

XL Insurance (Bermuda) Ltd
Consolidated Financial Statements
For The Years Ended
December 31, 2008 and 2007

PricewaterhouseCoopers
Chartered Accountants
Dorchester House
7 Church Street
Hamilton HM 11
Bermuda
Telephone +1 (441) 295 2000
Facsimile +1 (441) 295 1242
www.pwc.com/bermuda

Report of Independent Auditors

To the Shareholder of XL Insurance (Bermuda) Ltd:

In our opinion, the accompanying consolidated balance sheets and the related consolidated statements of income and retained earnings, comprehensive income, shareholder's equity and cash flows present fairly, in all material respects, the financial position of XL Insurance (Bermuda) Ltd. and its subsidiaries at December 31, 2008 and 2007, and the results of their operations and their cash flows for each of the two years then ended in conformity with accounting principles generally accepted in the United States of America. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits of these statements in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.


PricewaterhouseCoopers

Hamilton, Bermuda
April 14, 2009

XL Insurance (Bermuda) Ltd

Consolidated Balance Sheets As At December 31, 2008 And 2007

(Expressed in Thousands of U.S. dollars)

	2008	2007
Assets		
Fixed maturities, at fair value (amortized cost : 2008 - \$11,976,241; 2007 - \$15,259,085)	\$ 10,950,071	\$ 14,770,258
Equity securities, at fair value (cost : 2008 - \$7,693; 2007 - \$63,596)	6,870	63,186
Short-term investments, at fair value (amortized cost : 2008 - \$630,289; 2007 - \$1,093,522)	608,751	1,084,354
Total investments available for sale	11,565,692	15,917,798
Investments in affiliates	628,106	937,661
Other investments	224,690	280,305
Total investments	12,418,488	17,135,764
Cash and cash equivalents	2,648,587	3,062,939
Accrued investment income	138,410	172,200
Premiums receivable	4,585,283	5,574,688
Reinsurance balances receivable	783,978	888,227
Unpaid losses and loss expenses recoverable	11,778,001	12,278,481
Amounts due from parent and affiliated companies	1,017,906	1,748,408
Deferred acquisition costs	612,980	651,262
Prepaid reinsurance premiums	2,295,706	2,883,156
Goodwill and other intangible assets	464,045	463,423
Deferred tax asset, net	299,778	300,028
Other assets	471,026	560,269
Total assets	<u>\$ 37,514,188</u>	<u>\$ 45,718,845</u>
Liabilities And Shareholder's Equity		
Liabilities :		
Unpaid losses and loss expenses	\$ 19,453,425	\$ 20,770,061
Deposit liabilities	1,659,244	6,805,464
Future policy benefit reserves	2,963,232	3,786,674
Unearned premiums	3,830,055	4,249,437
Unearned commissions	573,561	709,081
Premiums received in advance	47,043	63,069
Reinsurance premiums payable	1,600,844	1,440,473
Amounts due to Parent and affiliated companies	718,329	539,719
Accounts payable and accrued liabilities	720,265	897,932
Net payable for investments purchased	135,902	148,928
Notes payable and debt	-	255,000
Minority interest	1,592	2,419
Total liabilities	<u>31,703,492</u>	<u>39,668,257</u>
Commitments and Contingencies (note 19)		
Shareholder's Equity :		
Share capital (par value \$0.10 per share; authorized, 15,000,000 issued and outstanding, 10,000,000 shares at December 31, 2008 and 2007 respectively)	1,000	1,000
Contributed surplus	6,763,074	4,427,548
Accumulated other comprehensive income	(932,150)	(31,016)
Retained (deficit)/earnings	(21,228)	1,653,056
Total shareholder's equity	<u>5,810,696</u>	<u>6,050,588</u>
Total liabilities and shareholder's equity	<u>\$ 37,514,188</u>	<u>\$ 45,718,845</u>

XL Insurance (Bermuda) Ltd

Consolidated Statements Of Income And Retained Earnings
For Years Ended December 31, 2008 And 2007
(Expressed in Thousands of U.S. dollars)

	2008	2007
Revenues :		
Net premiums earned	\$ 2,833,571	\$ 2,318,146
Net investment income	851,151	1,278,197
Net realized (losses) on investments	(762,080)	(474,582)
Net realized and unrealized gains on derivative instruments	(12,248)	(56,728)
Net (loss) income from investment fund affiliates	(46,170)	16,290
Fee income and other	96,727	22,931
	<u>2,960,951</u>	<u>3,104,254</u>
Total revenues		
Expenses :		
Net losses and loss expenses incurred	2,107,931	1,653,973
Acquisition costs, net of reinsurance commissions	(82,069)	(237,812)
Operating expenses	907,545	902,991
Net foreign exchange (gain)	(139,421)	(49,056)
Impairment of Goodwill	966	-
Amortization of intangible assets	2,968	1,680
Interest expense	168,057	443,174
	<u>2,965,977</u>	<u>2,714,950</u>
Total expenses		
Income (loss) before minority interest, income tax expense and net income of operating affiliates	(5,026)	389,304
Minority interest in net income of subsidiaries	-	23,928
Income tax expense	191,270	222,168
Net (loss) income from operating affiliates	<u>(1,477,988)</u>	<u>(1,084,990)</u>
Net income (loss)	<u>(1,674,284)</u>	<u>(941,782)</u>
Retained earnings – beginning of year	1,653,056	2,594,838
Dividends paid	<u>-</u>	<u>-</u>
Retained earnings (Deficit) - end of year	\$ <u>(21,228)</u>	\$ <u>1,653,056</u>

See accompanying notes to consolidated financial statements.

XL Insurance (Bermuda) Ltd

Consolidated Statements Of Comprehensive Income

For The Years Ended December 31, 2008 And 2007

(Expressed in Thousands of U.S. dollars)

	2008	2007
Net (loss)	\$ (1,674,284)	\$ (941,782)
Other comprehensive (loss)		
Change in net unrealized (losses) on investments, net of tax	(499,404)	(473,645)
Additional pension liability	(2,582)	3,255
Foreign currency translation adjustments	(399,148)	328,062
Realization of accumulated other comprehensive loss on sale of Syncora	-	4,954
Comprehensive (loss)	\$ <u>(2,575,418)</u>	\$ <u>(1,079,156)</u>

See accompanying notes to consolidated financial statements.

XL Insurance (Bermuda) Ltd

Consolidated Statements Of Shareholder's Equity
For The Years Ended December 31, 2008 And 2007
(Expressed in Thousands of U.S. dollars)

	2008	2007
Share Capital:		
Balance - beginning of year	\$ <u>1,000</u>	\$ <u>1,000</u>
Balance - end of year	\$ <u>1,000</u>	\$ <u>1,000</u>
Contributed Surplus :		
Balance - beginning of year	\$ 4,427,548	\$ 3,908,548
Contributed Surplus	<u>2,335,526</u>	<u>519,000</u>
Balance - end of year	\$ <u>6,763,074</u>	\$ <u>4,427,548</u>
Accumulated Other Comprehensive Income (Loss):		
Balance - beginning of year	\$ (31,016)	\$ 106,358
Net change in unrealized (losses) on investment portfolio	<u>(901,134)</u>	<u>(137,374)</u>
Balance - end of year	\$ <u>(932,150)</u>	\$ <u>(31,016)</u>
Retained Earnings:		
Balance - beginning of year	\$ 1,653,056	\$ 2,594,838
Net Loss	<u>(1,674,284)</u>	<u>(941,782)</u>
Balance - end of year	\$ <u>(21,228)</u>	\$ <u>1,653,056</u>
Total Shareholders' Equity	\$ <u>5,810,696</u>	\$ <u>6,050,588</u>

XL Insurance (Bermuda) Ltd

Consolidated Statements Of Cash Flows

For The Years Ended December 31, 2008 And 2007

(Expressed in Thousands of U.S. dollars)

	2008	2007
Cash flows (used in) provided by operating activities :		
Net (loss)	\$ <u>(1,674,284)</u>	<u>(941,782)</u>
Adjustments to reconcile net (loss) income to net cash provided by operating activities :		
Net realized losses on sales of investments	762,080	474,582
Net realized and unrealized losses on derivative instruments	12,248	56,728
Amortization of discounts on fixed maturities	(52)	(17,848)
Impairment of goodwill	966	-
Amortization of intangible assets	2,968	1,680
Accretion of deposit liabilities	109,265	370,921
Equity in net losses of investment and operating affiliates	1,524,160	1,068,700
Cash paid to Syncora	(1,775,000)	-
Accrued investment income	30,540	(3,992)
Amounts due to parent and affiliates	910,260	(987,190)
Premiums received in advance	(16,026)	(63,076)
Unpaid losses and loss expenses	(869,735)	938,364
Change in future policy benefit reserves	(235,749)	293,767
Unearned premiums	(429,318)	(42,244)
Premiums receivable	342,859	(165,853)
Unpaid losses and loss expenses recoverable	260,694	(472,178)
Prepaid reinsurance premiums	506,919	4,836
Reinsurance balances receivable	92,929	140,768
Reinsurance premiums payable	305,707	(161,977)
Deferred acquisition costs	5,946	(21,607)
Minority interest	-	23,928
Deferred tax asset	(19,525)	(60,892)
Other	77,420	<u>(125,002)</u>
Total net adjustments	<u>1,599,556</u>	<u>(1,252,415)</u>
Net cash (used in) provided by operating activities	<u>(74,728)</u>	<u>310,633</u>
Cash flows (used in) provided by investing activities :		
Proceeds from sale of fixed maturities and short-term investments	6,228,935	13,133,407
Proceeds from redemption of fixed maturities and short-term investments	1,143,476	859,317
Proceeds from sale of equity securities	52,095	144,163
Purchases of fixed maturities and short-term investments	(4,470,696)	(12,916,317)
Purchases of equity securities	(46,505)	(29,376)
Investments in affiliates, net of dividends received	253,098	(180,408)
Acquisition of subsidiaries, net of cash acquired	-	(32,918)
Proceeds from sale of Syncora Common Shares, net of cash sold upon deconsolidation	-	(110,843)
Other investments	<u>(21,305)</u>	<u>(127,081)</u>
Net cash provided by investing activities	<u>3,139,098</u>	<u>739,944</u>

XL Insurance (Bermuda) Ltd

Consolidated Statements Of Cash Flows (Continued)

For The Years Ended December 31, 2008 And 2007

(Expressed in Thousands of U.S. dollars)

	2008	2007
Cash flows (used in) provided by financing activities :		
Proceeds from (repayment) of debt	(255,000)	-
Contributed surplus from parent company	2,335,526	519,000
Deposit liabilities	(5,527,976)	(480,869)
Net cashflow on securities lending	10,445	13,920
Net Proceeds on sale of common shares of Syncora	-	-
Dividends paid to minority shareholders of Syncora	-	(16,130)
Proceeds from issuance of Syncora Series A perpetual preference ordinary shares	<u>-</u>	<u>247,248</u>
Net cash (used in) provided by financing activities	<u>(3,437,005)</u>	<u>283,169</u>
Effects of exchange rate changes on foreign currency cash	<u>(41,717)</u>	<u>58,741</u>
Increase (decrease) in cash and cash equivalents	<u>(414,352)</u>	<u>1,392,487</u>
Cash and cash equivalents - beginning of year	<u>3,062,939</u>	<u>1,670,452</u>
Cash and cash equivalents - end of year	\$ <u>2,648,587</u>	<u>3,062,939</u>
Net taxes paid	\$ <u>146,709</u>	\$ <u>152,615</u>
Interest paid	\$ <u>14,599</u>	\$ <u>16,779</u>

See accompanying notes to consolidated financial statements.

XL Insurance (Bermuda) Ltd

Notes to Consolidated Financial Statements (Continued)

For The Years Ended December 31, 2008 And 2007

(Expressed in Thousands Of U.S. dollars)

1. History

XL Insurance (Bermuda) Ltd (“XL” or the “Company”) is an insurance company formed in 1986 under the laws of Bermuda and is a wholly-owned subsidiary of XL Capital Ltd (formerly known as Exel Limited), a Cayman Islands company. XL formed XL Europe Insurance, an insurance company organized under the laws of Ireland to serve European clients. In December 2008, XL Europe was merged with XL Insurance Company Ltd, a wholly owned subsidiary of the company. XL formed X.L. Investments Ltd., with limited liability under the laws of Bermuda, and various other subsidiaries, for the purpose of investing in short and long-term securities, equities, limited partnerships and other investments.

On August 4, 2006, the Company completed the sale of 37% of its then financial guarantee reinsurance and insurance businesses through an initial public offering (“IPO”) 23.4 million common shares of Syncora Holdings Ltd. (“Syncora”) (formerly Security Capital Assurance Ltd. or “SCA”). On June 6, 2007, the Company completed the sale of a portion of Syncora’s common shares owned by the Company through a secondary offering and thereby reduced its ownership of Syncora’s outstanding common shares from approximately 63% to approximately 46%. On August 5, 2008, the Company closed an agreement (the “Master Agreement”) with Syncora and its subsidiaries, as well as certain counterparties to credit default swap agreements, in connection with the termination of certain reinsurance and other agreements. As part of the Master Agreement, the Company transferred all of the shares it owned in Syncora to a trust and as a result has no further ownership interest in the company. For further details relating to the Master Agreement, see Note 5, “Syncora Holdings Ltd.”

Effective January 1, 2005, XL Capital Ltd transferred the ownership of XL Life Ltd and its subsidiaries to the Company. These companies primarily assume life reinsurance business written by various affiliated Companies within the XL Capital group.

Effective January 1, 2002, the Company increased its shareholding in Le Mans Re from 49% to 67% in order to expand its international reinsurance operations. On September 3, 2003, the Company exercised its option to buy the remaining 33% from MMA and changed the name of Le Mans Ré to XL Re Europe S.A. On October 18, 2006, the Company received approval to form a new European company, XL Re Europe Ltd, based in Dublin, Ireland, which is licensed to write all classes of reinsurance business. XL Re Europe is the headquarters of the Company’s European reinsurance platform with branch offices in France and the U.K.

On July 25, 2001, the Company acquired certain Winterthur International insurance operations (“Winterthur International”) to extend its predominantly North American based large corporate business globally. Results of operations of Winterthur International have been included from July 1, 2001, the date from which the economic interest was transferred to the Company. See Note 6 (b) for additional information.

On June 18, 1999, XL Capital merged with NAC Re Corp (“NAC”), a Delaware corporation. NAC was organized in 1985 and, through its subsidiaries, writes property and casualty insurance and reinsurance in the U.S., Canada and Europe. Subsequent to the merger, NAC became a wholly-owned subsidiary of XL America, Inc. (“XLA”), which in turn, is a wholly-owned subsidiary of XL. XL’s U.S. operations are also conducted through its wholly-owned subsidiary XL Reinsurance America Inc., a reinsurance company domiciled in the State of New York, and six affiliated pool members (all subsidiaries of XLA), who possess property, casualty and reinsurance licenses throughout the 50 states.

XL Insurance (Bermuda) Ltd

Notes to Consolidated Financial Statements (Continued)

For The Years Ended December 31, 2008 And 2007

(Expressed in Thousands Of U.S. dollars)

1. History (continued)

The Company further expanded into the U.S. in 1999 by completing the acquisition of both Intercargo Corporation and ECS, Inc (now XL Environmental Inc). Intercargo Insurance Company (renamed XL Specialty) which is a subsidiary of Intercargo Corporation, underwrites specialty insurance products for companies engaged in international trade, including U.S. Customs bonds. XL Environmental is an underwriting manager, which specializes in environmental insurance coverages and risk management services.

2. Nature of Business

Insurance Operations

The Company provides commercial property and casualty insurance products on a global basis. Products generally provide tailored coverages for complex corporate risks and include the following lines of business: Property, casualty, professional liability, environmental liability, aviation and satellite, marine and offshore energy, equine, fine art and specie, excess and surplus lines and other insurance coverages including program business.

Property and casualty products are typically written as global insurance programs for large multinational companies and institutions and include umbrella liability, product recall, U.S. workers' compensation, property catastrophe and primary master property and liability coverages. Property and casualty products generally provide large capacity on a primary, quota share or excess of loss basis. In North America, the casualty business written includes primary, umbrella and high layer excess business. The primary casualty programs (including workers' compensation) generally require customers to take large deductibles or self-insured retentions. For the umbrella and excess business written, the Company's liability attaches after large deductibles, including self insurance or insurance from other companies. Outside of North America, casualty business is also written on a primary basis. 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 written includes exposures to man-made and natural disasters, and generally, loss experience is characterized as low frequency and high severity.

Professional liability insurance includes directors' and officers' liability, errors and omissions liability and employment practices 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, company securities and private company directors' and officers' liability. Employment practices liability is written primarily for very large corporations 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.

Environmental liability products include pollution and remediation legal liability, general and project-specific pollution and professional liability, 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. The Company also offers commercial general liability and automobile liability insurance to environmental businesses.

Aviation and satellite products include comprehensive airline hull and liabilities, airport liability, aviation manufacturers' products liability, aviation ground handler liability, large aircraft hull and liability, corporate non-owned aircraft liability, space third party liability and satellite

XL Insurance (Bermuda) Ltd

Notes to Consolidated Financial Statements (Continued)

For The Years Ended December 31, 2008 And 2007

(Expressed in Thousands Of U.S. dollars)

2. Nature of Business (continued)

Insurance Operations (continued)

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 and equine insurance are also provided by the Company. Marine and energy coverage includes marine hull and machinery, marine war, marine excess liability, cargo and offshore energy insurance. Equine products specialize in providing bloodstock, livestock and aquaculture insurance.

Excess and surplus lines products include both general liability and property coverages. For general liability, most Insurance Services Office, Inc. products are written. For property, limits are relatively low and coverages exclude flood, earthquake and difference in conditions.

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 automobile extended warranty and other property and casualty coverage.

Certain structured indemnity products, previously structured by XL Financial Solutions ("XLFS"), are included within the results of the Insurance operations covering a range of insurance risks including property and casualty insurance, certain types of residual exposures and other market risk management products. In August 2008, the Company ceased operations that included the closure of the XLFS business unit and reassignment of responsibility for existing structured indemnity business to its core insurance operations.

The Insurance operations also include XL GAPS, a loss prevention service which offers individually tailored risk management solutions to risk managers, insurance brokers and insurance company clients operating on a global basis.

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 and various reinsurance arrangements, discussed below.

The Company has decided to follow the guidelines of the U.S. Terrorism Risk Insurance Act of 2002 ("TRIA"), as amended, which established the Terrorism Risk Insurance Program ("TRIP") which became effective on November 26, 2002 and was a three-year federal program effective through 2005. On December 22, 2005, a bill was signed extending TRIA ("TRIAE") for two more years, continuing TRIP through 2007. On December 26, 2007, the Terrorism Risk Insurance Program Reauthorization Act of 2007 ("TRIPRA") was signed which further extended TRIP for 7 years until December 31, 2014 and also eliminated the distinction between foreign and domestic acts of terrorism.

XL Insurance (Bermuda) Ltd

Notes to Consolidated Financial Statements (Continued)

For The Years Ended December 31, 2008 And 2007

(Expressed in Thousands Of U.S. dollars)

2. Nature of Business (continued)

Insurance Operations (continued)

The Company had, prior to the passage of the TRIP and the related legislation, underwritten exposures under certain insurance policies that included coverage for terrorism. The passage of TRIP and the related legislation has required the Company to make a mandatory offer of “Certified” terrorism coverage with respect to relevant covered insurance policies as specified under the related legislation. In addition, the Company underwrites a limited number of policies providing terrorism coverage that are not subject to TRIA.

Reinsurance Operations

The Company provides casualty, property risk (including energy and engineering), property catastrophe, marine, aviation, and other specialty reinsurance on a global basis with business being written on both a proportional and non-proportional basis. Business written on a non-proportional basis generally provides for an indemnification by the Company to the ceding company for a portion of the 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 basis including “quota share” or “surplus basis” basis, the Company receives an agreed percentage of the premium and is liable for the same percentage of each/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. Occasionally this commission could be on a sliding scale depending on the loss ratio performance in which case there is generally no profit commission. Reinsurance may be written on a portfolio/treaty basis or on an individual risk/facultative basis. The treaty business is mainly underwritten using reinsurance intermediaries while the individual risk business is generally underwritten directly with the ceding companies, especially for business written in the U.S.

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, programs as well as on an individual risk basis 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 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. This may result in volatility in the Company’s results of operations, financial condition and liquidity.

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

XL Insurance (Bermuda) Ltd

Notes to Consolidated Financial Statements (Continued)

For The Years Ended December 31, 2008 And 2007

(Expressed in Thousands Of U.S. dollars)

2. Nature of Business (continue d)

Reinsurance Operations (continued)

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 also been restricted or excluded in many territories and classes. Some U.S. States make it mandatory to provide 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.

The Company had, prior to the passing of TRIA, underwritten reinsurance exposures in the U.S. that included terrorism coverage. Since the passage of TRIA in the U.S., together with the TRIEA and TRIPRA extensions noted above, the Company has underwritten a very limited number of stand-alone terrorism coverage policies in addition to coverage included within non-stand-alone policies. In the U.S., in addition to "NBRC" acts, the Company generally excludes coverage included under TRIA from the main catastrophe exposed policies. In other cases, both within and outside the U.S., the Company generally relies on either a terrorism exclusion clause, which does not include personal lines, excluding NBRC, or a similar clause that excludes terrorism completely. There are a limited number of classes underwritten where no terrorism exclusion exists.

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, space, engineering, fidelity, trade credit and political risk. The Company also underwrites a small portfolio of contracts covering trade credit.

The Company's also assumes life reinsurance business, from affiliated Companies, primarily in respect of European lives, and includes term assurances, group life, critical illness cover, immediate annuities and disability income business. The majority of the business written is on a proportional basis. The Company has also written a few large contracts relating to portfolios of 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 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.

XL Insurance (Bermuda) Ltd

Notes to Consolidated Financial Statements (Continued)

For The Years Ended December 31, 2008 And 2007

(Expressed in Thousands Of U.S. dollars)

2. Nature of Business (continued)

Other Financial Lines

Other Financial Lines is comprised of remaining contracts associated with the funding agreement ("FA") business and previously included the guaranteed investment contract ("GIC") business. GICs and FAs provide users guaranteed rates of interest on amounts previously invested with the Company. FAs are very similar to GICs in that they have known cash flows. FAs were sold to institutional investors, typically through medium term note programs.

Reinsurance Ceded

The Company uses reinsurance to support the underwriting and retention guidelines of each entity 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. Under its reinsurance security policy, the Company's seeks to cede business to reinsurers generally rated "A" or better by Standard & Poor's ("S&P") or, in the case of Lloyd's syndicates, "B+" from Moody's Investor Service ("Moody's"). 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.

a) Insurance Operations

In certain cases, the risks assumed by the Company 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. A quota share treaty is in place for casualty business emanating from North America, Bermuda and Ireland and the balance of the business written is protected by an excess of loss cover. The professional liability business is protected by an excess of loss treaty. A per-risk excess and catastrophe excess of loss treaty protects the Company's large risk, multi-national property business. The Company maintains retentions within each reinsurance program.

b) Reinsurance Operations

Reinsurance is purchased at several levels ranging from reinsurance of risks assumed on individual contracts to reinsurance covering the aggregate exposures. Upon expiration of the Company's quota share reinsurance treaty with Cyrus Re which reduced the Company's catastrophe exposures, the Company, effective January 1, 2008, entered into a quota share reinsurance treaty with a newly-formed Bermuda reinsurance company, Cyrus Re II. Pursuant to the terms of the quota share reinsurance treaty, Cyrus Re II assumed a 10% cession of certain lines of property catastrophe reinsurance and retrocession business underwritten by certain operating subsidiaries of the Company for business that incepted between January 1, 2008 and July 1, 2008. In connection with such cessions, the Company paid Cyrus Re II reinsurance premium less a ceding commission, which included a reimbursement of direct acquisition expenses incurred by the Company as well as a commission to the Company for generating the business. The quota share reinsurance treaty also provided for a profit commission payable to the Company. Cyrus Re II was canceled and not renewed at December 31, 2008.

The traditional catastrophe retrocession program was renewed in June 2008 to cover certain of the Company's exposures net of Cyrus Re II cessions. 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

XL Insurance (Bermuda) Ltd

Notes to Consolidated Financial Statements (Continued)

For The Years Ended December 31, 2008 And 2007

(Expressed in Thousands Of U.S. dollars)

2. Nature of Business (continued)

b) Reinsurance Operations (continued)

retentions within this program. The Company renewed additional structures with a restricted territorial scope for 12 months at July 2008. The Company continued to buy additional protection for the Company's marine and offshore energy exposures. These covers provide protection in various layers and excess of varying attachment points according to the scope of cover provided. The Company has co-reinsurance participations within this program.

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

3. 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"). All significant intercompany accounts and transactions have been eliminated.

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;
- deposit liabilities;
- valuation of certain derivative instruments;
- other than temporary impairments in the value 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

XL Insurance (Bermuda) Ltd

Notes to Consolidated Financial Statements (Continued)

For The Years Ended December 31, 2008 And 2007

(Expressed in Thousands Of U.S. dollars)

3. Significant Accounting Policies (continued)

(b) Fair Value Measurements

Financial Instruments subject to Fair Value Measurements

In September 2006, the FASB issued No. FAS 157, "Fair Value Measurements" ("FAS 157"). FAS 157 clarifies that fair value is an exit price, representing the amount that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants. Under FAS 157, fair value measurements are not adjusted for transaction costs. FAS 157 nullifies the guidance included in EITF Issue No. 02-3, "Issues Involved in Accounting for Derivative Contracts Held for Trading Purposes and Contracts Involved in Energy Trading and Risk Management Activities," that prohibited the recognition of a day one gain or loss on derivative contracts (and hybrid financial instruments measured at fair value under FAS 155) where a company was unable to verify all of the significant model inputs to observable market data and/or verify the model to market transactions. However, FAS 157 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.

In addition, FAS 157 prohibits the recognition of "block discounts" for large holdings of unrestricted financial instruments where quoted prices are readily and regularly available for an identical asset or liability in an active market. The provisions of FAS 157 are to be applied prospectively, except changes in fair value measurements that result from the initial application of FAS 157 to existing derivative financial instruments measured under EITF Issue No. 02-3, existing hybrid financial instruments measured at fair value and block discounts, all of which are to be recorded as an adjustment to beginning retained earnings in the year of adoption.

The Company adopted FAS 157 as of January 1, 2008, applying the provisions of the statement prospectively to assets and liabilities measured at fair value. There was no transition adjustment required to opening retained earnings as a result of the adoption of this standard. As noted above, 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.

In February 2008, the FASB issued FSP FAS 157-2, "Effective Date of FASB Statement No. 157" ("FSP FAS 157-2"), which permits a one-year deferral of the application of FAS 157 for all non-financial assets and non-financial liabilities, except those that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually). FSP FAS 157-2 is effective in conjunction with FAS 157 for interim and annual financial statements issued after January 1, 2009. Accordingly, the provisions of FAS 157 have not been applied to goodwill and other intangible assets held by the Company which are measured periodically for impairment testing purposes only.

In October 2008, the FASB issued FSP No. FAS 157-3, "Determining the Fair Value of a Financial Asset When the Market for That Asset Is Not Active" ("FSP FAS 157-3"). This FSP clarifies the application of FAS 157 in a market that is not active and provides an example to illustrate key considerations in the determination of the fair value of a financial asset when the market for that asset is not active. The key considerations illustrated in the FSP FAS 157-3

XL Insurance (Bermuda) Ltd

Notes to Consolidated Financial Statements (Continued)

For The Years Ended December 31, 2008 And 2007

(Expressed in Thousands Of U.S. dollars)

3. Significant Accounting Policies (continued)

(b) Fair Value Measurements (continued)

example include the use of an entity's own assumptions about future cash flows and appropriately risk-adjusted discount rates, appropriate risk adjustments for nonperformance and liquidity risks, and the reliance that an entity should place on quotes that do not reflect the result of market transactions. FSP FAS 157-3 was preceded by a press release that was jointly issued by the Office of the Chief Accountant of the SEC and the FASB staff on September 30, 2008 which provided immediate clarification on fair value accounting based on the measurement guidance of FAS 157. FSP FAS 157-3 was effective upon issuance. The Company determined that applying the principles of FAS 157-3 with respect to the CLO portfolio was appropriate.

Basis of Fair Value Measurement

FAS 157 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's 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 under FAS 157 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.
- **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 FAS 157 to illustrate the bases for determining the fair values of the assets and liabilities held by the Company are detailed in each respective significant accounting policy section of this note.

XL Insurance (Bermuda) Ltd

Notes to Consolidated Financial Statements (Continued)

For The Years Ended December 31, 2008 And 2007

(Expressed in Thousands Of U.S. dollars)

3. Significant Accounting Policies (continued)

(b) Fair Value Measurements (continued)

Fair values of investments and derivatives are based on published market values if available, estimates of fair values of similar issues, estimates of fair values provided by independent pricing services or estimates of fair values determined by the Company. 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. Those 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. Certain financial instruments, particularly insurance contracts, are excluded from fair value disclosure requirements of FAS 107, Disclosures about Fair Value of Financial Instruments. For further information on accounting policies relating to other financial instruments, investments, other investments, notes payable and debt and derivative instruments, see Notes 4, 9, 11, 16, and 17, respectively.

(c) 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. Financial guarantee installment premiums are recorded as premiums written when due.

Premiums are earned on a pro-rata basis over the period the coverage is provided. Financial guarantee insurance premiums are earned pro-rata to the amount of risk outstanding over the life of the exposure. 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 writes 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.

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

XL Insurance (Bermuda) Ltd

Notes to Consolidated Financial Statements (Continued)

For The Years Ended December 31, 2008 And 2007

(Expressed in Thousands Of U.S. dollars)

3. Significant Accounting Policies (continued)

(c) Premiums and Acquisition Costs (continued)

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.

(d) 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. Prepaid 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.

(e) 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.

(f) Other Than Temporary Impairments in Investments

The Company reviews the fair value of its investment portfolio on a periodic basis to identify declines in fair value below the carrying value that are other than temporary. This review involves consideration of several factors including (i) the time period during which there has been a significant decline in fair value below carrying value, (ii) an analysis of the liquidity, business prospects and overall financial condition of the issuer, (iii) the significance of the decline, (iv) an analysis of the collateral structure and other credit support, as applicable, of the securities in question, (v) expected future interest rate movements, and (vi) the Company's intent and ability to hold the investment for a sufficient period of time for the value to recover. Where the Company concludes that declines in fair values are other than temporary, the cost of the security is written down to fair value below carrying value and the previously unrealized loss is therefore realized in the period such determination is made.

With respect to securities where the decline in value is determined to be temporary and the security's value 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 changing information. For further details on the factors considered in evaluation other than temporary impairment see Note 9 "Investments".

XL Insurance (Bermuda) Ltd

Notes to Consolidated Financial Statements (Continued)

For The Years Ended December 31, 2008 And 2007

(Expressed in Thousands Of U.S. dollars)

3. Significant Accounting Policies (continued)

(g) 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 master netting arrangement.

Derivative contracts can be exchange-traded or 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.

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, with resulting gains and losses reflected within Level 3. Level 3 inputs are only changed when corroborated by evidence such as similar market transactions, pricing services and/or broker or dealer quotations.

XL Insurance (Bermuda) Ltd

Notes to Consolidated Financial Statements (Continued)

For The Years Ended December 31, 2008 And 2007

(Expressed in Thousands Of U.S. dollars)

3. Significant Accounting Policies (continued)

(g) Derivative Instruments (continued)

The Company conducts its derivative activities in four main areas: investment related derivatives, credit derivatives, other non-investment related derivatives, and weather and energy derivatives.

Investment related derivatives

The Company's direct use of derivatives includes futures, forwards, swaps and option contracts that derive their value from underlying assets, indices, reference rates or a combination of these factors. The Company uses derivatives to manage duration, credit and foreign currency exposure for its investment portfolio as well as to add value to the investment portfolio through replicating permitted investments, provided the use of such investments is incorporated into the overall portfolio evaluation and complies with the Company's investment guidelines.

The Company uses derivative instruments, primarily interest rate swaps, to manage the interest rate exposure associated with certain assets and liabilities. All 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); a hedge of a net investment in a foreign operation; or the Company may not designate any hedging relationship for a derivative contract.

Credit derivatives

Credit derivatives are recorded at fair value, which is determined using either models developed by the Company or third party prices and are dependent upon a number of factors, including 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.

Other Non-Investment Related Derivatives

The Company may also enter into derivatives as part of its contingent capital facilities including put options, interest rate swaps, and asset return swaps or hold contracts containing embedded derivatives such as life reinsurance contracts containing guaranteed minimum income benefits ("GMIB") 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.

XL Insurance (Bermuda) Ltd

Notes to Consolidated Financial Statements (Continued)

For The Years Ended December 31, 2008 And 2007

(Expressed in Thousands Of U.S. dollars)

3. Significant Accounting Policies (continued)

(g) Derivative Instruments (continued)

Weather and Energy derivatives

Fair values for the Company's natural gas contracts are determined through the use of quoted market prices. As quoted market prices are not widely available in the weather and electricity derivative markets, management uses available market data and internal pricing models based upon consistent statistical methodologies to estimate fair values. Estimating the fair value of instruments which do not have quoted market prices requires management's judgment in determining amounts which could reasonably be expected to be received from, or paid to, a third party in settlement of the contracts. The amounts could be materially different from the amounts that might be realized in an actual sale transaction. Fair values are subject to change in the near-term and reflect management's best estimate based on various factors including, but not limited to, actual and forecasted weather conditions, changes in commodity prices, changes in interest rates and other market factors.

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.

Net Investment in a Foreign Operation Hedges

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." Periodic derivative net coupon settlements are recorded in net investment income. There were hedges of net investment in a foreign operation in place at December 31, 2006.

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

XL Insurance (Bermuda) Ltd

Notes to Consolidated Financial Statements (Continued)

For The Years Ended December 31, 2008 And 2007

(Expressed in Thousands Of U.S. dollars)

3. Significant Accounting Policies (continued)

(g) Derivative Instruments (continued)

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” and 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.

The Company also has investment related derivatives embedded in certain reinsurance contracts. For a particular life reinsurance contract, the Company pays the ceding company a fixed amount equal to the estimated present value of the excess of GMIB 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 and recorded at fair value with changes in fair value recognized in earnings.

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 value of fixed maturity securities is 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 markets, 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 maturity 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

XL Insurance (Bermuda) Ltd

Notes to Consolidated Financial Statements (Continued)

For The Years Ended December 31, 2008 And 2007

(Expressed in Thousands Of U.S. dollars)

3. Significant Accounting Policies (continued)

(h) Total Investments

Investments Available For Sale

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, 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 one or more 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 sources.

Broker 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 obtained to support a Level 2 classification.

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. During periods of market disruption including periods of significantly rising or high interest rates, rapidly widening credit spreads or illiquidity, such as the market disruption experienced during the year ended December 31, 2008, it may be difficult to value certain of the Company’s securities, for example, CLOs, Alt-A and sub-prime mortgage backed securities, if trading becomes less frequent and/or market data becomes less observable. There may be certain asset classes that were in active markets with significant observable data that become illiquid due to the current financial environment. In such cases, more securities may fall to Level 3 and thus require more subjectivity and management judgment. As such, valuations may include inputs and assumptions that are less observable or require greater estimation as well as valuation methods which are more sophisticated or require greater estimation thereby resulting in values which may be different than the value at which the investments may be ultimately sold.

The net unrealized gain or loss on investments, net of tax, is included in “accumulated other comprehensive income (loss).” Any unrealized depreciation in value considered by management to be other than temporary is charged to income in the period in which that determination is made.

XL Insurance (Bermuda) Ltd

Notes to Consolidated Financial Statements (Continued)

For The Years Ended December 31, 2008 And 2007

(Expressed in Thousands Of U.S. dollars)

3. Significant Accounting Policies (continued)

(h) Total Investments (continued)

Short-term investments comprise investments with a remaining maturity of less than one year and are valued using the same external factors and in the same manner as fixed maturity 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 the basis of average cost and amortized cost, respectively. 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. Amortization of discounts on fixed maturities includes amortization to expected recovery values for investments which 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.

Investment 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 until timely information becomes available. 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 greater in closed end funds, limited partnerships, LLCs or similar investment vehicles. The Company records its alternative and private fund affiliates on a one month and three month lag, respectively, and its operating affiliates on a three month lag. Significant influence is considered for other strategic investments on a case-by-case basis. Investments in affiliates are not subject to FAS 157 as they are not considered to be fair value measurements under FAS 157. However, impairments associated with investments in affiliates that are deemed to be other-than-temporary are calculated in accordance with FAS 157 and appropriate disclosures included within the financial statements during the period the losses are recorded.

Other investments

Contained within this asset class are investments including direct equity investments, investment funds, limited partnerships, unrated tranches of collateralized debt obligations and certain structured project finance transactions. The Company accounts for its other investments that do not have readily determinable market values at estimated fair value as it has no significant influence (as defined above) over these entities.

XL Insurance (Bermuda) Ltd

Notes to Consolidated Financial Statements (Continued)

For The Years Ended December 31, 2008 And 2007

(Expressed in Thousands Of U.S. dollars)

3. Significant Accounting Policies (continued)

(h) Total Investments (continued)

Other investments

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.

Income on unrated tranches of collateralized debt obligations is reflected only to the extent the Company's principal has been fully recovered. This is not considered to be a fair value measurement under FAS 157 and accordingly these investments have been excluded from FAS 157 disclosures. These investments are carried under the cost recovery method given the uncertainty of future cash flows. The carrying value of these investments held by the Company at December 31, 2008 and December 31, 2007 was \$4.7 million and \$22.7 million, respectively.

In addition, the Company historically participated in structured transactions in project finance related areas under which the Company provides a cash loan supporting a trade finance transaction. These transactions are accounted for in accordance with SOP 01-6, "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. These investments are not considered to be fair value measurements under FAS 157 and accordingly they have been excluded from the FAS 157 disclosures. The carrying value of these investments held by the Company at December 31, 2008 and December 31, 2007 was \$80.1 million and \$125.1 million, respectively.

Securities lending

The Company engages in a securities lending program whereby certain securities from the Company's portfolio are loaned to other institutions for short periods of time. The market value of the loaned securities is monitored on a daily basis, with additional collateral obtained or refunded as the market value of the loaned securities changes. The Company's policy is to require fixed maturities and initial cash collateral equal to between 102% and 105% of the fair value of the loaned securities depending on the class of assets loaned. The Company continues to earn interest on the securities loaned. In addition, the Company shares a portion of the interest earned on the collateral with the lending agent. The proceeds from securities lending collateral is invested and included in cash and cash equivalents or investments available for sale with a corresponding liability related to the Company's obligation to return the collateral plus interest included in net payable for investments purchased. During 2008, XL Capital group capped its

XL Insurance (Bermuda) Ltd

Notes to Consolidated Financial Statements (Continued)

For The Years Ended December 31, 2008 And 2007

(Expressed in Thousands Of U.S. dollars)

3. Significant Accounting Policies (continued)

(h) Total Investments (continued)

maximum participation in the securities lending program at \$300 million and is in the process of unwinding its participation.

(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 FAS 157 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 FASB Statement of Financial Accounting Standards No. 142, 'Goodwill and Other Intangible Assets' ("FAS 142"), the Company tests goodwill for potential impairment annually as of June 30 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. The Company tests for impairment at the reporting unit level, which is generally one level below its business segments. The Company evaluates goodwill for impairment using the two-step process prescribed in FAS 142. The first step is to identify potential impairment by comparing the fair value of a reporting unit to the estimated book value, including goodwill. 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. If the fair value of a reporting unit exceeds the estimated book value, goodwill is not considered impaired. If the book value exceeds the fair value, the second step of the process is performed to measure the amount of impairment.

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

XL Insurance (Bermuda) Ltd

Notes to Consolidated Financial Statements (Continued)

For The Years Ended December 31, 2008 And 2007

(Expressed in Thousands Of U.S. dollars)

3. Significant Accounting Policies (continued)

(k) Goodwill and Other Intangible Assets (continued)

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 FASB Statement of Financial Accounting Standards No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets" ("FAS 144") when events or conditions indicate that the carrying value of an asset may not be fully recoverable from future cash flows. A test for recoverability is done by comparing the asset's carrying value to the sum of the undiscounted future net cash inflows expected to be generated from the use of the asset over its remaining useful life. In accordance with FAS 144, impairment exists if the sum of the undiscounted expected future net cash inflows is less than the carrying amount of the asset. Impairment would result in a write-down of the asset to its estimated fair value. The estimated fair values of these assets are based on the discounted present value of the stream of future net cash inflows expected to be derived over their remaining useful lives. If an impairment write-down is recorded, the remaining useful life of the asset will be evaluated to determine whether revision of the remaining amortization or depreciation period is appropriate.

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 FAS 142, 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 FAS 142, 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 amounts reported from insureds or ceding companies, and represents 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.

For the Company's financial guarantee reserves, a case basis reserve for unpaid losses and loss adjustment expenses is recorded at the net present value of an estimated loss when, in management's opinion, the likelihood of a future loss on a particular insured obligation is

XL Insurance (Bermuda) Ltd

Notes to Consolidated Financial Statements (Continued)

For The Years Ended December 31, 2008 And 2007

(Expressed in Thousands Of U.S. dollars)

3. Significant Accounting Policies (continued)

(l) Losses and Loss Expenses (continued)

probable and determinable at a balance sheet date. The Company also maintains an unallocated reserve on its legacy financial guarantee business which is based on actuarial reserving analysis. This non-specific reserve is established for expected levels of losses associated with currently insured credits and is based on a portion of premiums earned to date. The Company, on an ongoing basis, monitors these reserves and may periodically adjust such reserves based on the Company's actual loss experience, its future mix of business, and its view of future economic conditions.

Certain workers' compensation and financial guarantee case reserve contracts are considered fixed and determinable and are subject to tabular reserving. Reserves associated with these liabilities 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 there from are reflected in income of the year in which the adjustments are made.

(m) Deposit liabilities

Contracts entered into by the Company with cedants which 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. 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.

Funding agreements, when previously written by the Company in the past, were initially recorded at an amount equal to the value of assets received. In relation to the payments to be made under these contracts, the Company used derivative instruments in order to hedge the Company's exposure to fluctuations in interest rates related to these contracts. As described in Note 2(g), in relation to hedges in place on the remaining funding agreements, changes in the fair value of the hedging instrument are recognized in income. The change in the fair value of the hedged item, attributable to the hedged risk, is recorded as an adjustment to the carrying amount of the hedged item and is recognized in income.

XL Insurance (Bermuda) Ltd

Notes to Consolidated Financial Statements (Continued)

For The Years Ended December 31, 2008 And 2007

(Expressed in Thousands Of U.S. dollars)

3. Significant Accounting Policies (continued)

(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 SOP 03-1 "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 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.

The Company adopted the provisions of FASB Interpretation No. 48 ("FIN 48"), 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 the implementation of FIN 48.

XL Insurance (Bermuda) Ltd

Notes to Consolidated Financial Statements (Continued)

For The Years Ended December 31, 2008 And 2007

(Expressed in Thousands Of U.S. dollars)

3. Significant Accounting Policies (continued)

(p) Recent Accounting Pronouncements

In December 2007, the FASB issued FAS 141(R), Business Combinations (“FAS 141(R)”). This statement retains the purchase method of accounting for acquisitions, and requires that an acquirer recognize and measure in its financial statements the identifiable assets acquired, the liabilities assumed, and any noncontrolling interest in the acquiree at their fair values as of the acquisition date. FAS 141(R) changes the recognition of assets acquired and liabilities assumed arising from contingencies, requires the expensing of acquisition-related costs as incurred, and establishes a framework for recognizing and measuring goodwill or a gain from a bargain purchase at the acquisition date. FAS 141(R) also establishes disclosure requirements to enable the evaluation of the nature and financial effects of the business combination. FAS 141(R) will be effective for interim and annual financial statements issued after January 1, 2009 and primarily applies prospectively to business combinations for which the acquisition date is subsequent to January 1, 2009. Earlier adoption is prohibited.

In December 2007, the FASB issued FAS No. 160, “Noncontrolling Interests in Consolidated Financial Statements – an amendment of ARB No. 51” (“FAS 160”), to establish accounting and reporting standards for the noncontrolling interest in a subsidiary and for the deconsolidation of a subsidiary. FAS 160 requires a company to clearly identify and present ownership interests in subsidiaries held by parties other than the company in the consolidated financial statements within the equity section but separate from the company’s equity. It also requires the amount of consolidated net income attributable to the parent and to the noncontrolling interest be clearly identified and presented on the face of the consolidated statement of income; requires any changes in ownership interest of the subsidiary be accounted for as equity transactions; and requires that when a subsidiary is deconsolidated, any retained noncontrolling equity investment in the former subsidiary and the gain or loss on the deconsolidation of the subsidiary be measured at fair value. FAS 160 will be effective for interim and annual financial statements issued after January 1, 2009. FAS 160 must be applied prospectively; however, the presentation and disclosure standards must be applied retrospectively to all periods presented. Earlier adoption is prohibited. The Company is currently evaluating the potential impact of this guidance.

During February 2007, the FASB issued FAS No. 159, “The Fair Value Option for Financial Assets and Financial Liabilities” (“FAS 159”), which permits entities to choose to measure many financial instruments and certain other items at fair value. A company must report unrealized gains and losses on items for which the fair value option has been elected in earnings at each subsequent reporting date. The fair value option may be applied on an instrument by instrument basis, with a few exceptions. The fair value option is irrevocable (unless a new election date occurs) and the fair value option may be applied only to entire instruments and not to portions of instruments. FAS 159 is effective for interim and annual financial statements issued after January 1, 2008. The Company did not elect to apply the fair value option to any existing assets or liabilities as of January 1, 2008.

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Notes to Consolidated Financial Statements (Continued)

For The Years Ended December 31, 2008 And 2007

(Expressed in Thousands Of U.S. dollars)

3. Significant Accounting Policies (continued)

(p) Recent Accounting Pronouncements (continued)

In March 2008, the FASB issued FAS No. 161, "Disclosures about Derivative Instruments and Hedging Activities — an amendment of FASB Statement No. 133." FAS 161 requires enhanced disclosures about an entity's derivative and hedging activities, and is effective for financial statements issued for fiscal years beginning after November 15, 2008, with early application encouraged. The Company will adopt the standard as of January 1, 2009. FAS 161 requires only additional disclosures concerning derivatives and hedging activities, and therefore the adoption of FAS 161 will not have an impact on the Company's financial condition and results of operations.

In April 2008, the FASB issued FASB Staff Position 142-3, "Determination of the Useful Lives of Intangible Assets", which amends the factors that should be considered in developing renewal or extension assumptions used to determine the useful life of an intangible asset. This interpretation will be effective for the Company beginning January 1, 2009 and must also be applied to interim periods within 2009. The Company is currently evaluating the potential impact of this guidance; however, it is not expected to have a significant impact on the Company's financial condition and results of operations.

In May 2008, the FASB issued FAS 162, "The Hierarchy of Generally Accepted Principles" (FAS 162) which outlines the order of authority for the sources of accounting principles. FAS 162 will be effective 60 days following the SEC's approval of the Public Company Accounting Oversight Board amendments to AU Section 411, "The Meaning of Present Fairly in Conformity with Generally Accepted Accounting Principles." The Company does not expect FAS 162 to have an impact on its financial condition and results of operations.

In May 2008, the FASB issued FAS 163, "Accounting for Financial Guarantee Insurance Contracts, an interpretation of FAS 60" ("FAS 163") to address current diversity in practice with respect to accounting for financial guarantee insurance contracts by insurance enterprises under FAS 60, "Accounting and Reporting by Insurance Enterprises" ("FAS 60"). That diversity results in inconsistencies in the recognition and measurement of claim liabilities because of differing views regarding when a loss has been incurred under FAS 5, "Accounting for Contingencies". FAS 163 requires that an insurance enterprise recognize a claim liability prior to an event of default (insured event) when there is evidence that credit deterioration has occurred in an insured financial obligation. FAS 163 also clarifies how FAS 60 applies to financial guarantee insurance contracts, including the recognition and measurement to be used to account for premium revenue and claim liabilities. Those clarifications will increase comparability in financial reporting of financial guarantee insurance contracts by insurance enterprises. FAS 163 also requires expanded disclosures about financial guarantee insurance contracts. The standard is effective for the Company beginning January 1, 2009, and must be applied to all interim periods within 2009, except for certain disclosures about the Company's risk management activities which were required and included within the Company's quarterly report on Form 10-Q for the period ended September 30, 2008. Except for those disclosures, earlier application is not permitted. The Company had reserves for financial guarantee insurance contracts of \$14.5 million and \$427.4 million, respectively, recorded within "Unpaid Losses and Loss Expenses", at December 31, 2008 and December 31, 2007, respectively. At December 31, 2007 the most significant financial guarantee exposures were related to the Company's reinsurance agreements with Syncora and its

XL Insurance (Bermuda) Ltd

Notes to Consolidated Financial Statements (Continued)

For The Years Ended December 31, 2008 And 2007

(Expressed in Thousands Of U.S. dollars)

3. Significant Accounting Policies (continued)

(q) Recent Accounting Pronouncements (continued)

subsidiaries. Following the closing of the Master Agreement, the Company's financial guarantee exposures associated with Syncora were eliminated, with the exception of the guarantee of Syncora's obligations under certain policies with European Investment Bank which are not subject to FAS 163. For further details on this guarantee see Note 4, "Syncora Holdings Ltd. ("Syncora")."

As of December 31, 2008, the Company's outstanding financial guarantee contracts that were subject to FAS 163 included the reinsurance of 48 financial guarantee contracts with total insured contractual payments outstanding of \$936.6 million (\$798.5 million of principal and \$138.1 million of interest) with a remaining weighted-average contract period of 7.9 years. The total gross claim liability and unearned premiums recorded at December 31, 2008 were \$14.5 million and \$3.1 million, respectively. Of the contractual exposure existing at December 31, 2008, the Company has reinsured \$360.5 million with a third party. There are no gross claim liabilities or recoverables recorded relating to this exposure. 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. Of the 48 contracts noted above, 5 contracts with total insured contractual payments outstanding of \$18.4 million had experienced an event of default and were considered by the Company to be non-performing at December 31, 2008, while the remaining 43 contracts were considered to be performing at such date.

In May 2008, the FASB issued FSP APB 14-1, "Accounting for Convertible Debt Instruments That May Be Settled in Cash upon Conversion (Including Partial Cash Settlement)", which clarifies that convertible debt instruments that may be settled in cash upon conversion (including partial cash settlement) are not addressed by paragraph 12 of APB Opinion No. 14, "Accounting for Convertible Debt and Debt Issued with Stock Purchase Warrants." Additionally, this FSP specifies that issuers of such instruments should separately account for the liability and equity components in a manner that will reflect the entity's non-convertible debt borrowing rate when interest cost is recognized in subsequent periods. This FSP will be effective for the Company as of January 1, 2009 and will have to be applied retrospectively to all periods presented. The Company will evaluate the impact of the adoption in the event any instruments that would be subject to this guidance are being considered in the future, however, it is not expected to have any impact on the Company's financial condition and results of operations upon adoption as the Company does not have any instruments issued and outstanding that will be subject to this guidance.

In September 2008, the FASB issued FSP FAS No. 133-1 and FIN 45-4, "Disclosures about Credit Derivatives and Certain Guarantees: An Amendment of FASB Statement No. 133 and FASB Interpretation No. 45; and Clarification of the Effective Date of FASB Statement No. 161." FSP FAS No. 133-1 and FIN 45-4 requires enhanced disclosures about credit derivatives and guarantees and amends FIN 45, "Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others" to exclude derivative instruments accounted for at fair value under FAS 133. The FSP is effective for financial statements issued for reporting periods ending after November 15, 2008. Since FSP FAS No

XL Insurance (Bermuda) Ltd

Notes to Consolidated Financial Statements (Continued)

For The Years Ended December 31, 2008 And 2007

(Expressed in Thousands Of U.S. dollars)

3. Significant Accounting Policies (continued)

(q) Recent Accounting Pronouncements (continued)

133-1 and FIN 45-4 only requires additional disclosures concerning credit derivatives and guarantees, adoption of FSP FAS No. 133-1 and FIN 45-4 will not impact the Company's financial condition or results of operations.

In December 2008, the FASB issued FSP FAS 132(R)-1, "Employer's Disclosures about Postretirement Benefit Plan Assets" ("FSP FAS 132(R)-1"). FSP FAS 132(R)-1 amends FAS No. 132 (Revised 2003), "Employers' Disclosures about Pensions and Other Postretirement Benefits", to provide guidance on an employer's disclosures about plan assets of a defined benefit pension or other postretirement plan. The disclosures about plan assets required by this FSP must be provided for fiscal years ending after December 15, 2009. This standard affects disclosures only and accordingly will not have an impact on the Company's financial condition and results of operations.

In December 2008, the FASB issued FSP FAS 140-4 and FIN 46(R)-8, "Disclosures by Public Entities (Enterprises) about Transfers of Financial Assets and Interests in Variable Interest Entities" ("FSP FAS 140-4 and FIN 46(R)-8"). FSP FAS 140-4 and FIN 46(R)-8 amends FAS 140 and FIN 46(R) to require additional disclosures regarding transfers of financial assets and interest in variable interest entities. FSP FAS 140-4 and FIN 46(R)-8 is effective for interim or annual reporting periods ending after December 15, 2008. This standard affects disclosures only and accordingly did not have an impact on the Company's financial condition and results of operations.

In January 2009, the FASB issued FSP EITF 99-20-1, Amendments to the Impairment Guidance of EITF Issue No. 99-20 ("FSP EITF 99-20-1"). This FSP amends the impairment guidance in EITF Issue No. 99-20, Recognition of Interest Income and Impairment on Purchased Beneficial Interests and Beneficial Interests That Continue to Be Held by a Transferor in Securitized Financial Assets, to align it with the impairment guidance within FAS 115 by removing from EITF 99-20 the requirement to place exclusive reliance on market participants' assumptions about future cash flows when evaluating an asset for other-than-temporary impairment. Both standards now require that assumptions about future cash flows consider reasonable management judgment about the probability that the holder of an asset will be unable to collect all amounts due. The FSP was effective for interim and annual reporting periods ending after December 15, 2008. The application of this guidance did not have a significant impact on the Company's financial condition, results of operations or cash flows.

4. Fair Value Measurements

Effective January 1, 2008, the Company adopted FAS 157, which requires disclosures about the Company's assets and liabilities that are carried at fair value. As required by FAS 157, financial assets and liabilities are classified in their entirety based on the lowest level of input that is significant to the fair value measurement.

The following tables set forth the Company's assets and liabilities that were accounted for at fair value as of December 31, 2008 by level within the fair value hierarchy (see Note 3 (b) to the Consolidated Financial Statements, "Significant Accounting Policies –Fair Value Measurements" for further information on the fair value hierarchy):

XL Insurance (Bermuda) Ltd

Notes to Consolidated Financial Statements (Continued)

For The Years Ended December 31, 2008 And 2007

(Expressed in Thousands Of U.S. dollars)

4. Fair Value Measurements (Continued)

(U.S. dollars in thousands) (Unaudited)	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Collateral and Counterparty Netting	Balance as of December 31, 2008
Assets					
Fixed maturities, at fair value	\$ —	\$ 10,662,686	\$ 287,385	\$ —	\$ 10,950,071
Equity securities, at fair value	2,251	4,619	—	—	6,870
Short-term investments, at fair value	—	606,365	2,386	—	608,751
Total investments available for sale	\$ 2,251	\$ 11,273,670	\$ 289,771	\$ —	\$ 11,565,692
Cash equivalents (1)	1,488,939	124,157	—	—	1,613,096
Other investments (2)	—	81,620	58,223	—	139,843
Other assets (3)(5)	—	165,167	270,893	(340,642)	95,418
Total assets accounted	\$ 1,491,190	\$ 11,644,614	\$ 618,887	\$ (340,642)	\$ 13,414,049
Liabilities					
Other liabilities (4)(5)	—	19,656	88,088	5,442	113,186
Total liabilities accounted for at fair value	\$ —	\$ 19,656	\$ 88,088	\$ 5,442	\$ 113,186

- (1) Cash equivalents balances subject to fair value measurements include certificates of deposit and money market funds. Operating cash balances are not subject to FAS 157.
- (2) The other investments balance excludes certain unrated tranches of collateralized loan obligations which are carried under the cost recovery method given the uncertainty of future cash flows, as well as certain investments in project finance transactions which are carried at amortized cost. See Note 2 (h) to the Consolidated Financial Statements, "Significant Accounting Policies - Total Investments", for further details.
- (3) Other assets include derivative instruments.
- (4) Other liabilities include derivative instruments.
- (5) The derivative balances included in each category above 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 an ISDA master netting agreement. In addition, the company holds cash collateral related to derivative assets of \$346 million. This 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 ISDA master netting agreement. The fair value of the individual derivative contracts are reported gross in their respective levels based on the fair value hierarchy.

XL Insurance (Bermuda) Ltd

Notes to Consolidated Financial Statements (Continued)

For The Years Ended December 31, 2008 And 2007

(Expressed in Thousands Of U.S. dollars)

4. Fair Value Measurements (continued)

Level 3 Gains and Losses

The table below presents 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 table reflects gains and losses for the twelve month period ended December 31, 2008 for all financial assets and liabilities categorized as Level 3 as of December 31, 2008. The table does 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, 2008. 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 table does 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.

(U.S. dollars in thousands)
(Unaudited)

	Level 3 Assets and Liabilities Year Ended December 31, 2008			
	Fixed Maturities	Short-term Investment	Other Investment	Derivative Contracts -
Balance, beginning of period	\$ 1,163,252	\$ 15,032	\$ 27,789	\$ (37,418)
Realized (losses) gains	(74,739)	13	—	25,013
Movement in unrealized (losses) gains	(87,121)	(121)	(1,688)	176,975
Purchases, issuances and settlements	(696,460)	(12,538)	32,122	18,235
Transfers in and/or out of Level 3	(17,546)	—	—	—
Balance, end of period	<u>\$ 287,386</u>	<u>\$ 2,386</u>	<u>\$ 58,223</u>	<u>\$ 182,805</u>
Movement in total (losses) gains above relating to instruments still held at the	<u>\$ (145,329)</u>	<u>\$ (3)</u>	<u>\$ (1,688)</u>	<u>\$ 176,975</u>

Level 3 assets include securities for which the values were obtained from brokers where either significant inputs were utilized in determining the value 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. Level 3 assets also include securities for which the Company determined current market trades represent distressed transactions, and accordingly, the Company determined fair value using certain inputs that are not observable to market participants.

Fixed maturities and short term investments

In periods of market dislocation, the observability of prices and inputs may be reduced for many instruments as is currently the case for certain U.S. collateralized mortgage obligations (“CMOs”), asset backed securities (“ABSs”), commercial mortgage backed securities (“CMBSs”), collateralized debt obligations (“CDOs”), and other Topical Assets (which the Company defines as sub-prime non-agency securities, second liens, ABS CDOs with sub-prime collateral as well as Alt-A mortgage exposures) for which sufficient information, such as cash flows or other security structure or market information, is not available to enable a model derived price to be determined. Generally, securities that are less liquid are more difficult to value and/or dispose of. Fixed maturities and short term investments classified within Level 3 are made up of those securities for which the values were obtained from brokers where either significant inputs were utilized in

XL Insurance (Bermuda) Ltd

Notes to Consolidated Financial Statements (Continued)

For The Years Ended December 31, 2008 And 2007

(Expressed in Thousands Of U.S. dollars)

4. Fair Value Measurements (continued)

determining the value that were difficult to corroborate with observable market data, or sufficient information regarding the specific inputs utilized by the broker was not obtained to support a Level 2 classification, or for which the Company determined current trading conditions represent distressed markets. The fair values of the majority of the Company's holdings in securities exposed to sub-prime mortgages are generally not based on quoted prices for identical securities, however, where they are based on model-derived valuations from pricing services in which all significant inputs and significant value drivers are considered to be observable in active markets, these securities continue to be classified within Level 2. In certain instances, given the current market dislocation, the Company had elected to utilize Level 3 broker valuations over available pricing service valuations during the prior quarter; however, during the current quarter certain fixed maturity investments were recorded based upon pricing service valuations where available resulting in transfers being recorded from Level 3 to Level 2. If the Company were forced to sell certain of its assets in a period of market disruption, there can be no assurance that the Company will be able to sell them for the prices at which the Company has recorded them.

During the fourth quarter of 2008, the Company determined that for certain of its CDO holdings with a fair value of \$90.5 million and a par value of \$212.0 million, that valuations were as a result of broker bids that used recent market trading which the Company considered to be stressed transactions. The markets for CDO's have become extremely illiquid due to a number of factors including risk aversion and reduction among institutional buyers. As a result, the Company believes that current market conditions reflect loss expectations that are improbable relative to historical stressed periods. Trading prices in late 2008 do not reflect fair values at which willing buyers and sellers would transact at. The Company determined that internal models would be more appropriate and better representative of the fair value these securities would be sold at in an orderly market. Although similar conditions exist in other portions of the Company's holdings, primarily RMBS, the Company believes that there was only sufficient and robust historical data covering previously stressed market conditions in its CLO portfolio.

The Company's internal models resulted in a fair value that was \$53.1 million higher than those that would have been determined by its previous methodology of utilizing third party values sourced through brokers or pricing services. This variance represents 25.0% of par value of these holdings. The Company believes that, in the aggregate, this is appropriate as compared to current estimates of market credit spreads.

The Company's approach for determining its CLO portfolio fair value was to apply a 60% weighting to three scenarios that the Company considered as extreme, and 40% weighting to a scenario that the Company viewed as likely. This resulted in a valuation that was based primarily on extreme loss outcomes, which the Company does not believe are likely, but recognizes as a possibility that an orderly market would price into its credit assessments given the level of uncertainty currently in the market.

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Notes to Consolidated Financial Statements (Continued)

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4. Fair Value Measurements (continued)

Other investments

Included within the Other Investments component of the Company's Level 3 valuations are private equity investments where the Company is not deemed to have significant influence over the investee. 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 which 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 also incorporates factors such as the most recent financial information received, the values at which capital transactions with the investee take place, and management's judgment regarding whether any adjustments should be made to the net asset value in recording the fair value of each position.

Derivative instruments

Derivative instruments classified within Level 3 include: (i) certain interest rate swaps where the duration of the contract the Company holds exceeds that of the longest term on a market observable input, (ii) weather and energy derivatives, (iii) GMIB derivatives embedded within a certain reinsurance contract, (iv) put options included within contingent capital facilities and (v) credit derivatives sold providing protection on senior tranches of structured finance transactions where the value is obtained directly from the investment bank counterparty for which sufficient information regarding the inputs utilized in the valuation was not obtained to support a Level 2 classification. In addition, prior to the closing of the Master Agreement (as described below), derivative instruments classified as Level 3 included credit derivatives written by Syncora and embedded in reinsurance provided by the Company. Subsequent to the closing of the Master Agreement, these credit derivative exposures were eliminated by virtue of the commutation of the relevant reinsurance agreements. For further details relating to the Master Agreement, see Note 5 to the Consolidated Financial Statements, "Syncora Holdings Ltd. ("Syncora")." 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.

In addition, see Note 3 to the Consolidated Financial Statements, "Significant Accounting Policies", for a general discussion of types of assets and liabilities that are classified within Level 3 of the fair value hierarchy as well as the Company's valuation policies for such instruments.

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5. Syncora Holdings Ltd. (“Syncora”)

On August 4, 2006, the Company completed the sale of approximately 37% of its then financial guarantee reinsurance and insurance businesses through an initial public offering (“IPO”) of 23.4 million common shares of Syncora for proceeds of approximately \$446.9 million. On June 6, 2007, the Company completed the sale of a portion of Syncora’s common shares still owned by the Company through a secondary offering and thereby reduced its ownership of Syncora’s outstanding common shares further from approximately 63% to approximately 46%. Accordingly, subsequent to June 6, 2007 and up until the execution of the Master Agreement on August 5, 2008, as described below, the Company accounted for its remaining investment in Syncora using the equity method of accounting. Subsequent to August 5, 2008, the Company has no further ownership interest in Syncora.

Given management’s view of the risk exposure along with the uncertainty facing the entire financial guarantee industry, the Company reduced the reported value of its investment in Syncora to nil at December 31, 2007. The Company’s shares in Syncora were unregistered and thus illiquid. Throughout 2008 market developments with respect to the monoline industry continued to be largely negative and Syncora was downgraded by several rating agencies during this period. Accordingly, throughout 2008 and up until the closing of the Master Agreement with Syncora which resulted in the transfer by the Company of all of the shares it owned in Syncora, the Company reported its investment in Syncora at nil and less than the traded market value during this time, as it was believed the decline in value was other than temporary.

Concurrent with the initial public offering (“IPO”) of Syncora and subsequently, the Company has entered into certain service, reinsurance and guarantee arrangements with Syncora and its subsidiaries, to govern certain aspects of the Company’s relationship with Syncora. Prior to the sale of Syncora shares through the secondary offering on June 6, 2007, the effect of these arrangements have been eliminated upon consolidation of the Company’s results. The income statement impacts of all transactions with Syncora subsequent to June 6, 2007, including the impact of the closing of the transactions subject to the Master Agreement on August 5, 2008, were included in “Net (loss) income from operating affiliates.” In 2007, net losses were recorded with respect to the previous excess of loss and facultative reinsurance of Syncora subsidiaries in the amounts of \$300.0 million and \$12.8 million, respectively. In addition, during 2007, the Company incurred \$17.9 million in additional mark-to-market losses related to those underlying contracts in credit default swap form subject to the provisions noted above.

As at September 30, 2008 and December 31, 2007, Syncora had total assets of \$4.2 billion and \$3.6 billion, total liabilities of \$4.1 billion and \$3.1 billion, outstanding preferred share equity of \$246.6 million, and common shareholders’ (deficit) equity of \$(183.1) million and \$180.5 million, respectively. During the nine months ended September 30, 2008 and the year ended December 31, 2007, Syncora had net earned premiums of \$238.6 million and \$215.7 million, total revenues of \$(1.0) billion and \$(356.8) million, and a net loss to common shareholders before minority interest of \$2.0 billion and \$1.2 billion, respectively.

Service agreements

Previously, the Company had entered into a series of service agreements under which subsidiaries of the Company provided services to Syncora and its subsidiaries or received certain services from Syncora subsidiaries for a period of time after the IPO. As detailed below, subsequent to June 30, 2008 the Company executed the Master Agreement in connection with, among other things, the termination of these service agreements.

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Notes to Consolidated Financial Statements (Continued)

For The Years Ended December 31, 2008 And 2007

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5. Syncora Holdings Ltd. (“Syncora”) (continued)

Reinsurance agreements

As noted above, the Company previously provided certain reinsurance protections with respect to adverse development on certain transactions as well as indemnification under specific facultative and excess of loss coverages for subsidiaries of Syncora: Syncora Guarantee Re Inc. (“Syncora Guarantee Re”) (formerly XL Financial Assurance Ltd. Or “XLFA”) and Syncora Guarantee Inc. (Syncora Guarantee”) (formerly XL Capital Assurance or “XLCA”). The adverse development cover related to a specific project financing transaction while the facultative covers generally reinsured certain policies up to the amount necessary for Syncora Guarantee and Syncora Guarantee Re to comply with certain regulatory and risk limits. The excess of loss reinsurance provided indemnification for the portion of any individual paid loss covered by Syncora Guarantee Re in excess of 10% of Syncora Guarantee Re’s surplus, up to an aggregate amount of \$500 million, and excluded coverage for liabilities arising other than pursuant to the terms of the underlying policies. In 2007, in relation to the excess of loss and facultative reinsurance agreements described above, the Company recorded within “loss from operating affiliates”, losses in the amount of \$300.0 million and \$12.8 million, respectively. As detailed below, subsequent to June 30, 2008 the Company executed the Master Agreement in connection with, among other things, the termination of these reinsurance agreements. As at June 30, 2008 and December 31, 2007, the Company’s total net exposure under its facultative agreements with Syncora subsidiaries was approximately \$6.4 billion and \$7.7 billion, respectively, of net par outstanding.

Guarantee agreements

Previously, the Company also entered into certain guarantee agreements with subsidiaries of Syncora. These guarantee agreements terminated with respect to any new business written by Syncora through the underlying agreements after the effective date of Syncora’s IPO, but the agreements remained in effect with respect to cessions or guarantees written under these agreements prior to the IPO. The agreements unconditionally and irrevocably guaranteed: (i) Syncora Guarantee for the full and complete performance when due of all Syncora Guarantee Re’s obligations under its facultative quota share reinsurance agreement with Syncora Guarantee, (ii) the full and complete payment when due of Syncora Guarantee’s obligations under certain financial guarantees issued by Syncora Guarantee and arranged by Syncora Guarantee (U.K.) Limited for the benefit of the European Investment Bank (“EIB”) and (iii) Financial Security Assurance (“Financial Security”) for the full and complete performance of Syncora Guarantee Re’s obligations under a Financial Security Master Facultative Agreement. The guarantees the Company provided contained a dual trigger, such that the guarantees responded only if two events were to occur. First, the underlying guaranteed obligation must have defaulted on payments of interest and principal, and secondly, the relevant Syncora subsidiary must have failed to meet its obligations under the applicable reinsurance or guarantee. As detailed below, subsequent to June 30, 2008 the Company executed the Master Agreement in connection with, among other things, the termination of reinsurance agreements with Syncora and its subsidiaries. As a result of the termination of these reinsurance agreements, the related guarantee agreements described above, with the exception of certain exposures relating to the European Investment Bank as described below, no longer have any force or effect. As at June 30, 2008 and December 31, 2007, the Company’s total net par outstanding falling under these guarantees was \$59.2 billion and \$75.2 billion, respectively.

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Notes to Consolidated Financial Statements (Continued)

For The Years Ended December 31, 2008 And 2007

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5. Syncora Holdings Ltd. (“Syncora”) (continued)

Other agreements

As at December 31, 2007, the Company had approximately \$4.0 billion of deposit liabilities associated with guaranteed investment contracts (“GICs”) for which credit enhancement was provided by Syncora Guarantee. Based on the terms and conditions of the underlying GICs, upon the downgrade of Syncora Guarantee below certain ratings levels, all or portions of outstanding principal balances on such GICs would come due. Throughout 2008, several rating agencies downgraded Syncora and its subsidiaries and as a result, the Company settled all of the GIC liabilities during 2008.

Agreement with Syncora with Respect to Pre -IPO Guarantee and Reinsurance Agreements and Service Agreements

On July 28, 2008, the Company announced that it and certain of its subsidiaries had entered into an agreement (the “Master Agreement”) with Syncora and certain of its subsidiaries (sometimes collectively referred to herein as “Syncora”) as well as certain counterparties to credit default swap agreements (the “Counterparties”), in connection with the termination of certain reinsurance and other agreements as described below. The transactions and termination of certain reinsurance and other agreements under the Master Agreement closed on August 5, 2008. As part of the transaction, the Counterparties provided full releases to the Company and Syncora.

The Master Agreement provided for the payment by the Company to Syncora of \$1.775 billion in cash, the issuance by the Company to Syncora of eight million of XL Capital’s Class A Ordinary Shares which were newly issued by the Company and the transfer by the Company of all of its voting, economic or other rights in the shares it owned in Syncora (representing approximately 46% of Syncora’s issued and outstanding shares) (the “Syncora Shares”) to an escrow agent in accordance with an escrow agreement between Syncora and the Counterparties. This consideration was made in exchange for, among other things, the full and unconditional:

- commutation of the Third Amended and Restated Facultative Quota Share Reinsurance Treaty, effective July 1, 2006, between Syncora Guarantee Re and Syncora Guarantee and all individual risk cessions thereunder, as a result of which the guarantee by the company of Syncora Guarantee Re’s obligations to Syncora Guarantee thereunder no longer has any force or effect;
- commutation of the Excess of Loss Reinsurance Agreement, executed on October 3, 2001, pursuant to which the company agreed to reinsure certain liabilities of Syncora Guarantee Re (the “Excess of Loss Agreement”);
- commutation of the Second Amended and Restated Facultative Master Certificate, effective March 1, 2007, pursuant to which a subsidiary of the company, XL Re America, Inc. (“XLRA”) agreed to reinsure certain liabilities of Syncora Guarantee, and all individual risk cessions thereunder; (the “XLRA Master Facultative Agreement”);
- commutation of the Facultative Quota Share Reinsurance Agreement, effective August 17, 2001, as amended by Amendment No. 1 to such agreement, dated as of August 4, 2006, pursuant to which the company agreed to reinsure certain liabilities of Syncora Guarantee Re, and all individual risk cessions thereunder;
- commutation of the Adverse Development Reinsurance Agreement, dated as of August 4, 2006, between Syncora Guarantee and XLRA, and the Indemnification Agreement, dated as of August 4, 2006, between Syncora Guarantee Re and the company; and

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Notes to Consolidated Financial Statements (Continued)

For The Years Ended December 31, 2008 And 2007

(Expressed in Thousands Of U.S. dollars)

5. Syncora Holdings Ltd. ("Syncora") (continued)

- termination of certain indemnification and services agreements between the Company and Syncora

The Company and Syncora obtained approval from the New York State Insurance Department for the Master Agreement and each of the commutations to which XLRA or Syncora Guarantee was a party. Syncora also complied with all applicable procedures of the Bermuda Monetary Authority, the Delaware Insurance Department and other regulators.

On August 5, 2008, and simultaneous with the closing of the Master Agreement, Syncora commuted the Amended and Restated Master Facultative Reinsurance Agreement, dated November 3, 1998, between Financial Security and Syncora Guarantee Re, and all individual risk cessions thereunder. As a result of this commutation, the Company's guarantee of Syncora Guarantee Re's obligations thereunder (the "Financial Security Guarantee") no longer has any force or effect.

After the closing of the Master Agreement on August 5, 2008, approximately \$64.6 billion of the Company's total net exposure (which was \$65.7 billion as at June 30, 2008) under reinsurance agreements and guarantees with Syncora subsidiaries was eliminated. Pursuant to the terms of the Master Agreement, Syncora is required to use commercially reasonable efforts to commute the agreements that are the subject of the Company's guarantee of Syncora Guarantee's obligations under certain financial guarantees issued by Syncora Guarantee to the European Investment Bank (the "EIB Policies"), subject to certain limitations. These guarantees were provided for the benefit of EIB and are made up of transportation and public building risk with an average rating of BBB, written between 2001 and 2006 with anticipated maturities ranging between 2027 and 2038. As at December 31, 2008, the Company's exposures relating to the EIB Policies (which relate to project finance transactions) was approximately \$955.4 million, reduced from \$1.1 billion at June 30, 2008, mainly due to the strengthening of the U.S. dollar against the currencies of the underlying obligations. As of December 31, 2008, there have been no reported events of default on the underlying obligations, accordingly, no reserves have been recorded.

The terms of the Master Agreement were determined in consideration of a number of commercial and economic factors associated with all existing relationships with Syncora, including, but not limited to, a valuation of the consideration for the commuted agreements and any potential future claims thereunder and the impact of outstanding uncertainty on both the ratings and business operations of the Company. The total value of the consideration noted above of \$1.775 billion as well as the eight million ordinary shares of the Company transferred to Syncora valued at \$128.0 million, significantly exceeded the carried net liabilities of approximately \$490.7 million related to such reinsurances and guarantees. Management considers the execution of the Master Agreement as the event giving rise to the additional liability. As detailed in the table below, the Company recorded a loss of approximately \$1.4 billion in respect of the closing of the Master Agreement during the year ended December 31, 2008:

(U.S. dollars in millions)

Carried liabilities in relation to reinsurance and guarantee agreements commuted under the Master Agreement	\$	490.7
Other accruals		(5.2)
Cash payment made to Syncora in August 2008		(1,775.0)
Value of XL common shares transferred under the Master Agreement		(128.0)
Net loss associated with Master Agreement recorded in the year ended December 31, 2008	\$	<u>(1,417.5)</u>

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Notes to Consolidated Financial Statements (Continued)

For The Years Ended December 31, 2008 And 2007

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6. Restructuring Charges

Given the softening property and casualty market conditions, the Company implemented in the third quarter of 2008, an expense reduction initiative designed to reduce the Company's operating expenses. The goal of this initiative was to achieve enhanced efficiency and an overall reduction in operating expenses by streamlining processes across all geographic locations, with a primary emphasis on corporate functions. To date, this has been achieved through redundancies, increased outsourcing and the cessation of certain projects and activities. Charges have been recognized and accrued as restructuring in accordance with FAS 146, "Accounting for Costs Associated with Exit or Disposal Activities" Other costs that do not meet the criteria for accrual are being expensed as restructuring charges as they are incurred. In relation to this initiative, the Company recorded restructuring and asset impairment charges totaling \$42.7 million during the year ended December 31, 2008 and expects to record further charges of approximately \$1.8 million through the expected completion date of the activities under the expense reduction initiative in the second quarter of 2009. Restructuring charges relate mainly to employee termination benefits as well as costs associated with ceasing to use certain leased property accounted for as operating leases. Restructuring charges noted above have been recorded in the Company's income statement under 'Operating Expenses.'

In February 2009, the Company announced further restructuring initiatives that will result in a reduction of approximately 10% of the Company's global workforce in 2009, resulting in approximately \$40 to \$60 million of further restructuring charges.

Costs incurred through December 31, 2008 and total estimated costs the Company expects to incur in connection with the restructuring and asset impairment are as follows:

(U.S. dollars in millions)	Total Expected Costs	Costs Incurred through December 31, 2008
Employee Termination Benefits	\$ 37.8	\$ 36.0
Lease Termination and Other Costs	6.7	6.7
Total	\$ 44.5	\$ 42.7

Activity related to restructuring and asset impairment charges for the year ended December 31, 2008 was as follows:

(U.S. dollars in millions)	Accrual at December 31, 2007	Costs Incurred	Amounts Paid	Balance of Liability at December 31, 2008
Employee Termination Benefits	\$ -	\$ 36.0	\$ 31.9	\$ 4.1
Lease Termination and Other Costs	-	6.7	1.2	5.5
Total	\$ -	\$ 42.7	\$ 33.1	\$ 9.6

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Notes to Consolidated Financial Statements (Continued)

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7. Goodwill and Intangibles

The following table shows 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, 2008 and 2007:

	Goodwill	Intangible assets with an indefinite life	Intangible assets with a definite life	Total
Balance at January 1, 2007	408,320	\$ 26,147	\$ 5,956	440,423
Addition and write-down	35,112	-	-	35,112
Deduction of SCA goodwill upon deconsolidation	(11,529)	-	-	(11,529)
Amortization	-	-	(1,680)	(1,680)
Foreign Currency Translation	1,097	-	-	1,097
Balance at December 31, 2007	433,000	26,147	4,276	463,423
Reclassification	5,089	(11,529)	6,440	-
Write Down	(965)			(965)
Amortization			(2,968)	(2,968)
Foreign Currency Translation	4,555			4,555
Balance at December 31, 2008	441,679	14,618	7,748	464,045

The addition to goodwill during 2007 was related to the Company's purchase of Global Asset Protection Services LLC ("GAPS"). See Note 8, "Business Combinations" for further details.

8. Business Combinations

Global Asset Protection Services LLC

On November 30, 2007, the Company purchased all of the issued and outstanding limited liability company interests in GAPS, a loss prevention consulting service provider. GAPS is a provider of unbundled loss prevention consulting services, offering individually tailored risk management solutions to risk managers, insurance brokers and insurance company clients operating on a global basis.

The GAPS operation and XL Insurance's existing loss prevention services were merged to form XL GAPS. XL GAPS employs more than 150 engineers worldwide, with a strong presence in America, Europe, Asia and Australia and will remain independent of XL's underwriting operations and will continue to provide loss prevention consulting services to existing clients as well as to clients of the Company. The acquisition is intended to help the Company achieve its long-term growth plans in both the loss prevention market and as a primary insurer. The focus is to offer XL GAPS clients high quality risk management solutions.

The aggregate purchase price after receipt of a final closing balance sheet in 2008 was \$33.4 million. Of the final purchase price paid, \$4.7 million was allocated to the identifiable net assets assumed, with the remaining \$28.7 million recorded as goodwill. GAPS results of operations were included in the Company's income statement from the date of purchase.

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Notes to Consolidated Financial Statements (Continued)

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9. Investments

Net investment income is derived from the following sources:

	2008	2007
Fixed maturities, short-term investments and cash equivalents	\$ 874,229	\$ 1,292,653
Equity securities and other investments	12,380	23,290
Funds withheld	<u>3,406</u>	<u>8,137</u>
Total gross investment income	890,015	1,324,080
Allocated investment expenses	<u>(38,864)</u>	<u>(45,883)</u>
Net investment income	\$ <u>851,151</u>	\$ <u>1,278,197</u>

The following represents an analysis of realized gains (losses) and the change in unrealized appreciation (depreciation) on investments:

	2008	2007
Net realized gains (losses):		
Fixed maturities and short-term investments :		
Gross realized gains	\$ 267,939	\$ 46,186
Gross realized losses	<u>(1,013,338)</u>	<u>(607,900)</u>
Net realized (losses) gains	<u>(745,399)</u>	<u>(561,714)</u>
Equity securities :		
Gross realized gains	3,147	103,602
Gross realized losses	<u>(14,410)</u>	<u>(16,470)</u>
Net realized (losses) gains	<u>(11,263)</u>	<u>87,132</u>
Other investments :		
Gross realized gains	2,609	-
Gross realized losses	<u>(8,027)</u>	<u>-</u>
Net realized (losses)	<u>(5,418)</u>	<u>-</u>
Net realized (losses) on investments	(762,080)	(474,582)
Net realized and unrealized gains (losses) on investment derivative instruments	<u>(12,248)</u>	<u>(56,728)</u>
Net realized (losses) gains on investments and net realized and unrealized gains on investment derivative instruments	<u>(774,328)</u>	<u>(531,310)</u>
Change in net unrealized appreciation (depreciation):		
Fixed maturities and short-term investments	(549,712)	(446,204)
Equity securities	(413)	(4,934)
Affiliates and other investments	<u>(8,004)</u>	<u>(2,484)</u>
Net change in net unrealized appreciation (depreciation)	<u>(558,129)</u>	<u>(453,622)</u>
Total net realized gains (losses) and change in unrealized appreciation (depreciation) on investments and investment derivative instruments	\$ <u>(1,332,457)</u>	\$ <u>(984,932)</u>

Net realized gains and losses in 2008 and 2007 included a loss of \$286.9 million and \$391.6 million, respectively relating to certain fixed income, equity securities and other investments where the Company determined that there was an other than temporary decline in the

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9. Investments (continued)

value of those investments.

The total amount of other than temporary declines in value in 2008 related to \$281.4 million on fixed income securities, \$5.2 million on equity securities and \$0.3 million on other investments. The total amount of other than temporary declines in value in 2007 related to \$391.6 million on fixed income securities.

The cost (amortized cost for fixed maturities and short-term investments), market value and related gross unrealized gains (losses) of investments are as follows:

<u>December 31, 2008</u>	<u>Cost or Amortized Cost</u>	<u>Gross Unrealized Gains</u>	<u>Gross Unrealized Losses</u>	<u>Market Value</u>
Fixed maturities:				
U.S. Government and Government agency	\$ 2,121,491	\$ 171,765	\$ (1,722)	\$ 2,291,534
Corporate	4,027,567	53,213	(631,713)	3,449,067
Mortgaged and asset backed securities	4,132,182	46,816	(684,460)	3,494,538
U.S. States and political subdivisions of the States	442,178	4,768	(17,421)	429,525
Non-U.S. Sovereign Government	1,252,823	64,208	(31,624)	1,285,407
Total fixed maturities	<u>\$ 11,976,241</u>	<u>\$ 340,770</u>	<u>\$ (1,366,940)</u>	<u>\$ 10,950,071</u>
Total short-term investments	<u>\$ 630,289</u>	<u>\$ 3,074</u>	<u>\$ (24,612)</u>	<u>\$ 608,751</u>
Total equity securities	<u>\$ 7,693</u>	<u>\$ -</u>	<u>\$ (823)</u>	<u>\$ 6,870</u>
<u>December 31, 2007</u>	<u>Cost or Amortized Cost</u>	<u>Gross Unrealized Gains</u>	<u>Gross Unrealized Losses</u>	<u>Market Value</u>
Fixed maturities:				
U.S. Government and Government agency	\$ 1,027,742	\$ 40,071	\$ (66)	\$ 1,067,747
Corporate	4,788,884	29,694	(195,279)	4,623,299
Mortgaged and asset backed securities	7,859,043	46,998	(421,595)	7,484,446
U.S. States and political subdivisions of the States	233,083	2,240	(1,717)	233,606
Non-U.S. Sovereign Government	1,350,333	16,237	(5,410)	1,361,160
Total fixed maturities	<u>\$ 15,259,085</u>	<u>\$ 135,240</u>	<u>\$ (624,067)</u>	<u>\$ 14,770,258</u>
Total short-term investments	<u>\$ 1,093,522</u>	<u>\$ 3,742</u>	<u>\$ (12,910)</u>	<u>\$ 1,084,354</u>
Total equity securities	<u>\$ 63,596</u>	<u>\$ 1,303</u>	<u>\$ (1,713)</u>	<u>\$ 63,186</u>

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Notes to Consolidated Financial Statements (Continued)

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9. Investments (continued)

The Company has gross unrealized losses of \$1,392.4 million which it considers to be temporary impairments. Individual security positions comprising this balance have been evaluated by management, based on specified criteria, to determine if these impairments should be considered other than temporary. These criteria include an assessment of the severity and length of time securities have been impaired, along with management's ability and intent to hold the securities to recovery, among other factors included below.

Factors considered in determining that additional other-than-temporary impairment charges were not warranted include; managements' consideration of current and near term liquidity needs, an evaluation of the factors and time necessary for recovery, and the results of on-going retrospective reviews of security sales and the basis for such sales. Securities in an unrealized loss position at December 31, 2008 are comprised of sub-prime first liens and Alt-A asset backed securities, CDOs with insignificant residential mortgage collateral, unrealized foreign exchange losses on U.S. dollar investments held in foreign subsidiaries with little underlying value impairment and unrealized losses on investments supporting long-term liabilities which have no history of significant sales at a loss. Following a detailed review of the Company's underlying sub-prime and related residential mortgage exposures ("topical assets") described above, as well as a consideration of the broader structured credit market, the Company has concluded that the remaining investments in these asset classes have decreased in value due to technical spreads widening and broader market sentiment, rather than fundamental collateral deterioration. Topical assets are held primarily in the Company's Other Financial Lines operations portfolios and management has put in place a strategy to monitor and address the liquidity needs associated with these portfolios with the intent of holding the positions to recovery. The fact that the underlying securities cash flows continue to be in accordance with their contractual terms, combined with manager evaluations of the fundamentals supporting the underlying positions, have lead management to conclude that the values of the investments for which it reports unrealized losses as at December 31, 2008 are not other than temporarily impaired, as management currently has the intent and ability to hold these securities for a period of time sufficient to allow for any anticipated recovery in market value.

At December 31, 2008, there was \$1,391.6 million of gross unrealized losses on fixed maturities and short-term investments, and \$0.8 million of gross unrealized losses on equity securities. At December 31, 2007, there was \$637.0 million of gross unrealized losses on fixed maturities and short-term investments, and \$1.7 million of gross unrealized losses on equity securities. At both December 31, 2008 and 2007, approximately 2.5% of the Company's fixed income investment portfolio was invested in securities which were below investment grade or not rated. Approximately 13.2% of the unrealized losses in the Company's fixed income securities portfolio at December 31, 2008 related to securities that were below investment grade or not rated. The information shown below about the unrealized losses on the Company's investments at December 31, 2008 concerns the potential affect upon future earnings and financial position should management later conclude that some of the current declines in the fair value of these investments are other than temporary declines.

XL Insurance (Bermuda) Ltd

Notes to Consolidated Financial Statements (Continued)

For The Years Ended December 31, 2008 And 2007

(Expressed in Thousands Of U.S. dollars)

9. Investments (continued)

The following is an analysis of how long each of those securities at December 31, 2008 had been in a continual unrealized loss position:

	<u>Less than 12 months</u>		<u>Equal to or greater than 12 months</u>	
	<u>Market Value</u>	<u>Gross Unrealized Losses</u>	<u>Market Value</u>	<u>Gross Unrealized Losses</u>
<u>December 31, 2008</u>				
Fixed maturities (including short-term investments):				
U.S. Government and Government agency	\$ 55,152	\$ (2,670)	\$ -	\$ -
Corporate	1,693,383	(397,443)	796,661	(242,454)
Mortgaged and asset backed securities	1,113,776	(235,557)	782,225	(450,288)
U.S. States and political subdivisions of the States	172,059	(9,223)	27,332	(8,234)
Non-U.S. Sovereign Government	157,066	(30,330)	41,460	(15,353)
Total fixed maturities	<u>\$ 3,191,436</u>	<u>\$ (675,223)</u>	<u>\$ 1,647,678</u>	<u>\$ (716,329)</u>
Total equity securities	<u>\$ 1,923</u>	<u>\$ (823)</u>	<u>\$ -</u>	<u>\$ -</u>

The following is an analysis of how long each of those securities at December 31, 2007 had been in a continual unrealized loss position:

	<u>Less than 12 months</u>		<u>Equal to or greater than 12 months</u>	
	<u>Market Value</u>	<u>Gross Unrealized Losses</u>	<u>Market Value</u>	<u>Gross Unrealized Losses</u>
<u>December 31, 2007</u>				
Fixed maturities (including short-term investments):				
U.S. Government and Government agency	\$ 32,306	\$ (67)	\$ 2,890	\$ (5)
Corporate	2,892,032	(147,154)	737,033	(60,845)
Mortgaged and asset backed securities	4,005,566	(360,113)	916,028	(61,482)
U.S. States and political subdivisions of the States	60,403	(1,487)	3,230	(232)
Non-U.S. Sovereign Government	321,352	(4,072)	162,393	(1,520)
Total fixed maturities	<u>\$ 7,311,659</u>	<u>\$ (512,893)</u>	<u>\$ 1,821,574</u>	<u>\$ (124,084)</u>
Total equity securities	<u>\$ 46,578</u>	<u>\$ (1,713)</u>	<u>\$ -</u>	<u>\$ -</u>

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Notes to Consolidated Financial Statements (Continued)

For The Years Ended December 31, 2008 And 2007

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9. Investments (continued)

The contractual maturities of fixed maturity securities 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, 2008		December 31, 2007	
	Amortized Cost	Market Value	Amortized Cost	Market Value
Due after 1 through 5 years	\$ 4,198,272	3,984,265	\$ 3,145,583	\$ 3,110,707
Due after 5 through 10 years	2,461,595	2,358,507	2,975,742	2,922,853
Due after 10 years	1,184,193	1,112,762	1,278,717	1,252,253
Mortgage and asset backed investments	4,132,181	3,494,537	7,859,043	7,484,445
Total fixed maturities	<u>\$ 11,976,241</u>	<u>10,950,071</u>	<u>\$ 15,259,085</u>	<u>\$ 14,770,258</u>

The Company participates in a securities lending program operated by a third party banking institution, whereby certain assets are loaned out and for which the Company earns an incremental return. For securities on loan, the lending agent receives cash collateral generally worth 102 to 105% of the loaned securities which must be returned to the borrower upon return of the securities and which in the meantime is invested in a collateral pool managed by the banking institution. The collateral pool is subject to written investment guidelines with key objectives which includes safeguard of principal and adequate liquidity to meet anticipated needs with a maximum weighted average maturity of ninety days. At December 31, 2008 and December 31, 2007, \$134.2 million and \$123.7 million, respectively, of securities included in investments available for sale were loaned to various counter parties through the securities lending program. The cash collateral received as at December 31, 2008 and December 31, 2007 was \$136.1 million and \$125.4 million respectively. At December 31, 2008 and December 31, 2007, the value of the Company's share of the collateral pool and investments available-for-sale held was \$129.3 million and \$125.4 million, respectively, in connection with these loans, and is included in cash and cash equivalents, with a corresponding liability reflected in net payable for investments purchased.

Certain of the Company's invested assets are held in trust and pledged in support of insurance and reinsurance liabilities. 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. In addition certain deposit liabilities and annuity contracts require the use of pledged assets. As at December 31, 2008 the Company had approximately \$2.8 billion in pledged assets.

The fair values of securities on loan at December 31, 2008 and 2007 are detailed below:

	2008	2007
Fixed maturities.....	\$134,209	\$123,764
Equities.....	-	-
Total	<u>\$134,209</u>	<u>\$123,764</u>

XL Insurance (Bermuda) Ltd

Notes to Consolidated Financial Statements (Continued)

For The Years Ended December 31, 2008 And 2007

(Expressed in Thousands Of U.S. dollars)

10. Investments in affiliates

The Company's investment in affiliates and equity in net income (loss) from such affiliates are summarized below:

	December 31, 2008		December 31, 2007	
	Carrying Value	Equity in Net Income (Loss) for the Year	Carrying Value	Equity in Net Income (Loss) for the Year
Investment affiliates.....	344,774	(46,170)	\$611,332	\$ 16,290
Operating affiliates:				
Financial affiliates.....	20,479	(1,502,646)	21,045	(1,189,542)
Insurance affiliates.....	67,529	10,001	78,483	7,300
Investment management affiliates	195,324	14,657	226,801	97,252
	<u>628,106</u>	<u>(1,524,160)</u>	<u>937,661</u>	<u>\$(1,068,700)</u>

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 recent available financial statements are used. This lag in reporting is applied consistently until timely information becomes available.

The Company has invested in certain closed end funds, certain limited partnerships, LLC's and similar investment vehicles, including funds managed by certain of its investment management affiliates. Collectively, these investments in funds, partnerships and other vehicles are classified as "investment fund affiliates". At December 31, 2008, investment affiliates were \$0.3 billion of which \$0.2 billion was invested in the alternative investment portfolio and \$0.1 billion consisted of private investments. At December 31, 2007, investment affiliates were \$0.6 billion of which \$0.5 billion was included in the alternative investment portfolio and \$0.1 billion consisted of private investments.

The Company's net loss from investment fund affiliates during the year ended December 31, 2008 reflected broad-based market declines, combined with extreme volatility, a sharp pull-back in the availability of credit and short sale restrictions implemented by securities market regulators, proved highly challenging for the strategies employed by many of the Company's alternative investment managers. Net income from investment fund affiliates increased in 2007 as compared to 2006 due primarily to exceptional results in the alternative portfolio and as a result of a higher investment asset base.

The Company's significant financial operating affiliate investments at December 31, 2007 included Syncora and Primus Guaranty, Ltd. ("Primus") with ownership of 46.9% and 33.1%, respectively. Given management's view of the risk exposure, expected losses in 2007 by both Syncora and Primus, along with the uncertainty facing the entire financial guarantee industry, the Company reduced the reported value of its investment in both Syncora and Primus to nil at December 31, 2007. The write down in the Syncora and Primus equity investments in 2007, combined with net losses recorded in the same period under the excess of loss and facultative reinsurance agreements with Syncora of \$300.0 million and \$12.8 million, respectively, were the primary drivers behind the net loss from financial operating affiliates of \$1.2 billion recorded during the year ended December 31, 2007.

XL Insurance (Bermuda) Ltd

Notes to Consolidated Financial Statements (Continued)

For The Years Ended December 31, 2008 And 2007

(Expressed in Thousands Of U.S. dollars)

10. Investments in affiliates (continued)

Market developments with respect to the monoline industry continued to be largely negative throughout 2008 and during the same period, Syncora was downgraded by several rating agencies. Accordingly, throughout 2008 and up until the closing of the Master Agreement in August 2008 which resulted in the transfer by the Company of all of the shares it owned in Syncora, the Company reported its investment in Syncora at nil and less than the traded market value during this time, as it was believed the decline in value was other than temporary. In addition to the transfer of the Company's shares it owned in Syncora as described above, under the Master Agreement, the Company paid consideration to Syncora of \$1.775 billion cash as well as eight million ordinary shares valued at \$128.0 million. The Master Agreement terminated certain reinsurance and service agreements with Syncora and as a result, related guarantee agreements with Syncora, with the exception of certain exposures relating to the European Investment Bank, no longer had any force or effect. As the total value of the consideration paid to Syncora significantly exceeded the liabilities related to such reinsurances and guarantees, the Company recorded a loss of approximately \$1.4 billion, in "net (loss) income from operating affiliates", in respect of the closing of the Master Agreement in the third quarter of 2008. See Note 5, "Syncora Holdings Ltd" for further details.

The Company's insurance affiliate investments at December 31, 2008 included a \$63.2M investment in ITAU XL Seguros Corporativos S.A., with ownership in this entity at 49.9%.

The Company's investment manager affiliates include Highfields Capital Management LP, a global equity investment firm, MKP Capital Management, a fixed income investment manager, specializing in mortgage-backed securities, Stanfield Capital Partners, a credit-orientated asset management firm specializing in collateralized loan obligations, One Capital Management Partners, a diversified alternative investment management firm, Artemis Advisor LLC, a U.S. focused equity firm, HighVista Strategies LLC, a diversified wealth management firm, and Finisterre Cayman Limited, an emerging market specialist asset management firm.

During 2006, the Company sold its interest in FrontPoint Partners LLC, an integrated alternative asset firm, resulting in equity earnings of \$41.7 million recorded in 2006 related to the initial sale and \$32.4 million recorded in 2007, primarily related to the receipt of contingent proceeds and the balance of \$2.3 million received in 2008.

In addition to the writedowns above, during the years December 31, 2008 and 2007 the Company recorded other than temporary declines in the values of certain affiliates totaling nil and \$63.5 million, respectively. Other than temporary declines in 2008 and 2007 declines related primarily to investment management affiliates.

In certain investments, the carrying value is different from the share of the investee's underlying net assets. The difference represents goodwill on acquisition or other-than-temporary impairments recorded with respect to the investment.

See Note 19(c), "Commitments and Contingencies – Investments in Affiliates," for further information regarding commitments related to investment in affiliates.

XL Insurance (Bermuda) Ltd

Notes to Consolidated Financial Statements (Continued)

For The Years Ended December 31, 2008 And 2007

(Expressed in Thousands Of U.S. dollars)

11. Other Investments

Other investments include investments over which the Company does not have significant influence and whose fair value is generally unquoted. This includes investments in limited partnerships where the Company does not participate in the management of the partnerships and investments in non-rated collateralized loan obligations. Income from other investments was \$3.6 million and \$16.9 million for the years ended December 31, 2008 and 2007, respectively. Unrealized gains from these limited investment partnerships was \$0.1 million and \$1.1 million as at December 31, 2008 and 2007, respectively.

Income on unrated tranches of collateral loan obligations is reflected only to the extent the Company's principal has been fully recovered. Income on alternative investments included in other investments is realized only on ultimate sale of these investments. The Company had net unrealized gains of \$15.3 million and \$12.1 million, respectively, at December 31, 2008 and 2007, related to these alternative investments.

See Note 19(b), "Commitments and Contingencies – Other Investments," for further information regarding commitments related to other investments.

The Company regularly reviews the performance of these other investments. The Company recorded losses of \$0.3 million and \$0.1 million in 2008 and 2007, respectively, due to other than temporary declines in values of these investments.

12. Unpaid losses and loss expenses

Unpaid losses and loss expense reserves for the Company's operations are comprised of:

	2008	2007
Reserve for reported losses and loss expenses	\$ 8,629,496	\$ 9,456,225
Reserve for losses incurred but not reported	<u>10,823,928</u>	<u>11,313,836</u>
Unpaid losses and loss expense reserves	\$ <u>19,453,424</u>	\$ <u>20,770,061</u>

Net losses and loss expenses incurred, excluding claims and policy benefits for the life operations, comprise:

	2008	2007
Loss and loss expense payments	\$ 4,503,431	\$ 4,372,530
Change in unpaid losses and loss expenses	(424,495)	192,287
Change in unpaid losses and loss expenses recoverable	606,471	(380,585)
Paid loss recoveries	<u>(2,961,578)</u>	<u>(2,918,131)</u>
Net loss and loss expenses incurred	\$ <u>1,723,829</u>	\$ <u>1,266,101</u>

XL Insurance (Bermuda) Ltd

Notes to Consolidated Financial Statements (Continued)

For The Years Ended December 31, 2008 And 2007

(Expressed in Thousands Of U.S. dollars)

12. Unpaid losses and loss expenses (continued)

Reconciliation of unpaid losses and loss expense reserves, excluding claims and policy benefits for the life operations :

	2008	2007
Unpaid losses and loss expenses at beginning of year	\$ 20,770,061	\$ 19,294,378
Unpaid losses and loss expenses recoverable	12,209,871	11,619,561
Financial Guarantee reserves related to previous reinsurance agreements with Syncora that were recorded within "Net loss from operating affiliates"	(350,988)	-
Net unpaid losses and loss expenses at beginning of year	8,209,202	7,674,817
Increase (decrease) in net losses and loss expenses incurred in respect of losses occurring in :		
Current year	1,981,285	1,345,863
Prior years	(257,455)	(79,762)
Total net incurred losses and loss expenses	1,723,830	1,266,101
Exchange Rate effects	(176,733)	224,931
Net loss reserves (disposed) acquired	(455,352)	497,753
Losses and loss expenses paid in respect of losses occurring in :		
Current year	382,452	178,747
Prior years	1,159,401	1,275,653
Total net paid losses	1,541,853	1,454,400
Net Unpaid losses and loss expenses at end of year	7,759,094	8,209,202
Unpaid losses and loss expenses recoverable	11,694,331	12,209,871
Financial Guarantee losses recorded within net income from Operating affiliates	-	350,988
Unpaid losses and loss expenses at end of year	\$ 19,453,425	\$ 20,770,061

Certain aspects of the Company's business have loss experience characterized as low frequency but high severity in nature. This may result in volatility in the Company's results of operations and financial condition and liquidity.

The following table presents the net (favorable) adverse development of reserves analyzed by each of the Company's operations:

	2008	2007
Insurance	\$ (306,546)	\$ (195,150)
Reinsurance	(176,354)	(168,951)
Subtotal	(482,900)	(364,101)
Quota share arrangements with affiliated companies	225,445	284,339
Total net adverse(favorable) prior year development	\$ (257,455)	\$ (79,762)

Insurance Operations

Net favorable prior year development in the year ended December 31, 2008, totaled \$306.5 million, primarily due to reserve releases in certain casualty lines primarily in 2003 to 2006 accident years due to lower than expected reported loss activity and favorable reserve

XL Insurance (Bermuda) Ltd

Notes to Consolidated Financial Statements (Continued)

For The Years Ended December 31, 2008 And 2007

(Expressed in Thousands Of U.S. dollars)

12. Unpaid losses and loss expenses (continued)

development in global property lines of business as a result of favorable claim development. In addition, net reserve releases resulted from an agreement with Axa/Winterthur of approximately \$80.9 million in the fourth quarter of 2008 in regards to certain reinsurance recoverable balances relating to casualty lines and to a lesser extent, certain property lines of business. Offsetting this favorable development was modest reserve strengthening within specialty lines, primarily in the environmental lines of business, as well as strengthening associated with certain structured indemnity contracts. Within the professional lines, reserve releases in the 2003 to 2006 accident years were largely offset by strengthening of reserves in the 2007 year. Gross prior year favorable development for the year ended December 31, 2008 of \$633.2 million exceeded the corresponding net favorable development during the same period of \$306.5 million, as the impact of reductions in gross reported losses on older years in certain casualty lines was mostly offset by the impact of the reinsurance recoverable component on such losses. In addition, the impact of gross reserve releases in professional lines was mostly offset by the impact of a reduction in estimated ceded IBNR following reserve reviews in these lines.

In 2007, net prior year reserve releases consisted of \$85.4 million in property and \$162.2 million in casualty lines of business, partially offset by net adverse development of \$20.8 million, \$5.7 million and \$26.1 million in certain professional, marine and other lines of business, respectively. Casualty releases relate primarily to the European casualty portfolio in accident years 2002-2005. The professional lines development reflects net adverse prior year development of the Bermuda E&O portfolio and releases from the U.S. and European professional lines portfolios. Net adverse prior year development in other insurance lines relates to adverse development in discontinued specialty lines, surety and environmental, partially offset by favorable development in aerospace and political risk. Gross prior year releases totaled \$155.8 million for the Insurance operations during 2007.

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.

Reinsurance Operations

For the year ended December 31, 2008, net favorable prior year reserve development included casualty and other lines reserve releases in both European and U.S. casualty and professional portfolios. In the same period, property and other short-tail lines net favorable development was attributable to most business units globally. Gross prior year favorable development for the year ended December 31, 2008 of \$307.1 million exceeded the corresponding net favorable development during the same period of \$176.4 million as the impact of favorable loss experience related to a large crop program was mostly offset by the impact of retrocessional protection related to this program.

In 2007, within the Reinsurance operations, net prior year releases of \$169.0 million in the year ended December 31, 2007 consisted of \$113.9 million primarily in property and other short-tail lines of business and \$55.1 million in casualty and other lines. Releases in the short-tail lines relate primarily to the 2005 and 2006 accident years. The casualty and other lines favorable development of \$55.1 million reflects the net result of releases of \$89.1 million primarily in the US and non-US casualty portfolios, partially offset by net adverse development of \$13.0 million associated with the results of an external review of the Company's asbestos and environmental reserves and \$21.0 million related to a commutation of a stop loss reinsurance agreement.

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Notes to Consolidated Financial Statements (Continued)

For The Years Ended December 31, 2008 And 2007

(Expressed in Thousands Of U.S. dollars)

12. Unpaid losses and loss expenses (continued)

Favorable gross prior year development of \$166.6 million was in line with the net development.

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.

Exchange rate effects and other adjustments

Exchange rate effects on net loss reserves in the years ended December 31, 2008 and 2007 related to the global operations of the Company primarily where reporting units have a functional currency that is not the U.S. dollar. The increase in the value of the U.S. dollar in 2008 combined with the decrease in the value of the U.S. dollar in 2007 mainly compared to the Swiss franc, U.K. Sterling and the Euro, gave rise to translation and revaluation exchange movements related to carried loss reserve balances of \$(176.7) million and \$224.9 million in 2008 and 2007, respectively.

Other Loss information

Net losses disposed in 2008 of \$455.4 million primarily represents net losses disposed of \$490.8 million from an affiliate company as a result of an XL Capital organizational restructuring of its UK and European affiliated reinsurance operations.

Net losses acquired in 2007 in the amount of \$97.8 million primarily represent net losses acquired of \$661.5 million from an affiliate company as a result of an XL Capital organizational restructuring of its UK and European affiliated reinsurance operations, partially offset by reserves associated with the de-consolidation of SCA following the secondary offering on June 6, 2007 of \$181.4 million.

The Company's net unpaid losses and loss expenses included estimates of actual and potential non-recoveries from reinsurers. As at December 31, 2008 and 2007, the reserve for potential non-recoveries from reinsurers was \$100.3 million and \$98.3 million, respectively.

Except for certain financial guarantee and workers' compensation liabilities, the Company does not discount its unpaid losses and loss expenses.

With respect to financial guarantee liabilities the amount of the case basis reserve is based on the net present value of the expected ultimate loss and loss adjustment expense payments that the Company expects to make, net of expected recoveries under salvage and subrogation rights. Case basis reserves are determined using cash flow or similar models to estimate the net present value of the anticipated shortfall between (i) scheduled payments on the insured obligation plus anticipated loss adjustment expenses and (ii) anticipated cash flow from the proceeds to be received on sales of any collateral supporting the obligation and other anticipated recoveries.

The net income impact in 2007 of case basis reserves with respect to reinsurance previously provided to Syncora subsequent to the secondary sale of Syncora common shares on June 6, 2007 of \$351.0 million was included in "Net loss from operating affiliates", and the unpaid case reserves related to such losses were recorded in unpaid losses and loss expenses. However, following the closing of the Master Agreement and the consideration paid to Syncora, the liabilities associated with the reinsurance previously provided to Syncora were settled. See Note 5, "Syncora Holdings Ltd. ("Syncora") for further information.

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Notes to Consolidated Financial Statements (Continued)

For The Years Ended December 31, 2008 And 2007

(Expressed in Thousands Of U.S. dollars)

12. Unpaid losses and loss expenses (continued)

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% (2007: 5%). 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, 2008 and 2007 were \$755.8 million and \$813.7 million, respectively. The related discounted unpaid losses and loss expenses were \$346.0 million and \$377.0 million as of December 31, 2008 and 2007, respectively.

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.

During 2008 and 2007, the net reserve development on the quota share arrangements is due to net reserve releases in the underlying business written in the Company's North America and U.K./European insurance and reinsurance operations. Accordingly, the quota share arrangements for the U.K./European operations had reinsurance recovery releases of \$88.2 million and \$145.5M, while the U.S. operations had reinsurance recovery releases of \$142.9 million and \$118.9 million in 2008 and 2007, respectively.

13. 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 rated "A" or better by Standard & Poor's ("S&P") or, in the case of Lloyd's syndicates, "B+" from Moody's Investor Service, Inc. ("Moody's"). The Company will consider 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.

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Notes to Consolidated Financial Statements (Continued)

For The Years Ended December 31, 2008 And 2007

(Expressed in Thousands Of U.S. dollars)

13. Reinsurance (continued)

The effect of reinsurance activity retrocessional activity on premiums written and earned from general operations is shown below:

	2008	2007
Premiums written		
Direct	\$ 4,999,195	\$ 5,307,223
Assumed	2,019,550	2,261,031
Ceded	<u>(3,983,987)</u>	<u>(5,356,493)</u>
Net premiums written	\$ <u>3,034,758</u>	\$ <u>2,211,761</u>
Premiums earned		
Direct	\$ 5,271,524	\$ 5,359,364
Assumed	2,007,094	2,318,149
Ceded	<u>(4,445,047)</u>	<u>(5,359,367)</u>
Net premiums earned	\$ <u>2,833,571</u>	\$ <u>2,318,146</u>

At December 31, 2008, the total reinsurance assets of \$12.6 billion include reinsurance recoverables for paid losses and loss expenses of \$0.8 billion and \$11.8 billion with respect to the ceded reserve for losses and loss expenses, including ceded losses incurred but not reported. Of the \$11.8 billion and \$12.2 billion in unpaid losses and loss expenses recoverable due at December 31, 2008 and 2007, respectively, \$8.2 billion and \$7.9 billion are due from an affiliated company, under the quota share arrangements discussed below.

The Company recorded reinsurance recoveries on losses and loss expenses incurred of \$2.4 billion and \$3.2 billion for the years ended December 31, 2008 and 2007, respectively, of which \$1.8 billion and \$1.9 billion respectively, relate to recoveries due from an affiliated company. The recoveries due from an affiliated company, relate to various quota share arrangements which are in place for the Company and some of its subsidiary companies, during both the current and prior years. The total reinsurance premium ceded and earned for these quota share arrangements for the year ended December 31, 2008, was \$2.4 billion and \$2.8 billion and for December 31, 2007, \$3.8 billion and \$3.7 billion respectively.

Although the contractual obligation of individual reinsurers to pay their reinsurance obligations is based on specific contract provisions, the collectibility 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 their ability to meet these obligations and while they may continue to acknowledge their contractual obligation to do so, they may not have the financial resources or willingness to fully meet their obligation to the Company.

At December 31, 2008 and 2007, the provision for uncollectible reinsurance relating to both reinsurance balances receivable and unpaid losses and loss expenses recoverable was \$100.3 million and \$98.3 million, respectively. To estimate the provision for uncollectible reinsurance recoverable, the reinsurance recoverable must first be allocated to applicable reinsurers. This determination is based on a process rather than an estimate, although an element of judgment must be applied. 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.

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Notes to Consolidated Financial Statements (Continued)

For The Years Ended December 31, 2008 And 2007

(Expressed in Thousands Of U.S. dollars)

13. Reinsurance (continued)

The Company uses a default analysis to estimate uncollectible reinsurance. 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, 2008, collateralizing reinsurance recoverables with respect to certain reinsurers. Default factors require considerable judgment and are determined using the current rating, or rating equivalent, of each reinsurer as well as other key considerations and assumptions.

At December 31, 2008, 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 liquidity.

Approximately 83% of the total unpaid loss and loss expense recoverable and reinsurance balances receivable (excluding collateral held) outstanding at December 31, 2008, were due from reinsurers rated "A" or better by S&P. The following is an analysis of the total recoverable and reinsurance balances receivable at December 31, 2008, by reinsurers owing more than 3% of such total:

<u>Name of reinsurer</u>	<u>Standard and Poor's rating</u>	<u>% of total</u>
Munich Reinsurance Company	AA-/Stable	14.25%
Swiss Reinsurance Company	AA-/Watch Neg.	10.55%
Lloyd's Syndicates	A+/Stable	5.01%
Transatlantic Reinsurance Company	A+/Stable	3.98%
Swiss Re Frankona Reuckversicherungs AG	AA-/Watch Neg.	3.67%

(1) In February 2009, Swiss Reinsurance Company was downgraded by S&P to "A+" (Stable).

(2) The above excludes balances due from related parites.

The following table sets forth the ratings profile of the reinsurers that support the unpaid loss and loss expense recoverable and reinsurance balances receivable net of security noted above.

<u>Standard and Poor's rating</u>	<u>% of total</u>
AAA	7.5%
AA	46.3%
A	29.6%
BBB	0.8%
BB and below	0.1%
Captives	12.4%
Not Rated	0.4%
Other	2.9%
Total	<u>100%</u>

XL Insurance (Bermuda) Ltd

Notes to Consolidated Financial Statements (Continued)

For The Years Ended December 31, 2008 And 2007

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13. Reinsurance (continued)

AXA Agreement

On July 25, 2001, the Company completed the acquisition of certain Winterthur International insurance operations (the “Winterthur Business”) primarily to extend its predominantly North American-based large corporate insurance business globally. Under the terms of the Sale and Purchase Agreement, as amended, between the company and Winterthur Swiss Insurance Company (“WSIC”), (the “SPA”) WSIC provided the Company with post-closing protection with respect to third party reinsurance receivables and recoverables related to the acquisition of certain Winterthur International insurance operations (the “Winterthur Business”). Such protection was provided in the form of Sellers Retrocession Agreements and a Liquidity Facility.

On June 7, 2006, the company and subsidiaries, entered into an agreement (the “Agreement”) with WSIC. The purpose of this Agreement was to release all actual or potential disputes, claims or issues arising out of or related in any way to: (i) the Liquidity Facility and the Sellers Retrocession Agreements, as well as (ii) subject to certain exceptions, the SPA. The Agreement further provided for a four-year term, collateralized escrow arrangement (the “Fund”) of up to \$185 million (plus interest) to protect certain subsidiaries from future nonperforming third party reinsurance related to the Winterthur Business. The Fund was structured to align the parties’ interests by providing for any sums remaining in the Fund at the end of its term to be shared in agreed percentages.

On December 16, 2008, the Company entered into an agreement with AXA Insurance Ltd (the successor company to WSIC) (“AXA”), (the “AXA Agreement”). The AXA Agreement releases to the parties all funds from the Fund that was put in place in June 2006 as described above and releases both parties from all further obligations thereunder. Since the Fund was created, the Company was able to successfully collect more than 95% of such third-party reinsurance receivables on paid claims enabling the Company to agree with AXA to terminate the Fund early.

The AXA Agreement provided that the Fund, which contained approximately \$172 million as at December 16, 2008, be terminated and that the Company be paid a greater share of the remaining funds than was originally agreed. In return, the Company released AXA, subject to certain exceptions, from the SPA, as amended, between the Company and AXA, and commuted AXA’s share of various reinsurance contracts where AXA reinsured subsidiaries of the Company relating to certain parts of the Winterthur Business. In addition, the Company and AXA reached a definitive claims handling agreement governing defined Excluded Winterthur Business, including asbestos claims and business written prior to 1986, which remain the financial responsibility of AXA. In connection with the execution of the AXA Agreement and the adjustment of related provisions, the Company recorded income of approximately \$80.9 million in 2008, which was recorded as favorable net prior year development.

14. Deposit Liabilities

At December 31, 2008, deposit liabilities include remaining funding agreement contracts as well as reinsurance and insurance deposits. Previously, deposit liabilities included GICs. As at December 31, 2007, the Company had approximately \$4.0 billion of deposit liabilities associated with GICs which were correspondingly matched with invested assets. Based on the terms and conditions of the underlying GICs, upon the downgrade of Syncora Guarantee below certain ratings levels, all or portions of outstanding principal balances on such GICs would come due.

XL Insurance (Bermuda) Ltd

Notes to Consolidated Financial Statements (Continued)

For The Years Ended December 31, 2008 And 2007

(Expressed in Thousands Of U.S. dollars)

14. Deposit Liabilities (Continued)

Throughout 2008, several rating agencies downgraded Syncora and its subsidiaries and, as a result, the Company settled, in 2008 all of the GIC liabilities. In addition, certain funding agreement contracts matured, resulting in the settlement of the underlying principal and accrued interest. At December 31, 2008, the remaining balance of funding agreements, excluding accrued interest of \$6.6 million, was \$600.0 million, with settlements scheduled as follows: \$150.0 million in October 2009 and \$450.0 million in August 2010.

Funding agreements and GICs do not meet the definition of an insurance contract under FASB Statement of Financial Accounting No. 97. These contracts were sold with a guaranteed rate of return and the proceeds from the sale of such contracts were invested with the intent of realizing a greater return than is called for in the investment contracts. The Company has also entered into certain insurance and reinsurance policies that transfer insufficient risk under FASB Statement of Financial Accounting Standards No. 113 to be accounted for as insurance or reinsurance transactions and are deposit accounted. These structured property and casualty agreements, guaranteed investment contracts and funding 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. 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.

As at December 31, 2008 and 2007, total deposit liabilities are comprised of the following:

	<u>2008</u>	<u>2007</u>
Reinsurance and insurance deposit liabilities	\$ 757,009	\$ 630,862
Guaranteed investment contract deposit liabilities	902,235	6,174,602
Total deposit liabilities	<u>\$ 1,659,244</u>	<u>\$ 6,805,464</u>

Interest expense of \$119.2 million and \$370.9 million was recorded related to the accretion of deposit liabilities for the years ended December 31, 2008 and 2007, respectively.

15. Future Policy Benefit Reserves

The Company enters into long duration contracts that subject the Company to mortality and morbidity risks and which 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 4.2% and 4.3% at December 31, 2008 and 2007, respectively. Total future policy benefit reserves for the year ended December 31, 2008 and 2007 were \$3.0 billion and \$3.8 billion, respectively, with the decrease of \$0.8 billion mainly resulting from the strengthening of the U.S. dollar against the U.K. Pound Sterling in 2008.

XL Insurance (Bermuda) Ltd

Notes to Consolidated Financial Statements (Continued)

For The Years Ended December 31, 2008 And 2007

(Expressed in Thousands Of U.S. dollars)

15. Future Policy Benefit Reserves (continued)

Future policy benefit reserves are comprised of the following:

Year ended December 31, (U.S. dollars in thousands)	2008	2007
Traditional life.....	\$ 822,421	\$ 765,422
Annuities	2,140,811	3,021,252
Total future policy benefit reserves	<u>\$ 2,963,232</u>	<u>\$ 3,786,674</u>

16. Notes Payable and Debt and Financing Arrangements

As at December 31, 2008, the Company and several of its subsidiaries, in conjunction with XL Capital, had bank, letter of credit and loan facilities available from a variety of sources including commercial banks, totaling \$7.4 billion (2007: \$7.6 billion), of which \$2.2 billion (2007: \$2.2 billion) of debt and letters of credit were outstanding and in use. This includes \$2.2 billion (2007: \$2.0 billion) of outstanding letters of credit, 0.02% (2007: 0.12%) of which were collateralized by the Company's investment portfolio, primarily supporting U.S. non-admitted business and quota share agreements between affiliates.

The financing structure at December 31, 2008 was as follows:

Facility

	<u>Commitment (1)</u>	<u>In Use/ Outstanding (1)</u>
Debt:		
5-year revolvers expiring 2010/2012 (2)	1,000,000	-
5-year revolver expiring 2010	100,000	-
	<u>\$ 1,100,000</u>	<u>\$ -</u>
Letters of Credit:		
4 facilities—total.....	<u>\$ 6,250,423</u>	<u>\$ 2,148,508</u>
(1) "Commitment" and "In Use" data represent December 31, 2008 accreted values		
(2) The 2010 and 2012 5-year revolving credit facilities share a \$1 billion revolving credit sub-limit.		

The revolving credit facilities were unutilized at December 31, 2008.

The financing structure at December 31, 2007 was as follows:

Facility

	<u>Commitment (1)</u>	<u>In Use/ Outstanding (1)</u>
Debt:		
5-year revolvers expiring 2010/2012 (2)	1,000,000	-
5-year revolver expiring 2010	100,000	-
6.58% Guaranteed Senior Notes due 2011	255,000	255,000
	<u>\$ 1,355,000</u>	<u>\$ 255,000</u>
Letters of Credit:		
8 facilities—total.....	<u>\$ 6,252,270</u>	<u>\$ 1,957,142</u>
(1) "Commitment" and "In Use" data represent December 31, 2007 accreted values		
(2) The 2010 and 2012 5-year revolving credit facilities share a \$1 billion revolving credit sub-limit.		

XL Insurance (Bermuda) Ltd

Notes to Consolidated Financial Statements (Continued)

For The Years Ended December 31, 2008 And 2007

(Expressed in Thousands Of U.S. dollars)

16. Notes Payable and Debt and Financing Arrangements (continued)

The revolving credit facilities were unutilized at December 31, 2007.

In August 2008, the Company redeemed X.L. America, Inc.'s \$255 million 6.58% Guaranteed Senior Notes due 2011. In connection with the early redemption of the 6.58% Notes, the Company incurred debt extinguishment costs of approximately \$22.5 million.

On June 22, 2007, three facilities expired – a \$2 billion three-year unsecured credit and letter of credit facility issued in 2004, a \$500 million 364-day letter of credit facility issued in 2006, and a bilateral 364-day \$100 million credit and letter of credit facility issued in 2006.

On June 22, 2007, the Company closed a new \$4 billion unsecured revolving credit and letter of credit facility. The new facility has a term of five years. The facility is available in the form of revolving credit in the amount of \$1 billion (such limit is shared with the Company's other syndicated revolving credit facility that closed in June 2005) and in the form of letters of credit in the aggregate amount of \$4 billion.

On December 31, 2007, a \$150 million unsecured letter of credit facility expired and was not replaced.

On December 19, 2006, the Company replaced a \$150 million letter of credit facility that matured in December 2006 with a new 364-day facility of the same amount.

On December 16, 2006, the Company replaced a \$100 million credit facility that matured in December 2006 with a new 364-day facility of the same amount.

The Company has several letter of credit facilities provided on a syndicated and bilateral basis from commercial banks. These facilities are utilized to support non-admitted insurance and reinsurance operations in the U.S and capital requirements at Lloyd's. The commercial facilities are scheduled for renewal during 2009 through 2012. In addition to letters of credit, the Company has established insurance trusts in the U.S. that provide cedents with statutory relief required under state insurance regulation in the U.S. It is anticipated that the commercial facilities will be renewed on expiry but such renewals are subject to the availability of credit from banks utilized by the Company. In the event that such credit support is insufficient, the Company could be required to provide alternative security to cedents. 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.

Of the letters of credit outstanding at December 31, 2008, \$0.4 million (2007: \$2.3 million) were collateralized against the Company's investment portfolio and \$2.2 billion (2007: \$2.0 billion) were unsecured.

Associated with the Company's bank and loan commitments are various covenants that include, among other things, the requirement to maintain a minimum credit and financial strength rating and a minimum amount of consolidated shareholders' equity. The Company was in compliance with these covenants throughout 2008 and 2007.

17. Derivative Instruments

The Company enters into derivative instruments for both risk management and speculative purposes. The Company is exposed to potential loss from various market risks, and manages its market risks based on guidelines established by management. 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

XL Insurance (Bermuda) Ltd

Notes to Consolidated Financial Statements (Continued)

For The Years Ended December 31, 2008 And 2007

(Expressed in Thousands Of U.S. dollars)

17. Derivative Instruments (continued)

derivatives are designated as hedging instruments. The accounting for derivatives which are designated as hedging instruments is described in Note 3(g), Derivative Instruments. The following table summarizes these instruments by category and the effect on net income in the years ended December 31, 2008 and 2007.

	2008	2007
Investment related derivatives (1):	\$ (663)	\$ (42,070)
Credit risk:	732	(28,892)
Other non-investment derivatives	(22,923)	(5,402)
Weather and energy derivatives:	10,606	19,636
Net realized and unrealized gains on derivatives	\$ (12,248)	\$ (56,728)

(1) Includes derivatives entered into by the Company's investment portfolio managers including credit default swaps.

(a) 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), as a means of hedging exposure to interest rate, equity price change and foreign currency risk or for trading purposes.

Investment Related Derivatives - Foreign Exchange Exposure

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 and equity securities investments. 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. In addition, certain of the Company's investment managers may, subject to investment guidelines, enter into forward contracts where potential gains may exist. The Company has exposure to foreign currency exchange rate fluctuations through its operations and in its investment portfolio. In relation to foreign exchange contracts, the Company had a net payable of \$0.01 million and \$0.10 million, at December 31, 2008 and 2007, respectively, and the Company recorded net losses of \$55.2 million and \$9.3 million during the years ended December 31, 2008 and, 2007, respectively.

Investment Related Derivatives - Interest Rate Exposure

The Company utilizes a risk management strategy that incorporates the use of derivative financial instruments, primarily to reduce its exposure to interest rate risks associated with certain of its assets and liabilities. 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. The Company is exposed to credit risk in the event of non-performance by the counterparties to the swap contracts.

XL Insurance (Bermuda) Ltd

Notes to Consolidated Financial Statements (Continued)

For The Years Ended December 31, 2008 And 2007

(Expressed in Thousands Of U.S. dollars)

17. Derivative Instruments (continued)

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.

A portion of the Company's liabilities are hedged against changes in the applicable designated benchmark interest rate. In addition, 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. At December 31, 2008 and 2007, contracts designated as fair value hedges were in a net unrealized gain position of \$373.5 million and \$143.3 million, respectively. As a result of the fair value hedges, deposit liabilities were increased by \$242.3 million and \$92.4 million at December 31, 2008 and 2007, respectively. These interest rate swap hedges resulted in a net decrease in net investment income (net of interest expense) of \$24.2 million for the year ended December 31, 2008, and a net increase of \$14.5 million for the year ended December 31, 2007. The ineffective portion of the hedges totaled \$21.7 million and \$1.0 million as part of net realized losses for the years ended December 31, 2008 and 2007, respectively.

(a) Investment Related Derivatives

Interest rate swaps were previously used to hedge a portion of the Company's floating rate guaranteed investment contracts. These derivatives converted the floating rate guaranteed investment contract payments to a different floating rate basis to better match the cash receipts that were earned from the supporting investment portfolio. At December 31, 2008, there were no longer any guaranteed investment contracts outstanding and accordingly no cash flow hedges were in place. At December 31, 2007, contracts designated as cash flow hedges were in a net unrealized gain position of \$3.0 million. These interest rate swap hedges resulted in a reduction in interest expense of \$2.8 million and \$6.0 million for the years ended December 31, 2008 and 2007. The ineffective portion of the hedges amounted to \$3.0 million and \$8.4 million as part of net realized losses for the years ended December 31, 2008 and 2007, respectively.

Investment Related Derivatives - Financial Market Exposure

The Company also uses bond and stock index futures to add value to the portfolio where market inefficiencies are believed to exist, to equitize cash holdings of equity managers and to adjust the duration of a portfolio of fixed income securities to match the duration of related deposit liabilities. These instruments are marked to market on a daily basis and changes in fair values are recorded through net realized and unrealized gains and losses on derivative instruments. The Company measures potential losses in fair values using various statistical techniques.

Credit derivatives are purchased within the Company's investment portfolio in the form of credit default swaps used to hedge an existing position or concentration of holdings. The credit derivatives are recorded at fair value sourced from pricing vendors.

(b) Credit Risk

Credit derivatives are purchased within the Company's investment portfolio as noted above, have been sold through a limited number of contracts written as part of the Company's previous XL Financial Solutions business, and were previously entered into through the Company's prior reinsurance agreements with Syncora, as described below. From time to time,

XL Insurance (Bermuda) Ltd

Notes to Consolidated Financial Statements (Continued)

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(Expressed in Thousands Of U.S. dollars)

17. Derivative Instruments (continued)

(b) Credit Risk (continued)

the Company may purchase credit default swaps to hedge an existing position or concentration of holdings. The credit derivatives are recorded at fair value. Following the secondary sale of Syncora common shares, the Company retained some credit derivative exposures written by Syncora and certain of its subsidiaries through reinsurance agreements that had certain derivatives exposures embedded within them. Subsequent to June 6, 2007, the Company received Syncora related derivative fair values from Syncora management and reviewed the methodology applied in developing those estimates. In addition, the change in value of the derivative portion of the financial guarantee reinsurance agreements the Company had with Syncora was included in "Net (loss) income from operating affiliates." Following the closing of the Master Agreement which terminated certain reinsurance and other agreements, these credit derivative exposures were eliminated by virtue of the commutation of the relevant reinsurance agreements. As of December 31, 2008, the remaining credit derivative exposure outside of the Company's investment portfolio consisted of 23 contracts written by the Company that provide credit protection on senior tranches of structured finance transactions with total net par values outstanding of \$639.5 million, a weighted average contractual term to maturity of 5.7 years, a total liability recorded of \$28.6 million, and an average rating of AA on the underlying obligations. As of December 31, 2008, there have been no reported events of default on the underlying obligations.

Valuation of investment related credit derivatives is based on portfolio manager sourced valuations. In determining the fair value of credit derivatives written within financial operations, management differentiates between investment and non-investment grade exposures and models them separately. Management estimates fair value for investment grade exposures by monitoring changes in credit quality and selecting appropriate market indices to determine credit spread movements over the life of the contracts. The determination of the credit spread movements is the basis for calculating the fair value. For credit derivatives that are non-investment grade appropriate market indices are not readily available. Accordingly, the Company uses an alternative fair value methodology. Under this methodology, the fair value is determined using a cash flow model developed by the Company which is dependent upon a number of factors, including changes in interest rates, future default rates, credit spreads, changes in credit quality, future expected recovery rates and other market factors. For certain credit derivatives sold within the Financial Solutions business providing protection on senior tranches of structured finance transactions, the fair values are obtained directly from the investment bank counterparty. In general, the Company holds credit derivatives to maturity. Accordingly, changes in the fair value of such credit derivatives are unrealized.

(c) Other Non-Investment Derivatives

The Company holds warrants in conjunction with certain of its other investments. These warrants are recorded at fair value based on quoted market prices, where available.

In addition, the Company enters into derivatives as part of its contingent capital facilities including put options, interest rate swaps, and asset return swaps. These derivatives are recorded at fair value with changes in fair value recognized in earnings.

The Company also has investment related derivatives embedded in certain reinsurance contracts. For a particular life reinsurance contract, the Company pays the ceding company a fixed amount equal to the estimated present value of the excess of guaranteed benefit GMIB 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. At December 31,

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Notes to Consolidated Financial Statements (Continued)

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17. Derivative Instruments (continued)

(c) Other Non-Investment Derivatives (Continued)

2008 and 2007, the fair value was represented by liabilities of \$71.4 million and \$62.0 million, respectively. The change in fair value recorded for the GMIB was a loss of \$9.5 million and \$0.9 million for the year ended December 31, 2008 and 2007 respectively. 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 instrument. The change in fair value recorded for these agreements was not material for any of the years ended December 31, 2008 or 2007.

(d) Weather and Energy Derivatives

Weather and energy derivatives are recorded at fair value, which is determined through the use of quoted market prices where available. Where quoted market prices are unavailable, the fair values are estimated using available market data and internal pricing models based upon consistent statistical methodologies. Estimating fair value of instruments that do not have quoted market prices requires management's judgment in determining amounts that could reasonably be expected to be received from, or paid to, a third party in settlement of the contracts. The amounts could be materially different from the amounts that might be realized in an actual sale transaction. Fair values are subject to change in the near-term and reflect management's best estimate based on various factors including, but not limited to, actual and forecasted weather conditions, changes in commodity prices, changes in interest rates and other market factors. The change in fair value recorded for the weather and energy derivatives was a gain of \$10.6 million and \$19.6 million for the years ended December 31, 2008 and 2007, respectively.

18. Variable Interest Entities

The Company utilizes variable interest entities both indirectly and directly in the ordinary course of business. The Company invests in equity tranches (or similar instruments) of collateralized debt obligations ("CDOs"), collateralized bond obligations ("CBOs") and other investment vehicles that are issued through variable interest entities as part of the Company's risk asset portfolio. Certain collateral facilities and contingent capital facilities are also structured using variable interest entities, in which the Company has a variable interest. The Company was not the primary beneficiary of any of these entities. In addition, the Company does not believe that any of such interests would be characterized as significant to XL. The Company believes that the significance of the variability absorbed by XL as contemplated in paragraph 24 of FIN 46(R) must be considered in the context of XL Capital's consolidated financial statements. The Company considers the significance of its share of the entity's expected losses and expected residual returns in relation to the Company's consolidated results of operations, whether the Company holds a first loss portion in the entity, and the rating of its exposure and probability of loss.

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Notes to Consolidated Financial Statements (Continued)

For The Years Ended December 31, 2008 And 2007

(Expressed in Thousands Of U.S. dollars)

19. 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, 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”), investments balances.

The Company’s reinsurance assets at December 31, 2008 and 2007 amounted to \$12.6 billion and \$13.2 billion, respectively. Of this total \$8.5 billion and \$4.9 billion, at December 31, 2008 and 2007 respectively, resulted from reinsurance arrangements, with non-affiliated companies, 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.

The Company’s available for sale investment portfolio is managed by external managers in accordance with guidelines that have been tailored to meet specific investment strategies, including standards of diversification, which limit the allowable holdings of any single issue. The Company did not have an aggregate investment in a single entity, other than the U.S. government, in excess of 10% of the Company’s shareholders’ equity at December 31, 2008 and 2007.

In addition, the Company underwrites a significant amount of its general 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 2008 and 2007, approximately 17.0% and 19.3%, respectively, of the Company’s consolidated gross written premiums from property and casualty operations were generated from or placed by Marsh & McLennan Companies. During 2008 and 2007, approximately 16.6% and 18.4%, respectively, of the Company’s consolidated gross written premiums from property and casualty operations were generated from or placed by AON Corporation and its subsidiaries. Both of these companies are large, well established companies and there are no indications that either of them is financially troubled. No other broker and no one insured or reinsured accounted for more than 10% of gross premiums written from property and casualty operations in each of the two years ended December 31, 2008 and December 31, 2007.

(b) Other Investments

The Company has committed to invest in several limited partnerships as part of its overall corporate strategy. As of December 31, 2008, the Company has commitments, which include potential additional add-on clauses, to invest a further \$46.5 million over the next five years.

XL Insurance (Bermuda) Ltd

Notes to Consolidated Financial Statements (Continued)

For The Years Ended December 31, 2008 And 2007

(Expressed in Thousands Of U.S. dollars)

19. Commitments and Contingencies (continued)

(c) Investment 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 add-on clauses, to invest a further \$18.3 million over the next five years.

(d) Properties

The Company rents space for certain of its offices under leases which expire up to 2025. Total rent expense under operating leases for the years ended December 31, 2008 and 2007 was approximately \$40.5 million and \$34.1 million, respectively.

Future minimum rental commitments under existing operating leases are expected to be as follows:

Year ending December 31:	2009	\$	36,316
	2010		29,472
	2011		25,556
	2012		22,013
	2013		18,255
	Years 2014-2031		<u>81,791</u>
Total minimum future rentals			<u>\$213,403</u>

During 2003, XL Capital Ltd entered into a purchase, sale and leaseback transaction to acquire new office space in London. The Company has recognized a capital lease asset of \$129.3 million and \$160.8 million, while an affiliated company has recognized a deferred gain of \$34.2 million and \$48.9 million related to the sale at December 31, 2003, related to this lease at December 31, 2008 and 2007, 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 \$242.9 million and annually for the next five years are as follows:

Year Ended December 31:	
2009.....	\$ 9,818
2010.....	10,064
2011.....	10,315
2012.....	10,573
2013.....	10,838
2014-2028.....	<u>191,253</u>
Total future minimum lease payments	<u>242,861</u>

(e) Tax Matters

The Company is incorporated in Bermuda and, except as described below, neither it nor its non-U.S. subsidiaries have paid United States 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

XL Insurance (Bermuda) Ltd

Notes to Consolidated Financial Statements (Continued)

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(Expressed in Thousands Of U.S. dollars)

19. Commitments and Contingencies (continued)

(e) Tax Matters (continued)

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 30% “branch profits” tax 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, 2008 and 2007, \$2.2 billion and \$2.0 billion of letters of credit were outstanding respectively, 0.01% (2007: 0.12%) of which were collateralized by the Company’s investment portfolio, primarily supporting U.S. non-admitted business. In addition, the Company is a guarantor of letter of credit facilities, which primarily support XL Capital’s Lloyd’s Syndicates’ capital requirements and U.S. non-admitted business of affiliates. These facilities totaled \$0.6 billion and \$1.1 billion at December 31, 2008 and 2007, respectively, of which \$593.0 million and \$843.1 million were outstanding. See Note 14 for further information.

(g) Claims and Other Litigation

The Company is subject to litigation and arbitration in the normal course of its 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 legal 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, amongst 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. If management believed, based on available information, that an adverse outcome upon resolution of a given legal action was probable and the amount of that adverse outcome was reasonable to estimate, a loss would be recognized and a related liability recorded. No such liabilities were recorded by the Company at December 31, 2008 and 2007. In addition, the Company believes that the expected ultimate outcome of all outstanding litigation and arbitration will not have a material adverse effect on its consolidated financial condition, operating results and/or liquidity, although an adverse resolution of one or more of these items could have a material adverse effect on the Company’s results of operations in a particular fiscal quarter or year. The following information highlights ongoing legal proceedings related to the Company.

In November 2006, a subsidiary of the Company received a grand jury subpoena from the Antitrust Division of the U.S. Department of Justice (“DOJ”) and a subpoena from the SEC, both

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Notes to Consolidated Financial Statements (Continued)

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19. Commitments and Contingencies (continued)

(g) Claims and Other Litigation (continued)

of which sought documents in connection with an investigation into the municipal guaranteed investment contract (“GIC”) market and related products. In June 2008, subsidiaries of the Company also received a subpoena from the Connecticut Attorney General and an Antitrust Civil Investigative Demand from the Office of the Florida Attorney General in connection with a coordinated multi-state Attorneys General investigation into the matters referenced in the DOJ and SEC subpoenas. The Company is fully cooperating with these investigations.

Commencing in March 2008, the company’s parent, XL Capital Ltd, and two of the company’s subsidiaries were named, along with approximately 20 other providers and insurers of municipal Guaranteed Investment Contracts and similar derivative products in the U.S. (“collectively Municipal Derivatives”) as well as fourteen brokers of such products, in several purported federal antitrust class actions. The Judicial Panel on Multidistrict Litigation ordered that these be consolidated for pretrial purposes and assigned them to the Southern District of New York. The consolidated amended complaint filed in August 2008 alleges that there was a conspiracy among the defendants during the period from January 1, 1992 to the present to rig bids and otherwise unlawfully decrease the yield for Municipal Derivative products. The purported class of plaintiffs consists of purchasers of Municipal Derivatives. On October 21, 2008 most of the defendants filed motions to dismiss the consolidated amended complaint, which motions were fully briefed as of January 21, 2009. In addition, the same two subsidiaries of the Company have been named in a number of similar actions filed by various municipalities in California state courts. The Defendants have removed those cases to federal court. The Plaintiffs have filed motions to remand, most of which have been denied but some of which remain pending. Certain of the cases originally filed in California state courts have been transferred to the Southern District of New York by the Judicial Panel on Multidistrict Litigation. The Company intends to vigorously defend these actions.

From time to time, the Company has also received and responded to additional requests from Attorneys General, state insurance regulators and federal regulators for information relating to the Company’s contingent commission arrangements with brokers and agents and/or the Company’s insurance and reinsurance practices in connection with certain finite-risk and loss mitigation products. Similarly, the Company’s affiliates outside the U.S. have, from time to time, received and responded to requests from regulators relating to the Company’s insurance and reinsurance practices regarding contingent commissions or finite-risk and loss mitigation products. The Company has fully cooperated with the regulators in these matters.

In August 2005, plaintiffs in a proposed class action (the “Class Action”) that was consolidated into a multidistrict litigation in the United States District Court for the District of New Jersey, captioned *In re Insurance Brokerage Antitrust Litigation*, MDL No. 1663, Civil Action No. 04-5184 (the “MDL”), filed a consolidated amended complaint (the “Amended Complaint”), which named as new defendants approximately 30 entities, including Greenwich Insurance Company, Indian Harbor Insurance Company and XL Capital Ltd. In the MDL, the Class Action plaintiffs asserted various claims purportedly on behalf of a class of commercial insureds against approximately 113 insurance companies and insurance brokers through which the named plaintiffs allegedly purchased insurance. The Amended Complaint alleged that the defendant insurance companies and insurance brokers conspired to manipulate bidding practices for insurance policies in certain insurance lines and failed to disclose certain commission arrangements and asserted statutory claims under the Sherman Act, various state antitrust laws and the Racketeer Influenced and Corrupt Organizations Act (“RICO”), as well as common law claims alleging breach of fiduciary duty, aiding and abetting a breach of fiduciary duty and unjust

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Notes to Consolidated Financial Statements (Continued)

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19. Commitments and Contingencies (continued)

(g) Claims and Other Litigation

enrichment. By Opinion and Order dated August 31, 2007, the Court dismissed the Sherman Act claims with prejudice and, by Opinion and Order dated September 28, 2007, the Court dismissed the RICO claims with prejudice. The plaintiffs then appealed both orders to the U.S. Court of Appeals for the Third Circuit. Oral argument before the appellate court is expected in April 2009.

Various subsidiaries of the company have been named as defendants in three of the many tag-along actions that have been consolidated into the MDL for pretrial purposes. These tag-along actions make allegations similar to the Amended Complaint but do not purport to be class actions. On April 4, 2006, a tag-along Complaint was filed in the U.S. District Court for the Northern District of Georgia on behalf of New Cingular Wireless Headquarters LLC and several other corporations against approximately 100 defendants, including Greenwich Insurance Company, XL Specialty Insurance Company, XL Insurance America, Inc., XL Insurance Company Limited, and XL Capital Ltd. (the "New Cingular Lawsuit"). On or about May 21, 2007, a tag-along Complaint was filed in the U.S. District Court for the District of New Jersey on behalf of Henley Management Company, Big Bear Properties, Inc., Northbrook Properties, Inc., RCK Properties, Inc., Kitchens, Inc., Aberfeldy LP and Payroll and Insurance Group, Inc. against multiple defendants, including "XL Winterthur International" (the "Henley Lawsuit"). On October 12, 2007, a Complaint in a third tag-along action, captioned Sears Roebuck & Co. v. Marsh & McLennan Companies, Inc., et al., No. 1:07-CV-2535 (the "Sears Lawsuit"), was filed in the U.S. District Court for the Northern District of Georgia by Sears, Roebuck & Co., Sears Holdings Corporation, Kmart Corporation and Lands' End Inc. Among the many named defendants are X.L. America, Inc., XL Insurance America, Inc., XL Specialty Insurance Company and XL Insurance (Bermuda) Ltd. The three tag-along actions are currently stayed.

Three purported class actions on behalf of shareholders of Syncora have been filed in the Southern District of New York against the Company and one of its subsidiaries (collectively "XL"), Syncora, four Syncora officers, and various underwriters of Syncora securities. The Judge ordered that these be consolidated. The consolidated amended complaint, filed in August 2008, alleges violations of the Securities Act of 1933 arising out of the secondary public offering of Syncora common shares held by XL on June 6, 2007 and sales/exchanges by Syncora of certain preferred shares as well as under the Securities Exchange Act of 1934 arising out of trading in Syncora securities during the asserted class period of March 15, 2007 to March 17, 2008. The principal allegations are that Syncora failed to appropriately and timely disclose its exposures under certain derivative contracts and insurance of tranches of structured securities. XL is named as a party that "controlled" Syncora during the relevant time period. On October 14, 2008, XL and other defendants filed motions to dismiss the consolidated amended complaint. Plaintiffs filed opposition briefs on December 22, 2008, and XL and the other defendants filed reply briefs on February 5, 2009. The Company intends to vigorously defend these actions.

In connection with the secondary offering of the Company's Syncora shares, the Company and Syncora each agreed to indemnify the several underwriters of that offering against certain liabilities, including liabilities under the Securities Act of 1933 for payment of legal fees and expenses, settlements and judgments incurred with respect to litigation such as this. The Company and Syncora have agreed to each bear 50% of this indemnity obligation.

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

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Notes to Consolidated Financial Statements (Continued)

For The Years Ended December 31, 2008 And 2007

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19. Commitments and Contingencies (continued)

(g) Claims and Other Litigation

or threatened legal actions. Based on available information, it is the opinion of management that the ultimate resolution of pending or threatened legal actions, both individually and in the aggregate, will not result in losses having a material effect on the Company's financial position at December 31, 2008.

20. Contributed Surplus

During 2008 and 2007, XL's parent company increased the Company's contributed surplus by \$2.3 billion and \$0.5 billion, respectively, through cash settlements.

21. Dividends

The Company paid dividends of \$Nil in 2008 and 2007.

22. 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.

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 salary 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 \$44.4 million and \$50.1 million in the years ended December 31, 2008 and 2007, respectively.

Defined benefit plans

A qualified non-contributory defined benefit pension plan exists to cover a number of its U.S. employees. This plan also includes a non-qualified supplemental defined benefit plan designed to compensate individuals to the extent their benefits under the Company's qualified plan are curtailed due to Internal Revenue 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. The projected benefit obligation, accumulated benefit obligation and fair value of the assets for this plan with accumulated benefit obligations in excess of the plan assets were \$32.1 million and \$32.1 million and \$12.9 million, respectively as of December 31, 2008 and \$29.1 million and \$29.1 million and \$19.2 million, respectively, as of December 31, 2007.

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 December 31, 2008 and 2007 was \$3.4 million and \$5.5 million, respectively, representing the entire unfunded projected benefit obligations.

XL Insurance (Bermuda) Ltd

Notes to Consolidated Financial Statements (Continued)

For The Years Ended December 31, 2008 And 2007

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23. Amounts Due from/(to) Parent and Affiliates

Affiliate balances payable and receivable are in respect of amounts due to and from companies within the XL Capital Group. The balances arise as a result of the Company's operating and investing activities. All amounts are due on demand and are non interest bearing. The net inter-company receivable as at December 31, 2008 was \$299.6 million (2007: \$1,208.7 million).

During 2008, the company received \$789.7 million from its ultimate parent company, reducing the inter-company balance receivable from that entity as at December 31, 2008 to \$814.8 million (2007: \$1,604.5 million). The company has an inter-company balance receivable from its immediate parent company of \$10.3 million as at December 31, 2008 (2007: payable of \$5.8 million). The company has a net inter-company balance payable to affiliates of \$525.5 million as at December 31, 2008 (2007: receivable of \$390.0 million).

XL Insurance (Bermuda) Ltd

Notes to Consolidated Financial Statements (Continued)

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24. Accumulated Other Comprehensive Income

The movement in accumulated other comprehensive income balances for the years ended December 31, 2008 and 2007, are as follows:

	2008	2007
Balance – beginning of year	(31,016)	\$ 106,358
Net change in unrealized gains (losses) on investments, net of tax.....	(499,404)	(473,645)
Additional pension liability	(2,582)	3,255
Realized loss on sale of SCA	-	4,954
Foreign currency translation adjustments.....	(399,148)	328,062
Balance - end of year	<u>\$ (932,150)</u>	<u>\$ (31,016)</u>

The related tax effects allocated to each component of other comprehensive income were as follows:

Year ended December 31, 2008	Before Tax amount	Tax Expense (Benefit)	Net of Tax amount
Unrealized gains on investments:			
Unrealized gains (losses) arising during year.....	(1,213,282)	53,591	(1,266,873)
Less reclassification adjustment for gains (losses) realized in income	<u>(762,080)</u>	<u>5,389</u>	<u>(767,469)</u>
Net unrealized (loss)/ gains on investments.....	(451,202)	48,202	(499,404)
Additional pension liability	(2,582)	-	(2,582)
Foreign currency translation adjustments.....	<u>(396,707)</u>	<u>2,441</u>	<u>(399,148)</u>
Change in accumulated other comprehensive income	<u>\$ (850,491)</u>	<u>\$50,643</u>	<u>\$ (901,134)</u>

Year ended December 31, 2007

Unrealized gains on investments:			
Unrealized gains (losses) arising during year...	(924,643)	(15,359)	(909,285)
Less reclassification adjustment for gains (losses) realized in income	<u>(474,582)</u>	<u>(38,942)</u>	<u>(435,640)</u>
Net unrealized gains on investments.....	(450,061)	23,584	(473,645)
Additional pension liability	3,255		3,255
Realized gain (loss) on sale of SCA.....	4,954		4,954
Foreign currency translation adjustments.....	310,667	(17,395)	328,062
Change in accumulated other comprehensive income	<u>\$ (131,185)</u>	<u>\$ 6,189</u>	<u>(137,374)</u>

XL Insurance (Bermuda) Ltd

Notes to Consolidated Financial Statements (Continued)

For The Years Ended December 31, 2008 And 2007

(Expressed in Thousands Of U.S. dollars)

25. 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 Company and its Bermuda subsidiaries would be exempted from any such tax until March 2016 pursuant to the Bermuda Exempted Undertakings Tax Protection Act of 1966, and Amended Act of 1987.

The Company's Indian Subsidiary is not subject to certain income and capital gains taxes under current Indian law. This subsidiary is exempt from these taxes until March 31, 2010 pursuant to the Income Tax Act 1961. The subsidiary is subject to a Minimum Alternative Tax as of April 1, 2007.

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 Internal Revenue Code and Regulations thereunder. Should the U.S. subsidiaries pay a dividend to the Company, withholding taxes will apply.

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, India, Luxembourg and various countries in Latin America that are subject to relevant taxes in those jurisdictions.

Deferred income taxes have not been accrued with respect to 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 state of the paying entity. Currently however, no withholding taxes are accrued with respect to the earnings, as it is the intention that such earnings will remain reinvested indefinitely. The company has a 50% interest in an affiliate, the undistributed earnings of which are recognized for deferred tax as earned.

The Company adopted the provisions of FASB Interpretation No. 48 ("FIN 48"), 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 the implementation of FIN 48.

The Company has open examinations by tax authorities in Germany, France and Ireland. In addition the Company has been notified by the U.S. taxation authority of its intention to audit the Company's U.S. income tax returns. The Company believes that these examinations will be concluded within the next 12 months; however, it is not currently possible to estimate the outcome of these examinations.

The Company's policy is to recognize any interest accrued related to unrecognized tax benefits as a component of interest expense and penalties in the tax charge. As at December 31, 2008, the Company has accrued liabilities, relating to interest and penalties, of \$1.0 million.

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Notes to Consolidated Financial Statements (Continued)

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25. Taxation (continued)

The income tax provisions for the years ended December 31, 2008 and 2007 are as follows:

	2008	2007
Current expense :		
U.S.....	\$ 118,411	\$ 120,325
Non U.S.....	<u>56,349</u>	<u>133,550</u>
Total current expense.....	<u>174,760</u>	<u>253,875</u>
Deferred expense (benefit):		
U.S.....	(8,534)	16,270
Non U.S.....	<u>25,044</u>	<u>47,977</u>
Total deferred expense	<u>16,510</u>	<u>31,707</u>
Total tax expense	<u>\$ 191,270</u>	<u>\$ 222,168</u>

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. Reconciliation of the difference between the provision for income taxes and the expected tax provision at the weighted average tax rate for the years December 31, 2008 and 2007 is provided below:

	2008	2007
Expected tax provision at weighted average rate	(17,434)	\$ 45,548
Permanent differences:		
Non taxable income.....	(12,316)	(1,562)
Prior year adjustments.....	(18,649)	23,538
State, local and foreign taxes.....	51,183	24,325
Valuation allowance.....	192,703	84,323
Stock options.....	3,401	7,489
Transfer pricing adjustments.....	(13,274)	10,198
Non deductible expenses.....	5,656	12,291
Contingency reserve.....	-	1,106
Non deductible losses.....	-	12,000
Other.....	-	<u>2,912</u>
Total tax expense (benefit).....	<u>\$191,270</u>	<u>\$ 222,168</u>

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Notes to Consolidated Financial Statements (Continued)

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25. Taxation (continued)

Significant components of the Company's deferred tax assets and liabilities as of December 31, 2008 and 2007 were as follows:

	2008	2007
Deferred tax asset:		
Net unpaid loss reserve discount.....	\$ 100,816	\$ 43,142
Net unearned premiums.....	50,898	66,743
Compensation liabilities.....	46,649	29,787
Net operating losses.....	244,820	277,010
Currency translation adjustments.....	2,440	-
Investment adjustments.....	10,411	14,723
Deferred commission revenue.....	4,237	48,649
Pension.....	7,079	6,116
Bad debt reserve.....	3,600	9,472
Net unrealized depreciation on investments.....	131,036	100,829
Guaranty fund recoupment.....	3,008	5,195
Depreciation.....	22,898	16,429
Net unrealized capital losses.....	84,000	66,047
Capital Losses.....	196,308	29,550
Stock options.....	8,679	3,896
Other.....	<u>16,018</u>	<u>19,390</u>
Deferred tax asset, gross of valuation allowance.....	932,897	736,978
Valuation allowance.....	<u>551,653</u>	<u>370,510</u>
Deferred tax asset, net of valuation allowance.....	<u>\$381,244</u>	<u>\$366,468</u>
Deferred tax liability:		
Net Unrealized appreciation on investments.....	\$ 11,627	\$ 2,488
Deferred acquisition costs.....	11,057	4,135
Unremitted earnings.....	524	-
Currency translation adjustments.....	-	17,821
Deferred gains on investments.....	12,574	-
Investment adjustments.....	135	-
Regulatory reserves.....	43,089	39,409
Other.....	<u>2,460</u>	<u>2,587</u>
Deferred tax liability.....	<u>81,466</u>	<u>66,440</u>
Net deferred tax asset.....	<u>\$299,778</u>	<u>\$300,028</u>

The valuation allowance at December 31, 2008 and December 31, 2007 of \$551.6 million and \$370.5million, respectively, relates to net operating loss carry-forwards in Switzerland and net unrealized capital losses and realized capital loss carryforwards in the U.S that may not be realized within a reasonable period. As of December 31, 2008, the Company has net unrealized capital losses and realized capital loss carry forwards of approximately \$134.6 million and \$196.3 million respectively in the U.S., against which a valuation allowance of \$327.4 million has been established. Included within the capitalized realized losses are \$173.7 million of losses arising from the sale of investments to a group company, against which a valuation allowance of \$173.7 million has been established. These losses cannot be utilized to offset any future U.S. realized gains until the underlying assets have been sold to unrelated parties. Management believes it is more likely than not that the tax benefit of the remaining net deferred tax assets will be realized.

As of December 31, 2008, net operating loss carryforwards in Switzerland were approximately \$1,068.2 million and will expire in future years through 2015.

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Notes to Consolidated Financial Statements (Continued)

For The Years Ended December 31, 2008 And 2007

(Expressed in Thousands Of U.S. dollars)

25. Taxation (continued)

Management is required to determine if there is sufficient positive evidence to conclude that it is more likely than not that the deferred tax asset attributable to its U.K. group net operating losses would be utilized within a reasonable period. Management has reviewed historical taxable income and future taxable income projections for the U.K. group and has determined that in its judgment, the net operating losses will more likely than not be realized as reductions of future taxable income within a reasonable period. Specifically with regard to the U.K. group, management has determined that the projected U.K. group taxable income (using U.K. rules for group loss relief) will be sufficient to utilize the net operating losses of approximately \$96.7 million. 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 net deferred tax asset, in the amount of \$27.1 million.

Shareholders' equity at December 31, 2008 and 2007 reflects tax benefits of \$1.1 million and \$2.4 million, respectively, related to compensation expense deductions for stock options exercised for one of the Company's U.S. subsidiaries.

26. Statutory Financial Data

The Company's ability to pay dividends is subject to certain regulatory restrictions on the payment of dividends by its subsidiaries. The payment of such dividends is limited by applicable laws and statutory requirements of the various countries the Company operates in, including Bermuda, the U.S., Ireland and the U.K., among others. Statutory capital and surplus for the principal operating subsidiaries of the Company for the years ended December 31, 2008 and 2007 is summarized below. 2008 information is preliminary as many regulatory returns are due later in 2009 for many jurisdictions in which the company does business.

	Bermuda (3)		U.S.(1)		U.K., Europe and Other	
	December 31		December 31		December 31	
	2008	2007	2008	2007	2008	2007
Required statutory capital and surplus	\$ 2,054,455	\$ 593,262	\$ 608,128	\$ 638,340	\$ 904,595	\$ 562,778
Actual statutory capital and surplus(2)	\$ 6,504,254	\$ 5,770,751	\$ 2,319,107	\$ 2,044,480	\$ 2,879,319	\$ 2,888,748

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

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

(3) Required statutory capital and surplus represents 100% BSCR level for the company.

The difference between statutory financial statements and statements prepared in accordance with GAAP vary 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 and any unauthorized/authorized reinsurance charges.

Certain statutory restrictions on the payment of dividends from retained earnings by the Company's subsidiaries are further detailed below:

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Notes to Consolidated Financial Statements (Continued)

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26. Statutory Financial Data (continued)

Bermuda Operations

In early July, 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. (Re)insurers 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, 2008. The Company's capital requirements 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.

Under the Insurance Act 1978, amendments thereto and Related Regulations of Bermuda, the Company is restricted as to the payment of dividends for amounts greater than 25% of its prior year's statutory capital and surplus whereby a signed affidavit by at least two members of the Board of Directors attesting that a dividend in excess of this amount would not cause the company to fail to meet its relevant margins is required. At December 31, 2008 and 2007, the maximum dividend that the company could pay, without a signed affidavit, having met minimum levels of statutory capital and surplus and liquidity requirements, was approximately \$1.1 billion and \$1.4 billion, respectively.

U.S. Property and Casualty 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 which in any twelve month period exceed 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, 2008 and 2007, XLRA had statutory earned surplus of \$287.8 million and \$91.3 million, respectively. At December 31, 2008, XLRA's statutory policyholders' surplus was \$2.3 billion, and accordingly, the maximum amount of dividends XLRA can declare and pay in 2009, without prior regulatory approval, is \$231.9 million. At December 31, 2008, one of the seven property & casualty subsidiaries directly or indirectly owned by XLRA had a statutory earned deficit of \$5.8 million and three of the seven subsidiaries had statutory earned deficits ranging from \$1.7 million to \$21.5 million at December 31, 2007.

International Operations

The Company's international subsidiaries prepare statutory financial statements based on local laws and regulations. Some jurisdictions impose complex regulatory requirements on insurance companies while other jurisdictions impose fewer requirements. In some countries, the Company must obtain licenses issued by governmental authorities to conduct local insurance business. These licenses may be subject to 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

XL Insurance (Bermuda) Ltd

Notes to Consolidated Financial Statements (Continued)

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26. Statutory Financial Data (continued)

International Operations (continued)

Bermuda is held in Ireland (\$1.6 billion) and the U.K (\$919.2 million). Dividends from the U.K. and Ireland are limited to the equivalent of retained earnings. As a part of the restructuring that established XL Re (Europe), the Company is required to notify the regulator in order to reduce capital levels below \$1.5 billion in Ireland.

Statutory Capital and Rating Agencies

In addition to maintaining adequate levels of statutory capital at its principal operating subsidiaries, the Company's ability to underwrite business is dependent upon the quality of its principal operating subsidiaries' claims and financial strength ratings as evaluated by independent rating agencies. Should the principal operating subsidiaries be downgraded by two notches by these rating agencies the principal operating subsidiaries could potentially be required to return premiums to cedents, post cash collateral, and in certain limited instances return cash or assets to counterparties. Such a downgrade (or potential downgrade) in the principal operating subsidiaries' financial strength and credit ratings could materially and negatively impact the Company's business, financial condition, results of operations and/or liquidity. Key determinants for financial strength and credit ratings are capital adequacy, liquidity and risk management.

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 current statutory capital position of each of the principal operating subsidiaries as well as the ability of the holding company to allocate capital and liquidity around the group as and when needed.

27. Related Party Transactions

For detailed information regarding the company's transactions with Syncora see Note 5 "Syncora". For detailed information regarding amounts due from/(to) parent and affiliates see Note 23.

The Company has various assumed and ceded quota share arrangements in place, for both the current and prior years, with affiliated companies including XL Re Ltd, along with its branch operations in London and Australia and XL London Markets Ltd. See notes 10, 12 and 13 for further information.

At December 31, 2008 and 2007, the Company owned minority stakes in seven and eleven independent investment management companies ("Investment Management Affiliates"), respectively. The Company sought 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 pay management and performance fees to the Company's Investment Management Affiliates. See note 10 for further information.

In addition, the Company has entered into a reinsurance contract with another strategic affiliate, ITAU XL Seguros Corporativos S.A. The reinsurance contract resulted in reported net premiums of approximately \$3.2 million, loss reserves of nil, and reported acquisition costs of \$0.2 million during the year ended December 31, 2008, while in 2007, the same reinsurance contract resulted in reported net premiums of approximately \$0.35 million, loss reserves of nil, and reported acquisition costs of \$0.1 million during the year ended December 31, 2007.

XL Insurance (Bermuda) Ltd

Notes to Consolidated Financial Statements (Continued)

For The Years Ended December 31, 2008 And 2007

(Expressed in Thousands Of U.S. dollars)

27. Related Party Transactions (continued)

The company's cash sweep facility account is maintained in XL Capital Ltd, however, all balances within the sweep account represent immediate demand cash balances of the entity from which the cash was swept. As at December, 31, 2008 \$811.1million of the Company's cash and cash equivalents is held within the XL Capital sweep account.

In the normal course of business, the Company enters into cost sharing and service level agreement transactions with certain other strategic affiliates, which management believes to be conducted consistent with arms-length rates. Such transactions, individually and in the aggregate, are not material to the Company's financial condition, results of operations and cash flows.

28. Subsequent Event

Return of Surplus

Subsequent to December 31, 2008 the company returned surplus of \$300.0 million to its Parent Company.

Internal Reinsurance Arrangement

During March 2009 the Company entered into a 100% internal reinsurance arrangement with XL Re Ltd, an affiliated company. This arrangement effectively retroceded a quota share of XL Insurance Company Ltd's book of business for the underwriting years 2001 to 2008, which had been assumed by XL Re Ltd, to the Company. The quota share resulted in the Company assuming assets and liabilities of \$ 2.5 billion, each.

Reinsurance Operations

On March 24, 2009, the company announced that it has concluded most aspects of its strategic review of its life reinsurance operations announced in July 2008. The Company successfully concluded a renewal rights transaction relating to its Continental European Life, Accident and Health business in December 2008. Given current market conditions, the company has determined to put its U.K. and Irish life businesses into run-off. XL continues to explore options with respect to its U.S. life reinsurance operations. This is part of the company's previously announced strategy of focusing on its property and casualty businesses.