and are directly related to the acquisition of policies, consist primarily of commissions paid to brokers and cedants, and are deferred and amortized over the period that the premiums are earned. Acquisition costs are shown net of commissions earned on reinsurance ceded. Future earned premiums, the anticipated losses and other costs (and in the case of a premium deficiency, investment income) related to those premiums, are also considered in determining the level of acquisition costs to be deferred.

(e) Reinsurance

In the normal course of business, the Company seeks to reduce the potential amount of loss arising from claims events by reinsuring certain levels of risk assumed in various areas of exposure with other insurers or reinsurers. Reinsurance premiums ceded are expensed (and any commissions recorded thereon are earned) on a monthly pro-rata basis over the period the reinsurance coverage is provided. Ceded unearned reinsurance premiums represent the portion of premiums ceded applicable to the unexpired term of policies in force. Mandatory reinstatement premiums ceded are recorded at the time a loss event occurs. Amounts recoverable from reinsurers are estimated in a manner consistent with the claim liability associated with the reinsured policy. Provisions are made for estimated unrecoverable reinsurance.

(f) Fee Income and Other

Fee income and other includes fees received for insurance and product structuring services provided and is earned over the service period of the contract. Any adjustments to fees earned or the service period are reflected in income in the period when determined.

(g) Other–Than-Temporary Impairments (“OTTI”) of Available for Sale and Held to Maturity Securities

The Company’s process for identifying declines in the fair value of investments that are other-than-temporary involves consideration of several factors. These primary factors include (i) an analysis of the liquidity, business prospects and financial condition of the issuer including consideration of credit ratings, (ii) the significance of the decline, (iii) an analysis of the collateral structure and other credit support, as applicable, of the securities in question, and (iv) for debt securities, whether the Company intends to sell such securities. In addition, the authoritative guidance requires that OTTI for certain asset backed and mortgage backed securities is recognized if the fair value of the security is less than its discounted cash flow value and there has been a decrease in the present value of the expected cash flows since the last reporting period. Where the Company’s analysis of the above factors results in the Company’s conclusion that declines in fair values are other-than-temporary, the cost of the security is written down to discounted cash flow and a portion of the previously unrealized loss is therefore realized in the period such determination is made.

If the Company intends to sell an impaired debt security, or it is more likely than not that it will be required to sell the security before recovery of its amortized cost basis, the impairment is other-than-temporary and is recognized currently in earnings in an amount equal to the entire difference between fair value and amortized cost.

In instances in which the Company determines that a credit loss exists but the Company does not intend to sell the security, and it is not more likely than not that the Company will be required to sell the security before the anticipated recovery of its remaining amortized cost basis, the OTTI is separated into (1) the amount of the total impairment related to the credit loss and (2) the amount of the total impairment related to all other factors (i.e. the noncredit portion). The amount of the total OTTI related to the credit loss is recognized in earnings and the amount of the total OTTI related to all other factors is recognized in accumulated other comprehensive loss. The total OTTI is presented in the income statement with an offset for the amount of the total OTTI that is recognized in accumulated other comprehensive loss. Absent the intent or requirement to sell a security, if a credit loss does not exist, any impairment is considered to be temporary.

The noncredit portion of any OTTI losses on securities classified as available for sale is recorded as a component of other comprehensive income with an offsetting adjustment to the carrying value of the security. The fair value adjustment could increase or decrease the carrying value of the security. The noncredit portion of any OTTI losses recognized in accumulated other comprehensive loss for debt securities classified as held to maturity would be accreted over the remaining life of the debt security (in a pro rata manner based on the amount of actual cash flows received as a percentage of total estimated cash flows) as an increase in the carrying value of the security until the security is sold, the security matures, or there is an additional OTTI that is recognized in earnings.

2. Significant Accounting Policies

In periods subsequent to the recognition of an OTTI loss, the other-than-temporarily impaired debt security is accounted for as if it had been purchased on the measurement date of the OTTI at an amount equal to the previous amortized cost basis less the credit-related OTTI recognized in earnings. For debt securities for which credit-related OTTI is recognized in earnings, the difference between the new cost basis and the cash flows expected to be collected is accreted into interest income over the remaining life of the security in a prospective manner based on the estimated amount and timing of future estimated cash flows.

With respect to securities where the decline in value is determined to be temporary and the security’s amortized cost is not written down, a subsequent decision may be made to sell that security and realize a loss. Subsequent decisions on security sales are made within the context of overall risk monitoring, changing information, market conditions generally and assessing value relative to other comparable securities. Day-to-day management of the Company’s investment portfolio is outsourced to third party investment manager service providers. While these investment manager service providers may, at a given point in time, believe that the preferred course of action is to hold securities with unrealized losses that are considered temporary until such losses are recovered, the dynamic nature of the portfolio management may result in a subsequent decision to sell the security and realize the loss, based upon a change in market and other factors described above. The Company believes that subsequent decisions to sell such securities are consistent with the classification of the Company’s portfolio as available for sale.

There are risks and uncertainties associated with determining whether declines in the fair value of investments are other-than-temporary. These include subsequent significant changes in general economic conditions as well as specific business conditions affecting particular issuers, the Company’s liability profile, subjective assessment of issue-specific factors (seniority of claims, collateral value, etc.), future financial market effects, stability of foreign governments and economies, future rating agency actions and significant disclosure of accounting, fraud or corporate governance issues that may adversely affect certain investments. In addition, significant assumptions and management judgment are involved in determining if the decline is other-than-temporary. If management determines that a decline in fair value is temporary, then a security’s value is not written down at that time. However, there are potential effects upon the Company’s future earnings and financial position should management later conclude that some of the current declines in the fair value of the investments are other-than-temporary declines. For further details on the factors considered in evaluation of OTTI see Note 5, “Investments.”

(h) Derivative Instruments

The Company recognizes all derivatives as either assets or liabilities in the balance sheet and measures those instruments at fair value. The changes in fair value of derivatives are shown in the consolidated statement of income as “net realized and unrealized gains and losses on derivative instruments” unless the derivatives are designated as hedging instruments. The accounting for derivatives which are designated as hedging instruments is discussed below. Changes in fair value of derivatives may create volatility in the Company’s results of operations from period to period. Amounts recognized for the right to reclaim cash collateral (a receivable) or the obligation to return cash collateral (a payable) are offset against net fair value amounts recognized in the consolidated balance sheet for derivative instruments executed with the same counterparty under the same netting arrangement to the extent that the Company intends to settle the amounts on a net basis.

Derivative contracts can be exchange-traded or over-the-counter (“OTC”). Exchange-traded derivatives (futures and options) typically fall within Level 1 of the fair value hierarchy depending on whether they are deemed to be actively traded or not. OTC derivatives are valued using market transactions and other market evidence whenever possible, including market-based inputs to models, model calibration to market clearing transactions, broker or dealer quotations or alternative pricing sources where an understanding of the inputs utilized in arriving at the valuations is obtained. Where models are used, the selection of a particular model to value an OTC derivative depends upon the contractual terms and specific risks inherent in the instrument as well as the availability of pricing information in the market. The Company generally uses similar models to value similar instruments. Valuation models require a variety of inputs, including contractual terms, market prices, yield curves, credit curves, measures of volatility, prepayment rates and correlations of such inputs. For OTC derivatives that trade in liquid markets, such as generic forwards, interest rate swaps and options, model inputs can generally be verified and model selection does not involve significant management judgment. Such instruments comprise the majority of derivatives held by the Company and are typically classified within Level 2 of the fair value hierarchy.

2. Significant Accounting Policies

Certain OTC derivatives trade in less liquid markets with limited pricing information, or required model inputs which are not directly market corroborated, which causes the determination of fair value for these derivatives to be inherently more subjective. Accordingly, such derivatives are classified within Level 3 of the fair value hierarchy. The valuations of less standard or liquid OTC derivatives are typically based on Level 1 and/or Level 2 inputs that can be observed in the market, as well as unobservable Level 3 inputs. Level 1 and Level 2 inputs are regularly updated to reflect observable market changes. Level 3 inputs are only changed when corroborated by evidence such as similar market transactions, pricing services and/or broker or dealer quotations. The Company conducts its non-hedging derivatives activities in three main areas: investment related derivatives, credit derivatives and other non-investment related derivatives.

The Company uses derivative instruments, primarily interest rate swaps, to manage the interest rate exposure associated with certain assets and liabilities. These derivatives are recorded at fair value. On the date the derivative contract is entered into, the Company may designate the derivative as a hedge of the fair value of a recognized asset or liability ("fair value" hedge); a hedge of the variability in cash flows of a forecasted transaction or of amounts to be received or paid related to a recognized asset or liability ("cash flow" hedge); or a hedge of a net investment in a foreign operation; or the Company may not designate any hedging relationship for a derivative contract. In addition, the Company previously wrote a number of resettable strike swaps contracts relating to an absolute return index and diversified basket of funds, all of which are recorded within Investment Related Derivatives – Financial Market Exposures. These resettable strike swaps all expired during 2011.

Fair Value Hedges

Changes in the fair value of a derivative that is designated and qualifies as a fair value hedge, along with the changes in the fair value of the hedged asset or liability that is attributable to the hedged risk, are recorded in current period earnings (through "net realized and unrealized gains and losses on derivative instruments") with any differences between the net change in fair value of the derivative and the hedged item representing the hedge ineffectiveness. Periodic derivative net coupon settlements are recorded in net investment income with the exception of hedges of Company issued debt, which are recorded in interest expense. The Company may designate fair value hedging relationships where interest rate swaps are used to hedge the changes in fair value of certain fixed rate liabilities and fixed maturity securities due to changes in the designated benchmark interest rate.

Cash Flow Hedges

Changes in the fair value of a derivative that is designated and qualifies as a cash flow hedge are recorded in accumulated other comprehensive income ("AOCI") and are reclassified into earnings when the variability of the cash flow of the hedged item impacts earnings. Gains and losses on derivative contracts that are reclassified from AOCI to current period earnings are included in the line item in the consolidated statements of operations in which the cash flows of the hedged item are recorded. Any hedge ineffectiveness is recorded immediately in current period earnings as "net realized and unrealized gains and losses on derivative instruments." Periodic derivative net coupon settlements are recorded in net investment income. The Company may designate cash flow hedging relationships where interest rate swaps are used to mitigate interest rate risk associated with anticipated issuances of debt or other forecasted transactions.

Hedges of the Net Investment in a Foreign Operation

Changes in fair value of a derivative used as a hedge of a net investment in a foreign operation, to the extent effective as a hedge, are recorded in the foreign currency translation adjustments account within AOCI. Cumulative changes in fair value recorded in AOCI are reclassified into earnings upon the sale or complete or substantially complete liquidation of the foreign entity. Any hedge ineffectiveness is recorded immediately in current period earnings as "net realized and unrealized gains and losses on derivative instruments."

2. Significant Accounting Policies

Hedge Documentation and Effectiveness Testing

To qualify for hedge accounting treatment, a derivative must be highly effective in mitigating the designated changes in value or cash flow of the hedged item. At hedge inception, the Company formally documents all relationships between hedging instruments and hedged items, as well as its risk-management objective and strategy for undertaking each hedge transaction. The documentation process includes linking derivatives that are designated as fair value, cash flow, or net investment hedges to specific assets or liabilities on the balance sheet or to specific forecasted transactions. The Company also formally assesses, both at the hedge's inception and on an ongoing basis, whether the derivatives that are used in hedging transactions are highly effective in offsetting changes in fair values or cash flows of hedged items. In addition, certain hedging relationships are considered highly effective if the changes in the fair value or discounted cash flows of the hedging instrument are within a ratio of 80-125% of the inverse changes in the fair value or discounted cash flows of the hedged item. Hedge ineffectiveness is measured using qualitative and quantitative methods. Qualitative methods may include comparison of critical terms of the derivative to the hedged item. Depending on the hedging strategy, quantitative methods may include the "Change in Variable Cash Flows Method," the "Change in Fair Value Method," the "Hypothetical Derivative Method" or the "Dollar Offset Method."

Discontinuance of Hedge Accounting

The Company discontinues hedge accounting prospectively when it is determined that the derivative is no longer highly effective in offsetting changes in the fair value or cash flows of a hedged item; the derivative is dedesignated as a hedging instrument; or the derivative expires or is sold, terminated or exercised. When hedge accounting is discontinued because it is determined that the derivative no longer qualifies as an effective fair-value hedge, the derivative continues to be carried at fair value on the balance sheet with changes in its fair value recognized in current period earnings through "net realized and unrealized gains and losses on derivative instruments." When hedge accounting is discontinued because the Company becomes aware that it is not probable that the forecasted transaction will occur, the derivative continues to be carried on the balance sheet at its fair value, and gains and losses that were accumulated in AOCI are recognized immediately in earnings.

(i) Cash Equivalents

Cash equivalents include fixed interest deposits placed with a maturity of under 90 days when purchased. Bank deposits are not considered to be fair value measurements and as such are not subject to the authoritative guidance on fair value measurement disclosures. Money market funds are classified as Level 1 as these instruments are considered actively traded; however, certificates of deposit are classified as Level 2.

(j) Foreign Currency Translation

Assets and liabilities of foreign operations whose functional currency is not the U.S. dollar are translated at prevailing year end exchange rates. Revenue and expenses of such foreign operations are translated at average exchange rates during the year. The net effect of the translation adjustments for foreign operations, net of applicable deferred income taxes, as well as any gains or losses on intercompany balances for which settlement is not planned or anticipated in the foreseeable future, are included in "accumulated other comprehensive income (loss)."

Monetary assets and liabilities denominated in currencies other than the functional currency of the applicable entity are revalued at the exchange rate in effect at the balance sheet date and revenues and expenses are translated at the exchange rate on the date the transaction occurs with the resulting foreign exchange gains and losses on settlement or revaluation recognized in income.

(k) Goodwill and Other Intangible Assets

The Company has recorded goodwill in connection with various acquisitions in prior years. Goodwill represents the excess of the purchase price over the fair value of net assets acquired. In accordance with accounting guidance for goodwill and other intangible assets, the Company tests goodwill for potential impairment annually as of June 30, during the third quarter, and between annual tests if an event occurs or circumstances change that may indicate that potential exists for the fair value of a reporting unit to be reduced to a level below its carrying amount. For further details on the factors considered in the goodwill impairment evaluation see Note 8, "Goodwill and Other Intangible Assets."

2. Significant Accounting Policies

The Company's other intangible assets consist of both amortizable and non-amortizable intangible assets. The Company's amortizable intangible assets consist primarily of acquired customer relationships and acquired software. All of the Company's amortizable intangible assets are carried at net book value and are amortized over their estimated useful lives. The amortization periods approximate the periods over which the Company expects to generate future net cash inflows from the use of these assets. Accordingly, customer relationships are amortized over a useful life of 10 years and acquired software is amortized over a useful life of 5 years. The Company's policy is to amortize intangibles on a straight-line basis.

All of the Company's amortizable intangible assets, as well as other amortizable or depreciable long-lived assets such as premises and equipment, are subject to impairment testing in accordance with authoritative guidance for the impairment or disposal of long-lived assets when events or conditions indicate that the carrying value of an asset may not be fully recoverable from future cash flows.

The Company's indefinite lived intangible assets consist primarily of acquired insurance and reinsurance licenses. These assets are deemed to have indefinite useful lives and are therefore not subject to amortization. In accordance with the authoritative guidance on intangibles and goodwill and other assets under GAAP, all of the Company's non-amortized intangible assets are subject to a test for impairment annually, or more frequently if events or changes in circumstances indicate that the asset might be impaired. Pursuant to the authoritative guidance, if the carrying value of a non-amortized intangible asset is in excess of its fair value, the asset must be written down to its fair value through the recognition of an impairment charge to earnings.

(l) Losses and Loss Expenses

Unpaid losses and loss expenses include reserves for reported unpaid losses and loss expenses and for losses incurred but not reported. The reserve for reported unpaid losses and loss expenses for the Company's property and casualty operations is established by management based on claims reported from insureds or amounts reported from ceding companies, and represent the estimated ultimate cost of events or conditions that have been reported to or specifically identified by the Company.

The reserve for losses incurred but not reported is estimated by management based on loss development patterns determined by reference to the Company's underwriting practices, the policy form, type of program and historical experience. The Company's actuaries employ a variety of generally accepted methodologies to determine estimated ultimate loss reserves, including the "Bornhuetter-Ferguson incurred loss method" and frequency and severity approaches.

Certain workers' compensation and certain U.K. motor liability claims liabilities are considered fixed and determinable and are discounted.

Management believes that the reserves for unpaid losses and loss expenses are sufficient to cover losses that fall within coverages assumed by the Company. However, there can be no assurance that losses will not exceed the Company's total reserves. The methodology of estimating loss reserves is periodically reviewed to ensure that the assumptions made continue to be appropriate and any adjustments resulting from such reviews are reflected in income in the year in which the adjustments are made.

(m) Deposit Liabilities

Contracts entered into by the Company that are not deemed to transfer significant underwriting and/or timing risk are accounted for as deposits, whereby liabilities are initially recorded at an amount equal to the assets received. The Company uses a portfolio rate of return of equivalent duration to the liabilities in determining risk transfer. An initial accretion rate is established based on actuarial estimates whereby the deposit liability is increased to the estimated amount payable over the term of the contract.

The deposit accretion rate is the rate of return required to fund expected future payment obligations (this is equivalent to the "best estimate" of future cash flows), which are determined actuarially based upon the nature of the underlying indemnifiable losses. Accretion of the liability is recorded as interest expense.

2. Significant Accounting Policies

The Company periodically reassesses the estimated ultimate liability. Any changes to this liability are reflected as adjustments to interest expense to reflect the cumulative effect of the period the contract has been in force, and by an adjustment to the future accretion rate of the liability over the remaining estimated contract term.

(n) Future Policy Benefit Reserves

The Company estimates the present value of future policy benefits related to long duration contracts using assumptions for investment yields, mortality, and expenses, including a provision for adverse deviation.

The assumptions used to determine future policy benefit reserves are best estimate assumptions that are determined at the inception of the contracts and are locked-in throughout the life of the contract unless a premium deficiency develops. As the experience on the contracts emerges, the assumptions are reviewed. If such review would produce reserves in excess of those currently held, then the lock-in assumptions will be revised and a claim and policy benefit is recognized at that time.

Certain life insurance and annuity contracts provide the holder with a guarantee that the benefit received upon death will be no less than a minimum prescribed amount. The contracts are accounted for in accordance with the authoritative guidance on Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Separate Accounts, which requires that the best estimate of future experience be combined with actual experience to determine the benefit ratio used to calculate the policy benefit reserve.

(o) Income Taxes

The Company utilizes the asset and liability method of accounting for income taxes. Under this method, deferred income taxes reflect the net tax effect of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for income tax purposes. The deferral of tax losses is evaluated based upon management's estimates of the future profitability of the Company's taxable entities based on current forecasts and the period for which losses may be carried forward. A valuation allowance is established for any portion of a deferred tax asset that management believes will not be realized. The Company continues to evaluate income generated in future periods by its subsidiaries in different jurisdictions in determining the recoverability of its deferred tax asset. If it is determined that future income generated by these subsidiaries is insufficient to cause the realization of the net operating losses within a reasonable period, a valuation allowance is established at that time.

(p) Stock Plans

The Company adopted authoritative guidance on the fair value recognition provisions for accounting for stock-based compensation, under the prospective method for options granted subsequent to January 1, 2003. Prior to 2003, the Company accounted for options under the disclosure-only provisions of the guidance and no stock-based employee compensation cost was included in net income as all options granted had an exercise price equal to the market value of the Company's ordinary shares on the date of the grant. At December 31, 2012, the Company had several stock-based Performance Incentive Programs, which are described more fully in Note 17, "Share Capital." Stock-based compensation issued under these plans generally has a life of not longer than ten years and vests as set forth at the time of grant. Awards currently vest annually over three or four years from the date of grant. The Company recognizes compensation costs for stock-based awards on a straight-line basis over the requisite service period (usually the vesting period) for each award.

Share-based payments to employees, including grants of employee stock options, are recognized in the financial statements over the vesting period based on their grant date fair values.

Authoritative guidance requires that compensation costs be recognized for unvested stock-based compensation awards over the period through the date that the employee is no longer required to provide future services to earn the award, rather than over the explicit service period. Accordingly, the Company follows a policy of recognizing compensation cost to coincide with the date that the employee is eligible to retire, rather than the actual retirement date, for all stock-based compensation granted.

2. Significant Accounting Policies

(q) Recent Accounting Pronouncements

In October 2010, the FASB issued an accounting standards update to address disparities in practice regarding the interpretation of which costs relating to the acquisition of new and renewal insurance contracts qualify for deferral. The provisions of the guidance specify that only costs that are related directly to the successful acquisition of new and renewal insurance contracts may be capitalized. These include incremental direct costs of contract acquisition and certain other costs related directly to underwriting activities. Incremental direct costs of contract acquisition are those that result directly from and are essential to a contract transaction, and would not have been incurred by the insurance entity had the transaction not occurred. Administrative costs, rent, depreciation, occupancy, equipment and all other general overhead costs are considered indirect costs and should be charged to expense as incurred. On January 1, 2012, the Company adopted this guidance on a retrospective basis for all fiscal years presented, and interim periods within those years. The impact of adoption was a reduction in deferred acquisition costs of approximately $21 million, a reduction in deferred tax liabilities of approximately $7 million, and a corresponding reduction in opening retained earnings of approximately $14 million within the Company's December 31, 2011 balance sheet. The adoption of this guidance did not have an impact on the Company's consolidated statements of income or comprehensive income.

In May 2011, the FASB issued an accounting standards update to amend existing requirements for fair value measurements and disclosures. The guidance expands the disclosure requirements around fair value measurements categorized in Level 3 of the fair value hierarchy, requiring quantitative and qualitative information to be disclosed related to: (1) the valuation processes used, (2) the sensitivity of the fair value measurement to changes in unobservable inputs and the interrelationships between those unobservable inputs, and (3) use of a nonfinancial asset in a way that differs from the asset's highest and best use. The guidance requires disclosure of the level in the fair value hierarchy of items that are not measured at fair value, but whose fair value must be disclosed. It also clarifies and expands upon existing requirements for fair value measurements of financial assets and liabilities, as well as instruments classified in shareholders' equity. The Company adopted this guidance from January 1, 2012; however, it impacted disclosure only and did not have an impact on the Company's financial condition or results of operations. See Note 3, "Fair Value Measurements," for these updated disclosures.

In June 2011, the FASB issued an accounting standards update concerning the presentation of comprehensive income in financial statements. This guidance allows an entity the option to present the total of comprehensive income, the components of net income, and the components of other comprehensive income either in a single continuous statement of comprehensive income or in two separate but consecutive statements. Under both options, an entity is required to present each component of net income along with total net income, each component of other comprehensive income along with a total for other comprehensive income, and a total amount for comprehensive income. This guidance eliminates the option to present the components of other comprehensive income only as part of the statement of changes in shareholders' equity. The guidance does not change the items that must be reported in other comprehensive income or when an item of other comprehensive income must be reclassified to net income. The Company adopted the guidance from January 1, 2012; however, it did not have an impact on the Company's disclosure, financial condition or results of operations or cash flows. In February 2013, the FASB issued an additional accounting standards update related to this topic that requires an entity to provide information about the amounts reclassified out of accumulated other comprehensive income by component. The guidance does not change the current requirements for reporting net income or other comprehensive income in financial statements. These amendments are effective prospectively from January 1, 2013. As this guidance is disclosure-related only, its adoption will not impact the Company's financial condition, results of operations, or cash flows.

2. Significant Accounting Policies

In September 2011, the FASB issued an accounting standards update to simplify how entities test goodwill for impairment, by allowing an entity the option to first assess qualitative factors to determine whether it is more likely than not that the fair value of a reporting entity is less than its carrying amount, as a basis for determining whether it is necessary to perform the two-step goodwill impairment test required under U.S. GAAP accounting rules. After assessing the circumstances that should be considered in making the qualitative assessment, if an entity determines that the fair value of a reporting unit as compared to its carrying value meets the threshold, then performing the two-step impairment step is unnecessary. In other circumstances, performance of the two-step test is required. The guidance also eliminates the option for an entity to carry forward its detailed calculation of a reporting unit's fair value in certain situations. The Company adopted this guidance from January 1, 2012. It did not have an impact on the Company's consolidated financial condition, results of operations, or cash flows.

In December 2011, the FASB issued an accounting standards update requiring additional disclosures about financial instruments and derivatives that are either: (1) offset for balance sheet presentation purposes or (2) subject to an enforceable master netting arrangement or similar arrangement, regardless of whether they are offset for balance sheet presentation purposes. In January 2013, the FASB issued an additional accounting standards update related to this topic clarifying that the disclosures would apply only to derivatives, repurchase and reverse repurchase agreements, and securities borrowing and securities lending transactions, each to the extent that they met one of the two conditions provided in the initial accounting standard. This guidance will be effective on January 1, 2013, with retrospective presentation of the new disclosures required. As this guidance is disclosure-related only and does not amend the existing balance sheet offsetting guidance, the adoption of this guidance will not impact the Company's financial condition, results of operations, or cash flows.

In July 2012, the FASB issued an accounting standards update to simplify how entities test indefinite-lived intangible assets for impairment. Under this new guidance, an entity is allowed the option to first assess qualitative factors to determine whether it is more likely than not that the fair value of an indefinite-lived intangible asset is less than its carrying value. After assessing the circumstances that should be considered in making the qualitative assessment, if an entity determines that the fair value of the intangible asset as compared to its carrying value meets the threshold, it may bypass the existing requirements to perform a full quantitative impairment test on the intangible asset, a test which otherwise would have to be performed annually, at a minimum. The guidance was effective during the fourth quarter of 2012. The adoption of this guidance did not have an impact on the Company's consolidated financial condition, results of operations or cash flows.

3. Fair Value Measurements

(a) Fair Value Summary

The following tables set forth the Company's assets and liabilities that were accounted for at fair value at December 31, 2012 and December 31, 2011 by level within the fair value hierarchy. For further information, see Note 2 (b), "Significant Accounting Policies – Fair Value Measurements":

December 31, 2012 *(U.S. dollars in thousands)*	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Other Unobservable Inputs (Level 3)	Collateral and Counterparty Netting	Balance at December 31, 2012
Assets					
U.S. Government and Government - Related/Supported	$ -	$ 1,968,149	$ -	$ -	$ 1,968,149
Corporate (1) (2)	-	9,944,450	30,060	-	9,974,510
Residential mortgage-backed securities – Agency ("RMBS - Agency")	-	4,861,413	32,005	-	4,893,418
Residential mortgage-backed securities – Non-Agency ("RMBS - Non-Agency")	-	540,473	116	-	540,589
Commercial mortgage-backed securities ("CMBS")	-	981,870	25,347	-	1,007,216
Collateralized debt obligations ("CDO")	-	8,080	701,736	-	709,816
Other asset-backed securities (2)	-	1,407,245	18,128	-	1,425,373
U.S. States and political subdivisions of the States	-	1,890,315	-	-	1,890,316
Non-U.S. Sovereign Government, Provincial, Supranational and Government-Related/Supported	-	4,251,137	-	-	4,251,137
Total fixed maturities, at fair value	$ -	$ 25,853,132	$ 807,392	$ -	$ 26,660,524
Equity securities, at fair value (3)	253,957	395,402	-	-	649,359
Short-term investments, at fair value (4)	-	322,703	-	-	322,703
Total investments available for sale	$ 253,957	$ 26,571,237	$ 807,392	$ -	$ 27,632,586
Cash equivalents (5)	1,357,142	408,292	-	-	1,765,434
Other investments (6)	-	792,240	107,741	-	899,981
Other assets (7)	-	17,837	-	12,130	29,967
Total assets accounted for at fair value	$ 1,611,099	$ 27,789,606	$ 915,133	$ 12,130	$ 30,327,968
Liabilities					
Financial instruments sold, but not yet purchased (8)	$ -	$ 26,235	$ -	$ -	$ 26,235
Other liabilities (7)	-	23,376	36,247	-	59,623
Total liabilities accounted for at fair value	$ -	$ 49,611	$ 36,247	$ -	$ 85,858

3. Fair Value Measurements

December 31, 2011 (U.S. dollars in thousands)	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Other Unobservable Inputs (Level 3)	Collateral and Counterparty Netting	Balance at December 31, 2011
Assets					
U.S. Government and Government - Related/Supported	$ -	$ 1,815,199	$ -	$ -	$ 1,815,199
Corporate (1) (2)	-	10,009,993	21,787	-	10,031,780
RMBS – Agency	-	4,954,413	32,041	-	4,986,454
RMBS – Non-Agency	-	441,379	-	-	441,379
CMBS	-	941,060	-	-	941,060
CDO	-	7,751	649,572	-	657,323
Other asset-backed securities (2)	-	949,514	12,933	-	962,447
U.S. States and political subdivisions of the States	-	1,794,094	-	-	1,794,094
Non-U.S. Sovereign Government, Provincial, Supranational and Government-Related/Supported	-	3,298,072	-	-	3,298,072
Total fixed maturities, at fair value (2)	$ -	$ 24,211,475	$ 716,333	$ -	$ 24,927,808
Equity securities, at fair value (3)	239,175	229,022	-	-	468,197
Short-term investments, at fair value (4)	-	359,064	-	-	359,064
Total investments available for sale	$ 239,175	$ 24,799,561	$ 716,333	$ -	$ 25,755,069
Cash equivalents (5)	1,686,101	1,068,264	-	-	2,754,365
Other investments (6)	-	547,607	106,290	-	653,897
Other assets (7)	-	143,622	-	(77,888)	65,734
Total assets accounted for at fair value	$ 1,925,276	$ 26,559,054	$ 822,623	$ (77,888)	$ 29,229,065
Liabilities					
Financial instruments sold, but not yet purchased (8)	$ -	$ 20,844	$ -	$ -	$ 20,844
Other liabilities (7)	-	16,871	42,644	(809)	58,706
Total liabilities accounted for at fair value	$ -	$ 37,715	$ 42,644	$ (809)	$ 79,550

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(1) Included within Corporate are certain medium term notes supported primarily by pools of European investment grade credit with varying degrees of leverage. The notes, which are in a gross unrealized loss position, had a fair value of $194.3 million and $266.0 million and an amortized cost of $194.8 million and $297.7 million at December 31, 2012 and December 31, 2011, respectively. These notes allow the investor to participate in cash flows of the underlying bonds including certain residual values, which could serve to either decrease or increase the ultimate values of these notes.

(2) The Company invests in covered bonds issued by financial institutions (“Covered Bonds”). Covered Bonds are senior secured debt instruments issued by financial institutions and backed by over-collateralized pools of public sector or mortgage loans. At December 31, 2012, Covered Bonds within Total fixed maturities with a fair value of $620.9 million are included within Other asset-backed securities to align the Company’s classification to market indices. At December 31, 2011, Covered Bonds within Total fixed maturities with a fair value of $368.7 million were reclassified from Corporate to Other asset-backed securities to conform to current period presentation.

(3) Included within Equity securities are investments in fixed income funds with a fair value of $101.9 million and $91.6 million at December 31, 2012 and December 31, 2011, respectively.

(4) Short-term investments consist primarily of Corporate securities and U.S. and Non-U.S. Government and Government-Related/Supported securities.

(5) Cash equivalents balances subject to fair value measurement include certificates of deposit and money market funds. Operating cash balances are not subject to fair value measurement guidance.

(6) The Other investments balance excludes certain structured transactions including certain investments in project finance transactions, a payment obligation and liquidity financing provided to a structured credit vehicle as a part of a third party medium term note facility. These investments, which totaled $312.1 million at December 31, 2012 and $323.7 million at December 31, 2011, are carried at amortized cost. For further details regarding the nature of Other investments and related features see Note 7, “Other Investments,” to the Consolidated Financial Statements.

(7) Other assets and other liabilities include derivative instruments. The derivative balances included in each category are reported on a gross basis by level with a netting adjustment presented separately in the Collateral and Counterparty Netting column. The Company often enters into different types of derivative contracts with a single counterparty and these contracts are covered under a netting agreement. In addition, at December 31, 2012 the Company paid net cash collateral related to these derivative positions of $12.1 million. The assets related to the net collateral paid were recorded as Other assets within the balance sheet. At December 31, 2011, the Company held net cash collateral of $77.1 million. The collateral balance was included within Cash and cash equivalents and the corresponding liability to return the collateral has been offset against the derivative asset within the balance sheet as appropriate under the netting agreement. The fair values of the individual derivative contracts are reported gross in their respective levels based on the fair value hierarchy.

(8) Financial instruments sold, but not yet purchased, represent “short sales” and are included within “Payable for investments purchased” on the balance sheet.

3. Fair Value Measurements

(b) Level 3 Assets and Liabilities

The tables below present additional information about assets and liabilities measured at fair value on a recurring basis and for which Level 3 inputs were utilized to determine fair value. The tables present a reconciliation of the beginning and ending balances for the year ended December 31, 2012 and 2011 for all financial assets and liabilities measured at fair value using significant unobservable inputs (Level 3) at December 31, 2012 and 2011, respectively. The tables do not include gains or losses that were reported in Level 3 in prior periods for assets that were transferred out of Level 3 prior to December 31, 2012 and 2011. Gains and losses for assets and liabilities classified within Level 3 in the table below may include changes in fair value that are attributable to both observable inputs (Levels 1 and 2) and unobservable inputs (Level 3). Further, it should be noted that the following tables do not take into consideration the effect of offsetting Level 1 and 2 financial instruments entered into by the Company that are either economically hedged by certain exposures to the Level 3 positions or that hedge the exposures in Level 3 positions.

In general, Level 3 assets include securities for which values were obtained from brokers where either significant inputs were utilized in determining the values that were difficult to corroborate with observable market data, or sufficient information regarding the specific inputs utilized by the broker was not available to support a Level 2 classification. Transfers into or out of Level 3 primarily arise as a result of the valuations utilized by the Company changing between either those provided by independent pricing services that do not contain significant observable inputs, or other valuations sourced from brokers that are considered Level 3.

There were no significant transfers between Level 1 and Level 2 during the years ended December 31, 2012 and 2011.

	Level 3 Assets and Liabilities - Year Ended December 31, 2012				
(U.S. dollars in thousands)	Corporate	RMBS - Agency	RMBS - Non Agency	CMBS	CDO
Balance, beginning of period	$ 21,787	$ 32,041	$ -	$ -	$ 649,572
Realized gains (losses)	4	(15)	-	-	(896)
Movement in unrealized gains (losses)	99	27	-	20	109,283
Purchases and issuances	10,278	-	-	25,546	1,232
Sales and settlements	(282)	(6,307)	-	(219)	(56,984)
Transfers into Level 3	2,813	21,249	116	-	-
Transfers out of Level 3	(4,639)	(14,990)	-	-	(471)
Balance, end of period	$ 30,060	$ 32,005	$ 116	$ 25,347	$ 701,736
Movement in total gains (losses) above relating to instruments still held at the reporting date	$ 122	$ 10	$ -	$ 20	$ 104,474

	Level 3 Assets and Liabilities - Year Ended December 31, 2012				
(U.S. dollars in thousands)	Other asset-backed securities	Non-US Sovereign Government, Provincial, Supranational and Government Related/Supported	Short-term investments	Other investments	Derivative Contracts - Net
Balance, beginning of period	$ 12,933	$ -	$ -	$ 106,290	$ (42,644)
Realized gains (losses)	6,768	-	-	3,980	-
Movement in unrealized gains (losses)	(2,785)	-	-	7,625	6,397
Purchases and issuances	12,373	-	-	7,376	-
Sales and settlements	(16,094)	-	-	(17,535)	-
Transfers into Level 3	4,933	-	-	5	-
Transfers out of Level 3	-	-	-	-	-
Balance, end of period	$ 18,128	$ -	$ -	$ 107,741	$ (36,247)
Movement in total gains (losses) above relating to instruments still held at the reporting date	$ (154)	$ -	$ -	$ 5,038	$ 6,397

3. Fair Value Measurements

	Level 3 Assets and Liabilities - Year Ended December 31, 2011				
(U.S. dollars in thousands)	Corporate	RMBS - Agency	RMBS - Non Agency	CMBS	CDO
Balance, beginning of period	$ 29,161	$ 30,255	$ 3,895	$ 1,611	$ 720,119
Realized gains (losses)	(33)	(11)	-	-	(3,458)
Movement in unrealized gains (losses)	(23)	(145)	-	-	2,404
Purchases and issuances	6,878	6,176	-	-	2,379
Sales and settlements	(9,379)	(4,186)	-	-	(67,991)
Transfers into Level 3	10,067	2,655	-	-	1,886
Transfers out of Level 3	(14,884)	(2,703)	(3,895)	(1,611)	(5,767)
Balance, end of period	$ 21,787	$ 32,041	$ -	$ -	$ 649,572
Movement in total gains (losses) above relating to instruments still held at the reporting date	$ (15)	$ (156)	$ -	$ -	$ (6,431)

	Level 3 Assets and Liabilities - Year Ended December 31, 2011				
(U.S. dollars in thousands)	Other asset-backed securities	Non-US Sovereign Government, Provincial, Supranational and Government Related/Supported	Short-term investments	Other investments	Derivative Contracts - Net
Balance, beginning of period	$ 22,179	$ 3,667	$ -	$ 125,937	$ (39,195)
Realized gains (losses)	(835)	-	-	7,568	-
Movement in unrealized gains (losses)	5,734	-	-	14,390	(3,173)
Purchases and issuances	-	-	-	12,177	-
Sales and settlements	(9,114)	-	-	(53,782)	(276)
Transfers into Level 3	-	-	-	-	-
Transfers out of Level 3	(5,031)	(3,667)	-	-	-
Balance, end of period	$ 12,933	$ -	$ -	$ 106,290	$ (42,644)
Movement in total gains (losses) above relating to instruments still held at the reporting date	$ 4,578	$ -	$ -	$ 21,958	$ (3,173)

3. Fair Value Measurements

(c) Fixed maturities and short-term investments

The Company's Level 3 assets consist primarily of CDOs, for which non-binding broker quotes are the primary source of the valuations. Sufficient information regarding the specific inputs utilized by the brokers was not available to support a Level 2 classification. The Company obtains the majority of broker quotes for these CDOs from third party investment managers who perform independent verifications of these valuations using pricing matrices based upon information gathered by market traders. In addition, for the majority of these securities, the Company compares the broker quotes to independent valuations obtained from third party pricing vendors, which may also consist of broker quotes, to assess if the prices received represent a reasonable estimate of the fair value. Although the Company does not have access to the specific unobservable inputs that may have been used in the fair value measurements of the CDO securities provided by brokers, we would expect that the significant inputs considered are prepayment rates, probability of default, loss severity in the event of default, recovery rates, liquidity premium and reinvestment rates. Significant increases (decreases) in any of those inputs in isolation could result in a significantly different fair value measurement. Generally, a change in the assumption used for the probability of default is accompanied by a directionally similar change in the assumption used for the loss severity and a directionally opposite change in the assumption used for prepayment rates.

The remainder of the Level 3 assets relate to primarily to private equity investments and certain derivative positions as described below.

(d) Other investments

Included within the Other investments component of the Company's Level 3 valuations are private investments and alternative fund investments over which the Company is not deemed to have significant influence. The fair value of these investments is based upon net asset values received from the investment manager or general partner of the respective entity. The nature of the underlying investments held by the investee that form the basis of the net asset value include assets such as private business ventures and are such that significant Level 3 inputs are utilized in the determination of the individual underlying holding values and, accordingly, the fair value of the Company's investment in each entity is classified within Level 3. The Company has not adjusted the net asset values received; however, management incorporates factors such as the most recent financial information received, annual audited financial statements and the values at which capital transactions with the investee take place when applying judgment regarding whether any adjustments should be made to the net asset value in recording the fair value of each position. Investments in alternative funds included in Other investments utilize strategies including arbitrage, directional, event driven and multi-style. These funds potentially have lockup and gate provisions which may limit redemption liquidity. For further details regarding the nature of Other investments and related features see Note 7, "Other Investments," for further details.

(e) Derivative instruments

Derivative instruments recorded within Other liabilities and classified within Level 3 include credit derivatives that provide protection on senior tranches of structured finance transactions where the value is obtained directly from the investment bank counterparty and sufficient information regarding the inputs utilized in such valuation was not obtained to support a Level 2 classification and guaranteed minimum income benefits ("GMIB") embedded within one reinsurance contract. The majority of inputs utilized in the valuations of these types of derivative contracts are considered Level 1 or Level 2; however, each valuation includes at least one Level 3 input that was significant to the valuation and, accordingly, the values are disclosed within Level 3.

(f) Non-recurring Fair Value Measurement

During the year ended December 31, 2011, the Company recorded a non-recurring fair value measurement relating to a goodwill impairment charge. This was a Level 3 fair value measurement as it reflected the Company's own assumptions about the assumptions that market participants would use in valuing the carried goodwill and was determined using a combination of discounted cash flow analysis and market value multiple based methodologies. See Note 8, "Goodwill and Other Intangible Assets," for further information.

3. Fair Value Measurements

(g) Financial Instruments Not Carried at Fair Value

Authoritative guidance over disclosures about the fair value of financial instruments requires additional disclosure of fair value information for financial instruments not carried at fair value in both interim and annual reporting periods. Certain financial instruments, particularly insurance contracts, are excluded from these fair value disclosure requirements. The carrying values of cash and cash equivalents, accrued investment income, net receivable from investments sold, other assets, net payable for investments purchased, other liabilities and other financial instruments not included below approximated their fair values. The following table includes financial instruments for which the carrying value differs from the estimated fair values at December 31, 2012 and 2011. All of these fair value estimates are considered Level 2 fair value measurements. The fair values for fixed maturities held to maturity are provided by third party pricing vendors and significant valuation inputs for all other items included were based upon market data obtained from sources independent of the Company, and are subject to the same control environment previously described.

	December 31, 2012		December 31, 2011	
(U.S. dollars in thousands)	Carrying Value	Fair Value	Carrying Value	Fair Value
Fixed maturities, held to maturity	$ 2,814,447	$ 3,262,804	$ 2,668,978	$ 2,895,688
Other investments - structured transactions	312,122	293,813	323,705	297,124
Financial Assets	$ 3,126,569	$ 3,556,617	$ 2,992,683	$ 3,192,812
Deposit liabilities	$ 1,551,398	$ 1,878,499	$ 1,608,108	$ 1,809,812
Notes payable and debt	-	-	599,971	599,430
Financial Liabilities	$ 1,551,398	$ 1,878,499	$ 2,208,079	$ 2,409,242

The Company historically participated in structured transactions. Remaining structured transactions include cash loans supporting project finance transactions, providing liquidity facility financing to structured project deals and an investment in a payment obligation with an insurance company. These transactions are carried at amortized cost. The fair value of these investments held by the Company is determined through use of internal models utilizing reported trades, benchmark yields, broker/dealer quotes, issuer spreads, two-sided markets, benchmark securities, bids, offers and reference data.

Deposit liabilities include obligations under structured insurance and reinsurance transactions. For purposes of fair value disclosures, the Company determined the estimated fair value of the deposit liabilities by assuming a discount rate equal to the appropriate U.S. Treasury rate plus 100.3 basis points at December 31, 2012 and the appropriate U.S. Treasury rate plus 161.8 basis points at December 31, 2011. The discount rate incorporates the Company’s own credit risk into the determination of estimated fair value.

The fair values of the Company’s notes payable and debt outstanding were determined based on quoted market prices.

There are no significant concentrations of credit risk within the Company’s financial instruments as defined in the authoritative guidance over disclosures of fair value of financial instruments not carried at fair value, which excludes certain financial instruments, particularly insurance contracts.

4. Segment Information

The Company is organized into three operating segments: Insurance, Reinsurance and Life operations. The Company's general investment and financing operations are reflected in Corporate.

The Company evaluates the performance of both the Insurance and Reinsurance segments based on underwriting profit while the Life operations segment performance is based on contribution. Other items of revenue and expenditure of the Company are not evaluated at the segment level. In addition, the Company does not allocate investment assets by segment for its Property and Casualty ("P&C") operations. Investment assets related to the Company's Life operations and certain structured products included in the Insurance and Reinsurance segments and Corporate are held in separately identified portfolios. As such, net investment income from these assets is included in the contribution from the applicable segment.

Year Ended December 31, 2012 *(U.S. dollars in thousands, except ratios)*	**Insurance**	**Reinsurance**	**Total P&C**	**Life Operations**	**Total**
Gross premiums written	$ 5,166,974	$ 2,008,156	$ 7,175,130	$ 355,754	$ 7,530,884
Net premiums written	4,072,513	1,884,508	5,957,021	324,432	6,281,453
Net premiums earned	3,924,640	1,841,342	5,765,982	324,459	6,090,441
Net losses and loss expenses	(2,691,056)	(1,074,426)	(3,765,482)	(486,198)	(4,251,680)
Acquisition costs	(504,227)	(368,172)	(872,399)	(41,093)	(913,492)
Operating expenses (1)	(754,306)	(157,657)	(911,963)	(9,336)	(921,299)
Underwriting profit (loss)	$ (24,949)	$ 241,087	$ 216,138	$ (212,168)	$ 3,970
Net investment income			604,494	299,442	903,936
Net results from structured products (2)	20,980	(15,882)	5,098	-	5,098
Net fee income and other (3)	(1,071)	2,493	1,422	426	1,848
Net realized gains (losses) on investments			114,034	(21,003)	93,031
Contribution from P&C and Life Operations			$ 941,174	$ 66,697	$ 1,007,871
Corporate & other:					
Net realized & unrealized gains (losses) on derivative instruments					5,246
Net income (loss) from investment fund affiliates and operating affiliates (4)					114,295
Exchange gains (losses)					(10,383)
Corporate operating expenses					(169,824)
Interest expense (5)					(16,800)
Non-controlling interests					(167)
Income tax					(35,668)
Net income (loss) attributable to XL Insurance (Bermuda) Ltd					$ 894,570
Ratios – P&C operations: (6)					
Loss and loss expense ratio	68.6%	58.4%	65.3%		
Underwriting expense ratio	32.0%	28.5%	31.0%		
Combined ratio	100.6%	86.9%	96.3%		

(1) Operating expenses exclude Corporate operating expenses, shown separately.
(2) The net results from P&C structured products include net investment income and interest expense of $71.7 million and $66.4 million, respectively.
(3) Net fee income and other includes operating expenses from the Company's loss prevention consulting services business.
(4) The Company records the income related to the alternative funds and to the private investment and operating fund affiliates on a one-month and three-month lag, respectively.
(5) Interest expense excludes interest expense related to deposit liabilities recorded in the Insurance and Reinsurance segments.
(6) Ratios are based on net premiums earned from P&C operations.

4. Segment Information

Year Ended December 31, 2011 *(U.S. dollars in thousands, except ratios)*	Insurance	Reinsurance	Total P&C	Life Operations	Corporate	Total
Gross premiums written	$ 4,824,665	$ 2,073,619	$ 6,898,284	$ 394,555	$ -	$ 7,292,839
Net premiums written	3,707,664	1,725,724	5,433,388	362,362	-	5,795,750
Net premiums earned	3,663,727	1,663,385	5,327,112	363,018	-	5,690,130
Net losses and loss expenses	(2,951,413)	(1,126,978)	(4,078,391)	(535,074)	-	(4,613,465)
Acquisition costs	(461,965)	(324,128)	(786,093)	(40,318)	-	(826,411)
Operating expenses (1)	(683,814)	(176,167)	(859,981)	(9,311)	-	(869,292)
Underwriting profit (loss)	$ (433,465)	$ 36,112	$ (397,353)	$ (221,685)	$ -	$ (619,038)
Net investment income			685,955	318,061		1,004,016
Net results from structured products (2)	10,976	12,053	23,029	-		23,029
Net fee income and other (3)	(16,370)	3,903	(12,467)	219	5,451	(6,797)
Net realized gains (losses) on investments			(40,386)	(89,999)	-	(130,385)
Contribution from P&C and Life Operations			$ 258,778	$ 6,596	$ 5,451	$ 270,825
Corporate & other:						
Net realized & unrealized gains (losses) on derivative instruments						633
Net income (loss) from investment fund affiliates and operating affiliates (4)						103,090
Exchange gains (losses)						40,129
Corporate operating expenses						(48,910)
Interest expense (5)						(49,189)
Non-controlling interests						(83)
Impairment of goodwill						(387,030)
Income tax						(59,668)
Net income (loss) attributable to XL Insurance (Bermuda) Ltd						$ (130,203)
Ratios – P&C operations: (6)						
Loss and loss expense ratio	80.6%	67.8%	76.6%			
Underwriting expense ratio	31.2%	30.0%	30.9%			
Combined ratio	111.8%	97.8%	107.5%			

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(1) Operating expenses exclude Corporate operating expenses, shown separately.
(2) The net results from P&C structured products include net investment income and interest expense of $74.6 million and $51.5 million, respectively.
(3) Net fee income and other includes operating expenses from the Company's loss prevention consulting services business and expenses related to the cost of an endorsement facility with National Indemnity Company.
(4) The Company records the income related to the alternative funds and to the private investment and operating fund affiliates on a one-month and three-month lag, respectively.
(5) Interest expense excludes interest expense related to deposit liabilities recorded in the Insurance and Reinsurance segments.
(6) Ratios are based on net premiums earned from P&C operations.

4. Segment Information

The following tables summarize the Company's net premiums earned by line of business:

(U.S. dollars in thousands) **Year Ended December 31, 2012**	Insurance	Reinsurance	Life Operations	Total
P&C Operations:				
Professional	$ 1,350,328	$ 213,322	$ -	$ 1,563,650
Casualty	1,157,909	311,160	-	1,469,069
Property catastrophe	-	463,977	-	463,977
Property	489,743	613,295	-	1,103,038
Marine, energy, aviation and satellite	-	147,370	-	147,370
Specialty	708,564	-	-	708,564
Other (1)	218,096	92,218	-	310,314
Total P&C Operations	$ 3,924,640	$ 1,841,342	$ -	$ 5,765,982
Life Operations:				
Annuity	$ -	$ -	$ 126,912	$ 126,912
Other Life	-	-	197,547	197,547
Total Life Operations	$ -	$ -	$ 324,459	$ 324,459
Total	$ 3,924,640	$ 1,841,342	$ 324,459	$ 6,090,441
Year Ended December 31, 2011				
P&C Operations:				
Professional	$ 1,287,231	$ 213,949	$ -	$ 1,501,180
Casualty	998,326	256,853	-	1,255,179
Property catastrophe	-	387,523	-	387,523
Property	464,576	587,611	-	1,052,187
Marine, energy, aviation and satellite	-	130,855	-	130,855
Specialty	702,604	-	-	702,604
Other (1)	210,990	86,594	-	297,584
Total P&C Operations	$ 3,663,727	$ 1,663,385	$ -	$ 5,327,112
Life Operations:				
Annuity	$ -	$ -	$ 132,232	$ 132,232
Other Life	-	-	230,786	230,786
Total Life Operations	$ -	$ -	$ 363,018	$ 363,018
Total	$ 3,663,727	$ 1,663,385	$ 363,018	$ 5,690,130

(1) Other within the Insurance segment includes: excess and surplus, surety, structured indemnity and certain other discontinued lines. Other within the Reinsurance segment includes: whole account contracts, surety and other lines.

4. Segment Information

The following table shows an analysis of the Company's net premiums written by geographical location of subsidiary where the premium is written for the years ended December 31:

P&C Operations:

(U.S. dollars in thousands)	2012	2011
Bermuda	$ 644,566	$ 572,825
United States	2,626,856	2,320,274
Europe and other	2,685,599	2,540,289
Total P&C operations	$ 5,957,021	$ 5,433,388

Life Operations:

(U.S. dollars in thousands)		
Bermuda	$ 62,660	$ 75,219
Europe and other	261,772	287,143
Total Life operations	$ 324,432	$ 362,362

5. Investments

(a) Fixed Maturities, Short-Term Investments and Equity Securities

Amortized Cost and Fair Value Summary

The cost (amortized cost for fixed maturities and short-term investments), fair value, gross unrealized gains and gross unrealized (losses), including, OTTI recorded in accumulated other comprehensive income ("AOCI") of the Company's available for sale ("AFS") and held to maturity ("HTM") investments at December 31, 2012 and December 31, 2011 were as follows:

December 31, 2012 *(U.S. dollars in thousands)*	Cost or Amortized Cost	Included in AOCI: Gross Unrealized Gains	Included in AOCI: Gross Unrealized Losses Related to Changes in Estimated Fair Value	Fair Value	Non-credit Related OTTI (1)
Fixed maturities - AFS					
U.S. Government and Government- Related/Supported(2)	$ 1,845,287	$ 126,151	$ (3,289)	$ 1,968,149	$ -
Corporate (3) (4) (5)	9,382,573	671,402	(79,465)	9,974,510	(11,453)
RMBS – Agency	4,723,875	175,440	(5,897)	4,893,418	-
RMBS – Non-Agency	540,719	40,025	(40,155)	540,589	(93,917)
CMBS	950,183	60,507	(3,474)	1,007,216	(1,524)
CDO	784,564	12,008	(86,756)	709,816	(4,872)
Other asset-backed securities (3)	1,380,985	57,782	(13,394)	1,425,373	(5,761)
U.S. States and political subdivisions of the States	1,749,452	143,815	(2,951)	1,890,316	-
Non-U.S. Sovereign Government, Provincial, Supranational and Government-Related/Supported (2)	4,071,825	187,505	(8,193)	4,251,137	-
Total fixed maturities - AFS	$ 25,429,463	$ 1,474,635	$ (243,574)	$ 26,660,524	$ (62,527)
Total short-term investments (2)	$ 322,561	$ 192	$ (50)	$ 322,703	$ -
Total equity securities	$ 617,486	$ 31,935	$ (62)	$ 649,359	$ -
Total investments - AFS	$ 26,369,510	$ 1,506,762	$ (243,686)	$ 27,632,586	$ (62,527)
Fixed maturities - HTM					
U.S. Government and Government- Related/Supported (2)	$ 10,788	$ 1,651	$ -	$ 12,439	$ -
Corporate (3)	1,425,320	190,871	(794)	1,615,397	-
RMBS – Non-Agency	83,205	10,502	-	93,707	-
CMBS	12,751	2,048	-	14,799	-
Other asset-backed securities (3)	222,340	29,287	(167)	251,460	-
Non-U.S. Sovereign Government, Provincial, Supranational and Government-Related/Supported (2)	1,060,043	216,679	(1,720)	1,275,002	-
Total investments - HTM	$ 2,814,447	$ 451,038	$ (2,681)	$ 3,262,804	$ -

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(1) Represents the non-credit component of OTTI losses, adjusted for subsequent sales of securities. It does not include the change in fair value subsequent to the impairment measurement date.

(2) U.S. Government and Government-Related/Supported, Non-U.S. Sovereign Government, Provincials, Supranationals and Government-Related/Supported and Total short-term investments includes government-related securities with an amortized cost of $1,905.9 million and fair value of $2,000.8 million and U.S. Agencies with an amortized cost of $343.1 million and fair value of $384.7 million.

(3) At December 31, 2012, Covered Bonds within Fixed maturities – AFS with an amortized cost of $572.5 million and a fair value of $612.3 million and Covered Bonds within Fixed maturities – HTM with an amortized cost of $8.4 million and a fair value of $8.6 million have been included within Other asset-backed securities to align the Company's classification to market indices. Covered Bonds were included in Corporate prior to January 1, 2012.

(4) Included within Corporate are certain medium term notes supported primarily by pools of European investment grade credit with varying degrees of leverage. The notes have a fair value of $194.3 million and an amortized cost of $194.8 million. These notes allow the investor to participate in cash flows of the underlying bonds including certain residual values, which could serve to either decrease or increase the ultimate values of these notes.

(5) Included within Corporate are Tier One and Upper Tier Two securities, representing committed term debt and hybrid instruments, which are senior to the common and preferred equities of the financial institutions. These securities have a fair value of $308.5 million and an amortized cost of $327.6 million at December 31, 2012.

5. Investments

December 31, 2011 *(U.S. dollars in thousands)*	**Cost or Amortized Cost**	**Included in AOCI: Gross Unrealized Gains**	**Included in AOCI: Gross Unrealized Losses Related to Changes in Estimated Fair Value**	**Fair Value**	**Non-credit Related OTTI (1)**
Fixed maturities - AFS					
U.S. Government and Government-Related/Supported (2)	$ 1,693,642	$ 125,716	$ (4,159)	$ 1,815,199	$ -
Corporate (3) (4) (5)	9,801,441	515,720	(285,381)	10,031,780	(51,666)
RMBS – Agency	4,808,632	181,669	(3,847)	4,986,454	-
RMBS – Non-Agency	558,087	10,693	(127,401)	441,379	(48,015)
CMBS	897,567	51,288	(7,795)	941,060	(4,686)
CDO	841,865	6,624	(191,166)	657,323	(4,997)
Other asset-backed securities (3)	968,963	18,493	(25,009)	962,447	(5,155)
U.S. States and political subdivisions of the States	1,695,565	100,749	(2,220)	1,794,094	-
Non-U.S. Sovereign Government, Provincial, Supranational and Government-Related/Supported (2)	3,188,526	127,385	(17,839)	3,298,072	-
Total fixed maturities - AFS	$ 24,454,288	$ 1,138,337	$ (664,817)	$ 24,927,808	$ (114,519)
Total short-term investments (2)	$ 359,378	$ 519	$ (833)	$ 359,064	$ -
Total equity securities	$ 480,685	$ 27,947	$ (40,435)	$ 468,197	$ -
Total investments - AFS	$ 25,294,351	$ 1,166,803	$ (706,085)	$ 25,755,069	$ (114,519)
Fixed maturities - HTM					
U.S. Government and Government-Related/Supported (3)	$ 10,399	$ 1,510	$ -	$ 11,909	$ -
Corporate (3)	1,298,266	91,313	(14,747)	1,374,832	-
RMBS – Non-Agency	80,955	6,520	(32)	87,443	-
Other asset-backed securities (3)	280,684	20,875	(6)	301,553	-
Non-U.S. Sovereign Government, Provincial, Supranational and Government-Related/Supported (2)	998,674	127,227	(5,950)	1,119,951	-
Total investments - HTM	$ 2,668,978	$ 247,445	$ (20,735)	$ 2,895,688	$ -

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(1) Represents the non-credit component of OTTI losses, adjusted for subsequent sales of securities. It does not include the change in fair value subsequent to the impairment measurement date.

(2) U.S. Government and Government-Related/Supported, Non-U.S. Sovereign Government, Provincials, Supranationals and Government-Related/Supported and Total short-term investments includes government-related securities with an amortized cost of $1,774.2 million and fair value of $1,810.3 million and U.S. Agencies with an amortized cost of $455.0 million and fair value of $500.8 million.

(3) Covered Bonds within Fixed maturities – AFS with an amortized cost of $345.4 million and a fair value of $353.9 million and Covered Bonds within Fixed maturities – HTM with an amortized cost of $8.1 million and a fair value of $7.7 million at December 31, 2011 have been reclassified from Corporate to Other asset-backed securities to align the Company's classification to market indices and conform to current period presentation.

(4) Included within Corporate are certain medium term notes supported primarily by pools of European investment grade credit with varying degrees of leverage. The notes have a fair value of $266.0 million and an amortized cost of $297.7 million. These notes allow the investor to participate in cash flows of the underlying bonds including certain residual values, which could serve to either decrease or increase the ultimate values of these notes.

(5) Included within Corporate are Tier One and Upper Tier Two securities, representing committed term debt and hybrid instruments, which are senior to the common and preferred equities of the financial institutions. These securities have a fair value of $380.6 million and an amortized cost of $487.7 million at December 31, 2011.

At December 31, 2012 and December 31, 2011, approximately 2.8% and 2.0%, respectively, of the Company’s fixed income investment portfolio at carrying value was invested in securities that were below investment grade or not rated. Approximately 33.1% and 22.5% of the gross unrealized losses in the Company’s fixed income securities portfolio at December 31, 2012 and December 31, 2011, respectively, related to securities that were below investment grade or not rated.

5. Investments

Classification of Fixed Income Securities

During the third quarter of 2011, the Company changed the manner in which it classifies fixed income securities between Fixed maturities and Short-term investments on the balance sheet and the related note disclosure. Short-term investments under the Company's previous classification comprised investments with a remaining maturity of less than one year from the reporting date. Under this prior presentation, longer term securities were reclassified from Fixed maturities to Short-term investments as they neared maturity. Under the Company's new classification, Short-term investments include investments due to mature within one year from the date of purchase and are valued using the same external factors and in the same manner as Fixed maturities. No reclassifications are made between Fixed maturities and Short-term investments subsequent to the initial date of purchase.

This change in classification did not have an impact on the total value of investments available for sale on the balance sheet, nor did it impact the consolidated statements of income, comprehensive income, shareholders' equity or cash flows. The only impact, other than the changes in the balance sheet line items, are changes required within the detailed tables included within this note as well as Note 3, "Fair Value Measurements," to allocate securities previously classified as Short-term investments under the former practice into the appropriate categories of Fixed maturities within each table to conform to the new accounting presentation for current and comparative periods.

Covered Bonds were included within Corporate securities prior to January 1, 2012. Beginning in 2012, they were classified as Other asset-backed securities to align the Company's classification to market indices. At December 31, 2011, Covered Bonds with a fair value of $353.9 million have been reclassified from Corporate to Other asset-backed securities to conform to current period presentation.

5. Investments

Contractual Maturities Summary

The contractual maturities of AFS and HTM fixed income securities at December 31, 2012 and December 31, 2011 are shown below. Actual maturities may differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

	December 31,2012 (1)		December 31,2011 (1)	
(U.S. dollars in thousands)	Amortized Cost	Fair Value	Amortized Cost	Fair Value
Fixed maturities - AFS				
Due less than one year	$ 1,865,204	$ 1,875,431	$ 1,873,405	$ 1,888,739
Due after 1 through 5 years	8,070,795	8,386,835	7,531,501	7,696,125
Due after 5 through 10 years	4,676,640	5,032,229	3,745,615	3,905,404
Due after 10 years	2,436,498	2,789,617	3,228,653	3,448,877
	$ 17,049,137	$ 18,084,112	$ 16,379,174	$ 16,939,145
RMBS – Agency	4,723,875	4,893,418	4,808,632	4,986,454
RMBS – Non-Agency	540,719	540,589	558,087	441,379
CMBS	950,183	1,007,216	897,567	941,060
CDO	784,564	709,816	841,865	657,323
Other asset-backed securities	1,380,985	1,425,373	968,963	962,447
Total mortgage and asset-backed securities	$ 8,380,326	$ 8,576,412	$ 8,075,114	$ 7,988,663
Total fixed maturities - AFS	$ 25,429,463	$ 26,660,524	$ 24,454,288	$ 24,927,808
Fixed maturities - HTM				
Due less than one year	$ 36,515	$ 37,580	$ 11,796	$ 11,768
Due after 1 through 5 years	195,121	205,562	122,091	123,871
Due after 5 through 10 years	377,541	420,008	393,865	402,424
Due after 10 years	1,886,974	2,239,688	1,771,530	1,960,886
	$ 2,496,151	$ 2,902,838	$ 2,299,282	$ 2,498,949
RMBS – Non-Agency	83,205	93,707	80,955	87,443
CMBS	12,751	14,799	-	-
Other asset-backed securities	222,340	251,460	288,741	309,296
Total mortgage and asset-backed securities	$ 318,296	$ 359,966	$ 369,696	$ 396,739
Total fixed maturities - HTM	$ 2,814,447	$ 3,262,804	$ 2,668,978	$ 2,895,688

(1) Included in the table above are Tier One and Upper Tier Two securities, representing committed term debt and hybrid instruments, which are senior to the common and preferred equities of the financial institutions, at their fair value of $308.5 million and $380.6 million at December 31, 2012 and December 31, 2011, respectively. These securities are reflected in the table based on their call date and have net unrealized losses of $19.1 million and $107.1 million at December 31, 2012 and December 31, 2011, respectively.

5. Investments

OTTI Considerations

Under final authoritative accounting guidance, a debt security for which amortized cost exceeds fair value is deemed to be other-than-temporarily impaired if it meets either of the following conditions: (a) the Company intends to sell, or it is more likely than not that the Company will be required to sell, the security before a recovery in value, or (b) the Company does not expect to recover the entire amortized cost basis of the security. Other than in a situation in which the Company has the intent to sell a debt security or more likely than not will be required to sell a debt security, the amount of the OTTI related to a credit loss on the security is recognized in earnings, and the amount of the OTTI related to other factors (e.g., interest rates, market conditions, etc.) is recorded as a component of OCI. The net amount recognized in earnings (“credit loss impairment”) represents the difference between the amortized cost of the security and the net present value of its projected future cash flows discounted at the effective interest rate implicit in the debt security prior to impairment (“NPV”). The remaining difference between the security’s NPV and its fair value is recognized in OCI. Subsequent changes in the fair value of these securities are included in OCI unless a further impairment is deemed to have occurred.

In the scenario where the Company has the intent to sell a security in which its amortized cost exceeds its fair value, or it is more likely than not it will be required to sell such a security, the entire difference between the security’s amortized cost and its fair value is recognized in earnings.

The determination of credit losses is based on detailed analyses of underlying cash flows. Such analyses require the use of certain assumptions to develop the estimated performance of underlying collateral. Key assumptions used include, but are not limited to, items such as RMBS default rates based on collateral duration in arrears, severity of losses on default by collateral class, collateral reinvestment rates and expected future general corporate default rates.

Factors considered for all securities on a quarterly basis in determining that a gross unrealized loss is not other-than-temporarily impaired include management’s consideration of current and near term liquidity needs and other available sources of funds, an evaluation of the factors and time necessary for recovery and an assessment of whether the Company has the intention to sell or considers it more likely than not that it will be forced to sell a security.

Pledged Assets

Certain of the Company’s invested assets are held in trust and pledged in support of insurance and reinsurance liabilities as well as credit facilities. Such pledges are largely required by the Company’s operating subsidiaries that are “non-admitted” under U.S. state insurance regulations, in order for the U.S. cedant to receive statutory credit for reinsurance. Also, certain deposit liabilities and annuity contracts require the use of pledged assets. At December 31, 2012 and December 31, 2011, the Company had $16.2 billion and $16.6 billion in pledged assets, respectively.

(b) Gross Unrealized Losses

The following is an analysis of how long the AFS and HTM securities at December 31, 2012 and December 31, 2011 had been in a continual unrealized loss position:

5. Investments

December 31, 2012 (U.S. dollars in thousands)	Less than 12 months		Equal to or greater than 12 months	
	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses
Fixed maturities and short-term investments - AFS				
U.S. Government and Government-Related/Supported	$ 325,937	$ (2,847)	$ 9,951	$ (471)
Corporate (1) (2) (3)	475,977	(11,116)	607,758	(68,349)
RMBS – Agency	632,393	(4,903)	11,135	(994)
RMBS – Non-Agency	8,090	(495)	290,196	(39,660)
CMBS	96,649	(675)	20,501	(2,799)
CDO	243	(1)	693,211	(86,755)
Other asset-backed securities (3)	120,390	(535)	90,586	(12,859)
U.S. States and political subdivisions of the States	77,955	(1,412)	12,851	(1,539)
Non-U.S. Sovereign Government, Provincial, Supranational and Government-Related/Supported	355,409	(1,378)	131,884	(6,836)
Total fixed maturities and short-term investments - AFS	$ 2,093,043	$ (23,362)	$ 1,868,073	$ (220,262)
Total equity securities (4)	$ 615	$ (62)	$ -	$ -
Fixed maturities -HTM				
Corporate (3)	$ 4,568	$ (31)	$ 23,005	$ (763)
Other asset-backed securities (3)	1,239	(167)	-	-
Non-U.S. Sovereign Government, Provincial, Supranational and Government-Related/Supported	-	-	10,518	(1,720)
Total fixed maturities - HTM	$ 5,807	$ (198)	$ 33,523	$ (2,483)

(1) Included within Corporate are certain medium term notes supported primarily by pools of European investment grade credit with varying degrees of leverage. The notes, which are in a gross unrealized loss position, have a fair value of $194.3 million and an amortized cost of $194.8 million. These notes allow the investor to participate in cash flows of the underlying bonds including certain residual values, which could serve to either decrease or increase the ultimate values of these notes.

(2) Included within Corporate are Tier One and Upper Tier Two securities, representing committed term debt and hybrid instruments, which are senior to the common and preferred equities of the financial institutions. These securities, which are in a gross unrealized loss position, have a fair value of $308.5 million and an amortized cost of $327.6 million at December 31, 2012.

(3) Covered Bonds within Fixed maturities and short-term investments – AFS with a fair value of $612.3 million and Covered Bonds within Fixed Maturities – HTM with a fair value of $8.6 million have been included within Other asset-backed securities to align the Company’s classification to market indices. Covered Bonds were included in Corporate prior to January 1, 2012.

(4) Included within equity securities are investments in fixed income funds with a fair value of $101.9 million and an amortized cost of $100.0 million at December 31, 2012.

5. Investments

December 31, 2011 (U.S. dollars in thousands)	Less than 12 months Fair Value	Less than 12 months Gross Unrealized Losses	Equal to or greater than 12 months Fair Value	Equal to or greater than 12 months Gross Unrealized Losses
Fixed maturities and short-term investments - AFS				
U.S. Government and Government-Related/Supported	$ 283,279	$ (247)	$ 43,622	$ (3,984)
Corporate (1) (2) (3)	1,076,087	(41,867)	1,189,595	(244,099)
RMBS – Agency	309,987	(847)	36,960	(3,000)
RMBS – Non-Agency	91,534	(30,198)	300,596	(97,203)
CMBS	66,236	(2,382)	33,855	(5,413)
CDO	3,357	(2,261)	635,129	(189,047)
Other asset-backed securities (3)	193,713	(2,494)	137,696	(22,515)
U.S. States and political subdivisions of the States	25,309	(199)	27,646	(2,021)
Non-U.S. Sovereign Government, Provincial, Supranational and Government-Related/Supported	265,766	(4,707)	202,890	(13,166)
Total fixed maturities and short-term investments - AFS	$ 2,315,268	$ (85,202)	$ 2,607,989	$ (580,448)
Total equity securities (4)	$ 361,585	$ (40,435)	$ -	$ -
Fixed maturities -HTM				
Corporate (3)	$ 147,836	$ (7,770)	$ 62,343	$ (6,663)
RMBS – Non-Agency	9,372	(32)	-	-
Other asset-backed securities (3)	7,743	(314)	1,106	(6)
Non-U.S. Sovereign Government, Provincial, Supranational and Government-Related/Supported	79,242	(1,206)	18,330	(4,744)
Total fixed maturities - HTM	$ 244,193	$ (9,322)	$ 81,779	$ (11,413)

(1) Included within Corporate are certain medium term notes supported primarily by pools of European investment grade credit with varying degrees of leverage. The notes, which are in a gross unrealized loss position, have a fair value of $266.0 million and an amortized cost of $297.7 million. These notes allow the investor to participate in cash flows of the underlying bonds including certain residual values, which could serve to either decrease or increase the ultimate values of these notes.

(2) Included within Corporate are Tier One and Upper Tier Two securities, representing committed term debt and hybrid instruments, which are senior to the common and preferred equities of the financial institutions. These securities, which are in a gross unrealized loss position, have a fair value of $380.6 million and an amortized cost of $487.7 million at December 31, 2011.

(3) Covered Bonds within Fixed maturities and short-term investments – AFS with a fair value of $353.9 million and Covered Bonds within Fixed Maturities – HTM with a fair value of $7.7 million have been included within Other asset-backed securities to align the Company’s classification to market indices and to conform to current period presentation. Covered Bonds were included in Corporate prior to January 1, 2012.

(4) Included within equity securities are investments in fixed income funds with a fair value of $91.6 million and an amortized cost of $100.0 million at December 31, 2011.

The Company had gross unrealized losses totaling $243.7 million on 1,180 securities out of a total of 7,088 held at December 31, 2012 in its AFS portfolio and $2.7 million on 5 securities out of a total of 206 held in its HTM portfolio, which it considers to be temporarily impaired or with respect to which reflects non-credit losses on OTTI. Individual security positions comprising this balance have been evaluated by management to determine the severity of these impairments and whether they should be considered other-than-temporary. Management believes it is more likely than not that the issuer will be able to fund sufficient principal and interest payments to support the current amortized cost.

Management, in its assessment of whether securities in a gross unrealized loss position are temporarily impaired, as described above, considers the significance of the impairments. At December 31, 2012, the Company had structured securities with gross unrealized losses of $20.6 million, which had a fair value of $7.4 million, and a cumulative fair value decline of greater than 50% of amortized cost. All of these securities are mortgage and asset-backed securities. These greater than 50% impaired securities include gross unrealized losses of $5.3 million on non-Agency RMBS, $14.8 million on Core CDOs and $0.6 million of CMBS holdings.

5. Investments

(c) Net Investment Income

Net investment income for the years ended December 31 is derived from the following sources:

(U.S. dollars in thousands)	2012	2011
Fixed maturities, short term investments and cash equivalents	$ 1,947,024	$ 1,109,092
Equity securities and other investments	29,807	17,729
Funds withheld	12,082	12,239
Total gross investment income	1,988,913	1,139,060
Investment expenses	(1,013,308)	(60,474)
Net investment income	$ 975,605	$ 1,078,586

(d) Net Realized Gains (Losses)

The following represents an analysis of net realized gains (losses) and the change in unrealized gains (losses) on investments for the years ended December 31:

(U.S. dollars in thousands)	2012	2011
Net realized gains (losses):		
Fixed maturities, short term investments, cash and cash equivalents:		
Gross realized gains	$ 217,425	$ 175,088
Gross realized losses on investments sold	(106,442)	(206,297)
OTTI on investments, net of amounts transferred to other comprehensive income	(50,073)	(106,313)
Net realized gains (losses)	60,910	(137,522)
Equity securities:		
Gross realized gains	42,009	2,093
Gross realized losses on investments sold	(7,121)	(4,265)
OTTI on investments, net of amounts transferred to other comprehensive income	(3,746)	-
Net realized gains (losses)	31,142	(2,172)
Other investments:		
Gross realized gains	11,589	14,747
Gross realized losses on investments sold	(7,889)	(4,765)
OTTI on investments, net of amounts transferred to other comprehensive income	(2,721)	(673)
Net realized gains (losses)	979	9,309
Net realized gains (losses) on investments	93,031	(130,385)
Net realized and unrealized gains (losses) on investment related derivative instruments	(1,203)	633
Net realized gains (losses) on investments and net realized and unrealized gains (losses) on investment related derivative instruments	91,828	(129,752)
Change in unrealized gains (losses):		
Fixed maturities - AFS	757,997	564,626
Fixed maturities - HTM	221,647	212,419
Equity securities	44,361	(40,424)
Affiliates and other investments	45,984	25,596
Net change in unrealized gains (losses) on investments	1,069,989	762,217
Total net realized gains (losses) on investments, net realized and unrealized gains (losses) on investment related derivative instruments, and net change in unrealized gains (losses) on investments	$ 1,161,817	$ 632,465

5. Investments

The significant components of the net impairment charges of $53.9 million for the year ended December 31, 2012 were:

- $20.1 million for structured securities, principally non-Agency RMBS, where we determined that the likely recovery on these securities was below the carrying value and, accordingly, recorded an impairment of the securities to the discounted value of the cash flows expected to be received on these securities.
- $21.0 million related to medium term notes backed primarily by European investment grade credit. On certain notes, management concluded that expected future returns on the underlying assets were not sufficient to support the previously reported amortized cost. We also adjusted the estimated remaining holding period of certain notes resulting in a shorter reinvestment spectrum.
- $6.5 million related to certain equities as the holdings were in a loss position for more than 11 months.
- $6.3 million related to currency losses primarily arising on Swiss franc and U.K. sterling denominated securities held in U.S. dollar portfolios.

The following table sets forth the amount of credit loss impairments on fixed income securities held by the Company as of the dates indicated, for which a portion of the OTTI loss was recognized in OCI, and the corresponding changes in such amounts.

Credit Loss Impairments

(U.S. dollars in thousands)	2012	2011
Balance at January 1,	$ 202,235	$ 266,615
Credit loss impairment recognized in the current period on securities not previously impaired	10,060	16,420
Credit loss impairments previously recognized on securities which matured, paid down, prepaid or were sold during the period	(65,453)	(131,777)
Credit loss impairments previously recognized on securities impaired to fair value during the period	3,286	-
Additional credit loss impairments recognized in the current period on securities previously impaired	30,552	46,630
Accretion of credit loss impairments previously recognized due to an increase in cash flows expected to be collected	(15,118)	4,347
Balance at December 31,	$ 165,562	$ 202,235

During the year ended December 31, 2012 and 2011, the $65.4 million and $131.8 million, respectively, of credit loss impairments previously recognized on securities that matured, or were paid down, prepaid or sold, includes $16.2 million and $68.7 million, respectively, of non-Agency RMBS.

6. Investments In Affiliates

The Company's investment portfolio includes certain investments over which the company is considered to have significant influence and which, therefore, are accounted for using the equity method. Significant influence is generally deemed to exist where the Company has an investment of 20% or more in the common stock of a corporation or an investment of 3% or more in closed end funds, limited partnerships, LLCs or similar investment vehicles. The Company generally records its alternative and private equity fund affiliates on a one-month and three-month lag, respectively, and its operating affiliates on a three-month lag. See Note 7, "Other Investments" for investments in alternative and private equity funds in which the Company generally owns less than 3% and are accounted for as "Other Investments."

Investments in affiliates comprised the following at December 31, 2012 and 2011:

(U.S. dollars in thousands)	2012	2011
Investment fund affiliates	$ 845,197	$ 768,846
Operating affiliates	281,678	283,878
Total investment affiliates	$ 1,126,875	$ 1,052,724

(a) Investment Fund Affiliates

The Company has invested in certain closed end funds, certain limited partnerships, LLCs and similar investment vehicles, including funds managed by certain of its investment manager affiliates. Collectively, these investments in funds, partnerships and other vehicles are classified as "investment fund affiliates." The Company's equity investment in investment fund affiliates and equity in net income (loss) from such affiliates as well as certain summarized financial information of the investee as a whole (shown as "Combined Funds") are included below:

	XL Investment			Combined Funds
Year Ended December 31, 2012 *(U.S. dollars in thousands, except percentages)*	Carrying Value	Equity in Net Income (Loss) for the Year	Weighted Average XL Percentage Ownership	Total Net Assets (Estimated) (2)
Alternative Funds (1):				
Arbitrage	$ 131,037	$ 7,149	3.7%	$ 3,517,404
Directional	297,535	14,791	5.9%	5,057,381
Event Driven (3)	198,282	13,125	2.4%	8,272,227
Multi-Style	326	(99)	13.5%	2,410
Total alternative funds	$ 627,180	$ 34,966	3.7%	$ 16,849,422
Private Investment Funds (1):	218,017	23,520	17.1%	1,275,543
Total Investment Fund Affiliates	$ 845,197	$ 58,486	4.7%	$ 18,124,965
Year Ended December 31, 2011				
Alternative Funds (1):				
Arbitrage	$ 123,969	$ 1,291	3.4%	$ 3,678,904
Directional	217,779	9,154	6.0%	3,619,272
Event Driven	229,956	(60)	3.1%	7,472,680
Multi-Style	425	(9)	17.6%	2,410
Total alternative funds	$ 572,129	$ 10,376	3.9%	$ 14,773,266
Private Investment Funds (1):	196,717	15,928	5.1%	3,820,488
Total Investment Fund Affiliates	$ 768,846	$ 26,304	4.1%	$ 18,593,754

(1) The Company generally records its alternative fund affiliates on a one-month lag and its private investment fund affiliates on a three-month lag.
(2) Total estimated net assets are generally as at November 30 and September 30, respectively.
(3) The Company accounts for its investment in certain funds where the ownership percentage is less than three percent using the equity method, where the Company has significant influence over the related investment management company.

6. Investments In Affiliates

Certain funds have a lock-up period and/or may also have the ability to impose a redemption gate. A lock-up period refers to the initial amount of time an investor is contractually required to remain invested before having the ability to redeem. Typically, the imposition of a gate delays a portion of the requested redemption, with the remaining portion settled in cash shortly after the redemption date.

The carrying value of the Company's holdings in funds that are subject to lockups and/or that have gate provisions in their governing documents as at December 31, 2012 and 2011 was $302.4 million and $419.4 million, respectively. The carrying value of the Company's holdings in funds where a gate was imposed at December 31, 2012 and 2011 was $1.4 million and nil, respectively.

Certain funds may be allowed to invest a portion of their assets in illiquid securities, such as private equity or convertible debt. In such cases, a common mechanism used is a side-pocket, whereby the illiquid security is assigned to a separate memorandum capital account or other designated account. Typically, the investor loses its redemption rights in the designated account. Only when the illiquid securities in the side-pocket are sold, or otherwise deemed liquid by the fund, may investors redeem that portion of their interest that has been "side-pocketed". At December 31, 2012 and 2011, the carrying value of our funds held in side-pockets was $39.7 million and $30.7 million, respectively. The underlying assets within these positions are generally expected to be liquidated over a period of approximately two to four years.

(b) Operating Affiliates

The Company has invested in investment and (re)insurance affiliates and investment management companies' securities or other forms of ownership interests. Collectively, these investments are classified as "operating affiliates."

The Company's equity investment in operating affiliates and equity in net income (loss) from such affiliates as well as certain summarized financial information of the investee as a whole are included below:

	XL Investment		Combined Investee Summarized Financial Data (Estimated) (1)			
Year ended December 31, 2012 *(U.S. dollars in thousands)*	Carrying Value	Equity in Net Income (Loss) for the Year	Total Assets	Total Liabilities	Total Revenue (Loss)	Net Income (Loss)
Financial operating affiliates	$ 732	$ -	$ 12,711,762	$ 12,678,810	$ 20,467	$ 6,183
Other strategic operating affiliates	192,792	27,033	2,094,539	1,512,551	698,665	51,702
Investment manager affiliates	88,154	28,776	610,940	37,699	364,551	274,312
Total operating affiliates	$ 281,678	$ 55,809	$ 15,417,241	$ 14,229,060	$ 1,083,683	$ 332,197
Year ended December 31, 2011						
Financial operating affiliates	$ 732	$ (1,018)	$ 11,957,534	$ 11,931,662	$ 12,564	$ 1,115
Other strategic operating affiliates	153,955	20,891	1,295,921	967,264	348,831	48,641
Investment manager affiliates (2)	129,191	56,913	601,511	38,349	319,984	222,260
Total operating affiliates	$ 283,878	$ 76,786	$ 13,854,966	$ 12,937,275	$ 681,379	$ 272,016

(1) The Company generally records its operating affiliates on a three month lag. Estimated assets and liabilities are generally at September 30, 2012 and 2011, respectively.

(2) During the year ended December 31, 2012 and 2011 the Company received distributions from its Investment Manager Affiliates of approximately $58.3 million and $23.2 million respectively. During 2011 the Company sold its interests in Finisterre for total proceeds of $35.0 million as explained below at "Investment Manager Affiliates."

6. Investments In Affiliates

In certain investments, the carrying value is different from the share of the investee's underlying net assets. The differences represent goodwill on acquisition, OTTI recorded with respect to the investment, or differences in the retained capital accounts of the various equity holders (including the Company).

See Note 16(c), "Commitments and Contingencies – Investments in Affiliates," for further information regarding commitments related to investment in affiliates.

Financial Operating Affiliates

The Company had no significant financial operating affiliates during 2012 or 2011 following the sale, during the fourth quarter of 2010, of approximately 76% of its investment in Primus Guaranty, Ltd. ("Primus"), reducing the Company's ownership interest from 39.7% to 9.8% at December 31, 2010. This sale generated total proceeds of $51.6 million during the year ended December 31, 2010. Given management's view of the risk exposure, expected losses and the uncertainty facing the entire financial guarantee industry in 2007, the Company had reduced the reported value of its investment in Primus to nil at December 31, 2007. The Company did not record any equity earnings during 2010, 2009 or 2008 in relation to Primus because of the significant losses and negative book value reported by Primus during these periods. Therefore, the sale in the fourth quarter of 2010 resulted in the recording of a gain of $51.6 million through "Income from operating affiliates." Subsequent to the sale, the Company's ownership of Primus shares was accounted for as an available for sale equity security.

Other Strategic Operating Affiliates

The Company's strategic operating affiliates included an investment in ARX Holding Corporation of 39.7% and 45.7% at December 31, 2012 and 2011, respectively. During 2012, the Company purchased interests in two additional strategic operating affiliates for $20.9 million. During the second quarter of 2010, the Company's 49.9% investment in the Brazilian joint venture ITAU XL Seguros Corporativos S.A. ("ITAU") was sold.

Investment Manager Affiliates

During the years ended December 31, 2012, 2011 and 2010, the Company's larger investment manager affiliates included Highfields Capital, a global equity investment firm, Polar Capital, an investment firm offering traditional and alternative products and HighVista Strategies, a diversified wealth management firm. The Company recorded, through net income in affiliates, other-than-temporary declines in the values of certain investment manager affiliates totaling nil and $0.6 million, for the years ended December 31, 2012 and 2011, respectively.

During the third quarter of 2011, the Company sold its interests in Finisterre for total proceeds of $35.0 million resulting in a gain of $25.3 million. In addition, this transaction includes the potential for additional amounts to be paid to the Company during 2013 and 2014 subject to the investment manager meeting certain performance targets. These amounts, if any, will be recorded when known with certainty.

Investment Fund Consolidation

During May 2012, the Company invested $25.0 million to obtain an approximately 94% interest in Five Oaks Investment Corp. ("Five Oaks"), a newly formed private investment company. Five Oaks is a mortgage real estate investment trust that is focused on investing in, financing and managing a leveraged portfolio of agency and non-agency residential mortgage-backed securities, residential mortgage loans and other mortgage-related investments. At December 31, 2012, the Company has consolidated Five Oaks resulting in the recording within its balance sheet of: RMBS securities at their fair value of $81.0 million (amortized cost: $77.3 million) within Fixed maturities, $8.4 million of Derivatives, $6.0 million of Cash and cash equivalents, $63.4 million of liabilities related to obligations under repurchase agreements within Other liabilities, and $1.8 million of Non-controlling interest in equity of consolidated subsidiaries. $66.3 million of securities held by Five Oaks and consolidated by the Company are pledged as collateral under the repurchase agreements. The repurchase agreements do not provide the counterparties any recourse to assets of the Company aside from its investment in Five Oaks. Amounts recorded within the Company's consolidated statement of income related to Five Oaks were immaterial during the year ended December 31, 2012. In addition, during March 2012, the Company purchased an equity interest in Oak Circle Capital Partners ("Oak Circle"), the investment management company that provides portfolio management and other administrative services to Five Oaks. The Company's investment in Oak Circle is included in investment manager affiliates.

7. Other Investments

Contained within this asset class are equity interests in investment funds, limited partnerships and unrated tranches of collateralized debt obligations for which the Company does not have sufficient rights or ownership interests to follow the equity method of accounting. The Company accounts for such equity securities at estimated fair value with changes in fair value recorded through AOCI as it has no significant influence over these entities. Also included within other investments are structured transactions that are carried at amortized cost.

Other investments comprised the following at December 31, 2012 and 2011:

Year ended December 31,

(U.S. dollars in thousands)	2012	2011
Alternative Investment Funds:		
Arbitrage	$ 278,680	$ 132,847
Directional	254,616	228,544
Event Driven	96,451	-
Multi-Style	65,125	93,664
Total alternative funds	$ 694,872	$ 455,055
Private investment funds	81,937	80,137
Overseas deposits	96,117	91,425
Structured transactions	312,122	323,705
Other	27,054	27,280
Total other investments	$ 1,212,102	$ 977,602

(a) Alternative and Private Equity Funds

At December 31, 2012, the alternative fund portfolio, accounted for as other investments, employed four strategies invested in 17 underlying funds, respectively. The Company is able to redeem the hedge funds on the same terms that the underlying funds can be redeemed. In general, the funds in which the Company is invested require at least 30 days notice of redemption, and may be redeemed on a monthly, quarterly, semi-annual, annual or longer basis, depending on the fund.

Certain funds have a lock-up period and/or may also have the ability to impose a redemption gate. A lock-up period refers to the initial amount of time an investor is contractually required to remain invested before having the ability to redeem. Typically, the imposition of a gate delays a portion of the requested redemption, with the remaining portion settled in cash shortly after the redemption date.

The fair value of the Company’s holdings in funds that may be subject to lockups and/or that have gate provisions in their governing documents at December 31, 2012 and 2011 was $335.2 million and $240.0 million, respectively. The Company did not have any holdings in funds where a gate was imposed at December 31, 2012 or 2011.

Certain funds may be allowed to invest a portion of their assets in illiquid securities, such as private equity or convertible debt. In such cases, a common mechanism used is a side-pocket, whereby the illiquid security is assigned to a separate memorandum capital account or other designated account. Typically, the investor loses its redemption rights in the designated account. Only when the illiquid securities in the side-pocket are sold, or otherwise deemed liquid by the fund, may investors redeem that portion of their interest that has been “side-pocketed”. At December 31, 2012 and 2011, the fair value of our funds held in side-pockets was $25.0 million and $28.4 million, respectively. The underlying assets within these positions are generally expected to be liquidated over a period of approximately two to four years.

An increase in market volatility and an increase in the volatility of hedge funds in general, as well as a decrease in market liquidity, could lead to a higher risk of a large decline in the value of the hedge funds in any given time period.

The following represents an analysis of the net realized gains and the net unrealized gains on the Company’s alternative investment funds and private equity funds:

7. Other Investments

Year ended December 31, (U.S. dollars in thousands)	Net Unrealized Gains (Losses) 2012	Net Unrealized Gains (Losses) 2011	Net Realized Gains (Losses) 2012	Net Realized Gains (Losses) 2011
Alternative investment funds	$ 130,702	$ 96,873	$ (2,153)	$ 10,120
Private investment funds	30,986	26,371	-	-
Total	$ 161,688	$ 123,244	$ (2,153)	$ 10,120

(b) Overseas Deposits

Overseas deposits include investments in private funds related to Lloyd's syndicates in which the underlying instruments are primarily government and government-related/supported and corporate fixed income securities. The funds themselves do not trade on an exchange and therefore are not included within available for sale securities. Also included in overseas deposits are restricted cash and cash equivalent balances held by Lloyd's syndicates for solvency purposes. Given the restricted nature of these cash balances, they are not included within the cash and cash equivalents category in the balance sheet.

(c) Structured Transactions

Project Finance Loans

The Company historically participated in structured transactions in project finance related areas under which the Company provided a cash loan supporting project finance transactions. These transactions are accounted for in accordance with guidance governing accounting by certain entities (including entities with trade receivables) that lend to or finance the activities of others under which the loans are considered held for investment as the Company has the intent and ability to hold for the foreseeable future or until maturity or payoff. Accordingly, these funded loan participations are reported in the balance sheet at outstanding principal adjusted for any allowance for loan losses as considered necessary by management.

The following table shows a summary of the structured project finance loans for the years ended December 31, 2012 and 2011:

Project Finance Loans

(U.S. dollars in thousands)	2012	2011
Aggregate loan value	$ 36,802	$ 49,650
Aggregate loan net carrying value	$ 31,219	$ 40,483
Opening allowance for loan losses	$ (9,167)	$ (9,167)
Amounts charged off during the period	3,584	-
Closing allowance for loan losses	$ (5,583)	$ (9,167)
Number of individual loan participations	4	6
Number of individual loan participations relating to the allowance for loan losses	1	2
Weighted average contractual term to maturity	1.0 years	2.1 years
Weighted average credit rating	BB	BB-
Range of individual credit ratings	BB+ to BB-	BB+ to CCC

Surveillance procedures are conducted over each structured project finance loan on an ongoing basis with current expectations of future collections of contractual interest and principal used to determine whether any allowance for loan losses may be required at each period end. If it is determined that a future credit loss on a specific contract is reasonably possible and an amount can be estimated, an allowance is recorded. The contractual receivable is only charged off when the final outcome is known and the Company has exhausted all commercial efforts to try and collect any outstanding balances.

7. Other Investments

National Indemnity Endorsement

On June 9, 2009, XL Specialty Insurance Company ("XL Specialty"), a wholly-owned subsidiary of the Company, entered into an agreement with National Indemnity Company, an insurance company subsidiary of Berkshire Hathaway Inc. ("National Indemnity"). Under the agreement, and a related reinsurance agreement, National Indemnity would issue endorsements ("Endorsements") to certain directors and officers liability insurance policies known as "Side A" coverage policies underwritten by XL Specialty (the "Facility") during an eighteen month period that ended in December 31, 2011.

In connection with the Facility, XL Insurance (Bermuda) Ltd ("XLIB") purchased a payment obligation (the "Obligation") in an aggregate principal amount of $150 million from National Indemnity. The outstanding Obligation was recorded in Other Investments at an estimated fair value of $128.1 million, pays a coupon of 3.5%, and is being accreted to $150 million over the 11.5 year term of the payment obligation. The difference between the estimated fair value of the Obligation and the cost of that Obligation at the time of the transaction was approximately $21.9 million and was recorded in Other Assets. This difference, together with fees of $2.5 million, was amortized in relation to the earning of the underlying policies written. During the years ended December 31, 2012 and 2011, amortization of nil and $9.4 million, respectively, was recorded.

Other Structured Transactions

On July 17, 2009, XLIB, a wholly-owned subsidiary of the Company, purchased notes with an aggregate face amount of $155 million. The carrying value of these notes at December 31, 2012 and 2011 was $147.8 million and $147.5 million, respectively. The issuer of the notes is a structured credit vehicle that holds underlying assets including corporate debt and preferred equity securities, including some securities issued by European financial institutions, as well as project finance debt securities. The notes, which are callable under certain criteria, have a final maturity of July 22, 2039.

These structured transactions are not considered to be fair value measurements under U.S. GAAP and, accordingly, they have been excluded from the fair value measurement disclosures. See Note 3, "Fair Value Measurements," for details surrounding the estimated fair value of these investments.

(d) Other

The Company regularly reviews the performance of these other investments. The Company recorded losses of $2.7 million and $0.7 million in the years ended December 31, 2012 and 2011, respectively, due to other than temporary declines in values of these other investments.

See Note 16 (b), "Commitments and Contingencies – Other Investments," for further information regarding commitments related to other investments.

8. Goodwill and Other Intangible Assets

The following table presents an analysis of intangible assets broken down between goodwill, intangible assets with an indefinite life and intangible assets with a definite life for the years ended December 31, 2012 and 2011:

(U.S. dollars in thousands)	Goodwill	Intangible assets with an indefinite life	Intangible assets with a definite life	Total
Balance at December 31, 2010	$ 642,785	$ 15,366	$ 1,896	$ 660,047
Impairment	(385,593)	-	-	(385,593)
Amortization	-	-	(1,438)	(1,438)
Foreign Currency Translation	(1,727)	-	-	(1,727)
Balance at December 31, 2011	$ 255,465	$ 15,366	$ 458	$ 271,289
Amortization	-	-	(178)	(178)
Foreign Currency Translation	1,383	-	-	1,383
Balance at December 31, 2012	$ 256,848	$ 15,366	$ 280	$ 272,494

The Company has goodwill of $256.8 million at December 31, 2012, all related to the Reinsurance segment. The estimated fair values of the reporting units' carrying goodwill exceeded their estimated net book values at December 31, 2012 and therefore no impairments were recorded during 2012. The Company recorded a non-cash impairment of $385.6 million during the fourth quarter of 2011 to write-off all of the goodwill associated with its Insurance segment reporting unit, as discussed further below. At December 31, 2012 and 2011, the ending goodwill balance is comprised of gross goodwill of $0.7 billion, offset by accumulated impairment charges of $ 0.4 billion.

The Company tests goodwill for impairment on an annual basis as of June 30, during the third quarter, and on an interim basis when certain events or circumstances exist. The Company tests for impairment at the reporting unit level in accordance with the authoritative guidance on intangibles and goodwill. For the Reinsurance segment, a reporting unit is one level below the business segment, while for Insurance, the segment is also the reporting unit. The first step is to identify potential impairment by comparing the estimated fair value of a reporting unit to its estimated book value, including goodwill. The fair value of each reporting unit is derived based upon valuation techniques and assumptions the Company believes market participants would use to value the business and this is then compared to the book value of the business. The Company derives the net book value of its reporting units by estimating the amount of shareholders' equity required to support the activities of each reporting unit. The estimated fair values of the reporting units are generally determined utilizing methodologies that incorporate price-to-net-tangible-book and price-to-earnings multiples of certain comparable companies in the industry, from an operational and economic standpoint. If such individual reporting unit estimated fair values - combined with an estimate of an appropriate control premium - exceed their related individual reporting unit net book values, goodwill for those individual reporting units is not deemed to be impaired. A control premium represents the value an investor would pay above non-controlling interest transaction prices in order to obtain a controlling interest in the respective company.

8. Goodwill and Other Intangible Assets

However, if the margin calculated between the estimated reporting unit fair value and its net book value indicates a potential impairment or a “close call”, a further analysis of the reporting unit’s estimated fair value is performed, using an entity-specific discounted cash flow methodology. This methodology establishes fair value by estimating the present value of the projected future cash flows to be generated from the reporting unit. The discount rate applied to the projected future cash flows to arrive at the present value is intended to reflect all risks of ownership and the associated risks of realizing the stream of projected future cash flows. The discounted cash flow methodology uses the Company’s projections of financial performance for a ten-year period combined with an estimated terminal value. The most significant assumptions used in the discounted cash flow methodology are the discount rate, the terminal value and expected future revenues, gross margins and operating margins, which vary among reporting units. If the individual reporting unit net book values exceed their related individual reporting unit estimated fair values based on this additional methodology, the second step of the goodwill impairment testing process is performed to measure the amount of impairment.

During the third quarter of 2011, the Company completed its annual goodwill impairment testing based on Company and industry data as of June 30, 2011, which ultimately did not result in any goodwill impairments being recorded by the Company. Although the results of this analysis did not indicate the need for any impairment charges, management evaluated the sensitivity of the fair value calculations in the goodwill impairment test and concluded that relatively small changes to key assumptions such as discount rate, the terminal value, expected future revenues, gross margins and operating margins could result in a calculated fair value insufficient to support the current level of goodwill in certain businesses. Management also concluded that the prolonged weakened market conditions resulted in the range of calculated fair values used for testing impairment in the reporting units being sufficiently close to the current net book values to warrant quarterly analysis until market conditions improve.

At December 31, 2011, the Company updated its impairment analytics utilizing all of the methodologies discussed above. As a result of the analysis performed, the Company concluded that the indicated ranges of fair values of the reporting units within the Reinsurance segment in which goodwill is carried was sufficient to support their goodwill balances; however, the indicated fair value of the Insurance segment reporting unit was not sufficient to support its goodwill balance, and thus did not pass step one of the impairment testing process. Therefore step two was required to quantify the amount of goodwill impairment. Following the step two valuation process, the $385.6million carrying value of goodwill was deemed to be impaired. As a result of the continued losses in certain businesses within the segment and continued low industry market valuations, the Company increased the rate of return a market participant would require from that used in previous goodwill testing and decreased the level of control premiums added to market value multiples for the insurance reporting unit. These factors taken together, led to the conclusion that the impairment was required. The assumptions utilized within the Reinsurance segment reporting unit valuations were not modified from those utilized during the third quarter as these units were not impacted by similar underperformance.

9. Reinsurance

The Company utilizes reinsurance and retrocession agreements principally to increase aggregate capacity and to reduce the risk of loss on business assumed. The Company's reinsurance and retrocession agreements provide for recovery of a portion of losses and loss expenses from reinsurers and reinsurance recoverables are recorded as assets. The Company is liable if the reinsurers are unable to satisfy their obligations under the agreements. Under its reinsurance security policy, the Company seeks to cede business to reinsurers generally with a financial strength rating of "A" or better. The Company considers reinsurers that are not rated or do not fall within the above rating categories and may grant exceptions to the Company's general policy on a case-by-case basis. The effect of reinsurance and retrocessional activity on premiums written and earned from property and casualty operations is shown below:

	Premiums Written Year Ended December 31,		Premiums Earned Year Ended December 31,	
(U.S. dollars in thousands)	2012	2011	2012	2011
Direct	$ 4,733,518	$ 4,714,588	$ 4,604,327	$ 4,624,557
Assumed	2,441,612	2,183,696	2,393,490	2,179,555
Ceded	(1,218,109)	(1,464,896)	(1,231,835)	(1,477,000)
Net	$ 5,957,021	$ 5,433,388	$ 5,765,982	$ 5,327,112

The Company recorded reinsurance recoveries on losses and loss expenses incurred of $0.6 billion and $1.1 billion for the years ended December 31, 2012 and 2011, respectively.

The following table presents an analysis of total unpaid losses and loss expenses and future policy benefit reserves recoverable for the year ended December 31:

(U.S. dollars in thousands)	2012	2011
P&C operations	$ 3,361,702	$ 3,629,928
Life Operations	20,399	25,020
Total unpaid losses and loss expenses recoverable	$ 3,382,101	$ 3,654,948

At December 31, 2012 and 2011, the total reinsurance assets of $3.4 billion and $3.9 billion, respectively, included reinsurance receivables for paid losses and loss expenses of $58.4 million and $220.0 million, respectively, with $3.4 billion and $3.7 billion relating to the ceded reserve for losses and loss expenses, including ceded losses incurred but not reported for each year end. Although the contractual obligation of individual reinsurers to pay their reinsurance obligations is based on specific contract provisions, the collectability of such amounts requires significant estimation by management. The majority of the balance the Company has accrued as recoverable will not be due for collection until sometime in the future. Over this period of time, economic conditions and operational performance of a particular reinsurer may impact its ability to meet these obligations and while it may continue to acknowledge its contractual obligation to do so, it may not have the financial resources or willingness to fully meet its obligations to the Company.

At December 31, 2012 and 2011, the allowance for uncollectible reinsurance relating to both reinsurance balances receivable and unpaid losses and loss expenses recoverable were $107.9 million and $99.2 million, respectively. To estimate the provision for uncollectible reinsurance recoverable, the reinsurance recoverable must first be allocated to applicable reinsurers. As part of this process, ceded IBNR is allocated by reinsurer. The allocations are generally based on historical relationships between gross and ceded losses. If actual experience varies materially from historical experience, the allocation of reinsurance recoverable by reinsurer will change.

The Company uses a default analysis to estimate uncollectible reinsurance recoverables. The primary components of the default analysis are reinsurance recoverable balances by reinsurer, net of collateral, and default factors used to determine the portion of a reinsurer's balance deemed uncollectible. The definition of collateral for this purpose requires some judgment and is generally limited to assets held in trust, letters of credit, and liabilities held by the Company with the same legal entity for which the Company believes there is a right of offset. The Company is the beneficiary of letters of credit, trust accounts and funds withheld in the aggregate amount of $1.7 billion at December 31, 2012 and 2011, collateralizing reinsurance recoverables with respect to certain reinsurers. Default factors require considerable judgment and are determined using the current financial strength rating, or rating equivalent, of each reinsurer as well as other key considerations and assumptions. The total allowance recorded relating to reinsurance recoverables was $53.3 million and $55.3 million at December 31, 2012 and 2011, respectively.

9. Reinsurance

The Company uses an aging analysis to estimate uncollectible reinsurance balances receivable relating to paid losses in addition to recording allowances relating to any specific balances with known collectability issues, irrespective of aging. The balances are aged from the date the expected recovery was billed to the reinsurer. Provisions are applied at specified percentages of the outstanding balances based upon the aging profile. Allowances otherwise required as a result of the aging process may not be recorded to the extent that specific facts and circumstances exist that lead management to believe that amounts will ultimately be collectible. The total allowance recorded relating to reinsurance balances receivable was $54.6 million and $43.9 million at December 31, 2012 and 2011, respectively.

At December 31, 2012, the use of different assumptions within the model could have a material effect on the bad debt provision reflected in the Company’s Consolidated Financial Statements. To the extent the creditworthiness of the Company’s reinsurers was to deteriorate due to an adverse event affecting the reinsurance industry, such as a large number of major catastrophes, actual uncollectible amounts could be significantly greater than the Company’s bad debt provision. Such an event could have a material adverse effect on the Company’s financial condition, results of operations, and cash flows.

Approximately 91% of the total unpaid loss and loss expense recoverable and reinsurance balances receivable (net of collateral held) outstanding at December 31, 2012 was due from reinsurers with a financial strength rating of “A” or better. The following is an analysis of the total recoverable and reinsurance balances receivable at December 31, 2012, by reinsurers owing 3% or more of such total:

Name of Reinsurer	Reinsurer Financial Strength Rating	% of Total
Munich Reinsurance Company	AA-/Stable	25.4%
Swiss Reinsurance Company	AA-/Stable	11.0%
Lloyd's Syndicate	A+/Stable	8.0%
Swiss Re Europe S.A.	AA-/Stable	5.5%
Transatlantic Reinsurance Company	A+/Stable	4.0%

The following table sets forth the ratings profile of the reinsurers that support the unpaid loss and loss expense recoverable and reinsurance balances receivable:

Reinsurer Financial Strength Rating	% of Total
AAA	1.2%
AA	53.1%
A	37.1%
BBB	0.3%
BB and below	0.0%
Captives	6.1%
Not Rated	0.2%
Other	2.0%
Total	100.0%

10. Losses and Loss Expenses

Unpaid losses and loss expenses for the indicated years ended December 31 are comprised of:

(U.S. dollars in thousands)	2012	2011
Reserve for reported losses and loss expenses	$ 7,976,121	$ 8,153,585
Reserve for losses incurred but not reported	12,508,000	12,460,316
Unpaid losses and loss expenses	$ 20,484,121	$ 20,613,901

Net losses and loss expenses incurred for the years indicated are comprised of:

(U.S. dollars in thousands)	2012	2011
Loss and loss expenses payments	$ 4,673,997	$ 4,911,737
Change in unpaid losses and loss expenses	(297,660)	260,631
Change in unpaid losses and loss expenses recoverable	279,900	(28,442)
Paid loss recoveries	(890,755)	(1,065,535)
Net losses and loss expenses incurred	$ 3,765,482	$ 4,078,391

The following table represents an analysis of the Company's paid and unpaid losses and loss expenses incurred and a reconciliation of the beginning and ending unpaid losses and loss expenses for the years indicated:

(U.S. dollars in thousands)	2012	2011
Unpaid losses and loss expenses at the beginning of the year	$ 20,613,901	$ 20,531,607
Unpaid losses and loss expenses recoverable	3,629,928	3,649,290
Net unpaid losses and loss expenses at the beginning of the year	$ 16,983,973	$ 16,882,317
Increase (decrease) in net losses and loss expenses incurred in respect of losses occurring in:		
Current year	4,081,377	4,363,258
Prior year	(315,895)	(284,867)
Total net incurred losses and loss expenses	$ 3,765,482	$ 4,078,391
Exchange rate effects	156,206	(130,533)
Less net losses and loss expenses paid in respect of losses occurring in:		
Current year	416,844	589,870
Prior year	3,366,398	3,256,332
Total net paid losses	$ 3,783,242	$ 3,846,202
Net unpaid losses and loss expenses at the end of the year	17,122,419	16,983,973
Unpaid losses and loss expenses recoverable	3,361,702	3,629,928
Unpaid losses and loss expenses at the end of the year	$ 20,484,121	$ 20,613,901

10. Losses and Loss Expenses

(a) Current year net losses incurred

Current year net losses incurred decreased by $281.9 million in 2012 as compared to 2011. This was mainly as a result of the current year loss ratio excluding prior year development decreasing by 11.1 loss percentage points due to lower losses from natural catastrophes as compared to 2011. In addition, the current year loss ratio excluding natural catastrophes improved in both the Insurance and Reinsurance segments due to lower large property risk losses, as well as business mix changes and other underwriting improvements.

Current year net losses incurred increased by $778.6 million in 2011 as compared to 2010. This was mainly as a result of the current year loss ratio excluding prior year development increasing by 10.7 loss percentage points due to higher losses from natural catastrophes as compared to 2010, but also from the following: (i) the Insurance segment in 2011 experienced higher large loss activity in the energy, property and marine businesses, as compared to 2010; and (ii) the Reinsurance segment in 2011 experienced higher levels of large loss events in U.S. property including a deterioration in the performance of a large U.S. agricultural program, higher attritional losses as well as business mix changes, as compared to 2010.

(b) Prior year net losses incurred

The following table presents the net (favorable) adverse prior year loss development of the Company's loss and loss expense reserves for its property and casualty operations by operating segment for each of the years indicated:

(U.S. dollars in thousands)	2012	2011
Insurance segment	$ (140,067)	$ (76,516)
Reinsurance segment	(175,828)	(208,351)
Total	$ (315,895)	$ (284,867)

The significant developments in prior year loss reserve estimates for each of the years indicated within the Company's Insurance and Reinsurance segments are discussed below.

Insurance Segment

The following table summarizes the net (favorable) adverse prior year development by line of business relating to the Insurance segment for the last three years ended December 31:

(U.S. dollars in thousands)	2012	2011
Property	$ (46,733)	$ (8,922)
Casualty	(61,633)	34,500
Professional	(106,368)	(87,520)
Specialty	(61,761)	(71,285)
Other	136,428	56,711
Total	$ (140,067)	$ (76,516)

Net favorable prior year reserve development for the Insurance Segment of $140.1 million for the year ended December 31, 2012 was mainly attributable to the following:

- For property lines, net prior year development during the year was $46.7 million favorable. This was driven by a release of $26.5 million for the non-catastrophe exposures in the general property, energy and construction books due to better than expected reported loss experience predominantly in the 2011 accident year. It was also driven by releases totaling $19.6 million for the catastrophe exposures, with $12.5 million and $6.1 million arising from the 2010 and 2011 accident years, respectively.

- For casualty lines, net prior year development during the year was $61.6 million favorable. This was driven by a release of $25.5 million in international primary casualty due to better than expected reported loss experience. The primary casualty releases relate to the 2006 to 2011 accident years. There was also a release of $50.7 million in the excess casualty lines due primarily to better than expected reported loss experience, the majority of which relates to the 2005 and prior accident years. The releases in primary and excess casualty were partially offset by an increase of $15.7 million in U.S. middle markets due to worse than expected reported loss experience primarily in the 2006 to 2011 accident years.

10. Losses and Loss Expenses

- For professional lines, net prior year development during the year was $106.4 million favorable. This was driven by releases in reserves for clash losses (which cover a number of substantially similar claims against multiple policyholders) in the U.S. and Bermuda core professional businesses totaling $120.8 million. This is comprised of $44.2 million and $37.0 million released from the 2010 and 2011 report years, respectively, to reflect the limited clash events for these years. In addition, $48.4 million was released from the 2007 report year to reflect that subprime claims are developing better than expected. Finally, the 2006 and prior report years were strengthened by $8.8 million to reflect the unfavorable reported loss experience across these years.

  In terms of non-clash losses in the core professional businesses, $18.2 million and $19.8 million was released from the U.S. and Bermuda books, respectively, due to better than expected reported loss experience while the International core book was strengthened by $39.5 million due to unfavorable reported loss experience. Although this led to a relatively immaterial $1.5 million strengthening in aggregate across the core professional businesses, this resulted in strengthening between the 2009 and 2011 report years offset by releases in the 2008 and prior report years.

  Offsetting the above, the Design portfolio, covering architects' and engineers' professional liability, was strengthened by $22.9 million due to worse than expected reported loss experience in the Canadian book partially offset by a release of $9.6 million in the U.S. book as a result of favorable reported loss experience.

- For specialty lines, net prior year development during the year was $61.8 million favorable. This was driven by releases of $44.0 million, $4.5 million and $4.0 million for the non-catastrophe exposures in aerospace, specie and product recall, respectively, due to continued better than expected reported loss experience in the more recent accident years. It was also driven by a release of $8.6 million in the London Market discontinued political risk book reflecting the limited remaining exposures on this mature portfolio.

- For other lines, net prior year development during the year was $136.4 million unfavorable. Continued adverse reported loss experience in the excess and surplus lines led to a strengthening of $80.4 million between the 2006 and 2011 accident years. This was primarily driven by strengthening of $36.5 million and $38.4 million in the Apartments and New York Contractors books respectively. The discontinued surety book was strengthened by $44.9 million based on recent settlements while a claims audit led to an increase of $11.8 million in programs predominantly in the more recent accident years.

Net favorable prior year reserve development for the Insurance segment of $76.5 million (corresponding gross development was $23.1 million unfavorable) for the year ended December 31, 2011 was mainly attributable to releases of $87.5 million in professional lines, $71.3 million for specialty lines and $8.9 million for property lines partially offset by strengthening of $34.5 million for casualty lines and $56.7 million for other lines. The professional lines benefitted from releases in reserves for clash losses totaling $88.5 million. Better than expected reported loss experience in the marine, aerospace, specie and discontinued lines led to the release in the specialty lines while the property lines benefited from better than expected reported loss activity for the non-catastrophe exposures. The strengthening in the casualty lines mainly related to adverse development on large excess casualty claims associated with the Deepwater Horizon event in the 2010 accident year totaling $135.6 million gross and $33.4 million net. Adverse development in the excess and surplus lines and run-off surety book of business led to the unfavorable result in other lines.

Net favorable prior year reserve development for the Insurance segment of $127.4 million for the year ended December 31, 2010 was mainly attributable to releases of $118.6 million in professional lines, $66.3 million for specialty lines and $23.5 million for property lines partially offset by strengthening of $29.0 million for casualty lines and $52.0 million for other lines. The favorable professional lines result was driven by lower than expected actual losses in the core professional businesses totaling $216.3 million partially offset by unfavorable development of $63.7 million in the U.S. Private Commercial lines, $27.4 million in the Select portfolio and $6.2 million in the Design portfolio. Lower than expected actual losses in the aerospace, marine, specie, equine and discontinued lines led to the release in the specialty lines while the property lines benefited from lower than expected actual losses for the non-catastrophe exposures. The strengthening in the casualty lines was driven by unfavorable development of $45.1 million in the U.S. risk management lines and $15.5 million in the environmental lines partially offset by a $26.0 million decrease in the uncollectible reinsurance reserve from reduced exposures and lower estimated risk levels from the Swiss operations. An unfavorable settlement in the surety lines and an unfavorable commutation in the financial lines led to the adverse result in other lines.

There is no assurance that conditions and trends that have affected the development of liabilities in the past will continue. Accordingly, it may not be appropriate to extrapolate future redundancies or deficiencies based on the Company's historical results.

10. Losses and Loss Expenses

Reinsurance Segment

The following table summarizes the net (favorable) adverse prior year development by line of business relating to the Reinsurance segment for the last three years ended December 31:

(U.S. dollars in thousands)	2012	2011
Property and other short-tail lines	$ (107,613)	$ (64,267)
Casualty and other	(68,215)	(144,084)
Total	$ (175,828)	$ (208,351)

Net favorable prior year reserve development for the Reinsurance segment of $175.8 million for the year ended December 31, 2012 was mainly attributable to the following:

- Net favorable prior year development during the year of $107.6 million for the short-tailed lines and details of these by specific lines are as follows:
    - For property catastrophe lines, net prior year development during the year was $16.5 million favorable mainly driven by lower than expected incurred losses for the 2011 and 2005 catastrophe losses on the Bermuda book.
    - For property other lines, net prior year development during the year was $49.0 million favorable mainly due to favorable claim development on the International, North America and Bermuda books offset by some unfavorable claim development on the Latin America book.
    - For marine and aviation lines, net prior year development during the year was $42.2 million favorable due mainly to favorable attritional development of $27.3 million on the International book together with $6.1 million release on prior year large losses. There is an additional $4.9 million favorable prior year development in Bermuda and $4.1 million favorable prior year development in North America.
- Net favorable prior year development during the year of $68.2 million for the long-tailed lines and details of these by specific lines are as follows:
    - For casualty lines, net prior year development during the year was $60.3 million favorable arising mainly out of the North America book due to more favorable than expected development on the 2003 and 2004 underwriting years.
    - For other lines, net prior year development during the year was $7.9 million favorable mainly driven by $8.4 million release on the Structured Indemnity book.

Net favorable prior year reserve development for the Reinsurance segment of $208.4 million for the year ended December 31, 2011 was attributable to a net favorable prior year development of $64.3 million for the short-tailed lines and a net favorable prior year development of $144.1 million for the long-tailed lines. The net favorable prior year development for short-tailed was explained by $37.3 million in favorable property catastrophe development, by $40.5 million in favorable property other lines releases and was partially offset by $13.5 million in unfavorable marine and aviation development. The net favorable prior year development for long-tailed lines was explained by $109.4 million in favorable casualty lines development and by additional $34.7 million in favorable other lines development mainly due to reserve releases on whole account treaties written on Lloyd’s syndicates for the 2008 underwriting year as well as releases on large losses and trade credit.

Net favorable prior year reserve development for the Reinsurance segment of $245.5 million for the year ended December 31, 2010 was attributable to a net favorable prior year development of $145.8 million for the short-tailed lines and a net favorable prior year development of $99.7 million for the long-tailed lines. The net favorable prior year development for short-tailed lines was explained by $35.6 million net in favorable property catastrophe development, by $87.4 million in favorable property other lines releases and by additional $22.8 million net in favorable marine and aviation development. The net favorable prior year development for long-tailed lines was explained by $25.2 million in favorable casualty and professional development and by additional $74.5 million in favorable other lines development is mainly driven by reserve releases on whole account treaties written in Lloyd’s syndicates.

There is no assurance that conditions and trends that have affected the development of liabilities in the past will continue. Accordingly, it may not be appropriate to extrapolate future redundancies or deficiencies based on the Company’s historical results.

10. Losses and Loss Expenses

(c) Exchange rate effects

Exchange rate effects on net loss reserves in each of the two years ended December 31, 2012 and 2011 related to our global operations primarily where reporting units have a functional currency that is not the U.S. dollar. In 2012, the U.S. dollar was weaker against the major currencies to which we are exposed, including the U.K. sterling, the Euro and the Swiss franc. In 2011, the U.S. dollar was stronger against U.K. sterling, the Euro, the Brazilian real and the Swiss franc, which more than offset losses that were driven by a stronger Australian dollar. These movements in the U.S. dollar gave rise to translation and revaluation exchange movements related to carried loss reserve balances of $156.2 million and $(130.5) million million in the years ended December 31, 2012 and 2011, respectively.

(d) Net paid losses

Total net paid losses were $3.8 billion and $3.8 billion in 2012 and 2011, respectively.

(e) Other loss information

The Company did not dispose of or acquire net loss reserves in 2012 and 2011.

The Company's net incurred losses and loss expenses include actual and estimates of potential non-recoveries from reinsurers. As at December 31, 2012 and 2011, the reserve for potential non-recoveries from reinsurers was $107.9 million and $99.2 million, respectively. For further information, see Note 9, "Reinsurance."

Except for certain workers' compensation (including long term disability) liabilities and certain U.K. motor liability claims, the Company does not discount its unpaid losses and loss expenses.

The Company utilizes tabular reserving for workers' compensation (including long-term disability) unpaid losses that are considered fixed and determinable, and discounts such losses using an interest rate of 5% in 2012 and 2011. The interest rate approximates the average yield to maturity on specific fixed income investments that support these liabilities. The tabular reserving methodology results in applying uniform and consistent criteria for establishing expected future indemnity and medical payments (including an explicit factor for inflation) and the use of mortality tables to determine expected payment periods. Tabular unpaid losses and loss expenses, net of reinsurance, at December 31, 2012 and 2011 on an undiscounted basis were $645.2 million and $612.9 million, respectively. The related discounted unpaid losses and loss expenses were $343.0 million and $290.3 million at December 31, 2012 and 2011, respectively.

The Company records a specific reserve allowance for Periodical Payment Orders ("PPO") in the U.K. motor liabilities. This allowance includes the unpaid losses for claims already settled and notified as PPO at December 31, 2012, as well as the unpaid losses for claims to be settled in the future. The future care element of the unpaid losses were discounted using an interest rate of 1.5% at December 31, 2012 reduced from 2% at December 31, 2011 to reflect the increased reserve and the yields obtained on the additional purchase of assets. Unpaid losses and loss expenses, net of reinsurance, at December 31, 2012 and 2011 on an undiscounted basis were $240.0 million and $52.8 million, respectively. After discounting of the future care element the unpaid losses and loss expenses were $148.6 million and $29.6 million at December 31, 2012 and 2011, respectively. The increase in net undiscounted unpaid losses and loss expenses between December 31, 2011 and December 31, 2012 is explained in part by the identification of a proportion of the overall UK motor reserves that will settle as Periodical Payment claims in the future. This is in addition to a revision of the assumptions underlying the PPO reserve calculation and the worse than expected settlement of claims as PPOs during 2012.

The nature of the Company's high excess of loss liability and catastrophe business can result in loss events that are both irregular and significant. Similarly, adjustments to reserves for individual years can be irregular and significant. Such adjustments are part of the normal course of business for the Company. Conditions and trends that have affected development of liability in the past may not continue in the future. Accordingly, it is inappropriate to extrapolate future redundancies or deficiencies based upon historical experience.

10. Losses and Loss Expenses

(f) Discontinued Asbestos and Run-Off Environmental Related Claims

The Company's reserving process includes a continuing evaluation of the potential impact on unpaid liabilities from exposure to discontinued asbestos and run-off environmental claims, including related loss adjustment expenses. Liabilities are established to cover both known and incurred but not reported claims. The Company's reserving and exposures to environmental liability business currently written within the NAPC and IPC business groups are not included in this note, which only relates to specific discontinued and/or run-off coverages, not originally written specifically to cover such environmental hazards.

The Company's exposure to discontinued asbestos and run-off environmental claims arises from the following three sources:

(1) Reinsurance contracts written, both on a proportional and excess basis, after 1972. The Company discontinued writing contracts with these exposures in 1985. Business written was across many different policies, each with a relatively small contract limit. The Company's reported asbestos claims relate to both traditional products and premises and operations coverage.

(2) Winterthur – business of Winterthur purchased by the Company from AXA Insurance (formerly Winterthur Swiss Insurance Company) in 2001. Pursuant to the Sale and Purchase Agreement and related agreements, AXA Insurance reimburses the Company for all asbestos losses.

(3) During 2006, the Company acquired $40.2 million in losses through a loss portfolio transfer contract of which $18.3 million in losses related to asbestos and environmental claims. Given the terms of the policy, the combined aggregate limit on the total acquired reserves is limited to $60.0 million, not including coverage for claims handling costs over a defined period.

A reconciliation of the opening and closing unpaid losses and loss expenses related to discontinued asbestos and run-off environmental exposure claims for the years indicated is as follows:

Year ended December 31, *(U.S. dollars in thousands)*	**2012**	**2011**
Net unpaid losses and loss expenses at beginning of year	$ 77,778	$ 84,075
Net incurred losses and loss expenses	6,558	(41)
Less net paid losses and loss expenses	6,021	6,256
Net increase (decrease) in unpaid losses and loss expenses	537	(6,297)
Net unpaid losses and loss expenses at end of year	78,315	77,778
Unpaid losses and loss expenses recoverable at end of year	123,799	134,323
Gross unpaid losses and loss expenses at end of year	$ 202,114	$ 212,101

Reserves for incurred but not reported losses, net of reinsurance, included in the above table were $52.2 million and $47.2 million in 2012 and 2011, respectively. Unpaid losses recoverable are net of potential uncollectible amounts.

At December 31, 2012, the Company had 1,073 open claim files for potential discontinued asbestos claims exposures and 354 open claim files for potential run-off environmental claims exposures. Approximately 42% and 43%of the open claim files are due to precautionary claim notices in 2012 and 2011, respectively. Precautionary claim notices are submitted by the ceding companies in order to preserve their right to receive coverage under the reinsurance contract.

Such notices do not contain an incurred loss amount to the Company. The development of the number of open claim files for potential discontinued asbestos and run-off environmental claims, including precautionary claims, is as follows:

10. Losses and Loss Expenses

	Asbestos Claims	Environmental Claims
Total number of claims outstanding at December 31, 2010	1,200	417
New claims reported in 2011	106	36
Claims resolved in 2011	(268)	(91)
Total number of claims outstanding at December 31, 2011	1,038	362
New claims reported in 2012	236	60
Claims resolved in 2012	(201)	(68)
Total number of claims outstanding at December 31, 2012	1,073	354

The Company's reserving process includes a continuing evaluation of the potential impact on unpaid liabilities from exposure to discontinued asbestos and run-off environmental claims, including related loss adjustment expenses. Liabilities are established to cover both known and incurred but not reported claims.

The estimation of loss and loss expense liabilities for discontinued asbestos and run-off environmental exposures is subject to much greater uncertainty than is normally associated with the establishment of liabilities for certain other exposures due to several factors, including: (i) uncertain legal interpretation and application of insurance and reinsurance coverage and liability; (ii) the lack of reliability of available historical claims data as an indicator of future claims development; (iii) an uncertain political climate which may impact, among other areas, the nature and amount of costs for remediating waste sites; and (iv) the potential of insurers and reinsurers to reach agreements in order to avoid further significant legal costs. Due to the potential significance of these uncertainties, the Company believes that no meaningful range of loss and loss expense liabilities beyond recorded reserves can be established. As the Company's net unpaid loss and loss expense reserves related to discontinued asbestos and run-off environmental exposures are less than 1% of the total net reserves at December 31, 2012 and 2011, further adverse development is not expected to be material to the Company's overall net loss reserves. The Company believes it has made reasonable provision for its discontinued asbestos and run-off environmental exposures and is unaware of any specific issues that would significantly affect its estimate for loss and loss expenses.

11. Deposit Liabilities

The Company has entered into certain insurance and reinsurance policies that transfer insufficient risk under GAAP to be accounted for as insurance or reinsurance transactions and are recognized as deposits. These structured property and casualty agreements have been recorded as deposit liabilities and are initially matched by an equivalent amount of investments. The Company has investment risk related to its ability to generate sufficient investment income to enable the total invested assets to cover the payment of the ultimate liability. See Note 5, “Investments,” for further information relating to the Company’s net investment income as well as realized and unrealized investment (losses) gains. Each deposit liability accrues at a rate equal to the internal rate of return of the payment receipts and obligations due during the life of the agreement. Where the timing and/or amount of future payments are uncertain, cash flows reflecting the Company’s actuarially determined best estimates are utilized. Deposit liabilities are initially recorded at an amount equal to the assets received.

Total deposit liabilities were $1.6 billion for the years ended December 31, 2012 and 2011. Interest expense of $66.3 million and $51.3 million was recorded related to the accretion of deposit liabilities for the years ended December 31, 2012 and 2011, respectively.

12. Future Policy Benefit Reserves

Future policy benefit reserves are comprised of the following:

Year ended December 31 *(U.S. dollars in thousands)*	**2012**	**2011**
Traditional Life	805,558	812,628
Annuities	4,006,487	4,032,766
Total future policy benefit reserves	4,812,045	4,845,394

The Company entered into long duration contracts that subject the Company to mortality and morbidity risks and that were accounted for as life premiums earned. Future policy benefit reserves were established using appropriate assumptions for investment yields, mortality, and expenses, including a provision for adverse deviation. The average interest rate used for the determination of the future policy benefits for these contracts was 4.5% at December 31, 2012 and 2011. Total future policy benefit reserves for the year ended December 31, 2012 and 2011 were $4.8 billion. There were normal course releases on single premium annuities in line with the benefits paid and mortality of underlying policyholders, which has been partially offset by foreign exchange movements, resulting in a net decrease of $26.3 million during 2012.

13. Notes Payable and Debt and Financing Arrangements

At December 31, the Company's financing structure, which includes senior unsecured notes, bank and loan facilities available from a variety of sources, including commercial banks, and letter of credit facilities was as follows:

	2012		2011	
(U.S. dollars in thousands)	Commitment/ Debt	In Use/ Outstanding (1)	Commitment/ Debt	In Use/ Outstanding (1)
Debt:				
4-year revolver expiring 2015 (2)	$ 1,000,000	$ -	$ 1,000,000	$ -
6.50% Guaranteed Senior Notes due 2012 (3)	-	-	600,000	599,971
Total debt	$ 1,000,000	$ -	$ 1,600,000	$ 599,971
Carrying value	$ 1,000,000	$ -	$ 1,600,000	$ 599,971
Letters of Credit:				
5 facilities - total	$ 4,000,000	$ 1,757,250	$ 4,000,000	$ 1,871,192

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(1) "In Use" and "Outstanding" data represent December 31, 2012 and 2011 accreted values.
(2) This credit facility has a $1 billion revolving credit sub-limit.
(3) The 6.50% Guaranteed Senior Notes were repaid at maturity on January 15, 2012.

(a) Notes Payable and Debt

At December 31, 2011, all outstanding debt was issued by XL Capital Finance (Europe) plc ("XLCFE"), a wholly owned subsidiary of the Company and were repaid at maturity on January 15, 2012. The XLCFE Notes were fully and unconditionally guaranteed by XL Company Switzerland GmbH. The Company's ability to obtain funds from its subsidiaries to satisfy any of its obligations under guarantees is subject to certain contractual restrictions, applicable laws and statutory requirements of the various countries in which the Company operates, including, among others, Bermuda, the United States, Ireland, Switzerland and the U.K. For details of the required statutory capital and surplus for the principal operating subsidiaries of the Company, see Note 23, "Statutory Financial Data."

13. Notes Payable and Debt and Financing Arrangements

(b) Letter of Credit Facilities and Other Sources of Collateral

The Company has several letter of credit facilities provided on a syndicated and bilateral basis from commercial banks. These facilities are utilized primarily to support non-admitted insurance and reinsurance operations in the U.S. and capital requirements at Lloyd's. The Company's letter of credit facilities and revolving credit facilities at December 31, were as follows:

(U.S. dollars in thousands)	2012 (1)	2011 (1)
Revolving credit facility (2)	$ 1,000,000	$ 1,000,000
Available letter of credit facilities - commitments (3) (4)	$ 4,000,000	$ 4,000,000
Available letter of credit facilities - in use	$ 1,757,250	$ 1,871,192
Collateralized by certain assets of the Company's investment portfolio	93.3%	93.8%

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(1) At December 31, 2012 and December 31, 2011, there were five available letter of credit facilities.
(2) At December 31, 2012 and December 31, 2011, the revolving credit facility was unutilized.
(3) The Company has the option to increase the size of the March 2011 Credit Agreement by an additional $500 million and the size of the facilities under the December 2011 Credit Agreements by an additional $500 million across both such facilities.
(4) This amount excludes $1.0 billion that is also included in the revolving credit facility above.

13. Notes Payable and Debt and Financing Arrangements

In 2011, the Company, XLIT Ltd. (the Company's intermediate parent, formerly called XL Capital Ltd), XL Group plc (the Company's ultimate parent)and certain of its subsidiaries (i) entered into three new credit agreements, which are described below and provide for an aggregate amount of outstanding letters of credit and revolving credit loans up to $3 billion, subject to certain options to increase the size of the facilities, and (ii) terminated the five-year credit agreement dated June 21, 2007 (the "2007 Credit Agreement"), which had provided for an aggregate amount of outstanding letters of credit and revolving credit loans up to $4 billion.

On March 25, 2011, the Company and certain of its subsidiaries entered into a secured credit agreement (the "March 2011 Credit Agreement") that currently provides for the issuance of letters of credit of up to $1 billion with the option to increase the size of the facility by an additional $500 million. The commitments under the 2011 Credit Agreement will expire on, and the credit facility is available on a continuous basis until, the earlier of (i) March 25, 2014 and (ii) the date of termination in whole of the commitments upon an optional termination or reduction of the commitments by the account parties or upon an event of default.

In October 2011, the $75,000 letter of credit facility that was supporting a subsidiary of the Company was terminated.

On December 9, 2011, the Company and certain of its subsidiaries entered into (i) a new secured credit agreement (the "December 2011 Secured Credit Agreement") and (ii) a new unsecured credit agreement (the "December 2011 Unsecured Credit Agreement" and together with the December 2011 Secured Credit Agreement, the "December 2011 Credit Agreements"). In connection with the December 2011 Credit Agreements, the 2007 Credit Agreement was terminated. The March 2011 Credit Agreement continues in force, but was amended to conform certain of its terms to those of the December 2011 Secured Credit Agreement.

The 2007 Credit Agreement had provided for letters of credit and for revolving credit loans of up to $750 million with the aggregate amount of outstanding letters of credit and revolving credit loans thereunder not to exceed $3 billion. At the time at which it was terminated and the December 2011 Credit Agreements became effective, there were no outstanding revolving credit loans under the 2007 Credit Agreement. A portion of the letters of credit outstanding under the 2007 Credit Agreement at the time of its termination was continued under the March 2011 Credit Agreement and the remainder was continued under the December 2011 Credit Agreements.

The December 2011 Secured Credit Agreement provides for issuance of letters of credit up to $650 million. The December 2011 Unsecured Credit Agreement is a $1.35 billion facility that provides for issuance of letters of credit and up to $1 billion of revolving credit loans. The Company has the option to increase the maximum amount of letters of credit available by an additional $500 million across the facilities under the December 2011 Credit Agreements.

The commitments under each December 2011 Credit Agreement expire on, and such credit facilities are available until, the earlier of (i) December 9, 2015 and (ii) the date of termination in whole of the commitments upon an optional termination or reduction of the commitments by the account parties or upon an event of default.

The availability of letters of credit under the December 2011 Secured Credit Agreement and the March 2011 Credit Agreements is subject to a borrowing base requirement, determined on the basis of specified percentages of the face value of eligible categories of assets varying by type of collateral.

On August 3, 2010, a $100 million five-year revolving credit facility expired and was not replaced, and on June 22, 2010, a $2.3 billion five-year letter of credit facility expired and was not replaced.

In addition to letters of credit, the Company has established insurance trusts in the U.S. that provide cedants with statutory relief required under state insurance regulation in the U.S. It is anticipated that the commercial facilities may be renewed on expiry but such renewals are subject to the availability of credit from banks utilized by the Company and may be renewed with materially different terms and conditions. In the event that such credit support is insufficient, the Company could be required to provide alternative security to cedants. This could take the form of additional insurance trusts supported by the Company's investment portfolio or funds withheld using the Company's cash resources. The value of letters of credit required is driven by, among other things, loss development of existing reserves, the payment pattern of such reserves, the expansion of business written by the Company and the loss experience of such business.

13. Notes Payable and Debt and Financing Arrangements

In general, all of the Company's bank facilities, indentures and other documents relating to the Company's outstanding indebtedness (collectively, the "Company's Debt Documents"), as described above, contain cross acceleration or cross default provisions to each other and the Company's Debt Documents contain affirmative covenants. These covenants provide for, among other things, minimum required ratings of the Company's insurance and reinsurance operating subsidiaries and the level of secured indebtedness in the future. In addition, generally each of the Company's Debt Documents provide for an event of default in the event of a change of control of the Company or some events involving bankruptcy, insolvency or reorganization of the Company. The Company's credit facilities also contain minimum consolidated net worth covenants.

Under the March 2011 Credit Agreement and December 2011 Credit Agreements, in the event that XL Insurance (Bermuda) Ltd, XL Re Ltd or XL Re Europe Ltd fail to maintain a financial strength rating of at least "A–" from A.M. Best, an event of default would occur.

Given that all of the Company's Debt Documents contain cross acceleration or cross default provisions, a default by one of these subsidiaries may result in all holders declaring their debt due and payable and accelerating all debt due under those documents. If this were to occur, the Company may not have funds sufficient at that time to repay any or all of such indebtedness.

14. Derivative Instruments

The Company enters into derivative instruments for both risk management and investment purposes. The Company is exposed to potential loss from various market risks, and manages its market risks based on guidelines established by management and the Risk and Finance Committee of the Company's Board of Directors. The Company recognizes all derivatives as either assets or liabilities in the balance sheet and measures those instruments at fair value with the changes in fair value of derivatives shown in the consolidated statement of income as "net realized and unrealized gains and losses on derivative instruments" unless the derivatives are designated as hedging instruments. The accounting for derivatives that are designated as hedging instruments is described in Note 2(h), "Significant Accounting Policies – Derivative Instruments." The following table summarizes information on the location and gross amounts of derivative fair values contained in the consolidated balance sheet as at December 31, 2012 and 2011:

(U.S. dollars in thousands)	December 31, 2012 Asset Derivative Notional Amount	December 31, 2012 Asset Derivative Fair Value (1)	December 31, 2012 Liability Derivative Notional Amount	December 31, 2012 Liability Derivative Fair Value (1)	December 31, 2011 Asset Derivative Notional Amount	December 31, 2011 Asset Derivative Fair Value (1)	December 31, 2011 Liability Derivative Notional Amount	December 31, 2011 Liability Derivative Fair Value (1)
Derivatives designated as hedging instruments:								
Interest rate contracts (2)	$ -	$ -	$ -	$ -	$ 156,271	$ 109,761	$ -	$ -
Foreign exchange contracts (2)	670,751	12,511	2,382,507	(23,715)	2,033,428	25,387	457,892	(4,518)
Total derivatives designated as hedging instruments	$ 670,751	$ 12,511	$ 2,382,507	$ (23,715)	$ 2,189,699	$ 135,148	$ 457,892	$ (4,518)
Derivatives not designated as hedging instruments:								
Investment Related Derivatives:								
Interest rate exposure	$ 45,604	$ 2,060	$ 26,139	$ (253)	$ 70,978	$ 1,946	$ 55,033	$ (43)
Foreign exchange exposure	33,007	226	54,449	(1,790)	232,422	3,759	384,592	(11,737)
Credit exposure	25,000	486	436,959	(15,472)	172,500	5,271	449,513	(13,986)
Financial market exposure	72,597	9,559	16,910	-	23,874	615	14,321	-
Financial Operations Derivatives: (3)								
Credit exposure (2)	-	-	46,903	-	-	-	81,678	(10,288)
Other Non-Investment Derivatives:								
Guaranteed minimum income benefit contract	-	-	69,051	(25,396)	-	-	78,777	(22,490)
Modified coinsurance funds withheld contract	76,975	-	-	-	77,200	-	-	-
Total derivatives not designated as hedging instruments	$ 253,183	$ 12,331	$ 650,411	$ (42,911)	$ 576,974	$ 11,591	$ 1,063,914	$ (58,544)

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(1) Derivative instruments in an asset or liability position are included within Other assets or Other liabilities, respectively, in the balance sheet on a net basis where the Company has both a legal right of offset and the intentions to settle the contracts on a net basis.

(2) At December 31, 2012, the Company paid net cash collateral related to these derivative positions of $12.1 million. The assets related to the net collateral paid have been recorded as Other assets within the balance sheet. At December 31, 2011, the Company held net cash collateral of $77.1 million. The collateral balance is included within Cash and cash equivalents and the corresponding liability to return the collateral has been offset against the derivative asset within the balance sheet as appropriate under the netting agreement.

(3) Financial operations derivatives represent interests in variable interest entities as described in Note 15, "Variable Interest Entities."

14. Derivative Instruments

(a) Derivative Instruments Designated as Fair Value Hedges

The Company designates certain of its derivative instruments as fair value hedges or cash flow hedges and formally and contemporaneously documents all relationships between the hedging instruments and hedged items and links the hedging derivative to specific assets and liabilities. The Company assesses the effectiveness of the hedge both at inception and on an on-going basis, and determines whether the hedge is highly effective in offsetting changes in fair value or cash flows of the linked hedged item.

The Company may hedge portions of its liabilities against changes in the applicable designated benchmark interest rate. Interest rate swaps are also used to hedge the changes in fair value of certain fixed rate liabilities and fixed income securities due to changes in the designated benchmark interest rate. In addition, the Company utilizes foreign exchange contracts to hedge the fair value of certain fixed income securities as well as to hedge certain net investments in foreign operations.

The following table provides the total impact on earnings relating to derivative instruments formally designated as fair value hedges along with the impacts of the related hedged items for the years ended December 31, 2012 and 2011:

Derivatives Designated as Fair Value Hedges: *(U.S. dollars in thousands)*	Gain/(Loss) Recognized in Income on Derivative	Hedged Items - Amount of Gain/(Loss) Recognized in Income Attributable to Risk			
Year Ended December 31, 2012		Deposit Liabilities	Fixed Maturity Investments	Notes Payable and Debt	Ineffective Portion of Hedging Relationship - Gain/(Loss)
Interest rate exposure	$ 1,813				
Foreign exchange exposure	(24,183)				
Total	$ (22,370)	$ (6,182)	$ 23,967	$ -	$ (4,585)
Year Ended December 31, 2011					
Interest rate exposure	$ 25,680				
Foreign exchange exposure	15,135				
Total	$ 40,815	$ (27,391)	$ (15,299)	$ -	$ (1,875)

The gains (losses) recorded on both the derivatives instruments and specific items designated as being hedged as part of the fair value hedging relationships outlined above are recorded through Net realized and unrealized gains (losses) on derivative instruments in the income statement along with any associated ineffectiveness in the relationships. In addition, the periodic coupon settlements relating to the interest rate swaps are recorded as adjustments to net investment income for the hedges of fixed maturity investments and as adjustments to interest expense for the hedges of deposit liabilities and notes payable and debt.

The periodic coupon settlements resulted in increases to Net investment income of nil and nil for the years ended December 31, 2012 and 2011.

The periodic coupon settlements also resulted in decreases to Interest expense of $4.9 million and $10.2 million for the years ended December 31, 2012 and 2011.

14. Derivative Instruments

Settlement of Fair Value Hedges

During the year ended December 31, 2010, the Company settled the interest rate contracts designated as fair value hedges of certain of the Company's notes payable and debt and also settled three interest rate contracts designated as fair value hedges of certain of the Company's deposit liability contracts. The cumulative increase recorded to the carrying value of the hedged notes payable and debt of $21.6 million, and the deposit liability contracts of $149.5 million, representing the effective portion of the hedging relationship, is amortized through interest expense over the remaining terms of the debt and deposit liability contracts.

In July 2012, the Company settled two interest rate contracts designated as fair value hedges of certain of the Company's deposit liability contracts. At settlement, the cumulative increase recorded to the carrying value of the hedged deposit liability contracts was $83.7 million. This amount will be amortized, through interest expense, over the remaining terms of the deposit liability contracts. At settlement, the weighted average term remaining to maturity for these contracts was 16.1 years.

A summary of the fair value hedges that have been settled and their impact on results during the year ended December 31, 2012 and 2011 is shown below:

Settlement of Fair Value Hedges - Summary	**Fair Value Hedges - Notes Payable and Debt December 31,**		**Fair Value Hedges - Deposit Liabilities December 31,**	
(U.S. dollars in thousands, except years)	**2012**	**2011**	**2012**	**2011**
Cumulative reduction to interest expense	$ 14,949	$ 10,915	$ 21,395	$ 9,376
Remaining balance	$ 6,675	$ 10,709	$ 211,800	$ 140,109
Weighted average years remaining to maturity	1.7	2.5	25.3	30.7

(b) Derivative Instruments Designated as Hedges of the Net Investment in a Foreign Operation

The Company utilizes foreign exchange contracts to hedge the fair value of certain net investments in foreign operations. During the year ended December 31, 2012 and 2011, the Company entered into foreign exchange contracts that were formally designated as hedges of investments in foreign subsidiaries, the majority of which have functional currencies of either U.K. sterling or the Euro. There was no ineffectiveness in these transactions.

The following table provides the weighted average U.S. dollar equivalent of foreign denominated net assets that were hedged and the resultant gain (loss) that was recorded in the cumulative translation adjustment account within AOCI for the year ended December 31, 2012 and 2011.

Derivative Instruments Designated as Hedges of the Net Investment in a Foreign Operation - Summary

(U.S. dollars in thousands)	**2012**	**2011**
Weighted average of U.S. dollar equivalent of foreign denominated net assets	$ 1,962,076	$ 1,733,555
Derivative gains (losses) (1)	$ (36,649)	$ 36,836

(1) Derivative gains (losses) from derivative instruments designated as hedges of the net investment in a foreign operation are recorded in the cumulative translation adjustment account within AOCI for each period.

14. Derivative Instruments

(c) Derivative Instruments Not Formally Designated As Hedging Instruments

The following table provides the total impact on earnings relating to derivative instruments not formally designated as hedging instruments under authoritative accounting guidance and from the ineffective portion of fair value hedges. The impacts are all recorded through Net realized and unrealized gains (losses) on derivatives in the income statement for the years ended December 31, 2012 and 2011:

Net Realized and Unrealized Gains (Losses) on Derivative Instruments

(U.S. dollars in thousands)	2012	2011
Investment Related Derivatives:		
Interest rate exposure	$ 4,394	$ 4,155
Foreign exchange exposure	(1,059)	(175)
Credit exposure	(7,611)	(16,527)
Financial market exposure	3,073	(4,827)
Commodity exposure	-	(304)
Financial Operations Derivatives:		
Credit exposure	10,511	16,976
Other Non-Investment Derivatives:		
Guaranteed minimum income benefit contract	(2,906)	(1,300)
Modified coinsurance funds withheld contract	3,429	4,510
Total derivatives not designated as hedging instruments	$ 9,831	$ 2,508
Amount of gain (loss) recognized in income from ineffective portion of fair value hedges	(4,585)	(1,875)
Net realized and unrealized gains (losses) on derivative instruments	$ 5,246	$ 633

The Company's objectives in using these derivatives are explained below.

(d)(i) Investment Related Derivatives

The Company, either directly or through its investment managers, may use derivative instruments within its investment portfolio, including interest rate swaps, inflation swaps, credit derivatives (single name and index credit default swaps), options, forward contracts and financial futures (foreign exchange, bond and stock index futures) and options such derivative instruments, primarily as a means of economically hedging exposures to interest rate, credit spread, equity price changes and foreign currency risk or, in limited instances, for investment purposes. The Company is exposed to credit risk in the event of non-performance by the counterparties under any swap contracts, although the Company generally seeks to use credit support arrangements with counterparties to help manage this risk.

Investment Related Derivatives – Interest Rate Exposure

The Company utilizes risk management and overlay strategies that incorporate the use of derivative financial instruments, primarily to manage its fixed income portfolio duration and exposure to interest rate risks associated with primarily those assets and liabilities related to certain legacy other financial lines and structured indemnity transactions. The Company uses interest rate swaps to convert certain liabilities from a fixed rate to a variable rate of interest and may also use them to convert a variable rate of interest from one basis to another.

Investment Related Derivatives – Foreign Exchange Exposure

The Company has exposure to foreign currency exchange rate fluctuations through its operations and in its investment portfolio. The Company uses foreign exchange contracts to manage its exposure to the effects of fluctuating foreign currencies on the value of certain of its foreign currency fixed maturities primarily within its Life operations portfolio. These contracts are not designated as specific hedges for financial reporting purposes and, therefore, realized and unrealized gains and losses on these contracts are recorded in income in the period in which they occur. These contracts generally have maturities of twelve months or less.

14. Derivative Instruments

In addition, certain of the Company's investment managers may, subject to investment guidelines, enter into forward contracts where potential gains may exist.

Investment Related Derivatives – Credit Exposure

Credit derivatives may be purchased within the Company's investment portfolio in the form of single name and basket credit default swaps, which are used to mitigate credit exposure through a reduction in credit spread duration (i.e., macro credit strategies rather than single-name credit hedging) or exposure to selected issuers, including issuers that are not held in the underlying bond portfolio.

Investment Related Derivatives – Financial Market Exposure

Stock index futures may be purchased within the Company's investment portfolio in order to create synthetic equity exposure and to add value to the portfolio with overlay strategies where market inefficiencies are believed to exist. From time to time, the Company may enter into other financial market exposure derivative contracts on various indices including, but not limited to, inflation and commodity contracts.

(d)(ii) Financial Operations Derivatives – Credit Exposure

At December 31, 2012, the Company held one credit derivative exposure, which was written as part of the Company's previous financial lines business and is outside of the Company's investment portfolio. This is a European project finance loan participation which benefits from an 80% deficiency guarantee from the German state and federal governments. At December 31, 2011, the Company held two credit derivative exposures, the European project finance loan already mentioned and a credit default swap that was executed in 2000 with underlying collateral being predominantly pools of leveraged loans and bonds, which were fully paid off during 2012, resulting in the Company's release from its credit default swap. An aggregate summary of the credit derivative exposures at December 31, 2012 and December 31, 2011 is as follows:

Financial Operations Derivatives - Credit Exposure Summary:

(U.S. dollars in thousands, except term to maturity)	2012	2011
Principal outstanding	$ 44,281	$ 78,425
Interest outstanding	2,622	3,253
Aggregate outstanding exposure	$ 46,903	$ 81,678
Total liability recorded	$ -	$ 10,288
Weighted average contractual term to maturity	4.7 years	5.0 years
Underlying obligations credit rating	BB	BB

At December 31, 2012 and December 31, 2011, there were no reported events of default on these obligations. Credit derivatives are recorded at fair value based upon prices received from the investment bank counterparties and corroborated by using models developed by the Company. Although the Company does not have access to the specific unobservable inputs that may have been used in the value provided by the counterparties, it expects that the significant inputs considered would include changes in interest rates, future default rates, credit spreads, changes in credit quality, future expected recovery rates and other market factors. The change resulting from movements in credit and credit quality spreads is unrealized as the credit derivatives are not traded to realize this resultant value.

(d)(iii) Other Non-Investment Derivatives

The Company also has derivatives embedded in certain reinsurance contracts. For a certain life reinsurance contract, the Company pays the ceding company a fixed amount equal to the estimated present value of the excess of guaranteed benefit over the account balance upon the policyholder's election to take the income benefit. The fair value of this derivative is determined based on the present value of expected cash flows. In addition, the Company has modified coinsurance and funds withheld reinsurance agreements that provide for a return based on a portfolio of fixed income securities. As such, the agreements contain embedded derivatives. The embedded derivative is bifurcated from the funds withheld balance and recorded at fair value with changes in fair value recognized in earnings through Net realized and unrealized gains and losses on derivative instruments.

14. Derivative Instruments

(e) Contingent Credit Features

Certain derivatives agreements entered into by the Company or its subsidiaries contain rating downgrade provisions that permit early termination of the agreement by the counterparty if collateral is not posted following failure to maintain certain credit ratings from one or more of the principal credit rating agencies. If the Company were required to early terminate such agreements due to a rating downgrade, it could potentially be in a net liability position at the time of settlement. The aggregate fair value of all derivatives agreements containing such rating downgrade provisions that were in a liability position and the collateral posted under any of these agreements as of December 31, 2012 and December 31, 2011 were as follows:

Contingent Credit Features - Summary:

(U.S. dollars in thousands)	2012	2011
Aggregate fair value of derivative agreements with downgrade provisions in a net liability position	$ 20,366	$ 15,763
Collateral posted to counterparty	$ 5,490	$ 809

15. Variable Interest Entities

At times, the Company has utilized variable interest entities ("VIEs") both indirectly and directly in the ordinary course of the Company's business.

The Company invests in CDOs and other investment vehicles that are issued through VIEs as part of the Company's investment portfolio. The activities of these VIEs are generally limited to holding the underlying collateral used to service investments therein. The Company's involvement in these entities is passive in nature and we are not the arranger of these entities. In addition, the Company has not been involved in establishing these entities and is not the primary beneficiary of these VIEs as contemplated in current authoritative accounting guidance.

The Company has a limited number of remaining outstanding credit enhancement exposures, including written financial guarantee and credit default swap contracts. The obligations related to these transactions are often securitized through VIEs. The Company is not the primary beneficiary of these VIEs as contemplated in current authoritative accounting guidance on the basis that management does not believe that the Company has the power to direct the activities, such as asset selection and collateral management, which most significantly impact each entity's economic performance. For further details on the nature of the obligations and the size of the Company's maximum exposure, see Note 14, "Derivative Instruments," and Note 16 (h), "Commitments and Contingencies – Financial and Other Guarantee Exposures."

16. Commitments and Contingencies

(a) Concentrations of Credit Risk

The creditworthiness of any counterparty is evaluated by the Company, taking into account credit ratings assigned by rating agencies. The credit approval process involves an assessment of factors including, among others, the counterparty and country and industry credit exposure limits. Collateral may be required, at the discretion of the Company, on certain transactions based on the creditworthiness of the counterparty.

The areas where significant concentrations of credit risk may exist include unpaid losses and loss expenses recoverable and reinsurance balances receivable (collectively, “reinsurance assets”) and in the investment fixed income portfolio.

Reinsurance Assets

The Company’s reinsurance assets resulted from reinsurance arrangements in the course of its operations. A credit exposure exists with respect to reinsurance assets as they may be uncollectible. The Company manages its credit risk in its reinsurance relationships by transacting with reinsurers that it considers financially sound, and if necessary, the Company may hold collateral in the form of funds, trust accounts and/or irrevocable letters of credit. This collateral can be drawn on for amounts that remain unpaid beyond specified time periods on an individual reinsurer basis. For further details regarding the Company’s reinsurance assets, see Note 9, “Reinsurance.”

Fixed Income Portfolio

The Company did not have an aggregate direct investment in any single corporate issuer in excess of 5% of shareholders’ equity at December 31, 2012 or December 31, 2011. Corporate issuers represent only direct exposure to fixed maturities and short-term investments of the parent issuer and its subsidiaries. These exposures exclude asset and mortgage back securities that were issued, sponsored or serviced by the parent and government-guaranteed issues, but does include covered bonds.

Broker credit risk

In addition, the Company underwrites a significant amount of its insurance and reinsurance property and casualty business through brokers and a credit risk exists should any of these brokers be unable to fulfill their contractual obligations with respect to the payments of insurance and reinsurance balances to the Company. During the two years ended December 31, 2012 and 2011 P&C gross written premiums generated from or placed by the below companies individually accounted for more than 10% of the Company’s consolidated gross written premiums from P&C operations, as follows:

(Percentage of consolidated gross written premiums from P&C operations)	2012	2011
AON Corporation and subsidiaries	22%	20%
Marsh & McLennan Companies	21%	20%
Willis Group and subsidiaries	11%	12%

These companies are large, well established companies and there are no indications that any of them are financially troubled. No other broker and no one insured or reinsured accounted for more than 10% of gross premiums written from P&C operations in any of the two years ended December 31, 2012 and 2011.

(b) Other Investments

The Company has committed to invest in several limited partnerships and provide liquidity financing to a structured investment vehicle. At December 31, 2012, the Company has commitments, which include potential additional add-on clauses, to invest an additional $92.1 million over approximately the next nine years.

(c) Investments in Affiliates

The Company owns a minority interest in certain closed-end funds, certain limited partnerships and similar investment vehicles, including funds managed by those companies. The Company has commitments, which include potential additional add-on clauses, to invest an additional $49.7 million over approximately the next five years.

16. Commitments and Contingencies

(d) Properties

The Company rents space for certain of its offices under leases that expire up to 2031. Total rent expense under operating leases for the years ended December 31, 2012 and 2011 was approximately $35.6 million and $32.9 million, respectively. Future minimum rental commitments under existing operating leases are expected to be as follows:

Year Ended December 31, *(U.S. dollars in thousands)*		
2013	$	38,096
2014		35,235
2015		31,632
2016		27,137
2017		23,935
2018-2031		108,654
Total minimum future rentals	$	264,689

During 2003, the Company entered into a purchase, sale and leaseback transaction to acquire new office space in London. The Company has recognized a capital lease asset of $98.5 million and $100.7 million, and deferred a gain of $29.9 million and $30.6 million related to this lease at December 31, 2012 and 2011, respectively. The gain is being amortized to income in line with the amortization of the asset. The future minimum lease payments in the aggregate are expected to be $222.4 million and annually for the next five years are as follows:

Year Ended December 31, *(U.S. dollars in thousands)*		
2013	$	11,927
2014		12,226
2015		12,531
2016		12,845
2017		13,166
2018-2028		159,720
Total minimum future lease payments	$	222,415

(e) Tax Matters

The Company is incorporated in Bermuda, except as described below, neither it nor its non-U.S. subsidiaries have paid U.S. corporate income taxes (other than withholding taxes on dividend income) on the basis that they are not engaged in a trade or business or otherwise subject to taxation in the United States However, because definitive identification of activities which constitute being engaged in a trade or business in the United States is not provided by the Internal Revenue Code of 1986, regulations or court decisions, there can be no assurance that the Internal Revenue Service will not contend that the Company or its non-U.S. subsidiaries are engaged in a trade or business or otherwise subject to taxation in the United States. If the Company or its non-U.S. subsidiaries were considered to be engaged in a trade or business in the United States (and, if the Company or such subsidiaries were to qualify for the benefits under the income tax treaty between the United States and Bermuda and other countries in which the Company operates, such businesses were attributable to a “permanent establishment” in the United States), the Company or such subsidiaries could be subject to U.S. tax at regular tax rates on its taxable income that is effectively connected with its U.S. trade or business plus an additional “branch profits” tax (at a rate as high as 30%) on such income remaining after the regular tax, in which case there could be a significant adverse effect on the Company’s results of operations and financial condition.

(f) Letters of Credit

At December 31, 2012 and 2011, $1.8 billion and $1.9 billion of letters of credit were outstanding, of which 93.3% and 93.8%, respectively, were collateralized by the Company’s investment portfolios, primarily supporting U.S. non-admitted business and the Company’s Lloyd’s syndicates’ capital requirements.

16. Commitments and Contingencies

(g) Litigation

The Company and its subsidiaries are subject to litigation and arbitration in the normal course of business. These lawsuits and arbitrations principally involve claims on policies of insurance and contracts of reinsurance and are typical for the Company and for the property and casualty insurance and reinsurance industry in general. Such claims proceedings are considered in connection with the Company's loss and loss expense reserves. Reserves in varying amounts may or may not be established in respect of particular claims proceedings based on many factors, including the legal merits thereof. In addition to litigation relating to insurance and reinsurance claims, the Company and its subsidiaries are subject to lawsuits and regulatory actions in the normal course of business that do not arise from or directly relate to claims on insurance or reinsurance policies. This category of business litigation typically involves, among other things, allegations of underwriting errors or misconduct, employment claims, regulatory activity, shareholder disputes or disputes arising from business ventures. The status of these legal actions is actively monitored by management.

Legal actions are subject to inherent uncertainties, and future events could change management's assessment of the probability or estimated amount of potential losses from pending or threatened legal actions. Based on available information, it is the opinion of management that the ultimate resolution of pending or threatened legal actions other than claims proceedings, both individually and in the aggregate, will not result in losses having a material adverse effect on the Company's financial position or liquidity at December 31, 2012.

If management believes that, based on available information, it is at least reasonably possible that a material loss (or additional material loss in excess of any accrual) will be incurred in connection with any legal actions, the Company discloses an estimate of the possible loss or range of loss, either individually or in the aggregate, as appropriate, if such an estimate can be made, or discloses that an estimate cannot be made. Based on the Company's assessment at December 31, 2012, no such disclosures are considered necessary.

(h) Financial and Other Guarantee Exposures

Financial Guarantee Exposures

Year Ended December 31, *(U.S. dollars in thousands except number of contracts and term to maturity)*	**2012**	**2011**
Opening number of financial guarantee contracts	4	37
Number of financial guarantee contracts matured, prepaid or commuted during the period	-	(33)
Closing number of financial guarantee contracts	4	4
Principal outstanding	$ 115,464	$ 115,464
Interest outstanding	$ -	$ -
Aggregate exposure outstanding	$ 115,464	$ 115,464
Total gross claim liability recorded	$ 1,399	$ 1,399
Total unearned premiums and fees recorded	$ 279	$ 425
Weighted average contractual term to maturity in years	25.4	26.7

During January 2011, the Company commuted 32 of the 37 financial guarantee transactions that were outstanding at December 31, 2010 and were part of the Company's legacy financial guarantee business, including three non-performing transactions. This commutation eliminated $41.9 million of notional financial guarantee exposure (including principal and interest) for a payment of $22.1 million. The $22.1 million was included in the gross claim liability at December 31, 2010. In addition, during the fourth quarter of 2011, one guarantee was terminated upon prepayment of the underlying notes.

The Company's outstanding financial guarantee contracts at December 31, 2012 provide credit support for a variety of collateral types with the exposures comprised of (i) a $108.3 million notional financial guarantee on three notes backed by zero coupon long dated bonds and bank perpetual securities, including some issued by European financials; and (ii) a $7.2 million notional financial guarantee relating to future scheduled repayments on a government-subsidized housing project. At December 31, 2012, there were no reported events of default on these obligations.

16. Commitments and Contingencies

Surveillance procedures to track and monitor credit deteriorations in the insured financial obligations are performed by the primary obligors for each transaction on the Company's behalf. Information regarding the performance status and updated exposure values is provided to the Company on a quarterly basis and evaluated by management in recording claims reserves.

Other Guarantee Exposures

On June 28, 2010, the Company completed a commutation, termination and release agreement (the "Termination Agreement") with European Investment Bank ("EIB") which fully extinguished and terminated all of the guarantees issued to EIB by XLIB in connection with financial guaranty policies between certain subsidiaries of Syncora Holdings and EIB. These guarantees were provided for the benefit of EIB relating to project finance transactions comprised of transportation, school and hospital projects with an average rating of BBB, written between 2001 and 2006 with anticipated maturities ranging between 2027 and 2038. The guarantees had been accounted for under Accounting Standards Codification ("ASC") section 460-10, *Guarantees* (previously FIN 45, "Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others.")

Under the Termination Agreement, XLIB paid $38 million to EIB, and all of XLIB's exposures under the EIB guarantees, with aggregate par outstanding of approximately $900 million, were eliminated. In addition, a further $0.5 million was paid to EIB for expenses in relation to the termination. Pursuant to the obligations of Syncora Holdings and its affiliates (collectively "Syncora") under the Master Agreement, Syncora paid XLIB $15.0 million. The net cost of this transaction is reflected in the Company's Consolidated Statement of Income as "Loss on Termination of Guarantee."

17. Share Capital

(a) Authorized and Issued

The authorized share capital is 15,000,000 ordinary shares of par value $0.10 each, of which 10,000,000 were issued and outstanding as at December 31, 2012 and 2011.

(b) Stock Plans

The Company's ultimate parent, XL Group plc, performance incentive programs provide for grants of stock options, restricted stock, restricted stock units and performance units and stock appreciation rights. Share-based compensation granted by the XL Group plc generally contains a vesting period of three or four years, and certain awards also contain performance conditions. The Company records compensation expense related to each award over its vesting period, incorporating the best estimate of the expected outcome of performance conditions where applicable. Compensation expense is generally recorded on a straight line basis over the vesting period of an award.

In connection with, and effective upon, the completion of the Redomestication of the Company's ultimate parent, XL Group plc assumed the existing liabilities, obligations and duties of XLIT Ltd under the NAC Re Corp. 1989 Stock Option Plan (the "1989 Plan"), the XL Group plc Amended and Restated 1991 Performance Incentive Program (the "1991 Program"), the XL Group plc Amended and Restated 1999 Performance Incentive Program for Employees (the "1999 Program"), the XL Group plc Directors Stock & Option Plan (the "Directors Plan"), the XL Group plc 2009 Cash Long-Term Incentive Program (the "2009 Program"), the XL Group plc Supplemental Deferred Compensation Plan (the "DC Plan," and together with the 1989 Plan, 1991 Program, the 1999 Program, the Directors Plan and the 2009 Program, the "Programs"). Furthermore, in connection with, and effective upon, the completion of the Redomestication, the Programs were amended by XLIT Ltd., among other things, to (i) provide that XL Group plc and its Board of Directors will succeed to all powers, authorities and obligations of XLIT Ltd and its Board of Directors under each Program, (ii) provide that the securities to be issued pursuant to each Program will consist of ordinary shares of XL Group plc and (iii) otherwise to reflect the completion of the Redomestication.

(d) Options

The fair value of each option grant is estimated on the date of grant using the Black-Scholes option pricing model with the following weighted average assumptions:

	2012	2011
Dividend yield	1.90%	1.90%
Risk free interest rate	1.15%	2.60%
Volatility	46.00%	50.03%
Expected lives	6.0 years	6.0 years

The risk free interest rate is based on U.S. Treasury rates. The expected lives are estimated using the historical exercise behavior of grant recipients. The expected volatility is determined based upon a combination of the historical volatility of the Company's stock and the implied volatility derived from publicly traded options.

The following is a summary of the stock option plans for the two years ended December 31:

(U.S. Dollars in thousands except for weighted average fair value)	2012	2011
Options granted to purchase ordinary shares under directors and employees incentive compensation plans	-	-
Weighted average grant date fair value	$ -	$ -
Total intrinsic value of stock options exercised	$ 470	$ 301
Options exercised during the year	156	72
Compensation expense related to stock option plans	$ 73	$ 2,450
Estimated tax benefit related to stock option plans	$ 26	$ 722

17. Share Capital

The following is a summary of the stock options at December 31, 2012, and related activity for the year then ended for the Company:

(U.S. Dollars in thousands, except for option price and term)	Number of Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term	Aggregate Intrinsic Value
Outstanding - beginning of year	5,832	$ 52.02	4.1 years	$ 677
Granted	-	-		
Exercised	(156)	19.62		
Canceled/Expired	(1,152)	89.11		
Employee transfers (1)	119	45.23		
Outstanding - end of year	4,643	$ 43.82	3.9 years	$ 9,517
Options exercisable	4,635	$ 43.86	3.9 years	$ 9,482

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(1) Employee transfers consist of stock options held by employees who have transferred into the Company from an intermediate Parent Company.

The aggregate intrinsic value in the table above represents the total pre-tax intrinsic value (the difference between the Company's closing stock price on the last trading day of the 2012 fiscal year and the exercise price, multiplied by the number of in-the-money-options) that would have been received by the option holders had all option holders exercised their options on December 31, 2012. Total unrecognized stock-based compensation expense related to non-vested stock options was approximately $64,000 at December 31, 2012, related to approximately 8,460 options, which is expected to be recognized over a weighted-average period of 0.9 years. The exercise price of the Company's outstanding options granted is the market price of the Company's ordinary shares on the grant date, except that during 2004, 295,000 options were granted with an exercise price of $88.00 when the market price was $77.10.

(e) Restricted Stock, Restricted Stock Units and Performance Units

Restricted Stock

Restricted stock awards issued under the 1991 Performance Incentive Program and the Directors Stock and Option Plan vest as set forth in the applicable award agreements. Each restricted stock award represents the Company's obligation to deliver to the holder one ordinary share. The employees and directors who are granted a restricted stock award shall have all the rights of a shareholder, including the right to vote and receive dividends. These shares contained certain restrictions prior to vesting, relating to, among other things, forfeiture in the event of termination of employment and transferability.

A summary of the restricted stock awards issued under the 1991 Performance Incentive Program and the Directors Stock and Option Plan for the two years ended December 31 is as follows:

17. Share Capital

(In thousands except for weighted average fair value)	2012	2011
Restricted ordinary shares granted	325	-
Weighted average grant date fair value	$ 20.92	$ -
Aggregate grant date fair value	$ 6,811	$ -
Compensation expense related to restricted stock awards	$ 3,454	$ 5,066
Estimated tax benefit related to restricted stock awards	$ 1,113	$ 1,546

Total unrecognized stock based compensation expense related to non-vested restricted stock awards was approximately $5.4 million at December 31, 2012, related to approximately 0.5 million restricted stock awards, which is expected to be recognized over 1.4 years.

Non-vested restricted stock awards at December 31, 2012 and for the year then ended for the Company were as follows:

(In thousands except for weighted average grant date fair value)	Number of Shares	Weighted Average Grant Date Fair Value
Unvested at December 31, 2011	318	$ 43.54
Granted	325	$ 20.92
Vested	(154)	$ 32.06
Forfeited	(4)	$ 43.06
Employee transfers (1)	10	44.39
Unvested at December 31, 2012	495	$ 32.26

(1) Employee transfers consist of restricted stock held by employees who have transferred into the Company from an intermediate Parent Company.

Restricted Stock Units

Each restricted stock unit represents the Company's obligation to deliver to the holder one ordinary share upon satisfaction of the three-year vesting term. Restricted stock units are granted at the closing market price on the day of grant and entitle the holder to receive dividends declared and paid in the form of additional ordinary shares contingent upon vesting.

A summary of the restricted stock units issued to officers of the Company and its subsidiaries for the three years ended December 31 is as follows:

(In thousands)	2012	2011
Restricted stock units granted	1,312	1,178
Aggregate grant date fair value	$ 27,194	$ 26,957
Compensation expense related to restricted stock units	$ 23,054	$ 13,943
Estimated tax benefit related to restricted stock units	$ 6,501	$ 3,998

17. Share Capital

Total unrecognized stock-based compensation expense related to non-vested restricted stock units was approximately $31.7 million as of the end of December 31, 2012, related to approximately 2.4 million restricted stock units, which is expected to be recognized over 1.3 years.

Non-vested restricted stock units as of December 31, 2012 and for the year then ended for the Company were as follows:

(In thousands except for weighted average grant date fair value)	Number of Shares	Weighted Average Grant Date Fair Value
Unvested at December 31, 2011	1,860	$ 21.15
Granted	1,312	$ 20.72
Vested	(815)	$ 20.75
Forfeited	(93)	$ 21.42
Employee transfers (1)	112	21.69
Unvested at December 31, 2012	2,376	$ 21.06

(1) Employee transfers consist of restricted stock units held by employees who have transferred into the Company from an intermediate Parent Company.

Performance Units

The performance units vest after three years and entitle the holder to shares of the Parent Company's stock. There are no dividend rights associated with the performance units. Each grant of performance units has a target number of shares, with final payouts ranging from 0% to 200% of the grant amount depending upon a combination of corporate and business segment performance along with each employee's continued service through the vest date. Performance targets are based on relative and absolute financial performance metrics. A summary of the performance units issued to certain employees of the Company for the three years ended December 31 is as follows:

(In thousands)	2012	2011
Performance units granted	1,094	841
Potential maximum share payout	2,188	1,682
Aggregate grant date fair value	$ 21,147	$ 18,616
Compensation expense related to performance units	$ 6,739	$ 4,799
Estimated tax benefit related to performance units	$ 1,943	$ 1,419

Total unrecognized stock-based compensation expense related to non-vested performance units was approximately $19.2 million as of the end of December 31, 2012, related to approximately 1.8 million performance units, which is expected to be recognized over 1.9 years. Non-vested restricted performance units as of December 31, 2012 were as follows:

(In thousands except for weighted average grant date fair value)	Number of Shares	Weighted Average Grant Date Fair Value
Unvested at December 31, 2011	1,154	$ 19.54
Granted	1,094	$ 19.32
Vested	-	$ -
Forfeited	(91)	$ 20.24
Employee transfers (1)	63	$ 20.28
Performance driven reduction	(424)	$ 18.07
Unvested at December 31, 2012	1,796	$ 20.10

(1) Employee transfers consist of performance units held by employees who have transferred into the Company from an intermediate Parent Company.

18. Retirement Plans

The Company provides pension benefits to eligible employees through various defined contribution and defined benefit retirement plans sponsored by the Company, which vary for each subsidiary. Plan assets are invested principally in equity securities and fixed maturities.

(a) Defined contribution plans

The Company has qualified defined contribution plans which are managed externally and whereby employees and the Company contribute a certain percentage of the employee's gross compensation (base salary and annual bonus) into the plan each month. The Company's contribution generally vests over five years. The Company's expenses for its qualified contributory defined contribution retirement plans were $53.6 million and $42.4 at December 31, 2012 and 2011, respectively.

(b) Defined benefit plans

The Company maintains defined benefit plans that cover certain employees as follows:

U.S. Plan

A qualified non-contributory defined benefit pension plan exists to cover a number of its U.S. employees. The plan was curtailed in 2002 and was closed to new entrants at that time. Under the terms of the curtailment, existing plan participants were no longer entitled to earn additional defined benefits for future services performed after the curtailment date; however, accrued benefits are eligible for annual cost-of-living increases. This plan also includes a non-qualified supplemental defined benefit plan designed to compensate individuals to the extent that their benefits under the Company's qualified plan are curtailed due to IRS Code limitations. Benefits are based on years of service and compensation, as defined in the plan, during the highest consecutive three years of the employee's last ten years of employment. Under these plans, the Company's policy is to make annual contributions to the plan that are deductible for federal income tax purposes and that meet the minimum funding standards required by law. The contribution level is determined by utilizing the entry age cost method and different actuarial assumptions than those used for pension expense purposes.

In addition, certain former employees have received benefit type guarantees, not formally a part of any established plan. The liability recorded with respect to these agreements as at both December 31, 2012 and 2011 was $3.3 million, respectively, representing the entire unfunded projected benefit obligations.

Several assumptions and statistical variables are used in the models to calculate the expenses and liability related to the plans. The Company, in consultation with its actuaries, determines assumptions about the discount rate, the expected rate of return on plan assets and the rate of compensation increase. The table below includes disclosure of these rates on a weighted-average basis, encompassing all the international plans.

Net Benefit Cost - Weighted-average assumptions for the years ended December 31	**2012**	**2011**
Discount rate	4.4%	5.6%
Expected long-term rate of return on plan assets	8.0%	8.0%
Benefit Obligation - Weighted-average assumptions at December 31		
Discount rate	4.0%	4.4%

The U.S. Plan assets at December 31, 2012 and 2011 consist of two mutual funds. The first fund employs a core bond portfolio strategy that seeks maximum current income and price appreciation consistent with the preservation of capital and prudent risk taking with the focus on intermediate –term high quality bonds.

The second fund seeks long term growth of capital by investing in a diversified group of domestic and international companies. Using a quantitative approach, portfolio managers identify companies that they believe have favorable prospects for above average growth.

The fair value of the U.S. Plan assets at December 31, 2012 and 2011 was $29.8 million and $25.9 million, respectively. As both of the retirement plan's investments are mutual funds, they fall within Level 1 in the fair value hierarchy.

18. Retirement Plans

U.K. Plans

A contributory defined benefit pension scheme exists in the U.K. (the “Scheme”), but has been closed to new entrants since 1996. The Scheme has approximately 90 members, of whom approximately 55 are active or deferred members of the Scheme. Benefits are based on length of service and compensation as defined in the Trust Deed and Rules, and the Scheme is subject to triennial funding valuations, the most recent of which was conducted in 2010 and was reported in 2011. The $4.5 million deficit is being funded over a ten-year period. Current contribution rates are 24.6% and 3% of pensionable salary for employer and employee respectively.

The U.K. pension plan assets are held in a separate trustee administered fund to meet long term liabilities to past and present employees. The table below shows the composition of the Scheme’s assets and the fair value of each major category of plan assets as of December 31, 2012 and 2011, as well as the potential returns of the different asset classes. The totals of the asset values held in various externally managed portfolios are provided by third party pricing vendors. There is no significant concentration of risk within plan assets. The assets in the scheme and the expected rates of return were as follows:

(U.S. dollars in thousands, except percentages)	Expected Return on Assets for 2012	Weighted Value at December 31, 2012	Expected Return on Assets for 2011	Weighted Value at December 31, 2011
Equities	6.8%	$ 6,149	7.0%	$ 6,351
Gilts	3.0%	1,700	4.0%	1,350
Corporate Bonds	4.7%	1,566	5.5%	1,381
Other (cash)	3.5%	68	4.0%	12
Total market value of assets		$ 9,483		$ 9,094

In addition, during 2003 six members, five of whom are still employed by the Company in the U.K., transferred from a defined benefit plan into a defined contribution plan. These employees have a contractual agreement with the Company that provides a “no worse than final salary pension” guarantee in the event that they are employed by the Company until retirement, whereby the Company guarantees to top-up their defined contribution pension to the level of pension that they would have been entitled to receive had they remained in the defined benefit scheme. The pension liability recorded with respect to these individuals was $3.5 million and $3.3 million at December 31, 2012 and 2011, respectively, representing the entire unfunded projected obligation.

European Plans

Certain contributory defined benefit pension plans exist in several European countries, most notably Germany, which are closed to new entrants. Benefits are generally based on length of service and compensation defined in the related agreements. Included in the projected obligation amounts of $83.1 million and $72.3 million at December 31, 2012 and 2011, respectively, in the table below, are total unfunded projected obligations in relation to the European defined benefit schemes of $18.5 million and $14.6 million, respectively.

As a part of the purchase of XL GAPS, the Company acquired certain defined benefit pension liabilities. The related balances are not included in the tables below as the liabilities are insured under an annuity type contract.

The status of all the Company’s retirement plans at December 31, 2012 and 2011 is as follows:

18. Retirement Plans

Change in projected benefit obligation:

(U.S. dollars in thousands)	2012	2011
Projected benefit obligation - beginning of year	$ 72,267	$ 66,327
Service cost (1)	1,291	919
Interest cost	3,557	3,393
Actuarial (gain)/loss	7,922	3,837
Benefits and expenses paid	(2,069)	(1,612)
Foreign currency (gains)/losses	1,086	(597)
Settlements	(971)	-
Projected benefit obligation - end of year	$ 83,083	$ 72,267

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(1) Service costs include cost of living adjustments on curtailed plans.

Change in plan assets:

(U.S. dollars in thousands)	2012	2011
Fair value of plan assets - beginning of year	$ 34,956	$ 33,294
Actual return on plan assets	3,101	969
Employer contributions	2,133	1,941
Benefits and expenses paid	(1,258)	(1,132)
Foreign currency gains/(losses)	381	(116)
Fair value of plan assets - end of year	$ 39,313	$ 34,956
Funded status - end of year	$ (43,770)	$ (37,312)
Accrued pension liability	$ 43,770	$ 37,312

The components of the net benefit cost for the years ended December 31, 2012 and 2011 are as follows:

Components of net benefit cost:

(U.S. dollars in thousands)	2012	2011
Service cost	$ 1,291	$ 919
Interest cost	3,557	3,337
Expected return on plan assets	(3,028)	(1,558)
Amortization of net actuarial loss	915	373
Transfer from AOCI	3,363	-
Net benefit cost	$ 6,098	$ 3,071

19. Accumulated Other Comprehensive Income (Loss)

The related tax effects allocated to each component of the change in accumulated other comprehensive income (loss) were as follows:

(U.S. dollars in thousands)	Before Tax Amount	Tax (Benefit) Expense	Net of Tax Amount
Year Ended December 31, 2012:			
Unrealized gains on investments:			
Unrealized gains (losses) arising during year	$ 922,703	$ (7,348)	$ 930,051
Less reclassifications for (losses) realized in income	93,031	(24,137)	117,168
Net unrealized gains (losses) on investments	$ 829,672	16,789	812,883
Change in underfunded pension liability	(9,986)	-	(9,986)
Foreign currency translation adjustments	8,942	1,715	7,227
Change in accumulated other comprehensive income	$ 828,628	$ 18,504	$ 810,124
Year Ended December 31, 2011:			
Unrealized gains on investments:			
Unrealized gains (losses) arising during year	$ 408,958	$ 51,775	$ 357,183
Less reclassifications for (losses) realized in income	(130,385)	(9,927)	(120,458)
Net unrealized gains (losses) on investments	$ 539,343	61,702	477,641
Change in underfunded pension liability	(2,622)	-	(2,622)
Foreign currency translation adjustments	(25,625)	1,102	(26,727)
Change in accumulated other comprehensive income	$ 511,096	$ 62,804	$ 448,292

The December 31, 2012 and 2011 balance of each component of accumulated other comprehensive income (loss) were as follows:

(U.S. dollars in thousands)	2012	2011
Accumulated unrealized gains (losses) on investments, net of tax	$ 1,288,408	527,227
OTTI losses recognized in other comprehensive income, net of tax	(70,724)	(122,426)
Accumulated foreign currency translation	84,939	77,712
Accumulated underfunded pension liability	(27,507)	(17,521)
Total	$ 1,275,116	$ 464,992

20. Dividends

The Company paid a dividend of $607.3 million in 2012, $232.6 million was cash and $374.7 million was investments. The company paid a dividend of $711.6 million in 2011, $105.3 million was cash and $606.3 million was investments.

21. Taxation

The Company and its Bermuda subsidiaries are not subject to any income, withholding or capital gains taxes under current Bermuda law. In the event that there is a change such that these taxes are imposed, the Bermuda subsidiaries would be exempted from any such tax until March 2035 pursuant to the Bermuda Exempted Undertakings Tax Protection Act 1966, and the Exempted Undertakings Tax Protection Amendment Act 2011.

The Company's U.S. subsidiaries are subject to federal, state and local corporate income taxes and other taxes applicable to U.S. corporations. The provision for federal income taxes has been determined under the principles of the consolidated tax provisions of the U.S. Internal Revenues ("IRS") Code and Regulations thereunder.

The Company has operations in subsidiary and branch form in various other jurisdictions around the world, including but not limited to the U.K., Switzerland, Ireland, Germany, France, Canada, Brazil and various other countries in Latin America and Asia that are subject to relevant taxes in those jurisdictions.

Deferred income taxes have not been accrued with respect to certain undistributed earnings of foreign subsidiaries. If the earnings were to be distributed, as dividends or otherwise, such amounts may be subject to withholding taxation in the jurisdiction of the paying entity. During 2010, the Company revised its capital strategy such that it is no longer able to positively assert that all earnings arising in the U.S. will be permanently reinvested in that jurisdiction and, accordingly, a provision for withholding taxes arising in respect of U.S. earnings has been made. No withholding taxes are accrued with respect to the earnings of the Company's subsidiaries arising outside the U.S., as it is the intention that all such earnings will remain reinvested indefinitely.

The Company's current corporate structure is such that distribution of earnings from subsidiaries located outside of the United States would not be subject to significant incremental taxation. It is not practicable to estimate the amount of additional withholding taxes that might be payable on such earnings due to a variety of factors, including the timing, extent and nature of any repatriation.

The Company adopted the provisions of the final authoritative guidance on accounting for uncertainty in income taxes, on January 1, 2007. The Company did not recognize any liabilities for unrecognized tax benefits as a result of its implementation and has not recognized any liabilities in subsequent accounting periods. The Company's policy is to recognize any interest accrued related to unrecognized tax benefits as a component of interest expense and penalties accrued related to unrecognized tax benefits in the tax charge. At December 31, 2012 and 2011, the Company has no accrued liabilities for tax, interest and penalties relating to unrecognized tax benefits.

The Company has open examinations by tax authorities in the U.S. (2010), Ireland (2006 to 2009), the U.K. (2007 to 2010), Germany (2006 to 2009), Switzerland (2009 and 2010), India (2006 to 2011) and Singapore (2010). The Company believes that these examinations will be concluded within the next 24 months; however, it is not currently possible to estimate the outcome of these examinations.

The Company has open tax years that are potentially subject to examinations by local tax authorities, in the following major tax jurisdictions: the U.S. 2011 and 2012; the U.K., 2011 and 2012; Switzerland, 2008 to 2012; Ireland, 2008 to 2012; Germany, 2010 to 2012; and France, 2008 to 2012.

21. Taxation

The income tax provisions for the years ended December 31, 2012 and 2011 are as follows:

(U.S. dollars in thousands)	2012	2011
Current expense:		
U.S.	$ 13,105	$ 9,138
Non U.S.	46,115	87,181
Total current expense	$ 59,220	$ 96,319
Deferred expense (benefit):		
U.S.	$ (56,646)	$ (5,550)
Non U.S.	33,094	(31,101)
Total deferred expense (benefit)	$ (23,552)	$ (36,651)
Total tax expense	$ 35,668	$ 59,668

The weighted average expected tax provision has been calculated using the pre-tax accounting income (loss) in each jurisdiction multiplied by that jurisdiction's applicable statutory tax rate. The applicable statutory tax rates of the most significant jurisdictions contributing to the overall taxation of the Company are: Ireland 12.5% and 25%, Bermuda 0%, the U.S. 35%, the U.K. 24.5%, Switzerland 7.83% and 21.2%, Germany 15%, and France 36.13%. Reconciliation of the difference between the provision for income taxes and the expected tax provision at the weighted average tax rate for the years ended December 31, 2012 and 2011 is provided below:

(U.S. dollars in thousands)	2012	2011
Expected tax provision at weighted average rate	$ 67,887	$ (30,655)
Permanent differences:		
Non-taxable investment income (loss)	(16,717)	(14,246)
Non-taxable income (loss)	(25,711)	(3,155)
Prior year adjustments	(622)	(9,206)
Prior year adjustments on completion of IRS examinations	(19,192)	-
State, local and foreign taxes	18,284	42,541
Valuation allowance	(13,612)	(2,437)
Allocated investment income	41,726	21,483
Stock options	1,208	2,379
Non-deductible expenses	3,793	7,842
Realized capital loss carry-forward valuation allowance reduction	(24,472)	-
Non-deductible goodwill impairment	-	57,069
Non-taxable reserve release	3,096	(11,947)
Total tax expense	$ 35,668	$ 59,668

21. Taxation

Significant components of the Company's deferred tax assets and liabilities at December 31, 2012 and 2011 were as follows:

(U.S. dollars in thousands)	2012	2011
Deferred tax asset:		
Net unpaid loss reserve discount	$ 108,285	$ 108,981
Net unearned premiums	70,071	62,162
Compensation liabilities	56,245	35,830
Net operating losses	54,312	230,246
Investment adjustments	12,927	12,861
Pension	11,976	9,753
Bad debt reserve	14,901	10,829
Amortizable goodwill	8,958	10,732
Net unrealized depreciation on investments	38,652	320
Stock options	9,081	9,888
Depreciation	1,804	4,072
Net realized capital losses	98,971	119,307
Deferred intercompany capital losses	97,566	117,892
Other	9,498	7,573
Deferred tax asset, gross of valuation allowance	$ 593,247	$ 740,446
Valuation allowance	268,888	463,881
Deferred tax asset, net of valuation allowance	$ 324,359	$ 276,565
Deferred tax liability:		
Net unrealized appreciation on investments	$ 106,520	$ 96,797
Deferred acquisition costs	16,135	12,787
Currency translation adjustments	11,225	8,062
Regulatory reserves	146,101	125,249
Untaxed Lloyd's result	10,155	8,340
Other	13,838	4,787
Deferred tax liability	$ 303,974	$ 256,022
Net Deferred Tax Asset	$ 20,385	$ 20,543

The deferred tax asset and liability balances presented above represent the gross deferred tax asset and liability balances across each tax jurisdiction. The deferred tax asset balances of $162.2 million and $111.6 million at December 31, 2012 and 2011, respectively, and deferred tax liability balances of $141.8 million and $91.1million at December 31, 2012 and 2011, respectively, as disclosed on the consolidated balance sheets include netting of certain deferred tax assets and liabilities within a tax jurisdiction to the extent such netting is consistent with the regulations of the tax authorities in those jurisdictions.

The valuation allowance at December 31, 2012 and 2011 of $268.9 million and $463.9 million, respectively, related primarily to net operating loss carry forwards in Switzerland ($9.9 million and $183.1 million at December 31, 2012 and 2011 respectively), net operating loss and capital loss carry forwards in Ireland ($30.5 million and $30.5 million at December 31, 2012 and 2011 respectively), and net unrealized capital losses and realized capital loss carry forwards in the U.S. that may not be realized within a reasonable period ($196.5 million and $237.2 million at December 31, 2012 and 2011 respectively). The reduction in the valuation allowance in 2012 was primarily due to the expiration of $784.8 million of Swiss net operating losses, with a related valuation allowance of $166.4 million, and the release of certain valuation allowances held against capital loss carry-forwards in the U.S.

At December 31, 2012, the Company had realized capital loss carry forwards of approximately $282.8 million in the U.S. ($99.0 million tax effected). The 5 year limitation for the utilization of realized capital losses applies to this balance. Losses of $54.1 million will expire at the end of 2013 with another $228.7 million of realized capital losses expiring in future years through 2016. A valuation allowance ($99.0 million) has been established in respect of all of these realized capital losses. At December 31, 2012, the Company also had $278.8 million of U.S. capital losses arising from the sale of investments to a group company ($97.6 million tax effected), against which a valuation allowance of $97.6 million has been established. These losses cannot be utilized to offset any future U.S. realized capital gains, and will not begin to expire, until the underlying assets have been sold to unrelated partiesAt December 31, 2012, net operating loss carry forwards in the U.K. were approximately $45.2 million ($10.5 million tax effected) and have no expiration. A valuation allowance of $1.8 million has been established in respect of $7.8 million of these U.K. losses given

21. Taxation

management’s expectation that losses in specific U.K. entities will not be utilized in the future. At December 31, 2012, net operating loss carry forwards in Switzerland were approximately $67.3 million, of which $7.1 million will expire at the end of 2013 with the balance expiring in future years through 2019. A valuation allowance of $9.8 million has been established in respect of $61.7 million of the Swiss net operating losses which includes the $7.1 million of Swiss net operating losses that will expire in 2013. At December 31, 2012, capital loss carry forwards in Ireland were approximately $122.1 million. Although these Irish losses may be carried forward indefinitely, a valuation allowance ($30.5 million) has been established in respect of all of these Irish losses due to the uncertainty surrounding any future loss utilization.

Management has reviewed historical taxable income and future taxable income projections for its U.K. group and has determined that in its judgment substantially all of the U.K. net operating losses ($37.4 million) will more likely than not be realized as reductions to future taxable income within a reasonable period. Management will continue to evaluate income generated in future periods by the U.K. group in determining the reasonableness of its position. If management determines that future income generated by the U.K. group is insufficient to cause the realization of the net operating losses within a reasonable period, a valuation allowance would be required for the U.K. portion of the deferred tax asset balance related to net operating losses in the amount of $8.7 million.

Management believes it is more likely than not that the tax benefit of the remaining net deferred tax assets will be realized.

Shareholders’ equity at December 31, 2012 and 2011 reflected tax benefits of nil and nil, respectively, related to compensation expense deductions for stock options exercised by the Company’s U.S. subsidiaries.

22. Statutory Financial Data

The Company's ability to pay dividends or return capital from shareholders' equity is limited by applicable laws and regulations of the various jurisdictions in which the Company's principal operating subsidiaries operate, certain additional required regulatory approvals and financial covenants contained in the Company's letters of credit and revolving credit facilities. The payment of such dividends is regulated under the laws of various jurisdictions including Bermuda, the U.K., Ireland and Switzerland and certain insurance statutes of various states in the United States in which the principal operating subsidiaries are licensed to transact business and the other jurisdictions where the Company has regulated subsidiaries. Statutory capital and surplus for the principal operating subsidiaries of the Company for the years ended December 31, 2012 and 2011 are summarized below:

	Bermuda (1)		U.S. (2)		U.K., Europe and Other	
(U.S. dollars in thousands)	2012	2011	2012	2011	2012	2011
Required statutory capital and surplus	$ 6,555,743	$ 4,923,771	$ 649,166	$ 637,799	$ 1,313,424	$ 1,256,865
Actual statutory capital and surplus (3)	$ 10,343,015	$ 9,152,303	$ 2,237,834	$ 2,093,694	$ 2,495,982	$ 3,108,457

(1) Required statutory capital and surplus at December 31, 2012 represents 100% Bermuda Solvency Capital Requirement ("BSCR") level for the top Bermuda operating subsidiary, XL Insurance (Bermuda) Ltd, calculated on a consolidated basis (and therefore includes a BSCR requirement for all regions). Required statutory capital and surplus at December 31, 2011 represents 100% BSCR level for the principal Bermuda operating subsidiaries only. If the December 31, 2011 required statutory capital and surplus had been determined on a consolidated basis, consistent with the 2012 requirement, the amount would have been $6.5 billion.

(2) Required statutory capital and surplus represents 100% RBC level for principal U.S. operating subsidiaries.

(3) Statutory assets in Bermuda include investments in other U.S. and international subsidiaries reported separately herein.

Statutory net income (loss) for the principal operating subsidiaries of the Company for the years ended December 31, 2012 and 2011 is summarized below:

(U.S. dollars in thousands)	2012	2011
Bermuda	$ 817,461	$ 614,313
U.S.	106,510	23,350
U.K., Europe and Other	157,012	107,255

The difference between statutory financial statements and statements prepared in accordance with GAAP varies by jurisdiction, however, the primary difference is that statutory financial statements do not reflect deferred policy acquisition costs, deferred income tax net assets, intangible assets, unrealized appreciation on investments but they do reflect any unauthorized/authorized reinsurance charges.

Certain restrictions on the payment of dividends from retained earnings by the Company's principal operating subsidiaries are further detailed below.

Management has evaluated the principal operating subsidiaries' ability to maintain adequate levels of statutory capital, liquidity and rating agency capital and believes they will be able to do so. In performing this analysis, management has considered the most recent statutory capital position of each of the principal operating subsidiaries as well as the ability of the holding companies to allocate capital and liquidity around the group as and when needed.

Bermuda Operations

In early July 2008, the Insurance Amendment Act of 2008 was passed, which introduced a number of changes to the Bermuda Insurance Act 1978, such as allowing the Bermuda Monetary Authority (BMA) to prescribe standards for an enhanced capital requirement and a capital and solvency return that insurers and reinsurers must comply with. The Bermuda Solvency Capital Requirement (BSCR) employs a standard mathematical model that can relate more accurately the risks taken on by (re)insurers to the capital that is dedicated to their business. Insurers and reinsurers may adopt the BSCR model or, where an insurer or reinsurer believes that its own internal model better reflects the inherent risk of its business, an in-house model approved by the BMA. Class 4 (re)insurers, such as the Company, were required to implement the new capital requirements under the BSCR model beginning with fiscal years ending on or after December 31, 2009. The Company's capital requirements for its Bermuda principal operating subsidiaries, XL Re Ltd and XL Insurance (Bermuda) Ltd, under the BSCR are highlighted in the table above. In addition to the BSCR based requirements, the BMA also prescribes minimum liquidity standards which must be met.

22. Statutory Financial Data

Under the Insurance Act 1978, amendments thereto and related regulations of Bermuda, Class 4 (re)insurers are prohibited from declaring or paying dividends of more than 25% of each of their prior year's statutory capital and surplus unless they file with the BMA an affidavit stating that the dividend has not caused the Class 4 (re)insurer to fail to meet its relevant margins. At December 31, 2012 and 2011, the maximum dividend that our Bermuda Class 4 (re)insurers could pay, without a signed affidavit, having met minimum levels of statutory capital and surplus and liquidity requirements, was approximately $1.4 billion and $1.3 billion, respectively. No Class 4 (re)insurer may reduce its total statutory capital by 15% or more unless it has received the prior approval of the BMA, and it must also submit an affidavit stating that the proposed reduction will not cause it to fail to meet its minimum solvency margin or minimum liquidity ratio.

U.S. Operations

Unless permitted by the New York Superintendent of Insurance, the Company's lead property and casualty subsidiary in the United States ("XLRA") may not pay dividends to shareholders in an aggregate amount in any twelve month period that exceeds the lesser of 10 percent of XLRA's statutory policyholders' surplus or 100 percent of its "adjusted net investment income," as defined. The New York State insurance law also provides that any distribution that is a dividend may only be paid out of statutory earned surplus. At December 31, 2012 and 2011, XLRA had statutory earned surplus of $152.9 million and $59.7 million, respectively. At December 31, 2012, XLRA's statutory policyholders' surplus was $2.2 billion, and accordingly, the maximum amount of dividends XLRA can declare and pay in 2013, without prior regulatory approval, is $152.9 million. At December 31, 2012 and 2011, none of the seven property and casualty subsidiaries of XLRA had a statutory earned deficit.

International Operations

The Company's international principal operating subsidiaries prepare statutory financial statements based on local laws and regulations. Some jurisdictions impose enhanced regulatory requirements on insurance companies while other jurisdictions impose fewer requirements. In some countries, such subsidiaries must obtain licenses issued by governmental authorities to conduct local insurance business. These licenses may be subject to minimum reserves and minimum capital and solvency tests. Jurisdictions may impose fines, censure, and/or impose criminal sanctions for violation of regulatory requirements. The majority of the actual statutory capital outside of the U.S. and Bermuda is held in Ireland ($0.9 billion at December 31, 2012) and the U.K. ($1.0 billion at December 31, 2012). The Company's Irish operating subsidiary, XL Re Europe public limited company is required to seek prior approval from the Irish regulator to reduce its share capital or to pay dividends.

23. Related Party Transactions

At December 31, 2012 and 2011, the Company owned minority stakes in four and three, respectively, independent investment management companies ("Investment Manager Affiliates") that are actively managing client capital and seeking growth opportunities. The Company seeks to develop relationships with specialty investment management organizations, generally acquiring an equity interest in the business. The Company also invests in certain of the funds and limited partnerships and other legal entities managed by these affiliates and through these funds and partnerships pays management and performance fees to the Company's Investment Manager Affiliates.

In the normal course of business, the Company enters into reinsurance contracts with certain of its other strategic affiliates, or their subsidiaries. During the years ended December 31, 2012 and 2011, these contracts resulted in reported net premiums written, net reported claims and reported acquisition costs as summarized below. Management believes that these transactions are conducted at market rates consistent with negotiated arms-length contracts.

(U.S. dollars in thousands)	2012	2011
Reported net premiums written	$ 61,146	$ 66,489
Net losses incurred	$ 37,664	$ 34,720
Reported acquisition costs	$ 24,014	$ 25,635