

XL Insurance (Bermuda) Ltd
Consolidated Financial Statements
For The Years Ended
December 31, 2010 and 2009

XL INSURANCE (BERMUDA) LTD

CONSOLIDATED BALANCE SHEETS AS AT DECEMBER 31, 2010 AND 2009

(U.S. dollars in thousands, except share data)

	December 31, 2010	December 31, 2009
A S S E T S		
Investments:		
Fixed maturities, at fair value (amortized cost: 2010, \$24,359,305; 2009, \$27,158,783)	\$ 24,280,638	\$ 26,215,167
Equity securities, at fair value (cost: 2010, \$56,704; 2009, \$12,106)	84,640	15,379
Short-term investments, at fair value (amortized cost: 2010, \$1,620,661; 2009, \$1,428,608)	1,607,908	1,437,434
Total investments available for sale	25,973,186	27,667,980
Fixed maturities, held to maturity at amortized cost (fair value: 2010, \$2,742,626; 2009, \$530,319)	\$ 2,728,335	\$ 546,067
Investments in affiliates	1,068,820	1,185,323
Other investments	943,534	777,900
Total investments	30,713,875	30,177,270
Cash and cash equivalents	3,069,874	3,771,180
Accrued investment income	341,024	342,074
Deferred acquisition costs	633,035	654,065
Ceded unearned premiums	625,654	711,875
Premiums receivable	2,414,912	2,597,602
Reinsurance balances receivable	171,327	374,844
Unpaid losses and loss expenses recoverable	3,671,887	3,584,028
Net receivable from investments sold	21,716	83,936
Amounts due from Parent and affiliates	424,978	346,398
Goodwill and other intangible assets	660,047	665,669
Deferred tax asset	139,571	190,116
Other assets	575,081	574,919
Total assets	\$ 43,462,981	\$ 44,073,976
LIABILITIES AND SHAREHOLDER'S EQUITY		
Liabilities:		
Unpaid losses and loss expenses	\$ 20,531,607	\$ 20,823,524
Deposit liabilities	1,684,606	2,208,699
Future policy benefit reserves	5,075,127	5,490,119
Unearned premiums	3,484,830	3,651,310
Notes payable and debt	599,668	599,350
Reinsurance balances payable	122,250	378,887
Net payable for investments purchased	34,562	36,979
Deferred tax liability	105,667	-
Amount due to affiliates	116,654	2,752
Other liabilities	747,846	813,028
Total liabilities	\$ 32,502,817	\$ 34,004,648
Shareholder's Equity:		
Ordinary shares, 15,000,000 authorized, par value \$0.10; Issued and outstanding: (2010, 10,000,000; 2009, 10,000,000)	1,000	1,000
Additional paid in capital	8,995,334	9,179,675
Accumulated other comprehensive income (loss)	16,700	(979,188)
Retained earnings	1,944,834	1,865,536
Shareholder's equity attributable to XL Insurance (Bermuda) Ltd	\$ 10,957,868	\$ 10,067,023
Non-controlling interest in equity of consolidated subsidiaries	2,296	2,305
Total shareholder's equity	\$ 10,960,164	\$ 10,069,328
Total liabilities, redeemable preference ordinary shares and shareholder's equity	\$ 43,462,981	\$ 44,073,976

See accompanying Notes to Consolidated Financial Statements

DIRECTOR

DIRECTOR



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, 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, 2010 and December 31, 2009, and the results of their operations and their cash flows for the 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 audit 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.

As discussed in Notes 1 and 25, there have been significant related party transactions.

As discussed in Notes 2(g) and 8 to the consolidated financial statements, the Company adopted new accounting guidance that changed the manner in which it accounts for other than temporary impairments of available for sale securities in 2009.

A handwritten signature in black ink, appearing to read "PricewaterhouseCoopers", written in a cursive style.

April 29, 2011

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"PwC" refers to PricewaterhouseCoopers (a Bermuda partnership), which is a member of PricewaterhouseCoopers International Limited, each member firm of which is a separate legal entity.

XL INSURANCE (BERMUDA) LTD
CONSOLIDATED STATEMENTS OF INCOME
FOR THE YEARS ENDED DECEMBER 31, 2010 AND 2009

(U.S. dollars in thousands, except per share amounts)

	2010	2009
Revenues:		
Net premiums earned.....	\$ 5,414,061	\$ 5,706,840
Net investment income	1,121,934	1,303,627
Realized investment gains (losses):		
Net realized gains (losses) on investments sold	21,492	(498,228)
Other-than-temporary impairments on investments	(106,319)	(928,395)
Other-than-temporary impairments on investments transferred to (from) other comprehensive income	(40,146)	170,853
Total net realized (losses) on investments.....	(124,973)	(1,255,770)
Net realized and unrealized (losses) on derivative instruments.....	(25,579)	(24,816)
Income (loss) from investment fund affiliates.....	51,084	78,413
Fee income and other.....	48,261	56,914
Total revenues	\$ 6,484,788	\$ 5,865,208
Expenses:		
Net losses and loss expenses incurred	\$ 3,211,800	\$ 3,168,837
Claims and policy benefits	513,833	677,562
Acquisition costs	788,258	853,558
Operating expenses.....	867,525	943,835
Exchange (gains) losses.....	(11,472)	84,859
Interest expense	103,378	93,841
Loss on termination of guarantee	23,500	—
Amortization of intangible assets	1,858	1,836
Total expenses	\$ 5,498,680	\$ 5,824,328
Income (loss) before income tax and income (loss) from operating affiliates.....	\$ 986,108	\$ 40,880
Provision for income tax	162,937	114,525
Income (loss) from operating affiliates.....	121,371	59,713
Net income (loss)	\$ 944,542	\$ (13,932)
Non-controlling interest in net (income) loss of subsidiary.....	(4)	104
Net income (loss) attributable to XL Insurance Bermuda Ltd	\$ 944,538	\$ (13,828)

See accompanying Notes to Consolidated Financial Statements

XL INSURANCE (BERMUDA) LTD

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME FOR THE YEARS ENDED DECEMBER 31, 2010 AND 2009

(U.S dollars in thousands)

	<u>2010</u>	<u>2009</u>
Net income (loss) attributable to XL Insurance (Bermuda) Ltd.....	\$ 944,538	\$ (13,828)
Impact of adoption of new authoritative OTTI guidance, net of taxes	—	(229,594)
Impact of adoption of new authoritative embedded derivative guidance, net of taxes	31,917	—
Change in net unrealized gains (losses) on investments, net of tax	800,644	2,595,328
Change in net unrealized gains (losses) on affiliate and other investments net of tax	44,393	-
Change in OTTI losses recognized in other comprehensive income, net of tax	74,316	10,372
Change in underfunded pension liability	(2,619)	(2,255)
Change in net unrealized gains (losses) on future policy benefit reserves	(3,714)	5,382
Foreign currency translation adjustments	50,951	180,890
Comprehensive income (loss)	<u>\$ 1,940,426</u>	<u>\$ 2,546,295</u>

See accompanying Notes to Consolidated Financial Statements

XL INSURANCE (BERMUDA) LTD

CONSOLIDATED STATEMENTS OF SHAREHOLDER'S EQUITY FOR THE YEARS ENDED DECEMBER 31, 2010 AND 2009

(U.S. dollars in thousands)

	2010	2009
Non-controlling Interest in Equity of Consolidated Subsidiaries:		
Balance – beginning of year	\$ 2,305	\$ 1,598
Non-controlling interest in net income (loss) of subsidiary	4	(104)
Non-controlling interest share in change in AOCI	(13)	811
Balance – end of year	\$ 2,296	\$ 2,305
Ordinary Shares:		
Balance – beginning of year	\$ 1,000	\$ 1,000
Issuance of ordinary shares	–	–
Balance – end of year	\$ 1,000	\$ 1,000
Contributed Capital:		
Balance – beginning of year	\$ 9,179,675	\$ 11,113,193
Receipt of Capital	2,324	1,475,791
Return of Capital	(186,665)	(300,000)
Return of Capital (Transfer of Mid Ocean Limited)	–	(3,109,309)
Balance – end of year	\$ 8,995,334	\$ 9,179,675
Accumulated Other Comprehensive Income:		
Balance – beginning of year	\$ (979,188)	\$ (3,539,311)
Impact of adoption of new authoritative OTTI guidance, net of taxes	–	(229,594)
Impact of adoption of new authoritative embedded derivative guidance, net of taxes	31,917	–
Change in net unrealized gains (losses) on investments, net of tax	800,644	2,579,385
Change in net unrealized gains (losses) on affiliate and other investments, net of tax	44,393	15,943
Change in OTTI losses recognized in other comprehensive income, net of tax	74,316	10,372
Change in underfunded pension liability	(2,619)	(2,255)
Change in net unrealized gain (loss) on future policy benefit reserves	(3,714)	5,382
Foreign currency translation adjustments	50,951	180,890
Balance – end of year	\$ 16,700	\$ (979,188)
Retained (Deficit) Earnings:		
Balance – beginning of year	\$ 1,865,536	\$ 3,721,244
Impact of adoption of new authoritative OTTI guidance, net of tax	–	229,594
Impact of adoption of new authoritative embedded derivative guidance, net of taxes	(31,917)	–
Net income (loss) attributable to XL Insurance (Bermuda) Ltd	944,538	(13,828)
Dividends on ordinary shares	(833,323)	(2,071,474)
Balance – end of year	\$ 1,944,834	\$ 1,865,536
Total shareholder's equity	\$ 10,960,164	\$ 10,069,328

See accompanying Notes to Consolidated Financial Statements

XL INSURANCE (BERMUDA) LTD

CONSOLIDATED STATEMENTS OF CASH FLOWS FOR THE YEARS ENDED DECEMBER 31, 2010 AND 2009

(U.S. dollars in thousands)

	2010	2009
Cash Flows Provided by (used in) Operating Activities:		
Net income (loss)	\$ 944,538	\$ (13,828)
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:		
Non-controlling interest in net (income) loss of subsidiary	(4)	104
Net realized losses on sales of investments	124,973	1,255,770
Net realized and unrealized losses on derivative instruments	25,579	24,816
Amortization of premiums (discounts) on fixed maturities	52,403	(8,404)
(Income) loss from investment and operating affiliates	(172,455)	(138,126)
Share based compensation	26,164	26,444
Accretion of convertible debt	319	318
Depreciation expense	36,052	49,402
Accretion of deposit liabilities	104,311	88,752
Unpaid losses and loss expenses	(207,526)	(1,120,074)
Unearned premiums	(133,955)	(675,946)
Premiums receivable	94,649	634,893
Unpaid losses and loss expenses recoverable	(74,242)	443,510
Amounts due from parent and affiliates	83,215	(182,874)
Future policy benefit reserves	(197,570)	(340,690)
Ceded unearned premiums	83,246	204,442
Reinsurance balances receivable	201,479	191,462
Reinsurance balances payable	(253,213)	(368,928)
Deferred acquisition costs	12,235	64,736
Deferred tax asset	104,111	(3,959)
Other assets	(36,036)	70,661
Other liabilities	(55,056)	(112,375)
Derivatives	111,035	(201,127)
Other	(89,660)	126,171
Total adjustments	\$ (159,946)	\$ 28,978
Net cash provided by (used in) operating activities	\$ 784,592	\$ 15,150
Cash flows provided by (used in) investing activities:		
Proceeds from sale of fixed maturities and short-term investments	\$ 4,435,920	\$ 10,757,328
Proceeds from redemption of fixed maturities and short-term investments	1,482,847	1,733,917
Proceeds from sale of equity securities	21,452	394,002
Purchases of fixed maturities and short-term investments	(6,567,875)	(13,005,832)
Purchases of equity securities	(63,813)	(19,827)
Net dispositions of investment affiliates	319,036	769,140
(Acquisition) disposition of subsidiaries, net of cash acquired	-	41,446
Other investments, net	24,276	(135,128)
Net cash provided by (used in) investing activities	\$ (348,157)	\$ 535,046

See accompanying Notes to Consolidated Financial Statements

XL INSURANCE (BERMUDA) LTD

**CONSOLIDATED STATEMENTS OF CASH FLOWS FOR THE YEARS ENDED
DECEMBER 31, 2010 AND 2009 (Continued)**

(U.S. dollars in thousands)

	<u>2010</u>	<u>2009</u>
Cash Flows (Used in) Provided by Financing Activities:		
Dividends paid on ordinary shares	(487,200)	(394,000)
Receipt/(return) of capital.....	-	(300,000)
Deposit liabilities.....	(646,819)	(389,575)
Collateral received on securities lending	-	108,906
Collateral returned on securities lending	-	(351,568)
Net cash (used in) provided by financing activities	\$ (1,134,019)	\$ (1,326,237)
Effects of exchange rate changes on foreign currency cash	(3,722)	80,577
Increase (decrease) in cash and cash equivalents	(701,306)	(695,464)
Cash and cash equivalents – beginning of year	3,771,180	4,466,644
Cash and cash equivalents – end of year	<u>\$ 3,069,874</u>	<u>\$ 3,771,180</u>
Net taxes paid	\$ 75,429	\$ 134,948
Interest paid on notes payable and debt	\$ 39,000	\$ 39,000

See accompanying Notes to Consolidated Financial Statements

XL INSURANCE (BERMUDA) LTD

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS FOR THE YEARS ENDED DECEMBER 31, 2010 AND 2009

1. Nature of Operations

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

As of December 31, 2009 the ownership of Mid Ocean Limited, a company registered in the Cayman Islands, was transferred from XL Group Ltd. (the Company’s former ultimate parent previous known as XL Capital Ltd (“XL-Cayman”)) to the Company. The consideration paid for Mid Ocean Limited was \$3.1 Billion and was in the form of the forgiveness of debt of \$2.7 Billion and the assignment to XL Group Ltd of a receivable owed to the Company by its parent company, EXEL Holdings, of \$0.4 Billion. Mid Ocean Limited is the parent of the XL Re Limited and Ridgewood Holdings group of companies. As a result of this reorganization the Company now is the ultimate parent of all the operating units within the XL Group plc (the Company’s ultimate parent (“XL-Ireland”)) group. The impact of the above transaction on the Company’s Consolidated Net Income and Comprehensive Income was as follows:

<i>(U.S. dollars in thousands)</i>	<u>2009</u>
Pre Transaction	
Net Income	(67,063)
Comprehensive Income	701,988
Post Transaction	
Net Income	(13,828)
Comprehensive Income	2,546,295

Given the nature of related party transactions, there can be no assurance that these transactions have been conducted at arms-length.

Insurance Operations

The Company’s Insurance segment provides commercial property, casualty and specialty 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 property and liability coverages, umbrella liability, product recall, U.S. workers’ compensation and auto liability as well as property catastrophe. Property and casualty products generally provide large capacity on a primary, quota share or excess of loss basis. The primary casualty programs (including workers’ compensation and auto liability) 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. Policies are written on an occurrence, claims-made and occurrence reported basis. The Company’s property business written, 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. In addition to the property and casualty products noted above, in 2008 the Company launched underwriting capabilities for the Upper Middle Markets (“UMM”) in the U.S., U.K. and Continental Europe.

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 on an excess of loss basis and covers those firms for legal liability in regard to the treatment of employees. Errors and omissions coverage is written on a primary and excess basis.

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

XL INSURANCE (BERMUDA) LTD

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued) FOR THE YEARS ENDED DECEMBER 31, 2010 AND 2009

1. Nature of Operations (Continued)

Insurance Operations (Continued)

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

Marine and offshore energy, equine and fine art and specie 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 and livestock insurance. Fine art and specie coverages include fine art, jewelers block, cash in transit and related coverages for financial institutions.

Excess and surplus lines products include general liability coverages where most Insurance Services Office, Inc. ("ISO") products are written. The Company ceased offering excess and surplus property coverages in 2009.

The Company's program business specializes in insurance coverages for distinct market segments in North America, including program administrators and managing general agents who operate in a specialized market niche and have unique industry backgrounds or specialized underwriting capabilities. Products encompass mostly property and casualty coverages. The Company terminated an automobile extended warranty program in 2009.

Certain structured indemnity products, previously structured by XL Financial Solutions ("XLFS"), are included within the results of the Insurance segment 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 certain operations that included the closure of the XLFS business unit and reassignment of responsibility for existing structured indemnity business to either the Insurance or Reinsurance segment depending on the underlying nature of the transactions.

Also included as part of the Insurance segment is XL Global Asset Protection Services ("XL GAPS"), a fee for service loss prevention consulting 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 (e.g., monitoring of aggregate exposures) 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, 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, President George W. Bush signed a bill extending TRIA ("TRIAE") for two more years, continuing TRIP through 2007. On December 26, 2007, a bill was signed, the Terrorism Risk Insurance Program Reauthorization Act of 2007 ("TRIPRA"), which further extended TRIP for seven years until December 31, 2014 and also eliminated the distinction between foreign and domestic acts of terrorism.

The Company had, prior to the passage of 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's Reinsurance segment 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 and in certain limited instances on a direct basis.

XL INSURANCE (BERMUDA) LTD

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued) FOR THE YEARS ENDED DECEMBER 31, 2010 AND 2009

1. Nature of Operations (Continued)

Reinsurance Operations (Continued)

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

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

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

The Company's property catastrophe reinsurance account is generally "all risk" in nature. As a result, the Company is exposed to losses from sources as diverse as hurricanes and other windstorms, earthquakes, freezing, riots, floods, industrial explosions, fires, and many other potential natural or man-made disasters.

In accordance with market practice, the Company's policies generally exclude certain risks such as war, nuclear contamination or radiation. Following the terrorist attacks at the World Trade Center in New York City, in Washington, D.C. and in Pennsylvania on September 11, 2001 (collectively, "the September 11 event"), terrorism cover, including NBRC has 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 TRIAE 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, marine, aviation, space, engineering, fidelity, trade credit, and political risk. The Company underwrites a small portfolio of contracts covering political risk and trade credit. Exposure is assumed from a limited number of trade credit contracts.

XL INSURANCE (BERMUDA) LTD

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued) FOR THE YEARS ENDED DECEMBER 31, 2010 AND 2009

1. Nature of Operations (Continued)

Life Operations

During 2009, the Company completed a strategic review of its life reinsurance business. In relation to this initiative, the Company sold the renewal rights to its Continental European short-term life, accident and health business in December 2008. The Company also announced in March 2009 that it would run-off its existing book of U.K. and Irish traditional life and annuity business, and not accept new business. In addition, during July 2009, the Company entered into an agreement to sell its U.S. life reinsurance business. The transaction closed during the fourth quarter of 2009. In December 2009, the Company entered into an agreement to novate and recapture a number of U.K. and Irish term assurance and critical illness treaties. The transaction closed during the fourth quarter of 2009. During the first quarter of 2010, the Company entered into an agreement to recapture U.K. and Irish term assurance treaties and this transaction closed during March 2010. Further recaptures of U.K. term assurance treaties and U.S. mortality retrocession pools took place during the first and fourth quarters of 2010, respectively.

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

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

The portfolio has three particularly significant components:

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

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

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

Other Financial Lines

The Other Financial Lines Business previously included contracts associated with the funding agreement ("FA") business and 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. During August 2010, the remaining balance of FAs of \$450 million was settled and the business is no longer active.

Reinsurance Ceded

a) Insurance Operations

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

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

XL INSURANCE (BERMUDA) LTD

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued) FOR THE YEARS ENDED DECEMBER 31, 2010 AND 2009

1. Nature of Operations (Continued)

Reinsurance Ceded (Continued)

b) Reinsurance Operations

The Company uses third party reinsurance to support the underwriting and retention guidelines of each reinsurance subsidiary as well as seeking to limit the aggregate exposure of the Company to a particular risk or class of risks. Reinsurance is purchased at several levels ranging from reinsurance of risks assumed on individual contracts to reinsurance covering the aggregate exposures.

Reinsurance ceded varies by location and line of business based on factors including, among others, market conditions and the credit worthiness of the counterparty.

Effective January 1, 2008, the Company 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. The quota share with Cyrus Re II was canceled after its original term and not renewed.

The Company's traditional catastrophe retrocession program was renewed in June 2010 to cover certain of the Company's exposures. These protections, in various layers and in excess of varying attachment points according to the territory exposed, assist in managing the Company's net retention to an acceptable level. The Company has co-reinsurance retentions within this program. The Company renewed additional structures with a restricted territorial scope for 12 months at July 2010. 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 reinsurances on its credit and bond, motor third party liability, property and aviation portfolios to manage its net exposures in these classes.

2. Significant Accounting Policies

(a) Basis of Preparation and Consolidation

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

The re-organization of the company discussed in Note 1 has impacted the basis of how these financial statements have been prepared. The transfer of Mid Ocean Limited from XL Capital to the Company is a transfer of a related party/common control transaction as Mid Ocean Limited and the Company are both wholly owned subsidiaries of XL Capital. These financial statements are in effect those of a new reporting entity as the two commonly controlled entities have not previously been presented together. As such, the financial statements have been prepared retrospectively combining the entities for the year ended December 31, 2009 as if the combination had been in effect since the inception of common control.

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

- unpaid losses and loss expenses and unpaid losses and loss expenses recoverable;
- future policy benefit reserves;
- valuation and other than temporary impairments of investments;
- income taxes;

XL INSURANCE (BERMUDA) LTD

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued) FOR THE YEARS ENDED DECEMBER 31, 2010 AND 2009

2. Significant Accounting Policies (Continued)

(a) Basis of Preparation and Consolidation (Continued)

- reinsurance premium estimates; and
- goodwill carrying value.

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

(b) Fair Value Measurements

Financial Instruments subject to Fair Value Measurements

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

Basis of Fair Value Measurement

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

- **Level 1**—Quoted prices in active markets for identical assets or liabilities (unadjusted); no blockage factors.
- **Level 2**—Other observable inputs (quoted prices in markets that are not active or inputs that are observable either directly or indirectly) – include quoted prices for similar assets/liabilities (adjusted) other than quoted prices in Level 1; quoted prices in markets that are not active; or other inputs that are observable or can be derived principally from or corroborated by observable market data for substantially the full term of the assets or liabilities.
- **Level 3**—Unobservable inputs that are supported by little or no market activity and are significant to the fair value of the assets or liabilities. Unobservable inputs reflect the reporting entity's own assumptions about the assumptions that market participants would use in pricing the asset or liability. Level 3 assets and liabilities include financial instruments whose values are determined using pricing models, discounted cash flow methodologies, or similar techniques, as well as instruments for which the determination of fair value requires significant management judgment or estimation.

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

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

XL INSURANCE (BERMUDA) LTD

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued) FOR THE YEARS ENDED DECEMBER 31, 2010 AND 2009

2. Significant Accounting Policies (Continued)

(c) Total Investments

Investments Available For Sale

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

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

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, it may be difficult to value certain of the Company's securities, for example, collateralized loan obligations ("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, meaning that more subjectivity and management judgment is required with regard to fair value. 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)."

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 income securities.

XL INSURANCE (BERMUDA) LTD

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued) FOR THE YEARS ENDED DECEMBER 31, 2010 AND 2009

2. Significant Accounting Policies (Continued)

(c) Total Investments (Continued)

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. 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.

Investments Held to Maturity

Investments classified as held to maturity include securities for which the Company has the ability and intent to hold to maturity and are carried at amortized cost. During the current year, certain securities were transferred from an available for sale designation into held to maturity. For details see Note 8, "Investments."

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.

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

Other Investments

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

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

XL INSURANCE (BERMUDA) LTD

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued) FOR THE YEARS ENDED DECEMBER 31, 2010 AND 2009

2. Significant Accounting Policies (Continued)

(c) Total Investments (Continued)

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

The Company historically participated in structured transactions which include cash loans supporting project finance transactions, providing liquidity facility financing to a structured project deal in 2009 and the Company also invested in a payment obligation with an insurance company. These transactions are carried at amortized cost. For further details see Note 3, "Fair Value Measurements," and Note 10, "Other Investments."

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 fair value measurement disclosures. Money market funds are classified as Level 1 as these instruments are considered actively traded and values are quoted, however, certificates of deposit are classified as Level 2.

(d) Premiums and Acquisition Costs

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

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

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

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

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

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

(e) Reinsurance

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

XL INSURANCE (BERMUDA) LTD

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued) FOR THE YEARS ENDED DECEMBER 31, 2010 AND 2009

2. Significant Accounting Policies (Continued)

(f) Fee Income and Other

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

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

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

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

From April 1, 2009, in instances in which the Company determines that a credit loss exists but the Company does not intend to sell the security and it is not more likely than not that the Company will be required to sell the security before the anticipated recovery of its remaining amortized cost basis, the OTTI is separated into (1) the amount of the total impairment related to the credit loss and (2) the amount of the total impairment related to all other factors (i.e. the noncredit portion). The amount of the total OTTI related to the credit loss is recognized in earnings and the amount of the total OTTI related to all other factors is recognized in accumulated other comprehensive loss. The total OTTI is presented in the income statement with an offset for the amount of the total OTTI that is recognized in accumulated other comprehensive loss. Absent the intent or requirement to sell a security, if a credit loss does not exist, any impairment is considered to be temporary.

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

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

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

XL INSURANCE (BERMUDA) LTD

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued) FOR THE YEARS ENDED DECEMBER 31, 2010 AND 2009

2. Significant Accounting Policies (Continued)

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

There are risks and uncertainties associated with determining whether declines in the fair value of investments are other than temporary. These include subsequent significant changes in general economic conditions as well as specific business conditions affecting particular issuers, the Company’s liability profile, subjective assessment of issue-specific factors (seniority of claims, collateral value, etc.), future financial market effects, stability of foreign governments and economies, future rating agency actions and significant disclosure of accounting, fraud or corporate governance issues that may adversely affect certain investments. In addition, significant assumptions and management judgment are involved in determining if the decline is other than temporary. If management determines that a decline in fair value is temporary, then a security’s value is not written down at that time. However, there are potential effects upon the Company’s future earnings and financial position should management later conclude that some of the current declines in the fair value of the investments are other than temporary declines. For further details on the factors considered in evaluation other than temporary impairment see Note 8, “Investments.”

(h) Derivative Instruments

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

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

Certain OTC derivatives trade in less liquid markets with limited pricing information, or required model inputs which are not directly market corroborated, which causes the determination of fair value for these derivatives to be inherently more subjective. Accordingly, such derivatives are classified within Level 3 of the fair value hierarchy. The valuations of less standard or liquid OTC derivatives are typically based on Level 1 and/or Level 2 inputs that can be observed in the market, as well as unobservable Level 3 inputs. Level 1 and Level 2 inputs are regularly updated to reflect observable market changes. Level 3 inputs are only changed when corroborated by evidence such as similar market transactions, pricing services and/or broker or dealer quotations. The Company conducts its non-hedging derivatives activities in four main areas: investment related derivatives, credit derivatives, other non-investment related derivatives, and until late 2008 it also utilized weather and energy derivatives.

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

XL INSURANCE (BERMUDA) LTD

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued) FOR THE YEARS ENDED DECEMBER 31, 2010 AND 2009

2. Significant Accounting Policies (Continued)

(h) Derivative Instruments (Continued)

Fair Value Hedges

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

Hedges of the Net Investment in a Foreign Operation

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

Hedge Documentation and Effectiveness Testing

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

(i) Cash Equivalents

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

XL INSURANCE (BERMUDA) LTD

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued) FOR THE YEARS ENDED DECEMBER 31, 2010 AND 2009

2. Significant Accounting Policies (Continued)

(j) Foreign Currency Translation

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

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

(k) Goodwill and Other Intangible Assets

The Company has recorded goodwill in connection with various acquisitions in prior years. Goodwill represents the excess of the purchase price over the fair value of net assets acquired. In accordance with accounting guidance over goodwill and other intangible assets, 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’s other intangible assets consist of both amortizable and non-amortizable intangible assets. The Company’s amortizable intangible assets consist primarily of acquired customer relationships and acquired software. All of the Company’s amortizable intangible assets are carried at net book value and are amortized over their estimated useful lives. The amortization periods approximate the periods over which the Company expects to generate future net cash inflows from the use of these assets. Accordingly, customer relationships are amortized over a useful life of 10 years and acquired software is amortized over a useful life of 5 years. The Company’s policy is to amortize intangibles on a straight-line basis.

All of the Company’s amortizable intangible assets, as well as other amortizable or depreciable long-lived assets such as premises and equipment, are subject to impairment testing in accordance with authoritative guidance for the impairment or disposal of long-lived assets when events or conditions indicate that the carrying value of an asset may not be fully recoverable from future cash flows. 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 the authoritative guidance on property, plant and equipment under GAAP, 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 the authoritative guidance on intangibles and goodwill and other assets under GAAP, all of the Company’s non-amortized intangible assets are subject to a test for impairment annually, or more frequently if events or changes in circumstances indicate that the asset might be impaired. Pursuant to the authoritative guidance, if the carrying value of a non-amortized intangible asset is in excess of its fair value, the asset must be written down to its fair value through the recognition of an impairment charge to earnings.

(l) Losses and Loss Expenses

Unpaid losses and loss expenses include reserves for reported unpaid losses and loss expenses and for losses incurred but not reported. The reserve for reported unpaid losses and loss expenses for the Company’s property and casualty operations is established by management based on 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.

XL INSURANCE (BERMUDA) LTD

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued) FOR THE YEARS ENDED DECEMBER 31, 2010 AND 2009

2. Significant Accounting Policies (Continued)

(l) Losses and Loss Expenses (Continued)

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 from such reviews are reflected in income of the year in which the adjustments are made.

(m) Deposit liabilities

Contracts entered into by the Company 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, 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.

(n) Future policy benefit reserves

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

The assumptions used to determine future policy benefit reserves are best estimate assumptions that are determined at the inception of the contracts and are locked-in throughout the life of the contract unless a premium deficiency develops. As the experience on the contracts emerges, the assumptions are reviewed. If such review would produce reserves in excess of those currently held then the lock-in assumptions will be revised and a claim and policy benefit is recognized at that time. Certain life insurance and annuity contracts provide the holder with a guarantee that the benefit received upon death will be no less than a minimum prescribed amount. The contracts are accounted for in accordance with the authoritative guidance on Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Separate Accounts, which requires that the best estimate of future experience be combined with actual experience to determine the benefit ratio used to calculate the policy benefit reserve.

(o) Income Taxes

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

XL INSURANCE (BERMUDA) LTD

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued) FOR THE YEARS ENDED DECEMBER 31, 2010 AND 2009

2. Significant Accounting Policies (Continued)

(p) Stock Plans

The Company adopted authoritative guidance on the fair value recognition provisions for accounting for stock-based compensation, under the prospective method for options granted subsequent to January 1, 2003. Prior to 2003, the Company accounted for options under the disclosure-only provisions of the guidance and no stock-based employee compensation cost was included in net income as all options granted had an exercise price equal to the market value of the Company's ordinary shares on the date of the grant. At December 31, 2009, the Company had several stock based Performance Incentive Programs, which are described more fully in Item c, Note 20, "Share Capital." Stock-based compensation issued under these plans generally have a life of not longer than ten years and vest as set forth at the time of grant. Awards currently vest annually over three or four years from the date of grant. The Company recognizes compensation costs for stock-based awards on a straight-line basis over the requisite service period (usually the vesting period) for each award.

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

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

(q) Recent Accounting Pronouncements

In June 2009, the FASB issued final authoritative guidance over accounting for transfers of financial assets that removed the concept of a qualifying special-purpose entity from existing accounting guidance over transfers of financial assets and also removes the exception from applying guidance surrounding consolidation of variable interest entities to qualifying special-purpose entities. This new guidance was applied by the Company from January 1, 2010; however, it did not have an impact on the Company's financial condition or results of operations.

In June 2009, the FASB issued final authoritative accounting guidance in an effort to improve financial reporting by enterprises involved with variable interest entities. This guidance retains the scope of the previous standard covering variable interest entities except, as noted above, with the addition of entities previously considered qualifying special-purpose entities. The new guidance requires an enterprise to perform an analysis to determine whether the enterprise's variable interest or interests give it a controlling financial interest in a variable interest entity under revised guidance that are more qualitative than under previous guidance and amends previous guidance to require ongoing reassessments of whether an enterprise is the primary beneficiary of a variable interest entity. Before this update, previous guidance required reconsideration of whether an enterprise is the primary beneficiary of a variable interest entity only when specific events occurred. The new guidance also amends previous guidance to require enhanced disclosures that provide users of financial statements with more transparent information about an enterprise's involvement with a variable interest entity. The enhanced disclosures are required for any enterprise that holds a variable interest in a variable interest entity. The content of the enhanced disclosures required by this new guidance is generally consistent with that required by the previous standards. The Company applied this new guidance from January 1, 2010; however, it did not have an impact on the Company's financial condition and results of operations. See Note 18, "Variable Interest Entities," for the disclosures required by this guidance.

In January 2010, the FASB issued an accounting standards update on Improving Disclosures about Fair Value Measurements. The provisions of this authoritative guidance require new disclosures about recurring and nonrecurring fair value measurements including significant transfers into and out of Level 1 and Level 2 fair value measurements and information on purchases, sales, issuances, and settlements on a gross basis in the reconciliation of Level 3 fair value measurements. This guidance was effective for the Company beginning on January 1, 2010, except for the Level 3 reconciliation disclosures which are effective for annual periods beginning after December 15, 2010. This standard affects disclosures only and accordingly did not have an impact on the Company's financial condition or results of operations.

XL INSURANCE (BERMUDA) LTD

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued) FOR THE YEARS ENDED DECEMBER 31, 2010 AND 2009

2. Significant Accounting Policies (Continued)

(q) Recent Accounting Pronouncements (Continued)

In March 2010, the FASB issued authoritative guidance relating to derivative accounting. Under this guidance, all entities that enter into contracts containing an embedded credit derivative feature related to the transfer of credit risk that is not solely in the form of subordination of one financial instrument to another are required to separately account for the embedded credit derivative feature. This guidance has been applied effective July 1, 2010. The Company has investments in senior tranches of Synthetic collateralized debt obligations (“CDOs”) as well as certain CDO Squared structures which in turn hold Synthetic CDOs. The derivative instruments held within these structures require the application of this new guidance. Upon initial adoption of this guidance the Company elected the fair value option for impacted securities, which resulted in a decrease being recorded to opening retained earnings of \$31.9 million. For further information on these securities see Note 8, “Investments.”

In July 2010, the FASB amended the general accounting principles for receivables as they relate to the disclosures about the credit quality of financing receivables and the allowance for credit losses. This amendment requires additional disclosures that provide a greater level of disaggregated information about the credit quality of financing receivables and the allowance for credit losses. It also requires the disclosure of credit quality indicators, past due information, and modifications of financing receivables. The new disclosures are required for interim and annual periods ending after December 15, 2010, although the disclosures of reporting period activity (i.e., allowance roll-forward and modification disclosures) are required for interim and annual periods beginning after December 15, 2010. This standard affects disclosures only and, accordingly, did not have an impact on the Company’s financial condition or results of operations. See Note 10, “Other Investments,” and Note 12, “Reinsurance,” for disclosures provided related to this guidance.

In October 2010, the FASB issued authoritative guidance to address disparities in practice regarding the interpretation of which costs relating to the acquisition of new or renewal insurance contracts qualify for deferral. The amendments in the updated guidance specify that incremental direct costs of contract acquisition and certain costs related directly to the acquisition activities incurred in the acquisition of new or renewal contracts should be capitalized in accordance with the amendments in the updated guidance. Costs directly related to those activities include only the portion of an employee’s total compensation (excluding any compensation that is capitalized as incremental direct costs of contract acquisition) and payroll-related fringe benefits related directly to time spent performing those activities for actual acquired contracts, and other costs related directly to those activities that would not have been incurred if the contract had not been acquired. Administrative costs, rent, depreciation, occupancy, equipment and all other general overhead costs are considered indirect costs and should be charged to expense as incurred. This guidance is effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2011. The amendments in this guidance should be applied prospectively upon adoption. Retrospective application is also permitted. Early adoption is permitted as of the beginning of the fiscal year. The Company is in the process of evaluating the impact of this guidance; however, it is not expected to have a significant impact on the Company’s financial condition or results of operations.

XL INSURANCE (BERMUDA) LTD

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued) FOR THE YEARS ENDED DECEMBER 31, 2010 AND 2009

3. Fair Value Measurements

The following tables set forth the Company's assets and liabilities that were accounted for at fair value as of December 31, 2010 and December 31, 2009 by level within the fair value hierarchy (for further information, see Note 2 (b), "Significant Accounting Policies – Fair Value Measurements"):

December 31, 2010 <i>(U.S. dollars in thousands)</i>	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, 2010
Assets					
U.S. Government and Government- Related/Supported	\$ –	\$ 1,941,952	\$ –	\$ –	\$ 1,941,952
Corporate (1)	–	10,006,321	27,454	–	10,033,775
Residential mortgage-backed securities – Agency	–	4,814,618	30,255	–	4,844,873
Residential mortgage-backed securities – Non-Agency	–	686,781	3,895	–	690,676
Commercial mortgage-backed securities	–	1,128,186	1,611	–	1,129,797
Collateralized debt obligations	–	10,271	719,643	–	729,914
Other asset-backed securities	–	893,349	22,179	–	915,528
U.S. States and political subdivisions of the States	–	1,343,820	–	–	1,343,820
Non-U.S. Sovereign Government, Supranational and Government- Related	–	2,646,636	3,667	–	2,650,303
Total fixed maturities, at fair value	\$ –	\$ 23,471,934	\$ 808,704	\$ –	\$ 24,280,638
Equity securities, at fair value	71,284	13,356	–	–	84,640
Short-term investments, at fair value (1)(2)	–	1,605,725	2,183	–	1,607,908
Total investments available for sale	\$ 71,284	\$ 25,091,015	\$ 810,887	\$ –	\$ 25,973,186
Cash equivalents (3)	1,898,456	115,319	–	–	2,013,775
Other investments (4)	–	489,912	125,937	–	615,849
Other assets (5)(6)	–	108,056	7,882	(20,152)	95,786
Total assets accounted for at fair value	<u>\$ 1,969,740</u>	<u>\$ 25,804,302</u>	<u>\$ 944,706</u>	<u>\$ (20,152)</u>	<u>\$ 28,698,596</u>
Liabilities					
Financial instruments sold, but not yet purchased (7)	\$ 256	\$ 21,270	\$ –	\$ –	\$ 21,526
Other liabilities (5)(6)	–	11,651	47,077	2,843	61,571
Total liabilities accounted for at fair value	<u>\$ 256</u>	<u>\$ 32,921</u>	<u>\$ 47,077</u>	<u>\$ 2,843</u>	<u>\$ 83,097</u>

XL INSURANCE (BERMUDA) LTD

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
FOR THE YEARS ENDED DECEMBER 31, 2010 AND 2009**

3. Fair Value Measurements (Continued)

December 31, 2009 <i>(U.S. dollars in thousands)</i>	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, 2009
Assets					
U.S. Government and Government- Related/Supported	\$ —	\$ 2,486,594	\$ —	\$ —	\$ 2,486,594
Corporate (1)	—	9,644,458	10,273	—	9,654,731
Residential mortgage-backed securities – Agency	—	5,827,330	7,894	—	5,835,224
Residential mortgage-backed securities – Non-Agency	—	891,326	41,905	—	933,231
Commercial mortgage-backed securities	—	1,181,375	2,081	—	1,183,456
Collateralized debt obligations	—	506,211	189,537	—	695,748
Other asset-backed securities	—	1,088,248	33,955	—	1,122,203
U.S. States and political subdivisions of the States	—	905,986	—	—	905,986
Non-U.S. Sovereign Government, Supranational and Government- Related	—	3,394,777	3,217	—	3,397,994
Total fixed maturities, at fair value	\$ —	\$ 25,926,305	\$ 288,862	\$ —	\$ 26,215,167
Equity securities, at fair value	5,621	9,758	—	—	15,379
Short-term investments, at fair value (2)	—	1,430,948	6,486	—	1,437,434
Total investments available for sale	\$ 5,621	\$ 27,367,011	\$ 295,348	\$ —	\$ 27,667,980
Cash equivalents (3)	2,239,072	648,635	—	—	2,887,707
Other investments (4)	—	342,005	70,295	—	412,300
Other assets (5)(6)	—	111,717	185,455	(212,819)	84,353
Total assets accounted for at fair value	<u>\$2,244,693</u>	<u>\$ 28,469,368</u>	<u>\$551,098</u>	<u>\$ (212,819)</u>	<u>\$ 31,052,340</u>
Liabilities					
Financial instruments sold, but not yet purchased (7)	\$ —	\$ 36,979	\$ —	\$ —	\$ 36,979
Other liabilities (5)(6)	—	22,420	84,940	(49,319)	58,041
Total liabilities accounted for at fair value	<u>\$ —</u>	<u>\$ 59,399</u>	<u>\$ 84,940</u>	<u>\$ (49,319)</u>	<u>\$ 95,020</u>

Notes:

- (1) Included within Corporate are certain medium term notes supported primarily by pools of European credit with varying degrees of leverage. The notes had a fair value of \$454.8 million and \$587.7 million and an amortized cost of \$504.6 million and \$707.9 million at December 31, 2010 and December 31, 2009, respectively. These notes allow the investor to participate in cash flows of the underlying bonds including certain residual values, which could serve to either decrease or increase the ultimate values of these notes.
- (2) Short-term investments consist primarily of Corporate, U.S. Government and Government-Related/Supported securities and Non-U.S. Sovereign Government, Supranational and Government-Related securities.
- (3) Cash equivalents balances subject to fair value measurement include certificates of deposit and money market funds. Operating cash balances are not subject to fair value measurement guidance.
- (4) The Other investments balance excludes certain structured transactions including certain investments in project finance transactions, a payment obligation and liquidity financing provided to a structured credit vehicle as a part of a third party medium term note facility. These investments are carried at amortized cost that totaled \$327.7 million at December 31, 2010 and \$365.6 million at December 31, 2009
- (5) Other assets and other liabilities include derivative instruments.
- (6) 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 a netting agreement. In addition, the Company held net cash collateral related to derivative assets of approximately \$23.0 million and \$169.1 million at December 31, 2010 and December 31, 2009, respectively. 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 netting agreement. The fair value of the individual derivative contracts are reported gross in their respective levels based on the fair value hierarchy
- (7) Financial instruments sold, but not yet purchased represent "short sales" and are included within "Net payable for investments purchased" on the balance sheet.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued) FOR THE YEARS ENDED DECEMBER 31, 2010 AND 2009

3. Fair Value Measurements (Continued)

Level 3 Gains and Losses

The tables below present additional information about assets and liabilities measured at fair value on a recurring basis and for which Level 3 inputs were utilized to determine fair value. The table reflects gains and losses for the twelve month periods ended December 31, 2010 and 2009 for all financial assets and liabilities categorized as Level 3 as of December 31, 2010 and 2009, respectively. The tables do not include gains or losses that were reported in Level 3 in prior periods for assets that were transferred out of Level 3 prior to December 31, 2010 and 2009. 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.

In general, 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 may 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. Transfers from Level 3 to Level 2 during the year ended December 31, 2010, were primarily as a result of the Company utilizing values provided by pricing services not containing significant unobservable inputs, rather than other valuations for certain assets that would have been considered Level 3.

There were no transfers between Level 1 and Level 2 during the twelve month periods ended December 31, 2010 and 2009.

XL INSURANCE (BERMUDA) LTD

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
FOR THE YEARS ENDED DECEMBER 31, 2010 AND 2009

3. Fair Value Measurements (Continued)

Level 3 Gains and Losses (continued)

	Level 3 Assets and Liabilities Year Ended December 31, 2010				
	Corporate	Residential mortgage-backed securities – Agency	Residential mortgage-backed securities – Non Agency	Commercial mortgage-backed securities	Collateralized debt obligations
<i>(U.S. dollars in thousands)</i>					
Balance, beginning of period	\$ 10,273	\$ 7,894	\$ 41,905	\$ 2,081	\$ 189,537
Realized gains (losses)	(6,360)	(360)	(1,054)	(553)	(24,183)
Movement in unrealized gains (losses)	1,093	(74)	410	748	118,857
Purchases, (sales), issuances and (settlements), net	17,577	30,689	(2,226)	(64)	(1,834)
Transfers into Level 3	6,889	–	4,250	–	469,149
Transfers out of Level 3	(849)	(7,894)	(39,390)	–	–
Investments classification change	(1,169)	–	–	(601)	(31,883)
Balance, end of period	<u>\$ 27,454</u>	<u>\$ 30,255</u>	<u>\$ 3,895</u>	<u>\$ 1,611</u>	<u>\$ 719,643</u>
Movement in total gains (losses) above relating to instruments still held at the reporting date	<u>\$ 1,321</u>	<u>\$ (74)</u>	<u>\$ 71</u>	<u>\$ 251</u>	<u>\$ 118,415</u>

	Level 3 Assets and Liabilities Year Ended December 31, 2010 (Continued)				
	Other asset backed securities	Non-U.S. Sovereign Government and Supranationals and Government Related	Short-term Investments	Other investments	Derivative Contracts – Net
<i>(U.S. dollars in thousands)</i>					
Balance, beginning of period	\$ 33,955	\$ 3,217	\$ 6,486	\$ 70,295	\$ 100,515
Realized gains (losses)	(18,107)	–	(3,559)	(907)	874
Movement in unrealized gains (losses)	14,902	34	2,364	16,577	57,688
Purchases, (sales), issuances and (settlements), net	2,852	–	(4,753)	(10,159)	(198,272)
Transfers into Level 3	1,355	416	–	18,248	–
Transfers out of Level 3	(12,778)	–	–	–	–
Investments classification change	–	–	1,645	31,883	–
Balance, end of period	<u>\$ 22,179</u>	<u>\$ 3,667</u>	<u>\$ 2,183</u>	<u>\$ 125,937</u>	<u>\$ (39,195)</u>
Movement in total gains (losses) above relating to instruments still held at the reporting date	<u>\$ 8,253</u>	<u>\$ 34</u>	<u>\$ (103)</u>	<u>\$ 11,154</u>	<u>\$ 57,688</u>

XL INSURANCE (BERMUDA) LTD

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
FOR THE YEARS ENDED DECEMBER 31, 2010 AND 2009**

3. Fair Value Measurements (Continued)

Level 3 Gains and Losses (continued)

	Level 3 Assets and Liabilities Year Ended December 31, 2009				
	Corporate	Residential mortgage-backed securities – Agency	Residential mortgage-backed securities – Non Agency	Commercial mortgage-backed securities	Collateralized debt obligations
<i>(U.S. dollars in thousands)</i>					
Balance, beginning of period	\$ 62,506	\$ –	\$ 79,429	\$ 43,811	\$ 598,110
Realized (losses) gains	(12,738)	–	(13,254)	(8,195)	(43,145)
Movement in unrealized gains (losses)	12,224	(126)	21,990	2,447	50,446
Purchases, sales issuances and settlements, net	(21,751)	8,020	(15,420)	(4,017)	(11,313)
Transfers into Level 3	6,517	–	14,422	1,430	15,457
Transfers out of Level 3	(36,485)	–	(45,262)	(33,395)	(415,025)
Fixed maturities to short-term investments classification change	–	–	–	–	(4,993)
Balance, end of period	<u>\$ 10,273</u>	<u>\$ 7,894</u>	<u>\$ 41,905</u>	<u>\$ 2,081</u>	<u>\$ 189,537</u>
Movement in total (losses) above relating to instruments still held at the reporting date	<u>\$ 660</u>	<u>\$ (126)</u>	<u>\$ 15,719</u>	<u>\$ (9)</u>	<u>\$ 28,921</u>

	Level 3 Assets and Liabilities Year Ended December 31, 2009 (continued)				
	Other asset backed securities	Non-U.S. Sovereign Government and Supranationals and Government Related	Short-term Investments	Other investments	Derivative Contracts – Net
<i>(U.S. dollars in thousands)</i>					
Balance, beginning of period	\$ 78,871	\$ 89,152	\$ 20,746	\$ 58,239	\$ 226,818
Realized (losses) gains	(9,991)	–	(8,701)	–	2,807
Movement in unrealized gains (losses)	(2,652)	(94)	3,454	566	(147,216)
Purchases, sales issuances and settlements, net	(4,982)	(6,882)	(12,991)	11,490	18,106
Transfers into Level 3	8,531	–	–	–	–
Transfers out of Level 3	(35,822)	(76,740)	(3,234)	–	–
Fixed maturities to short-term investments classification change	–	(2,219)	7,212	–	–
Balance, end of period	<u>\$ 33,955</u>	<u>\$ 3,217</u>	<u>\$ 6,486</u>	<u>\$ 70,295</u>	<u>\$ 100,515</u>
Movement in total (losses) above relating to instruments still held at the reporting date	<u>\$ (13,607)</u>	<u>\$ 72</u>	<u>\$ (887)</u>	<u>\$ 566</u>	<u>\$ (147,216)</u>

XL INSURANCE (BERMUDA) LTD

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued) FOR THE YEARS ENDED DECEMBER 31, 2010 AND 2009

3. Fair Value Measurements (Continued)

Fixed maturities and short-term investments

During the year ended December 31, 2010, certain CDOs that were previously classified as Level 2 due to sufficient market data being available to allow a price to be determined and provided by third party pricing vendors, were transferred to Level 3 because third party vendor prices were no longer believed to be the most appropriate pricing source. Broker quotes, for which sufficient information regarding the specific inputs utilized by the broker was not available to support a Level 2 classification, are the primary source of the valuations for these CDO securities.

At December 31, 2009, certain assets which were previously classified as Level 3 assets due to a lack of observable market data are now classified as Level 2 assets as described further below.

For the period from December 31, 2008 through June 30, 2009, the Company had determined that internal models were more appropriate and better representative of the fair value of these securities. At June 30, 2009, these internal valuation models for Collateralized Debt Obligations holdings ("CDOs") resulted in a fair value of \$450.5 million as compared to a par value of \$807.5 million. However, as a result of numerous market factors, including increased volumes of trading and increased new issuance of CDOs beginning with the third quarter of 2009, the Company now believes that transactions in this market are no longer distressed and accordingly had reverted to third-party vendor pricing sources where transactions were available as of December 31, 2009, and where not available based the valuations on broker quotes. Accordingly, as at December 31, 2009, for those CDOs which were previously valued using internal models, the Company carried these assets at a fair value of \$538.5 million as compared to a par value of \$789.1 million. Of these holdings, \$457.6 million were valued by third party vendors and for which inputs are observable and accordingly are now classified as Level 2, and \$80.9 million were valued using broker quotations and for which inputs are unobservable and accordingly remain classified as Level 3.

The remainder of the Level 3 assets relate to private equity investments where the nature of the underlying assets held by the investee include positions such as private business ventures and are such that significant Level 3 inputs are utilized in the valuation, and certain derivative positions.

Other investments

Included within the Other investments component of the Company's Level 3 valuations are private investments and alternative 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 underlying investments held by the investee that form the basis of the net asset value include assets such as private business ventures that require the use of significant Level 3 inputs 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. Investments in private equity and alternative funds included in Other investments utilize strategies including Arbitrage, Directional, Event Driven and Multi-style. These funds potentially have lockup and gate provisions which may limit redemption liquidity.

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) guaranteed minimum income benefits ("GMIB") embedded within a certain reinsurance contract, (iii) a put option included within the Company's remaining contingent capital facility and (iv) 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. 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 2(h), "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.

XL INSURANCE (BERMUDA) LTD

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued) FOR THE YEARS ENDED DECEMBER 31, 2010 AND 2009

3. Fair Value Measurements (Continued)

Financial Instruments Not Carried at Fair Value

Authoritative guidance over disclosures about the fair value of financial instruments requires additional disclosure of fair value information for financial instruments not carried at fair value in both interim and annual reporting periods. Certain financial instruments, particularly insurance contracts, are excluded from these fair value disclosure requirements. The carrying values of cash and cash equivalents, accrued investment income, net receivable from investments sold, other assets, net payable for investments purchased, other liabilities and other financial instruments not included below approximated their fair values. The following table includes financial instruments for which the carrying value differs from the estimated fair values:

<i>(U.S. dollars in thousands)</i>	As of December 31, 2010		As of December 31, 2009	
	Carrying Value	Fair Value	Carrying Value	Fair Value
Fixed maturities, held to maturity	\$ 2,728,335	\$ 2,742,626	\$ 546,067	\$ 530,319
Other investments – structured transactions	327,686	317,524	365,600	341,352
Financial Assets	<u>\$ 3,056,021</u>	<u>\$ 3,060,150</u>	<u>\$ 911,667</u>	<u>\$ 871,671</u>
Deposit Liabilities	\$ 1,684,606	\$ 1,737,107	\$ 2,208,699	\$ 2,133,100
Notes payable and debt	599,668	621,900	599,350	621,750
Financial Liabilities	<u>\$ 2,284,274</u>	<u>\$ 2,359,007</u>	<u>\$ 2,808,049</u>	<u>\$ 2,754,850</u>

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

Deposit liabilities include obligations under structured insurance and reinsurance transactions. For purposes of fair value disclosures, the Company determines the estimated fair value of the deposit liabilities by assuming a discount rate equal to the appropriate U.S. Treasury rate plus 142.3 basis points and the appropriate U.S. Treasury Rate plus 108.3 basis points at December 31, 2010 and December 31, 2009, respectively. The discount rate incorporates the Company's own credit risk into the determination of estimated fair value.

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

There are no significant concentrations of credit risk within the Company's financial instruments as defined in the authoritative guidance over disclosures of fair value of financial instruments not carried at fair value.

XL INSURANCE (BERMUDA) LTD

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued) FOR THE YEARS ENDED DECEMBER 31, 2010 AND 2009

4. Syncora Holdings Ltd. (“Syncora”)

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. 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.

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 was required to use commercially reasonable efforts to commute the agreements that were 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.

On June 28, 2010, the Company completed a commutation, termination and release agreement (the “Termination Agreement”) with EIB which fully extinguished and terminated all of the guarantees issued to EIB by the Company in connection with financial guaranty policies between certain subsidiaries of Syncora and EIB. Under the Termination Agreement, the Company paid \$38 million to EIB, and all of the Company’s exposures under the EIB guarantees, with aggregate par outstanding of approximately \$900 million, were eliminated. In addition, a further \$0.5 million was paid to EIB for expenses in relation to the termination. Pursuant to the obligations of Syncora under the Master Agreement, Syncora paid the Company \$15.0 million. The net cost of this transaction is reflected in the Company’s Consolidated Statement of Income as “Loss on Termination of Guarantee.”

5. Restructuring and Asset Impairment Charges

During the third quarter of 2008 and during the first quarter of 2009, expense reduction initiatives were implemented in order to reduce the Company’s operating expenses. The goal of these initiatives 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 and asset impairment charges and allocated to the Company’s reportable segments in accordance with authoritative guidance over accounting for costs associated with exit or disposal activities and guidance over accounting for the impairment or disposal of long-lived assets. Other costs that do not meet the criteria for accrual are being expensed as restructuring charges as they are incurred. 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. Asset impairment charges relate primarily to the write-off of certain IT system and equipment costs previously capitalized. The Company recognizes an asset impairment charge when net proceeds expected from disposition of an asset are less than the carrying value of the asset and reduces the carrying amount of the asset to its estimated fair value. Restructuring and asset impairment charges noted above were recorded in the Company’s income statement under “Operating Expenses.”

The total cumulative costs the Company incurred in connection with these restructuring initiatives through their completion at December 31, 2009 were as follows:

	Costs Incurred During the Year Ended December 31, 2008	Costs Incurred During the Year Ended December 31, 2009	Cumulative Costs Incurred
<i>(U.S. dollars in millions)</i>			
Employee Termination Benefits	\$ 36.2	\$ 44.7	\$ 80.9
Lease Termination and Other Costs	6.6	8.0	14.6
Asset Impairment	-	20.5	20.5
Total	<u>\$ 42.8</u>	<u>\$ 73.2</u>	<u>\$ 116.0</u>

XL INSURANCE (BERMUDA) LTD

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued) FOR THE YEARS ENDED DECEMBER 31, 2010 AND 2009

6. Segment Information

Following a streamlining of the Company's operating segments in the first quarter of 2009, the Company is organized into three operating segments: Insurance, Reinsurance and Life operations. The Company's general investment and financing operations are reflected in Corporate.

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

Insurance

Insurance business written includes risk management and specialty lines. Risk management products comprise global property and casualty insurance programs for large multinational companies, including umbrella liability, products recall, U.S. workers' compensation, property catastrophe, and primary property and liability coverages. Specialty lines products include the following lines of business: professional liability, environmental liability, aviation and satellite, marine and offshore energy insurance, equine and other insurance coverages including program business. In addition, certain structured indemnity products previously structured by XLFS are included within the results of the Insurance segment covering a range of insurance risks including property and casualty insurance, certain types of residual value exposures and other market risk management products.

Reinsurance

Reinsurance business written includes treaty and facultative reinsurance to primary insurers of casualty and property risks, principally: general liability; professional liability; automobile and workers' compensation; commercial and personal property risks; specialty risks including fidelity and surety and ocean marine; property catastrophe; property excess of loss; property pro-rata; marine and energy; aviation and satellite; and various other reinsurance to insurers on a worldwide basis. In addition, the results of certain transactions previously structured by XLFS that were generally written on an aggregate stop loss or excess of loss basis are included within the results of the Reinsurance segment.

Life Operations

Life Operations covers life reinsurance business written with life insurance companies, principally to help them manage mortality, morbidity, survivorship, investment and lapse risks. This includes a broad range of underlying lines of life assurance business, including term assurances, group life, critical illness cover, immediate annuities, disability income cover, and short-term accident and health business. This also covers a range of geographic markets, with an emphasis on the U.K., the U.S. and Continental Europe.

XL INSURANCE (BERMUDA) LTD

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued) FOR THE YEARS ENDED DECEMBER 31, 2010 AND 2009

6. Segment Information (Continued)

Year ended December 31, 2010:

(U.S. dollars in thousands, except ratios)

	Insurance	Reinsurance	Total P&C	Life Operations	Corporate	Total
Gross premiums written.....	\$ 4,418,380	\$ 1,842,951	\$ 6,261,331	\$ 411,938	\$ —	\$ 6,673,269
Net premiums written	3,461,150	1,538,438	4,999,588	382,075	—	5,381,663
Net premiums earned.....	3,529,138	1,501,999	5,031,137	382,924	—	5,414,061
Net losses and loss expenses.....	(2,505,502)	(706,298)	(3,211,800)	(513,833)	—	(3,725,633)
Acquisition costs.....	(418,146)	(321,008)	(739,154)	(49,104)	—	(788,258)
Operating expenses (1)	(642,103)	(175,586)	(817,689)	(10,470)	—	(828,159)
Underwriting profit (loss)	\$ (36,613)	\$ 299,107	\$ 262,494	\$ (190,483)	\$ —	\$ 72,011
Net investment income			745,894	313,172	—	1,059,066
Net results from structured products (2)	14,696	3,075	17,771	—	9,804	27,575
Net fee income and other (3).....	(15,564)	2,488	(13,076)	249	2	(12,825)
Net realized gains (losses) on investments.....			(70,529)	(54,444)	—	(124,973)
Contribution from P&C, Life Operations and Corporate.....			\$ 942,554	\$ 68,494	\$ 9,806	\$ 1,020,854
Corporate & other:						
Net realized & unrealized gains (losses) on derivative instruments					\$ (25,579)	\$ (25,579)
Net income (loss) from investment fund affiliates and operating affiliates					172,455	172,455
Exchange gains (losses)					11,472	11,472
Corporate operating expenses					(10,755)	(10,755)
Interest expense (4)					(48,853)	(48,853)
Non-controlling interest in net (income) loss of subsidiary					(4)	(4)
Loss on termination of guarantee.....					(23,500)	(23,500)
Income taxes & other.....					(151,552)	(151,552)
Net income attributable to XL Insurance (Bermuda) Ltd						\$ 944,538
Ratios – P&C operations: (5)						
Loss and loss expense ratio.....	71.0%	47.0%	63.8%			
Underwriting expense ratio.....	30.0%	33.1%	31.0%			
Combined ratio	<u>101.0%</u>	<u>80.1%</u>	<u>94.8%</u>			

Notes:

- (1) Operating expenses exclude Corporate operating expenses, shown separately.
- (2) The net results from P&C and Corporate structured products include net investment income, interest expense and operating expenses of \$69.0 million, \$52.9 million and \$1.6 million (credit) and \$12.5 million, \$1.7 million and \$1.0 million, respectively.
- (3) Net fee income and other includes operating expenses from the Company's loss prevention consulting services business and expenses related to the cost of an endorsement facility with National Indemnity Company.
- (4) Interest expense excludes interest expense related to deposit liabilities recorded in the Insurance and Reinsurance segments and Corporate.
- (5) Ratios are based on net premiums earned from P&C operations.

XL INSURANCE (BERMUDA) LTD

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued) FOR THE YEARS ENDED DECEMBER 31, 2010 AND 2009

6. Segment Information (Continued)

Year ended December 31, 2009:

(U.S. dollars in thousands, except ratios)

	Insurance	Reinsurance	Total P&C	Life Operations	Corporate	Total
Gross premiums written.....	\$ 4,251,888	\$ 1,859,423	\$ 6,111,311	\$ 576,162	\$ —	\$ 6,687,473
Net premiums written	3,273,380	1,470,332	4,743,712	532,852	—	5,276,564
Net premiums earned	3,559,793	1,591,946	5,151,739	555,101	—	5,706,840
Net losses and loss expenses	(2,399,747)	(769,090)	(3,168,837)	(677,562)	—	(3,846,399)
Acquisition costs	(429,170)	(346,699)	(775,869)	(77,689)	—	(853,558)
Operating expenses (1)	(689,131)	(190,596)	(879,727)	(16,009)	—	(895,736)
Underwriting profit (loss)	\$ 41,745	\$ 285,561	\$ 327,306	\$ (216,159)	\$ —	\$ 111,147
Net investment income			866,552	332,425	—	1,198,977
Net results from structured products (2)	16,660	26,374	43,034	—	16,609	59,643
Net fee income and other (3)	(14,241)	6,209	(8,032)	290	—	(7,742)
Net realized gains (losses) on investments			(1,023,395)	(232,375)	—	(1,255,770)
Contribution from P&C, Life Operations and Corporate			\$ 205,465	\$ (115,819)	\$ 16,609	\$ 106,255
Corporate & other:						
Net realized & unrealized gains (losses) on derivative instruments					\$ (24,816)	\$ (24,816)
Net income (loss) from investment fund affiliates and operating affiliates					138,126	138,126
Exchange gains (losses)					(84,858)	(84,858)
Corporate operating expenses					4,110	4,110
Interest expense (4)					(50,102)	(50,102)
Non-controlling interest in net (income) loss of subsidiary					104	104
Loss on termination of guarantee					—	—
Income taxes & other					(102,647)	(102,647)
Net loss attributable to XL Insurance (Bermuda) Ltd						\$ (13,828)
Ratios – P&C operations: (5)						
Loss and loss expense ratio	67.4%	48.3%	61.5%			
Underwriting expense ratio	31.4%	33.8%	32.1%			
Combined ratio	98.8%	82.1%	93.6%			

Notes:

- (1) Operating expenses exclude Corporate operating expenses, shown separately.
- (2) The net results from P&C and Corporate structured products include net investment income, interest expense and operating expenses of \$79.3 million, \$36.3 million and \$nil, and \$25.3 million, \$7.4 million and \$1.3 million, respectively.
- (3) Net fee income and other includes operating expenses from the Company's loss prevention consulting services business and expenses related to the cost of an endorsement facility with National Indemnity Company.
- (4) Interest expense excludes interest expense related to deposit liabilities recorded in the Insurance and Reinsurance segments and Corporate.
- (5) Ratios are based on net premiums earned from P&C operations.

XL INSURANCE XL INSURANCE (BERMUDA) LTD

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
FOR THE YEARS ENDED DECEMBER 31, 2010 AND 2009**

6. Segment Information (Continued)

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

Year ended December 31, 2010:

(U.S. dollars in thousands, except ratios)

	<u>Insurance</u>	<u>Reinsurance</u>	<u>Life Operations</u>	<u>Total</u>
P&C Operations:				
Casualty – professional lines	\$ 1,316,173	\$ 222,720	\$ –	\$ 1,538,893
Casualty – other lines	632,737	219,154	–	851,891
Property catastrophe	–	323,588	–	323,588
Other property	416,917	534,422	–	951,339
Marine, energy, aviation and satellite	540,319	88,855	–	629,174
Other specialty lines (1)	606,682	–	–	606,682
Other (2)	1,554	112,305	–	113,859
Structured indemnity	14,756	955	–	15,711
Total P&C Operations	<u>\$ 3,529,138</u>	<u>\$ 1,501,999</u>	<u>\$ –</u>	<u>\$ 5,031,137</u>
Life Operations:				
Other Life	\$ –	\$ –	\$ 255,905	\$ 255,905
Annuity	–	–	127,019	127,019
Total Life Operations	<u>\$ –</u>	<u>\$ –</u>	<u>\$ 382,924</u>	<u>\$ 382,924</u>
Total	<u>\$ 3,529,138</u>	<u>\$ 1,501,999</u>	<u>\$ 382,924</u>	<u>\$ 5,414,061</u>

Year ended December 31, 2009:

(U.S. dollars in thousands, except ratios)

	<u>Insurance</u>	<u>Reinsurance</u>	<u>Life Operations</u>	<u>Total</u>
P&C Operations:				
Casualty – professional lines	\$ 1,276,005	\$ 196,624	\$ –	\$ 1,472,629
Casualty – other lines	655,126	257,610	–	912,736
Property catastrophe	2,396	312,780	–	315,176
Other property	424,045	560,379	–	984,424
Marine, energy, aviation and satellite	546,806	83,532	–	630,338
Other specialty lines (1)	634,436	–	–	634,436
Other (2)	12,217	172,588	–	184,805
Structured indemnity	8,762	8,433	–	17,195
Total P&C Operations	<u>\$ 3,559,793</u>	<u>\$ 1,591,946</u>	<u>\$ –</u>	<u>\$ 5,151,739</u>
Life Operations:				
Other Life	\$ –	\$ –	\$ 422,594	\$ 422,594
Annuity	–	–	132,507	132,507
Total Life Operations	<u>\$ –</u>	<u>\$ –</u>	<u>\$ 555,101</u>	<u>\$ 555,101</u>
Total	<u>\$ 3,559,793</u>	<u>\$ 1,591,946</u>	<u>\$ 555,101</u>	<u>\$ 5,706,840</u>

XL INSURANCE (BERMUDA) LTD

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued) FOR THE YEARS ENDED DECEMBER 31, 2010 AND 2009

6. Segment Information (Continued)

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

P&C operations:

(U.S. dollars in thousands)

	2010	2009
Bermuda.....	\$ 561,514	\$ 545,965
United States.....	2,143,240	2,342,656
Europe and other.....	2,294,834	1,855,091
Total P&C operations.....	<u>\$ 4,999,588</u>	<u>\$ 4,743,712</u>

Life Operations:

(U.S. dollars in thousands)

Bermuda.....	\$ 79,033	\$ 80,498
United States.....	—	31,478
Europe and other.....	303,042	420,876
Total Life Operations.....	<u>\$ 382,075</u>	<u>\$ 532,852</u>
Total	<u>\$ 5,381,663</u>	<u>\$ 5,276,564</u>

7. Goodwill and Other Intangible Assets

The following table presents an analysis of intangible assets broken down between goodwill, intangible assets with an indefinite life and intangible assets with a definite life for the years ended December 31, 2010 and 2009:

(U.S. dollars in thousands)	Goodwill	Intangible assets with an indefinite life	Intangible assets with a definite life	Total
Balance at December 31, 2008	\$ 645,370	\$ 18,666	\$ 10,052	\$ 674,088
Reclassification	—	—	(4,440)	(4,440)
Amortization	—	(3,300)	(1,858)	(5,158)
Foreign Currency Translation	1,179	—	—	1,179
Balance at December 31, 2009	\$ 646,549	\$ 15,366	\$ 3,754	\$ 665,669
Amortization	—	—	(1,858)	(1,858)
Foreign Currency Translation	(3,764)	—	—	(3,764)
Balance at December 31, 2010	<u>\$ 642,785</u>	<u>\$ 15,366</u>	<u>\$ 1,896</u>	<u>\$ 660,047</u>

The Company has goodwill of \$642.8 million as at December 31, 2010. The estimated fair values of these reporting units exceeded their net book values as of December 31, 2010 and therefore no impairments were recorded during 2010.

During July 2009, the Company entered into an agreement to sell its U.S. life reinsurance business. The transaction closed during the fourth quarter of 2009. Accordingly, the full value of the licenses held relating to this business of \$3.3 million was removed from intangible assets with an indefinite life as part of the sale transaction.

In addition, during 2009 certain internal use software acquired as part of the XL GAPS acquisition, which occurred in late 2007, with a carried value of \$4.4 million was reclassified from intangible assets with a definite life into other assets. No impairments were recorded on intangible assets during any of the years ended December 2010 and 2009.

XL INSURANCE (BERMUDA) LTD

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued) FOR THE YEARS ENDED DECEMBER 31, 2010 AND 2009

8. Investments

Net investment income is derived from the following sources:

Year ended December 31

(U.S. dollars in thousands)

	2010	2009
Fixed maturities, short-term investments and cash equivalents	\$ 1,169,839	\$ 1,320,609
Equity securities and other investments	20,688	13,753
Funds withheld	12,738	14,649
Total gross investment income	1,203,265	1,349,011
Investment expenses	(81,331)	(45,384)
Net investment income	\$ 1,121,934	\$ 1,303,627

The cost (amortized cost for fixed maturities and short-term investments), fair value, gross unrealized gains, gross unrealized (losses), and OTTI recorded in AOCI of the Company's available for sale investments at December 31, 2010 and December 31, 2009 were as follows:

		Included in Accumulated Other Comprehensive Income ("AOCI")			
			Gross Unrealized Losses		
	Cost or Amortized Cost	Gross Unrealized Gains	Related to changes in estimated fair value	OTTI included in other comprehensive income (Loss)(1)	Fair Value
December 31, 2010					
<i>(U.S. dollars in thousands)</i>					
Fixed maturities					
U.S. Government and Government-Related/Supported (2)	\$ 1,870,952	\$ 94,917	\$ (23,917)	\$ -	\$ 1,941,952
Corporate (3) (4)	10,035,798	332,214	(260,469)	(73,768)	10,033,775
Residential mortgage-backed securities – Agency	4,709,576	143,834	(8,537)	-	4,844,873
Residential mortgage-backed securities – Non-Agency	816,447	15,036	(95,553)	(45,254)	690,676
Commercial mortgage-backed securities	1,092,599	48,903	(5,665)	(6,040)	1,129,797
Collateralized debt obligations	914,092	9,946	(186,548)	(7,576)	729,914
Other asset-backed securities	926,723	15,625	(19,745)	(7,075)	915,528
U.S. States and political subdivisions of the States	1,362,606	16,477	(35,263)	-	1,343,820
Non-U.S. Sovereign Government, Supranational and Government-Related/Supported (2)	2,630,512	62,666	(42,875)	-	2,650,303
Total fixed maturities	<u>\$ 24,359,305</u>	<u>\$ 739,618</u>	<u>\$ (678,572)</u>	<u>\$ (139,713)</u>	<u>\$ 24,280,638</u>
Total short-term investments (3)	<u>\$ 1,620,661</u>	<u>\$ 16,690</u>	<u>\$ (29,443)</u>	<u>\$ -</u>	<u>\$ 1,607,908</u>
Total equity securities	<u>\$ 56,704</u>	<u>\$ 27,989</u>	<u>\$ (53)</u>	<u>\$ -</u>	<u>\$ 84,640</u>

- (1) Represents the amount of OTTI losses in AOCI, which from April 1, 2009 was not included in earnings under authoritative accounting guidance.
- (2) U.S. Government and Government-Related/Supported and Non-U.S. Sovereign Government, Supranationals and Government-Related/Supported includes government-related securities with an amortized cost of \$1,954.2 million and fair value of \$1,958.8 million and U.S. Agencies with an amortized cost of \$717.9 million and fair value of \$758.9 million.
- (3) Included within Corporate are certain medium term notes supported primarily by pools of European credit with varying degrees of leverage. The notes have a fair value of \$454.8 million and an amortized cost of \$504.6 million. These notes allow the investor to participate in cash flows of the underlying bonds including certain residual values, which could serve to either decrease or increase the ultimate values of these notes.
- (4) Included within Corporate are Tier One and Upper Tier Two securities, representing committed term debt and hybrid instruments senior to the common and preferred equities of the financial institutions. These securities have a fair value of \$703.0 million and an amortized cost of \$837.9 million at December 31, 2010.

XL INSURANCE (BERMUDA) LTD

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
FOR THE YEARS ENDED DECEMBER 31, 2010 AND 2009

8. Investments (Continued)

		Included in Accumulated Other Comprehensive Income ("AOCI")			
			Gross Unrealized Losses		
	Cost or Amortized Cost	Gross Unrealized Gains	Related to changes in estimated fair value	OTTI included in other comprehensive income (Loss)(1)	Fair Value
December 31, 2009					
(U.S. dollars in thousands)					
Fixed maturities					
U.S. Government and Government-Related/Supported (2)	\$ 2,445,313	\$ 69,581	\$ (28,300)	\$ —	\$ 2,486,594
Corporate (3) (4)	9,961,356	257,649	(453,021)	(111,253)	9,654,731
Residential mortgage-backed securities – Agency	5,777,191	92,316	(34,283)	–	5,835,224
Residential mortgage-backed securities – Non-Agency	1,216,936	10,526	(215,225)	(79,006)	933,231
Commercial mortgage-backed securities	1,233,008	6,296	(48,317)	(7,531)	1,183,456
Collateralized debt obligations	1,022,859	9,598	(328,185)	(8,524)	695,748
Other asset-backed securities	1,197,019	12,212	(77,928)	(9,100)	1,122,203
U.S. States and political subdivisions of the States	902,029	18,302	(14,345)	–	905,986
Non-U.S. Sovereign Government, Supranational and Government-Related/Supported (2)	3,403,072	60,352	(65,430)	–	3,397,994
Total fixed maturities	\$ 27,158,783	\$ 536,832	\$ (1,265,034)	\$ (215,414)	\$ 26,215,167
Total short-term investments	\$ 1,428,608	\$ 15,539	\$ (6,713)	\$ –	\$ 1,437,434
Total equity securities	\$ 12,106	\$ 3,631	\$ (358)	\$ –	\$ 15,379

- (1) Represents the amount of OTTI losses in AOCI, which from April 1, 2009 was not included in earnings under authoritative accounting guidance.
- (2) U.S. Government and Government-Related/Supported and Non U.S. Sovereign Government, Supranationals and Government-Related/Supported includes government-related securities with an amortized cost of \$2,273.8 million and fair value of \$2,274.7 million and U.S. Agencies with an amortized cost of \$1,091.1 million and fair value of \$1,121.0 million.
- (3) Included within Corporate are certain medium term notes supported primarily by pools of European credit with varying degrees of leverage. The notes have a fair value of \$587.7 million and an amortized cost of \$707.9 million. These notes allow the investor to participate in cash flows of the underlying bonds including certain residual values, which could serve to either decrease or increase the ultimate values of these notes.
- (4) Included within Corporate are Tier One and Upper Tier Two securities, representing committed term debt and hybrid instruments senior to the common and preferred equities of the financial institutions. These securities have a fair value of \$842.2 million and an amortized cost of \$1,053.6 million at December 31, 2009.

The Company had gross unrealized losses totaling \$0.8 billion at December 31, 2010 on its available for sale portfolio and \$24.7 million on its held-to-maturity portfolio, which it considers to be temporarily impaired. 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 of impairment along with management's assessment as to whether it is likely to sell these securities, among other factors included below.

At December 31, 2010 and December 31, 2009, approximately 2.9% and 3.6%, respectively, of the Company's fixed income investment portfolio at fair value was invested in securities which were below investment grade or not rated. Approximately 20.4% and 30.1% of the gross unrealized losses in the Company's fixed income securities portfolio at December 31, 2010 and 2009, respectively, related to securities that were below investment grade or not rated.

XL INSURANCE (BERMUDA) LTD

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued) FOR THE YEARS ENDED DECEMBER 31, 2010 AND 2009

8. Investments (Continued)

The following is an analysis of how long each of those available for sale securities at December 31, 2010 had been in a continual unrealized loss position:

	Less than 12 months		Equal to or greater than 12 months	
	Fair Value	Gross Unrealized Losses (1)	Fair Value	Gross Unrealized Losses (1)
December 31, 2010 (U.S. dollars in thousands)				
Fixed maturities and short-term investments:				
U.S. Government and Government-Related/Supported	\$ 278,514	\$ 25,465	\$ 104,614	\$ 10,398
Corporate (2) (3)	2,238,147	79,446	1,580,239	264,859
Residential mortgage-backed securities – Agency	277,119	6,645	34,186	1,913
Residential mortgage-backed securities – Non-Agency	29,408	1,615	574,832	139,473
Commercial mortgage-backed securities	42,854	446	60,412	11,279
Collateralized debt obligations	2,500	51	712,608	194,282
Other asset-backed securities	119,345	1,606	217,351	28,997
U.S. States and political subdivisions of the States	734,893	30,033	40,451	5,268
Non-U.S. Sovereign Government, Supranational and Government-Related	459,686	5,116	418,323	40,836
Total fixed maturities and short-term investments	\$ 4,182,466	\$ 150,423	\$ 3,743,016	\$ 697,305
Total equity securities	\$ 158	\$ 53	\$ —	\$ —

- (1) On securities impacted by the April 1, 2009 changes to OTTI values, length of time of impairment is measured from the point at which securities returned to a net unrealized loss position (i.e. from April 1, 2009).
- (2) Included within Corporate are certain medium term notes supported primarily by pools of European credit with varying degrees of leverage. The notes have a fair value of \$454.8 million and an amortized cost of \$504.6 million. These notes allow the investor to participate in cash flows of the underlying bonds including certain residual values, which could serve to either decrease or increase the ultimate values of these notes.
- (3) Included within Corporate are Tier One and Upper Tier Two securities, representing committed term debt and hybrid instruments senior to the common and preferred equities of the financial institutions. These securities have a fair value of \$703.0 million and an amortized cost of \$837.9 million at December 31, 2010.

The following is an analysis of how long each of those available for sale securities at December 31, 2009 had been in a continual unrealized loss position:

	Less than 12 months		Equal to or greater than 12 months	
	Fair Value	Gross Unrealized Losses (1)	Fair Value	Gross Unrealized Losses (1)
December 31, 2009 (U.S. dollars in thousands)				
Fixed maturities and short-term investments:				
U.S. Government and Government-Related/Supported	\$ 771,048	\$ 15,406	\$ 84,105	\$ 13,657
Corporate (2) (3)	1,860,257	54,823	2,830,623	509,451
Residential mortgage-backed securities – Agency	2,722,188	34,511	2,342	328
Residential mortgage-backed securities – Non-Agency	73,992	17,540	812,730	276,691
Commercial mortgage-backed securities	226,930	7,882	544,474	47,966
Collateralized debt obligations	126,871	35,320	561,138	301,445
Other asset-backed securities	267,520	4,485	543,638	82,579
U.S. States and political subdivisions of the States	325,019	5,506	55,051	8,869
Non-U.S. Sovereign Government, Supranational and Government-Related	943,437	17,347	513,919	53,355
Total fixed maturities and short-term investments	\$ 7,317,262	\$ 192,820	\$ 5,948,020	\$ 1,294,341
Total equity securities	\$ 1,661	\$ 358	\$ —	\$ —

- (1) On securities impacted by the April 1, 2009 changes to OTTI values, length of time of impairment is measured from the point at which securities returned to a net unrealized loss position (i.e. from April 1, 2009).
- (2) Included within Corporate are certain medium term notes supported primarily by pools of European credit with varying degrees of leverage. The notes have a fair value of \$587.7 million and an amortized cost of \$707.9 million. These notes allow the investor to participate in cash flows of the underlying bonds including certain residual values, which could serve to either decrease or increase the ultimate values of these notes.
- (3) Included within Corporate are Tier One and Upper Tier Two securities, representing committed term debt and hybrid instruments senior to the common and preferred equities of the financial institutions. These securities have a fair value of \$842.2 million and an amortized cost of \$1,053.6 million at December 31, 2009.

XL INSURANCE (BERMUDA) LTD

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued) FOR THE YEARS ENDED DECEMBER 31, 2010 AND 2009

8. Investments (Continued)

The contractual maturities of available for sale fixed income 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, 2010 (1)		December 31, 2009 (1)	
	Amortized Cost	Fair Value	Amortized Cost	Fair Value
<i>(U.S. dollars in thousands)</i>				
Due after 1 through 5 years	\$ 8,477,292	\$ 8,596,272	\$ 7,708,368	\$ 7,747,103
Due after 5 through 10 years	3,660,012	3,777,636	3,916,670	3,943,255
Due after 10 years	3,762,565	3,595,942	5,086,732	4,754,947
	<u>15,899,869</u>	<u>15,969,850</u>	<u>16,711,770</u>	<u>16,445,305</u>
Residential mortgage-backed securities – Agency	4,709,576	4,844,873	5,777,191	5,835,224
Residential mortgage-backed securities – Non-Agency	816,447	690,676	1,216,936	933,231
Commercial mortgage-backed securities	1,092,599	1,129,797	1,233,008	1,183,456
Collateralized debt obligations	914,092	729,914	1,022,859	695,748
Other asset-backed securities	926,723	915,528	1,197,019	1,122,203
Total mortgage and asset-backed securities	<u>8,459,437</u>	<u>8,310,788</u>	<u>10,447,013</u>	<u>9,769,862</u>
Total	<u>\$ 24,359,306</u>	<u>\$ 24,280,638</u>	<u>\$ 27,158,783</u>	<u>\$ 26,215,167</u>

(1) Included in the table above are Tier One and Upper Tier Two securities, representing committed term debt and hybrid instruments senior to the common and preferred equities of the financial institutions, at their fair value of \$703.0 million and \$842.2 million at December 31, 2010 and December 31, 2009, respectively. These securities have been distributed in the table based on their call date and have net unrealized losses of \$134.9 million and \$211.4 million at December 31, 2010 and December 31, 2009, respectively.

Factors considered in determining that the remaining gross unrealized loss is not other-than-temporarily impaired include management's consideration of current and near term liquidity needs and other available sources, 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.

Gross unrealized losses of \$0.8 billion on available for sale and \$24.7 million on held to maturity assets at December 31, 2010 can be attributed to the following significant drivers:

- gross unrealized losses of \$206.5 million related to the Company's Life Operations investment portfolio, which had a fair value of \$6.4 billion as at December 31, 2010. Of this, \$150.4 million of gross unrealized losses related to \$1.6 billion of exposures to corporate financial institutions including \$616.5 million Tier One and Upper Tier Two securities. In addition, \$75.8 million of gross unrealized losses are foreign exchange losses related to the corporate holdings within the Company's Life operations investment portfolio, that are expected to recover prior to the sale or maturity of the holdings. At December 31, 2010, this portfolio had an average interest rate duration of 8.3 years, primarily denominated in U.K. sterling and Euros. As a result of the long duration, significant gross losses have arisen as the fair values of these securities are more sensitive to prevailing government interest rates and credit spreads. This portfolio is generally matched to corresponding long duration liabilities. A hypothetical parallel increase in interest rates and credit spreads of 50 and 25 basis points, respectively, would increase the unrealized losses related to this portfolio at December 31, 2010 by approximately \$258.1 million and \$100.1 million, respectively on both the available for sale and held to maturity portfolios. Given the long term nature of this portfolio, and the level of credit spreads on financial institutions as at December 31, 2010 relative to historical averages within the U.K. and Euro-zone as well as the Company's liquidity needs at December 31, 2010, the Company believes that these assets will continue to be held until such time as they mature, or credit spreads on financial institutions revert to levels more consistent with historical averages.
- gross unrealized losses of \$193.0 million related to the non-life portfolio of Core CDO holdings (defined by the Company as investments in non-subprime collateralized debt obligations), which consisted primarily of CDOs and had a fair value of \$729.7 million as of December 31, 2010. The Company evaluated each of these securities in conjunction with its investment manager service providers and recognized charges to the extent it believed the discounted cash flow value of the security was below the amortized cost. The Company believes that the level of impairment is primarily a function of historically wide spreads in the CDO market during the period, driven by the level of illiquidity in this market. The Company previously announced its intention to reduce its exposure to this asset class over time as a part of its strategic portfolio realignment. The Company, based on current market conditions and liquidity needs as well as its assessment of the holdings, believes it is likely that the Company will continue to hold these securities until either maturity or a recovery of value, following which the Company intends to reduce its exposure to this asset class.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued) FOR THE YEARS ENDED DECEMBER 31, 2010 AND 2009

8. Investments (Continued)

- gross unrealized losses of \$170.8 million related to the corporate holdings within the Company's non-life fixed income portfolios, which had a fair value of \$8.4 billion as at December 31, 2010. During the year ended December 31, 2010, as a result of declining credit spreads, the gross unrealized losses on these holdings has decreased. Of the gross unrealized losses noted above \$63.8 million relate to financial institutions. In addition, \$49.7 million relate to medium term notes primarily supported by pools of investment grade European credit with varying degrees of leverage. These had a fair value of \$427.7 million at December 31, 2010. Management believes that expected cash flows over the expected holding period from these bonds is sufficient to support the remaining reported amortized cost.
- gross unrealized losses of \$141.1 million related to the non-Agency residential mortgage backed securities ("RMBS") portfolio (which consists of the Company's holdings of sub-prime non-agency securities, second liens, ABS CDOs with sub-prime collateral, Alt-A mortgage exposures and Prime RMBS), which had a fair value of \$604.2 million as at December 31, 2010. The Company, in conjunction with its investment manager service providers, undertook a security level review of these securities and recognized charges to the extent it believed the discounted cash flow value of any security was below its amortized cost. The Company has recognized realized losses, consisting of charges for OTTI and realized losses from sales, of approximately \$1.2 billion since the beginning of 2007 through December 31, 2010 on these asset classes.

Management, in its assessment of whether securities in a gross unrealized loss position are temporarily impaired, considers the significance of the impairments. The Company had structured credit securities with gross unrealized losses of \$44.4 million, with a fair value of \$16.9 million, which as at December 31, 2010 were impaired by greater than 50% of amortized costs. All of these are asset-backed securities. Of these gross unrealized losses, \$6.5 million are rated investment grade. The Company in conjunction with its investment manager service providers, undertook a security level review of these securities and recognized charges to the extent it believed the discounted cash flow value of any security was below its amortized cost. These securities include gross unrealized losses of \$18.6 million on non-Agency RMBS and \$25.4 million of Core CDOs.

The Company recorded net impairment charges of \$145.1 million and \$757.6 million for the years ended December 31, 2010 and 2009, respectively. The components of the 2010 impairments include:

- For structured credit securities, the Company recorded net impairments of \$58.5 million principally on non-agency RMBS securities for the year ended December 31, 2010. The Company determined that the likely recovery on these securities was below the carrying value, and accordingly impaired the securities to the discounted value of the cash flows of these securities.
- For corporate securities, excluding medium term notes backed primarily by investment grade European credit, the Company recorded net impairments totaling \$3.5 million for the year ended December 31, 2010.

In addition, the Company recorded impairments totaling \$11.6 million for the year ended December 31, 2010 in relation to medium term notes backed primarily by investment grade European credit. Management has concluded that, following recent credit spread movements since 2009, future yields within the supporting collateral were not sufficient to support the previously reported amortized cost.

- For the non-equity accounted alternative fund and private investment security, the Company recorded impairments of \$7.4 million for the year ended December 31, 2010 because the holdings were impaired by more than 50% of amortized cost.
- For equities, the Company recorded impairments of \$0.8 million for the year ended December 31, 2010.
- The Company recorded impairments of \$10.8 million related to currency losses for the year ended December 31, 2010.
- As a result of its intent to sell these securities, the Company recorded impairments totaling \$25.3 million in relation to medium term notes backed primarily by investment grade European credit and impairments totaling \$27.2 million in relation to subordinated Irish bank debt.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued) FOR THE YEARS ENDED DECEMBER 31, 2010 AND 2009

8. Investments (Continued)

For the year ended December 31, 2009, included in the above totals is \$160.6 million related to changes to intent-to-hold up to March 31, 2009, or intent to sell from April 2009, primarily representing exchanges of hybrid securities, and as part of the fourth quarter 2008 change in intent to hold.

The total amount of other than temporary declines in value in 2009 included \$730.4 million related to fixed income securities and short-term investments, and \$27.2 million on equity securities.

As discussed in Note 2, a portion of certain OTTI losses on fixed income securities and short-term investments are recognized in "Other comprehensive income (loss)" ("OCI"). Under final authoritative accounting guidance effective April 1, 2009, other than in a situation in which the Company has the intent to sell a security or more likely than not will be required to sell a security, the amount of the OTTI related to a credit loss is recognized in earnings, and the amount of the OTTI related to other factors (i.e., interest rates, market conditions, etc.) is recorded as a component of other comprehensive income (loss). The net amount recognized in earnings ("credit loss impairments") represents the difference between the amortized cost of the security and the net present value of its projected future cash flows discounted at the effective interest rate implicit in the debt security prior to impairment. Any remaining difference between the fair value and amortized cost is recognized in OCI. The following table sets forth the amount of credit loss impairments on fixed income securities held by the Company as of the dates indicated, for which a portion of the OTTI loss was recognized in OCI, and the corresponding changes in such amounts.

Year Ended December 31, (U.S. dollars in thousands)	OTTI related to Credit Losses recognized in earnings	
	2010	2009
Balance, January 1	\$ 373,398	\$ —
Credit losses remaining in retained earnings related to adoption of new authoritative guidance	—	187,272
Credit loss impairment recognized in the current period on securities not previously impaired	48,441	290,034
Credit loss impairments previously recognized on securities which matured, paid down, prepaid or were sold during the period	(70,665)	(176,905)
Credit loss impairments previously recognized on securities impaired to fair value during the period	(130,891)	(37,962)
Additional credit loss impairments recognized in the current period on securities previously impaired	61,757	116,563
Accretion of credit loss impairments previously recognized due to an increase in cash flows expected to be collected	(15,425)	(5,604)
Balance, December 31	<u>\$ 266,615</u>	<u>\$ 373,398</u>

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

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued) FOR THE YEARS ENDED DECEMBER 31, 2010 AND 2009

8. Investments (Continued)

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

Year ended December 31

(U.S. dollars in thousands)

	<u>2010</u>	<u>2009</u>
Net realized gains (losses):		
Fixed maturities, short-term investments, cash and cash equivalents:		
Gross realized gains.....	\$ 141,127	\$ 348,002
Gross realized losses.....	(248,921)	(1,555,981)
Net realized (losses).....	(107,794)	(1,207,979)
Equity securities:		
Gross realized gains.....	9,445	65,289
Gross realized losses.....	(11,195)	(124,748)
Net realized gains (losses).....	(1,750)	(59,459)
Other investments:		
Gross realized gains.....	4,889	27,647
Gross realized losses.....	(20,318)	(6,351)
Net realized gains (losses).....	(15,429)	21,296
Realized loss on sale of U.S. life reinsurance business.....	—	(9,628)
Net realized (losses) on investments.....	(124,973)	(1,255,770)
Net realized and unrealized (losses) on investment related derivative instruments	(25,579)	(24,816)
Net realized (losses) on investments and net realized and unrealized (losses) on investment related derivative instruments	(150,552)	(1,280,586)
Change in unrealized gains (losses):		
Fixed maturities and short-term investments, available for sale	843,370	2,449,251
Fixed maturities, held to maturity	30,039	(15,748)
Equity securities.....	24,663	(19,417)
Affiliates and other investments	44,392	15,943
Net change in unrealized gains (losses) on investments	942,464	2,430,029
Total net realized (losses) on investments, net realized and unrealized (losses) on investment related derivative instruments, and net change in unrealized gains (losses) on investments.....	<u>\$ 791,912</u>	<u>\$ 1,149,443</u>

On November 1, 2009 and August 1, 2010, the Company elected to hold certain fixed income securities to maturity. Consistent with this intention, the Company has reclassified these securities from available for sale to held to maturity in the consolidated financial statements. As a result of this classification, these fixed income securities are reflected in the held to maturity portfolio and recorded at amortized cost in the consolidated balance sheets and not fair value. The held to maturity portfolio is comprised of long duration non-U.S. securities which are Euro and U.K. sterling denominated. The Company believes this held to maturity strategy is achievable due to the relatively stable and predictable cash flows of the Company's long-term liabilities within its Life operations along with its ability to substitute other assets at a future date in the event that liquidity was required due to changes in expected cash flows or other transactions entered into related to the long-term liabilities supported by the held to maturity portfolio.

As at December 31, 2010, 99.5% of the held to maturity securities are rated A or higher. The unrealized appreciation at the dates of these transfers continues to be reported as a separate component of shareholder's equity and is being amortized over the remaining lives of the securities as an adjustment to yield in a manner consistent with the amortization of any premium or discount. On November 1, 2009 and August 1, 2010 the unrealized U.S. dollar equivalent appreciation related to securities transferred at each date was \$51.2 million and \$76.2 million, respectively with \$119.0 million unamortized at December 31, 2010.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued) FOR THE YEARS ENDED DECEMBER 31, 2010 AND 2009

8. Investments (Continued)

The fair values and amortized cost of held to maturity fixed maturities at December 31, 2010 and 2009 were:

December 31, 2010 <i>(U.S. dollars in thousands)</i>	Cost or Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Fixed maturities				
U.S. Government and Government Related/Supported.....	\$ 10,541	\$ 164	\$ (9)	\$ 10,696
Corporate	1,337,797	6,370	(16,325)	1,327,842
Residential mortgage-backed securities – Non-Agency	82,763	634	(546)	82,851
Other asset-backed securities.....	287,109	1,134	(1,410)	286,833
Non-U.S. Sovereign Government, Supranational and Government- Related	1,010,125	30,680	(6,401)	1,034,404
Total fixed maturities held to maturity	\$ 2,728,335	\$ 38,982	\$ (24,691)	\$ 2,742,626

December 31, 2009 <i>(U.S. dollars in thousands)</i>	Cost or Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Fixed maturities				
Non-U.S. Sovereign Government, Supranational and Government- Related	\$ 546,067	\$ –	\$ (15,748)	\$ 530,319
Total fixed maturities held to maturity	\$ 546,067	\$ –	\$ (15,748)	\$ 530,319

The Company had gross unrealized losses at December 31, 2010 and 2009, totaling \$24.7 million and \$15.7 million, respectively, on the above held to maturity income securities which it considered to be temporarily impaired as these holdings are predominantly highly rated quality government holdings and the loss has only arisen due to an interest rate increase in U.K. sterling and Euro currency.

The contractual maturities of held to maturity income securities are shown below.

	December 31, 2010		December 31, 2009	
<i>(U.S. dollars in thousands)</i>	Amortized Cost	Fair Value	Amortized Cost	Fair Value
Due after 1 through 5 years.....	\$ 125,449	\$ 125,416	\$ –	\$ –
Due after 5 through 10 years.....	348,797	346,494	–	–
Due after 10 years	1,884,217	1,901,032	546,067	530,319
	2,358,463	2,372,942	546,067	530,319
Residential mortgage-backed securities – Non-Agency	82,763	82,851	–	–
Other asset-backed securities	287,109	286,833	–	–
Total mortgage and asset-backed securities	369,872	369,684	–	–
Total.....	\$ 2,728,335	\$ 2,742,626	\$ 546,067	\$ 530,319

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. At December 31, 2010 and 2009, the Company had \$16.1 billion and \$16.7 billion in pledged assets, respectively.

XL INSURANCE (BERMUDA) LTD

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued) FOR THE YEARS ENDED DECEMBER 31, 2010 AND 2009

9. Investments in Affiliates

The Company's investment portfolio includes certain investments over which the company is considered to have significant influence and which, therefore, are accounted for using the equity method. Significant influence is generally deemed to exist where the Company has an investment of 20% or more in the common stock of a corporation or an investment of 3% or more in closed end funds, limited partnerships, LLCs or similar investment vehicles. The Company 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. See Note 10, "Other Investments" for investments in alternative and private equity funds in which the Company generally owns less than 3% and are accounted for as "Other Investments."

Investment Fund Affiliates

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 manager affiliates. Collectively, these investments in funds, partnerships and other vehicles are classified as "investment fund affiliates."

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

Year ended December 31, 2010:

(U.S. dollars in thousands, except percentages)

	Carrying Value	XL Group Investment Equity in Net Income (Loss) for the Year	Weighted Average XL Percentage Ownership	Combined Funds Total Net Assets (Estimated)
Alternative Funds (1):				
Arbitrage	\$ 156,511	\$ 9,477	4.1%	\$ 3,797,962
Directional.....	154,391	5,972	6.5%	2,388,306
Event Driven.....	215,352	7,605	2.9%	7,467,525
Multi-Style	787	30	8.1%	9,688
Total alternative funds	527,041	23,084	3.9%	13,663,481
Private equity funds (1).....	243,657	28,000	16.2%	1,508,357
	<u>\$ 770,698</u>	<u>\$ 51,084</u>	<u>5.1%</u>	<u>\$ 15,171,838</u>

Year ended December 31, 2009:

(U.S. dollars in thousands, except percentages)

	Carrying Value	XL Group Investment Equity in Net Income (Loss) for the Year	Weighted Average XL Percentage Ownership	Combined Funds Total Net Assets (Estimated)
Alternative Funds (1):				
Arbitrage	\$ 133,313	\$ 27,954	6.3%	\$ 2,109,012
Directional.....	208,862	31,456	10.5%	1,989,766
Event Driven.....	193,445	46,690	3.2%	6,042,056
Multi-Style	1,276	224	13.2%	9,688
Total alternative funds	536,896	106,324	5.3%	10,150,522
Private equity funds (1).....	248,996	(27,910)	16.9%	1,477,677
	<u>\$ 785,892</u>	<u>\$ 78,414</u>	<u>6.8%</u>	<u>\$ 11,628,199</u>

- (1) The Company records its alternative fund affiliates on a one month lag and its private equity fund affiliates on a one quarter lag. Total estimated net assets are generally as at November 30, 2010 and September 30, 2010, respectively.

XL INSURANCE (BERMUDA) LTD

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued) FOR THE YEARS ENDED DECEMBER 31, 2010 AND 2009

9. Investments in Affiliates (Continued)

Operating Affiliates

The Company had one significant financial operating affiliate during 2010 and 2009. During the fourth quarter of 2010, the Company sold approximately 76% of its investment in Primus Guaranty, Ltd. ("Primus"), reducing its ownership from 39.7% to 9.8%. This sale generated total proceeds of \$51.6 million. Given management's view of the risk exposure, expected losses and the uncertainty facing the entire financial guarantee industry in 2007, the Company had reduced the reported value of its investment in Primus to nil at December 31, 2007. The Company did not record any equity earnings during 2010, 2009 or 2008 in relation to Primus because of the significant losses and negative book value reported by Primus during these periods. Therefore, the sale in the fourth quarter of 2010 resulted in the recording of a gain of \$51.6 million through "Income from operating affiliates." As a result of the sale, at December 31, 2010, the Company's ownership of Primus shares is 9.8% of the total Primus shares outstanding and is accounted for as an available for sale equity security, which resulted in an increase in other comprehensive income of \$18.3 million at December 31, 2010.

The Company's strategic operating affiliates at December 31, 2010 and 2009 included an investment in ARX Holding Corporation of 45.7% and 45.9%, respectively. The Company's 49.9% investment in the Brazilian joint venture ITAU XL Seguros Corporativos S.A. ("ITAU") was sold during the second quarter of 2010.

The Company's larger investment manager affiliates include Highfields Capital Management LP, a global equity investment firm, Polar Capital Holdings plc, an investment firm offering traditional and alternative products, HighVista Strategies LLC, a diversified wealth management firm, and Finisterre Cayman Limited, an emerging market specialist asset management firm. During the years ended December 31, 2010 and 2009, the Company recorded through net income in affiliates other than temporary declines in the values of certain investment manager affiliates totaling \$4.4 million and \$6.9 million, respectively.

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

Year ended December 31, 2010:

(U.S. dollars in thousands)

	XL Investment		Combined Investee Summarized Financial Data (Estimated) (1)			
	Carrying Value	Equity in Net Income (Loss) for the Year	Total Assets	Total Liabilities	Total Revenue (Loss)	Net Income (Loss)
(U.S. dollars in thousands)						
Operating affiliates:						
Financial operating affiliates (2)	\$ 1,750	\$ 53,031	\$ 6,212,583	\$6,179,978	\$ (688)	\$ (15,641)
Other strategic operating affiliates	122,266	28,161	1,075,578	772,572	274,786	48,792
Investment manager affiliates	174,106	40,179	654,229	70,816	375,384	348,615
Total	\$ 298,122	\$ 121,371	\$ 7,942,390	\$7,023,366	\$ 649,482	\$ 381,766

(1) The Company records its operating affiliates on a one quarter lag. Estimated assets and liabilities are generally at September 30, 2010.

(2) Financial operating affiliates included an investment in Primus. During the fourth quarter of 2010, the Company sold a significant portion of its shareholding's in Primus for total proceeds of \$51.6 million and reclassified the remaining holdings of \$18.3 million as an available for sale equity security at December 31, 2010.

XL INSURANCE (BERMUDA) LTD

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued) FOR THE YEARS ENDED DECEMBER 31, 2010 AND 2009

9. Investments in Affiliates (Continued)

Year ended December 31, 2009:

(U.S. dollars in thousands)

	XL Investment		Combined Investee Summarized Financial Data (Estimated) (1)			
	Carrying Value	Equity in Net Income (Loss) for the Year	Total Assets	Total Liabilities	Total Revenue (Loss)	Net Income (Loss)
(U.S. dollars in thousands)						
Operating affiliates:						
Financial operating affiliates (2)	\$ 5,281	\$ 3,629	\$ 6,079,054	\$ 6,527,048	\$ 1,233,913	\$ 1,181,004
Other strategic operating affiliates	183,406	38,386	1,674,233	1,311,666	379,200	65,112
Investment manager affiliates	210,744	17,698	861,026	92,742	345,552	249,687
Total	<u>\$ 399,431</u>	<u>\$ 59,713</u>	<u>\$ 8,614,313</u>	<u>\$ 7,931,456</u>	<u>\$ 1,958,665</u>	<u>\$ 1,495,803</u>

(1) The Company records its operating affiliates on a one quarter lag. Estimated assets and liabilities are generally at September 30, 2009.

(2) Financial operating affiliates included an investment in Primus. In 2009 Primus reported significant gains and negative book value accounting for the excess of liabilities over assets and the majority of the total revenues and net income disclosed above under the combined investee summarized financial data.

In certain investments, the carrying value is different from the share of the investee's underlying net assets. The differences represent goodwill on acquisition or OTTI 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.

10. Other Investments

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

Other investments comprised the following at December 31, 2010 and 2009:

Year ended December 31,

(U.S. dollars in thousands)

	2010	2009
Alternative Investment Funds:		
Arbitrage	\$ 73,010	\$ 39,615
Directional	190,037	125,882
Event Driven	45,901	45,677
Multi-Style	97,506	52,138
Total alternative funds	406,454	263,312
Private investment funds	71,981	56,346
Overseas deposits	80,006	78,694
Structured transactions	330,185	379,548
Other	54,908	—
Total other investments	<u>\$ 943,534</u>	<u>\$ 777,900</u>

XL INSURANCE (BERMUDA) LTD

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued) FOR THE YEARS ENDED DECEMBER 31, 2010 AND 2009

10. Other Investments (Continued)

Alternative and Private Equity Funds

As of December 31, 2010, the alternative fund portfolio employed four strategies invested in 15 underlying funds, respectively. The Company is able to redeem the hedge funds on the same terms that the underlying funds can be redeemed. In general, the funds in which the Company is invested require at least 30 days notice of redemption, and may be redeemed on a monthly, quarterly, semi-annual, annual, or longer basis, depending on the fund.

Certain funds have a lock-up period. A lock-up period refers to the initial amount of time an investor is contractually required to invest before having the ability to redeem. Funds that do provide for periodic redemptions may, depending on the funds' governing documents, have the ability to deny or delay a redemption request, called a gate, or suspend redemptions as a whole. The fund may implement this restriction because the aggregate amount of redemption requests as of a particular date exceeds a specified level, generally ranging from 15% to 25% of the fund's net assets. The gate is a method for executing an orderly redemption process that reduces the possibility of adversely affecting the remaining investors in the fund in the event of substantial redemption requests falling on a single redemption date. Typically, the imposition of a gate delays a portion of the requested redemption, with the remaining portion settled in cash shortly after the redemption date.

The fair value of the Company's holdings in funds that could potentially have lockups or gates imposed as at December 31, 2010 and 2009 was \$406.5 million and \$263.3 million, respectively. The fair value of the Company's holdings in funds where a gate has been imposed as at December 31, 2010 and 2009 was \$45.9 million and \$45.7 million, respectively. In those funds where gates have been imposed, the underlying assets are expected to be liquidated by the investees over a period ranging between approximately one to three years.

Certain funds may be allowed to invest a portion of their assets in illiquid securities, such as private equity or convertible debt. In such cases, a common mechanism used is a side-pocket, whereby the illiquid security is assigned to a separate memorandum capital account or designated account. Typically, the investor loses its redemption rights in the designated account. Only when the illiquid securities in the side-pocket are sold, or otherwise deemed liquid by the fund, may investors redeem that portion of their interest that has been 'side-pocketed'. As at December 31, 2010 and 2009, the fair value of our funds held in side-pockets were \$39.5 million and \$45.4 million, respectively. The underlying assets within these positions are expected to be liquidated by the investees over a period of approximately two to four years.

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

As these alternative and private investments included in other investments do not pay dividends, income is realized only on partial or ultimate sale of these investments. The Company had net unrealized gains of \$86.1 million and \$51.9 million, respectively, at December 31, 2010 and 2009, related to alternative investments. On sales related to the alternative investments, the Company had realized gains of \$0.5 million and \$21.8 million in 2010 and 2009, respectively. For private investments, the company had net unrealized gains of \$10.4 million at December 31, 2010 and an unrealized loss of \$0.8 million, at December 31, 2009, and realized losses of \$1.6 million for the year ended December 31, 2010, and nil for the year ended December 31, 2009.

Overseas Deposits

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

XL INSURANCE (BERMUDA) LTD

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued) FOR THE YEARS ENDED DECEMBER 31, 2010 AND 2009

10. Other Investments (Continued)

Structured Transactions

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

The structured project finance related transactions described above include six separate loan participations with an aggregate net carrying value of \$42.3 million at December 31, 2010 and eight separate loan participations with an aggregate net carrying value of \$78.2 million at December 31, 2009. These contracts had a weighted average contractual term to maturity and weighted average credit rating of 3.25 years and BB, respectively. Credit ratings on the individual contracts ranged from B+ to BB+ at December 31, 2010. Surveillance procedures are conducted over each loan on an ongoing basis with current expectations of future collections of contractual interest and principal used to determine whether any allowance for loan losses may be required at each period end. If it is determined that a future credit loss on a specific contract is reasonably possible and an amount can be estimated, an allowance is recorded. The contractual receivable is only charged off when the final outcome is known and the Company has exhausted all commercial efforts to try and collect any outstanding balances.

Management conducted separate reviews of each loan participation and determined loss allowance estimates using a recovery value concept. Management considers recovery value to be the percentage of all future contractual interest and principal that the Company expects to receive from the borrower through any combination of regular debt service, other payments, salvage and recovery. The allowances for loan losses are made when it is probable that a loss will be incurred based upon current information received from the borrower.

At December 31, 2010, one of the loan participations is being restructured by the borrower and participating lenders. Management determined the expected recovery value for this participation based on multiple risk factors, including but not limited to a difficult trading environment where margins are compressed below the historical mean, a working capital shortage that has interrupted production and prompted lawsuits from suppliers, earnings on the project are well below plan, and local bankruptcy law is untested and may make it difficult to exercise the existing security package. A second loan participation has credit risk to the operations of a borrower that is experiencing a difficult trading environment. Management determined the expected recovery value for this participation based on multiple risk factors, including but not limited to increased raw material costs adversely impacting margins, the borrower is currently operating at a net loss and has high leverage, construction risk remains as the project is behind schedule, and exposure to natural hazards that have caused a long shut down of operations. During the fourth quarter of 2010, a total allowance of \$9.9 million was recorded related to these two structured project finance transactions. No allowances had been recorded relating to these transactions prior to the current period and no amounts have been charged off in any period.

On June 9, 2009, XL Specialty Insurance Company (“XL Specialty”), a wholly-owned subsidiary of the Company, entered into an agreement with National Indemnity Company, an insurance company subsidiary of Berkshire Hathaway Inc. (“National Indemnity”). Under the agreement, and a related reinsurance agreement, National Indemnity will issue endorsements (“Endorsements”) to certain directors and officers liability insurance policies known as “Side A” coverage policies underwritten by XL Specialty (the “Facility”).

The Endorsements entitle policyholders to present claims under such D&O policies directly to National Indemnity in the event that XL Specialty is unable to meet its obligations due to an order of insolvency, liquidation or an injunction that prohibits XL Specialty from paying claims. Under the terms of the Facility, National Indemnity will issue Endorsements with aggregate premiums of up to \$140 million. In addition, XL Specialty had an irrevocable option during the first eleven months of the Facility, to require National Indemnity to issue Endorsements on D&O policies with additional aggregate premiums up to \$100 million (the “Option”), however, the option was not exercised. The Endorsements will terminate on the tenth anniversary of their issuance. The Facility provides that National Indemnity will be obligated to issue Endorsements on D&O policies issued during an eighteen month period that commenced on June 8, 2009.

XL INSURANCE (BERMUDA) LTD

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued) FOR THE YEARS ENDED DECEMBER 31, 2010 AND 2009

10. Other Investments (Continued)

National Indemnity's obligations under the Facility to issue new Endorsements will terminate if XL Specialty's financial strength rating is downgraded to or below "BBB+" by Standard & Poor's Corporation or to or below "A-" by A.M. Best. In connection with the Facility, the Company will purchase a payment obligation in an aggregate principal amount of \$150 million from National Indemnity. In addition, XL Specialty established a trust to hold the premiums (net of commissions) on the D&O policies endorsed by National Indemnity. XL Specialty will also arrange to provide National Indemnity with a letter of credit in the event the assets in the trust are insufficient to meet XL Specialty's obligations under the Facility (the "Letter of Credit"). The trust, the Letter of Credit and the payment obligations collateralize XL Specialty's indemnity obligations under the Facility to National Indemnity for any payments National Indemnity is required to make under the Endorsements.

The outstanding payment obligation was recorded in Other Investments at an estimated fair value of \$128.1 million, pays a coupon of 3.5%, and will be accreted to \$150 million over the 11.5 year term of the payment obligation. The difference between the estimated fair value of the Obligation and the cost of that Obligation at the time of the transaction was approximately \$21.9 million and is recorded in Other Assets. This difference is being amortized in relation to the earning of the underlying policies written. During the years ended December 31, 2010 and 2009, amortization of \$9.5 million and \$5.5 million, respectively, was recorded.

On July 17, 2009, the Company purchased notes with an aggregate face amount of \$155 million which have a current carrying value of \$147.3 million. The issuer of the notes is a structured credit vehicle that holds underlying assets including corporate debt and preferred equity securities as well as project finance debt securities. The notes, which are callable under certain criteria, have a final maturity of July 22, 2039.

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

Other

As described in Note 2(q), "Significant Accounting Policies – Recent Accounting Pronouncements," the Company has investments in senior tranches of Synthetic CDOs as well as certain CDO Squared structures, which in turn hold Synthetic CDOs that were required to be evaluated for embedded credit derivatives at July 1, 2010. Investments in these securities were entered into in the normal course of portfolio investing and were considered from a risk management perspective to be consistent with traditional asset backed security ("ABS") CDOs. While the performance of the underlying securitized credit exposures varies, in management's judgment, the contractual subordination within the securitized interest is sufficient to absorb the current expected losses.

There is no obligation for the Company to fund any future payments under the embedded credit obligations in excess of the original invested amount. Upon initial adoption of this guidance, the Company elected the fair value option for impacted securities, which resulted in a decrease being recorded to opening retained earnings of \$31.9 million. These securities were previously classified as CDOs within available for sale securities, however, they are now included within "Other Investments." These securities are carried at fair value with changes in fair value recorded within "Net realized gains and losses on investments" each period. The following table details certain features of the instruments at December 31, 2010:

December 31, 2010 (U.S. dollars in thousands)	Weighted Average Life	Amortized Cost	Fair Value	Average Rating	Change in Fair Value during the six months ended December 31, 2010
Synthetic CDO	3.87	\$ 32,175	\$ 41,105	BB	\$ 8,930
CDO Squared	6.04	8,491	12,198	B	3,707
	4.37	<u>\$ 40,666</u>	<u>\$ 53,303</u>	BB	<u>\$ 12,637</u>

The Company regularly reviews the performance of these other investments. The Company recorded losses of \$7.8 million and \$0.9 million in the years ended December 31, 2010 and 2009, respectively, due to other than temporary declines in values of these other investments.

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

XL INSURANCE (BERMUDA) LTD

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued) FOR THE YEARS ENDED DECEMBER 31, 2010 AND 2009

11. Losses and Loss Expenses

Unpaid losses and loss expenses are comprised of:

Year Ended December 31

(U.S. dollars in thousands)

	2010	2009
Reserve for reported losses and loss expenses	\$ 8,510,605	\$ 8,978,612
Reserve for losses incurred but not reported	12,021,002	11,844,912
Unpaid losses and loss expenses	\$ 20,531,607	\$ 20,823,524

Net losses and loss expenses incurred are comprised of:

Year Ended December 31

(U.S. dollars in thousands)

	2010	2009
Loss and loss expenses payments	\$ 4,309,523	\$ 5,138,951
Change in unpaid losses and loss expenses (1)	(141,589)	(1,148,495)
Change in unpaid losses and loss expenses recoverable	(117,120)	441,397
Paid loss recoveries	(839,014)	(1,263,016)
Net losses and loss expenses incurred	\$ 3,211,800	\$ 3,168,837

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

(U.S. dollars in thousands)

	2010	2009
Unpaid losses and loss expenses at beginning of year	\$ 20,823,524	\$ 21,650,315
Unpaid losses and loss expenses recoverable	3,557,391	3,964,836
Net unpaid losses and loss expenses at beginning of year	17,266,133	17,685,479
Increase (decrease) in net losses and loss expenses incurred in respect of losses occurring in:		
Current year	3,584,662	3,453,577
Prior years	(372,862)	(284,740)
Total net incurred losses and loss expenses	3,211,800	3,168,837
Exchange rate effects	(125,107)	287,752
Less net losses and loss expenses paid in respect of losses occurring in:		
Current year	442,262	439,638
Prior years	3,028,247	3,436,297
Total net paid losses	3,470,509	3,875,935
Net unpaid losses and loss expenses at end of year	16,882,317	17,266,133
Unpaid losses and loss expenses recoverable	3,649,290	3,557,391
Unpaid losses and loss expenses at end of year	\$ 20,531,607	\$ 20,823,524

Current year net losses incurred

Net losses incurred were flat at \$3.2 billion in both 2010 and 2009. Net losses incurred decreased by \$794.1 million in 2009 as compared to 2008, mainly as a result of the 2009 year loss ratio decreasing by 9.4 loss percentage points during the same period. This decrease was due primarily to lower levels of large property risk and catastrophe losses occurring in 2009 combined with the impact of anticipated sub prime and credit related losses in 2008. The lower level of property losses in 2009 as well as business mix changes more than offset the impacts of a softening rate environment. The decrease in net losses incurred was also due to a reduction in business volume as net premiums earned decreased 14.0% in 2009 relative to 2008.

XL INSURANCE (BERMUDA) LTD

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued) FOR THE YEARS ENDED DECEMBER 31, 2010 AND 2009

11. Losses and Loss Expenses (Continued)

Prior year net losses incurred

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

<i>(U.S. dollars in millions)</i>	<u>2010</u>	<u>2009</u>
Insurance segment.....	\$ (127.4)	\$ (62.9)
Reinsurance segment	(245.5)	(221.8)
Total.....	<u>\$ (372.9)</u>	<u>\$ (284.7)</u>

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

During 2010, net favorable prior year development totaled \$372.9 million in the Company's property and casualty operations and included net favorable development in the Insurance and Reinsurance segments of \$127.4 million and \$245.4 million, respectively.

Insurance Segment

Net favorable prior year reserve development for the Insurance segment of \$127.4 million for the year ended December 31, 2010 was mainly attributable to the following:

- For property lines, net prior year development during the year was \$23.5 million favorable due mainly to lower than expected actual losses for non-catastrophe exposures for North America P&C and International P&C business.
- For casualty lines, net prior year development during the year was \$13.4 million unfavorable due mainly to a \$45.1 million strengthening in the North American risk management lines, where there has been higher than expected actual losses and reserve assumptions have been revised to give greater weight to actual experience relative to industry benchmarks. The unfavorable development was partially offset by a \$26.0 million decrease in the uncollectible reinsurance reserve from reduced exposures and lower estimated risk levels from the Swiss operations. On a gross basis, the excess casualty lines have experienced higher than expected actual losses which have only been partially offset by lower than expected actual losses in the primary casualty lines. However, the gross deterioration in excess casualty was heavily ceded so that on a net basis the strengthening in excess casualty has been almost entirely offset by the release in primary casualty.
- For professional lines, net prior year development was \$118.6 million favorable. This was driven by lower than expected actual losses in the Hartford Standard (\$89.8 million mainly from report years 2007 and prior) and International (\$41.1 million in report year 2006) lines, favorable reserve development in Bermuda errors and omissions lines (\$57.2 million for report years 2003 and prior), and favorable Clash development (\$28.2 million from report years 2006 and prior). This was partially offset by higher than expected actual losses in the Hartford Private Commercial lines (\$63.7 million), and in the small to midsize professional services lines, in particular in the miscellaneous professionals (\$21.8 million), architects and engineers (\$6.2 million), and real estate (\$5.5 million) books.
- For specialty and other lines, net prior year development was \$2.1 million unfavorable due mainly to an unfavorable settlement in the surety lines (\$40.4 million), higher than expected actual losses in the environmental lines (\$15.5 million), and an unfavorable commutation in the financial lines (\$9.1 million). This was mostly offset by lower than expected actual losses in the aerospace (\$32.9 million), marine (\$7.2 million), specie (\$5.5 million) and equine (\$3.1 million) lines as well as a reduction in the provision for unrecoverable reinsurance due to reduced exposures and lower estimated risk levels from the London Market operations (\$13.1 million).

XL INSURANCE (BERMUDA) LTD

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued) FOR THE YEARS ENDED DECEMBER 31, 2010 AND 2009

11. Losses and Loss Expenses (Continued)

Net favorable prior year reserve development for the Insurance segment of \$62.9 million for the year ended December 31, 2009 was mainly attributable to the following:

- For property lines, net prior year development during the year was \$50.7 million favorable largely as a result of a lower than expected level of attritional non-catastrophe claims across older accident years as well as reserve releases in the 2008 European general property portfolio due to lower than expected reported loss activity. Prior year catastrophe loss estimates remained stable.
- For casualty lines, net prior year development during the year was \$29.4 million unfavorable due to reserve strengthening on the European excess lines for accident years 2000 to 2004, and the recognition of potential excess casualty exposures on the discontinued casualty lines. Offsetting this reserve strengthening were reserve releases from the casualty primary business due to better than expected loss activity from the more recent accident years, and U.S. risk management lines due to greater reliance on actual loss experience over initial target loss ratios.
- For professional lines, net prior year development was \$70.4 million favorable, primarily as a result of lower incurred activity than expected based on the Company's prior valuation in global D&O lines, primarily for underwriting years 2002 to 2006. This release was partially offset by strengthening of global E&O reserves primarily in the 2000 and 2001 years due to large claims. In addition, there was a reallocation of subprime and related credit crisis reserves from the 2007 to 2008 report year to better reflect the indications of our latest exposure-based reserve analysis for these years.
- For specialty and other lines, net prior year adverse development was \$28.8 million due in part to a deterioration in environmental lines but mainly from discontinued specialty lines, specifically, for surety to reflect our assessment of the potential impact of the economic downturn on ultimate loss activity, the Lloyd's Accident & Health book where incurred development was higher than implied by the Company's selected benchmarks and the resulting lengthening of loss reporting patterns, and political risks where there was reserve strengthening on a specific potential claim. Offsetting the adverse development was favorable reserve development on the aerospace and marine and offshore energy lines due to better than expected activity and an update of development assumptions to reflect recent historical experience.

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 Segment

Net favorable prior year reserve development for the Reinsurance segment of \$245.5 million for the year ended December 31, 2010 was mainly attributable to the following:

- Net favorable prior year development of \$145.8 million for the short-tailed lines in the year ended December 31, 2010 and details of these by specific lines are as follows:
 - \$35.6 million in favorable property catastrophe development primarily due to better than expected activity in underwriting years 2007 to 2009, lowering of expected loss ratios to attritional levels on the 2009 underwriting year and reserve releases related to European windstorms of \$7.2 million and Hurricane Katrina of \$3.8 million.
 - \$87.4 million in favorable property other releases driven by \$50.7 million of releases from U.S. exposures for most underwriting years including \$7.9 million from reduced exposures relating to a U.S agricultural program from underwriting year 2009, \$20.0 million in releases from Latin America proportional exposures primarily from 2007 to 2009 underwriting years and \$16.7 million in releases from Europe and Asia Pacific exposures from most underwriting years.
 - \$22.8 million in marine and aviation lines due to favorable marine development of \$10.9 million and favorable aviation development of \$11.9 million due to better than expected activity in most underwriting years.
- Net favorable prior year development of \$99.7 million for the long-tailed lines for the year ended December 31, 2010 and details of these by specific lines are as follows:

XL INSURANCE (BERMUDA) LTD

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued) FOR THE YEARS ENDED DECEMBER 31, 2010 AND 2009

11. Losses and Loss Expenses (Continued)

- \$25.2 million in favorable casualty and professional development attributable to \$33.0 million in releases due to settlements related to Enron losses, \$21.6 million in releases mainly due to U.S. professional exposures in underwriting years 2005 and prior, \$11.9 million primarily due to releases related to revision of European loss development factors and initial expected loss ratios, \$7.1 million related to releases from run-off of Sydney casualty exposures in underwriting years 2005 and prior offset by adverse development of \$43.0 million related to Italian hospital medical malpractice exposures written through a Lloyd's syndicate and adverse development of \$5.4 million related to European Financial Institution exposures in underwriting years 2002 and 2004.
- \$74.5 million in favorable other lines development primarily driven by \$42.1 million in favorable development from whole account contracts written in Lloyd's syndicates of which \$36.1m in releases related to reinsurance to close ("RITC") in years of account 2007 and prior and \$6.0 million due to better than expected activity in underwriting years 2008 and 2009. Contributions also from North American bond run-off exposures due to better than expected activity in underwriting years 2006 and prior resulting in releases of \$12.6 million, a reduction of \$7.5 million in one political risks loss, Latin America Surety releases of \$5.6 million related to better than expected loss experience across most underwriting years, \$3.7 million in relation to one specific contract commutation and \$3.0 million in releases primarily due to favorable activity in European trade credit run-off exposures in most prior underwriting years.

Net favorable prior year reserve development for the Reinsurance segment of \$221.8 million for the year ended December 31, 2009 was mainly attributable to the following:

- Net favorable prior year development of \$142.5 million for the short-tailed lines in the year and details of these by specific lines are as follows:
 - \$46.2 million in favorable property catastrophe development due to lower than expected loss development, particularly on the 2008 underwriting year and \$12.3 million in reserve reductions for several 2005 natural catastrophe events including European floods, windstorm Erwin and California wildfires.
 - \$88.8 million in favorable development due primarily to lower than expected claim emergence from underwriting years 2005 to 2008 in Latin America (\$27.5 million), Europe (\$21.6 million), Bermuda (\$20.6 million) and U.S. (\$13.8 million).
 - \$7.5 million in marine and aviation lines due to lower than expected claim emergence in the European marine book for underwriting years 2007 and 2008 offset by minimal net reserve increases on the aviation book.
- Net favorable prior year development of \$79.3 million for the long-tailed lines in the year and details of these by specific lines are as follows:
 - \$21.0 million in favorable casualty development related primarily to the European General Liability and UK Motor portfolios in underwriting years 2004 to 2007.
 - \$40.7 million in favorable professional development due primarily to U.S. exposures for underwriting years 2002 and prior in addition to professional indemnity exposures for European underwriting years 2006 and prior.
 - \$17.6 million in favorable development in non-casualty long tail lines largely in Latin America due to favorable emergence from surety exposures.

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

Exchange rate effects on net loss reserves in each of the three years ended December 31 related to the global operations of the Company primarily where reporting units have a functional currency that is not the U.S. dollar. In 2010, the U.S. dollar was stronger against the Euro, while weaker against the Swiss franc, Canadian dollar and Brazilian real. In 2009, the U.S. dollar weakened against all of the Company's major currency exposures, particularly the Canadian dollar and U.K. sterling. These movements in the U.S. dollar gave rise to translation and revaluation exchange movements related to carried loss reserve balances of (\$125.1) million and \$287.8 million in the years ended December 31, 2010 and 2009, respectively.

XL INSURANCE (BERMUDA) LTD

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued) FOR THE YEARS ENDED DECEMBER 31, 2010 AND 2009

11. Losses and Loss Expenses (Continued)

Net paid losses

Total net paid losses were \$3.5 billion and \$3.9 billion in each of 2010 and 2009, respectively.

Other loss information

The Company did not dispose of or acquire net loss reserves in 2010 or 2009.

The Company's net unpaid losses and loss expenses included estimates of actual and potential non-recoveries from reinsurers. As at December 31, 2010 and 2009, the reserve for potential non-recoveries from reinsurers was \$121.9 million and \$189.8 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 exposures, the amount of 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 Company utilizes tabular reserving for workers' compensation (including long-term disability) unpaid losses that are considered fixed and determinable, and discounts such losses using an interest rate of 5% in 2010 and 2009. 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, 2010 and 2009 on an undiscounted basis were \$660.3 million and \$734.1 million, respectively. The related discounted unpaid losses and loss expenses were \$311.9 million and \$343.7 million as of December 31, 2010 and 2009, 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.

Asbestos and Environmental Related Claims

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

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

Year Ended December 31,	2010	2009
<i>(U.S. dollars in thousands)</i>		
Net unpaid losses and loss expenses at beginning of year	\$ 100,923	\$ 111,860
Net incurred losses and loss expenses.....	(130)	(312)
Less net paid losses and loss expenses.....	16,718	10,626
Net increase (decrease) in unpaid losses and loss expenses.....	(16,848)	(10,938)
Net unpaid losses and loss expenses at end of year	84,075	100,922
Unpaid losses and loss expenses recoverable at end of year.....	142,037	151,963
Gross unpaid losses and loss expenses at end of year	<u>\$ 226,112</u>	<u>\$ 252,885</u>

XL INSURANCE (BERMUDA) LTD

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued) FOR THE YEARS ENDED DECEMBER 31, 2010 AND 2009

11. Losses and Loss Expenses (Continued)

Reserves for incurred but not reported losses, net of reinsurance, included in the above table were \$54.9 million and \$68.5 million in 2010 and 2009, respectively. Unpaid losses recoverable are net of potential uncollectible amounts.

As of December 31, 2010, the Company had 1,200 open claim files for potential asbestos exposures and 417 open claim files for potential environmental exposures. Approximately 44% and 50% of the open claim files are due to precautionary claim notices in 2010 and 2009, respectively. Precautionary claim notices are submitted by the ceding companies in order to preserve their right to receive coverage under the reinsurance contract.

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

	Asbestos Claims	Environmental Claims
Total number of claims outstanding at December 31, 2008.....	1,546	548
New claims reported in 2009	221	38
Claims resolved in 2009.....	(330)	(102)
Total number of claims outstanding at December 31, 2009.....	1,437	484
New claims reported in 2010	125	31
Claims resolved in 2010.....	(362)	(98)
Total number of claims outstanding at December 31, 2010	<u>1,200</u>	<u>417</u>

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

- (1) Reinsurance contracts written, both on a proportional and excess basis, after 1972. The Company discontinued writing contracts with these exposures in 1985. Business written was across many different policies, each with a relatively small contract limit. The Company's reported asbestos claims relate to both traditional products and premises and operations coverage.
- (2) Winterthur – business of Winterthur purchased by the Company from AXA Insurance (formerly Winterthur Swiss Insurance Company) in 2001. AXA reimburses the Company for asbestos claim payments pursuant to the Sale and Purchase Agreement.
- (3) During 2006, the Company acquired \$40.2 million in losses through a loss portfolio transfer contract of which \$18.3 million in losses related to asbestos and environmental claims. Given the terms of the policy, the combined aggregate limit on the total acquired reserves is limited to \$60.0 million, not including coverage for claims handling costs over a defined period.

The estimation of loss and loss expense liabilities for asbestos and environmental exposures is subject to much greater uncertainty than is normally associated with the establishment of liabilities for certain other exposures due to several factors, including: (i) uncertain legal interpretation and application of insurance and reinsurance coverage and liability; (ii) the lack of reliability of available historical claims data as an indicator of future claims development; (iii) an uncertain political climate which may impact, among other areas, the nature and amount of costs for remediating waste sites; and (iv) the potential of insurers and reinsurers to reach agreements in order to avoid further significant legal costs. Due to the potential significance of these uncertainties, the Company believes that no meaningful range of loss and loss expense liabilities beyond recorded reserves can be established. As the Company's net unpaid loss and loss expense reserves related to asbestos and environmental exposures are less than 1% of the total net reserves at December 31, 2010 and 2009, further adverse development is not expected to be material to the Company's overall net loss reserves. The Company believes it has made reasonable provision for its asbestos and environmental exposures and is unaware of any specific issues that would significantly affect its estimate for loss and loss expenses.

XL INSURANCE (BERMUDA) LTD

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued) FOR THE YEARS ENDED DECEMBER 31, 2010 AND 2009

12. Reinsurance

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

	Premiums Written Year Ended December 31,		Premiums Earned Year Ended December 31,	
	2010	2009	2010	2009
(U.S. dollars in thousands)				
Direct	\$ 4,398,753	\$ 4,381,185	\$ 4,535,626	\$ 4,861,073
Assumed	1,862,578	1,730,126	1,837,528	1,877,634
Ceded	(1,261,743)	(1,367,599)	(1,342,017)	(1,586,968)
Net	\$ 4,999,588	\$ 4,743,712	\$ 5,031,137	\$ 5,151,739

The Company recorded reinsurance recoveries on losses and loss expenses incurred of \$1.0 billion and \$0.8 billion for the years ended December 31, 2010 and 2009, respectively.

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

	2010	2009
(U.S. dollars in thousands)		
P&C operations	\$ 3,649,290	\$ 3,557,391
Life operations	22,597	26,637
Total unpaid losses and loss expenses recoverable	<u>\$ 3,671,887</u>	<u>\$ 3,584,028</u>

At December 31, 2010 and 2009, the total reinsurance assets of \$3.8 billion and \$4.0 billion respectively, included reinsurance receivables for paid losses and loss expenses of \$171.3 million and \$374.8 million, respectively, with \$3.7 billion and \$3.6 billion respectively, relating to the ceded reserve for losses and loss expenses, including ceded losses incurred but not reported. 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 its ability to meet these obligations and while it may continue to acknowledge its contractual obligation to do so, it may not have the financial resources or willingness to fully meet its obligations to the Company.

At December 31, 2010 and 2009, the allowance for uncollectible reinsurance relating to both reinsurance balances receivable and unpaid losses and loss expenses recoverable were \$121.9 million and \$189.8 million, respectively. To estimate the provision for uncollectible reinsurance recoverable, the reinsurance recoverable must first be allocated to applicable reinsurers. As part of this process, ceded IBNR is allocated by reinsurer. The allocations are generally based on historical relationships between gross and ceded losses. If actual experience varies materially from historical experience, the allocation of reinsurance recoverable by reinsurer will change.

The Company uses a default analysis to estimate uncollectible reinsurance recoverables. The primary components of the default analysis are reinsurance recoverable balances by reinsurer, net of collateral, and default factors used to determine the portion of a reinsurer's balance deemed uncollectible. The definition of collateral for this purpose requires some judgment and is generally limited to assets held in trust, letters of credit, and liabilities held by the Company with the same legal entity for which the Company believes there is a right of offset. The Company is the beneficiary of letters of credit, trust accounts and funds withheld in the aggregate amount of \$1.5 billion at December 31, 2010, 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. The total allowance recorded relating to reinsurance recoverables was \$68.1 million and \$110.0 million at December 31, 2010 and 2009, respectively.

XL INSURANCE (BERMUDA) LTD

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued) FOR THE YEARS ENDED DECEMBER 31, 2010 AND 2009

12. Reinsurance (Continued)

The Company uses an aging analysis to estimate uncollectible reinsurance balances receivable relating to paid losses in addition to recording allowances relating to any specific balances with known collectability issues, irrespective of aging. The balances are aged from the date the expected recovery was billed to the reinsurer. Provisions are applied at specified percentages of the outstanding balances based upon the aging profile. Allowances otherwise required as a result of the aging process may not be recorded to the extent that specific facts and circumstances exist that lead management to believe that amounts will ultimately be collectible. The total allowance recorded relating to reinsurance balances receivable was \$53.8 million and \$79.8 million at December 31, 2010 and 2009, respectively.

At December 31, 2010, the use of different assumptions within the model could have a material effect on the bad debt provision reflected in the Company's Consolidated Financial Statements. To the extent the creditworthiness of the Company's reinsurers was to deteriorate due to an adverse event affecting the reinsurance industry, such as a large number of major catastrophes, actual uncollectible amounts could be significantly greater than the Company's bad debt provision. Such an event could have a material adverse effect on the Company's financial condition, results of operations, and cash flows.

Approximately 90% of the total unpaid loss and loss expense recoverable and reinsurance balances receivable (excluding collateral held) outstanding at December 31, 2010 was due from reinsurers with a financial strength rating of "A" or better. The following is an analysis of the total recoverable and reinsurance balances receivable at December 31, 2010, by reinsurers owing more than 3% of such total:

<u>Name of reinsurer</u>	<u>Reinsurer Financial Strength Rating</u>	<u>% of total</u>
Munich Reinsurance Company	AA-/Stable	21.5%
Swiss Reinsurance Company	A+/Positive	13.8%
Lloyd's Syndicates.....	A+/Stable	7.0%
Swiss Re Europe S.A.	A+/Positive	4.8%
Transatlantic Reinsurance Company	A+/Stable	3.8%

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

<u>Reinsurer Financial Strength Rating</u>	<u>% of total</u>
AAA.....	3.6%
AA	36.0%
A	49.8%
BBB	1.2%
BB and below.....	0.1%
Captives	6.5%
Not Rated	0.4%
Other	2.4%
Total.....	<u>100.0%</u>

XL INSURANCE (BERMUDA) LTD

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued) FOR THE YEARS ENDED DECEMBER 31, 2010 AND 2009

13. Deposit Liabilities

At December 31, 2010, deposit liabilities include reinsurance and insurance deposits while, at December 31, 2009 deposit liabilities included reinsurance and insurance deposits and the remaining funding agreement contracts. Funding agreements do not meet the definition of an insurance contract under FASB issued authoritative guidance. 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 GAAP to be accounted for as insurance or reinsurance transactions and are recognized as deposits. These structured property and casualty agreements 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. See Note 8, "Investments," for further information relating to the Company's net investment income as well as realized and unrealized investment (losses) gains. Each deposit liability accrues at a rate equal to the internal rate of return of the payment receipts and obligations due during the life of the agreement. Where the timing and/or amount of future payments are uncertain, cash flows reflecting the Company's actuarially determined best estimates are utilized. Deposit liabilities are initially recorded at an amount equal to the assets received. At December 31, 2009, the remaining balance of funding agreements, excluding accrued interest of \$6.5 million, was \$450 million, with the full balance being settled in August 2010.

Total deposit liabilities are comprised of the following:

Year ended December 31

(U.S. dollars in thousands)

	2010	2009
Reinsurance and insurance deposit liabilities	\$ 1,684,606	\$ 1,752,180
Funding agreement and guaranteed investment contract deposit liabilities	—	456,519
Total deposit liabilities	<u>\$ 1,684,606</u>	<u>\$ 2,208,699</u>

Interest expense of \$54.5 million and \$43.7 million was recorded related to the accretion of deposit liabilities for the years ended December 31, 2010 and 2009, respectively.

14. 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 4.5% at December 31, 2010 and 2009. Total future policy benefit reserves for the years ended December 31, 2010 and 2009 were \$5.1 billion and \$5.5 billion, respectively. The decrease of \$34.1 million in the Traditional Life business is mainly due to the novation and recapture of part of the U.K. and Irish term assurance and critical illness business and sale of the Company's U.S. life reinsurance business. The decrease of \$380.9 million in the Annuities is mainly due to foreign exchange movements and the normal releases on single premium annuities in line with benefits paid and mortality of underlying policyholders.

Future policy benefit reserves are comprised of the following:

Year ended December 31

(U.S. dollars in thousands)

	2010	2009
Traditional Life	\$ 809,776	\$ 843,915
Annuities	4,265,351	4,646,204
Total future policy benefit reserves	<u>\$ 5,075,127</u>	<u>\$ 5,490,119</u>

XL INSURANCE (BERMUDA) LTD

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued) FOR THE YEARS ENDED DECEMBER 31, 2010 AND 2009

15. Notes Payable and Debt and Financing Arrangements

As at December 31, 2010 and 2009, the Company had bank and loan facilities available from a variety of sources, including commercial banks, totaling \$1.6 billion and \$1.7 billion, respectively, of which \$0.6 billion and \$0.6 billion, respectively, of debt was outstanding. In addition, at December 31, 2010 and 2009, the Company had available letter of credit facilities totaling \$5.0 billion and \$7.3 billion, respectively, of which \$2.4 billion and \$3.0 billion, respectively, were outstanding as at December 31, 2010 and 2009, 21.1% and 21.3%, respectively, of which were collateralized by certain of the Company's investment portfolios, primarily supporting U.S. non-admitted business and the Company's Lloyd's syndicates' capital requirements. Of these amounts, \$1.0 billion was available in the form of revolving credit.

The financing structure at December 31, 2010 was as follows:

Facility	Commitment/ Debt	In Use/ Outstanding (1)
<i>(U.S. dollars in thousands)</i>		
Debt:		
5-year revolver expiring 2012 (2)	\$ 1,000,000	\$ —
6.50% Guaranteed Senior Notes due 2012	600,000	599,668
Total debt	<u>\$ 1,600,000</u>	<u>\$ 599,668</u>
Carrying Value	<u>\$ 1,600,000</u>	<u>\$ 599,668</u>
Letters of Credit:		
5 facilities – total	<u>\$ 5,000,114</u>	<u>\$ 2,395,242</u>

(1) "In Use" and "Outstanding" data represent December 31, 2010 accreted values.

(2) The 2012 5-year revolving credit facility has a \$1 billion revolving credit sub-limit.

The financing structure at December 31, 2009 was as follows:

Facility	Commitment/ Debt	In Use/ Outstanding (1)
<i>(U.S. dollars in thousands)</i>		
Debt:		
5-year revolvers expiring 2010/2012 (2)	\$ 1,000,000	\$ —
5-year revolver expiring 2010	100,000	—
6.50% Guaranteed Senior Notes due 2012	600,000	599,350
Total debt	<u>\$ 1,700,000</u>	<u>\$ 599,350</u>
Carrying Value	<u>\$ 1,700,000</u>	<u>\$ 599,350</u>
Letters of Credit:		
6 facilities – total	<u>\$ 7,250,230</u>	<u>\$ 3,012,169</u>

(1) "In Use" and "Outstanding" data represent December 31, 2009 accreted values.

(2) The 2010 and 2012 5-year revolving credit facilities share a \$1 billion revolving credit sub-limit.

All outstanding debt noted in the table above as at December 31, 2010 and 2009 was issued by XL Capital Finance (Europe) plc ("XLCFE"). XLCFE is a wholly owned subsidiary of the Company. These notes are fully and unconditionally guaranteed by XL Company Switzerland GmbH. The Company's ability to obtain funds from its subsidiaries to satisfy any of its obligations under this guarantee is subject to certain contractual restrictions, applicable laws and statutory requirements of the various countries in which the Company operates including among others, Bermuda, the U.S., Ireland and the U.K. Required statutory capital and surplus for the principal operating subsidiaries of the Company was \$6.2 billion as of December 31, 2010.

XL INSURANCE (BERMUDA) LTD

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued) FOR THE YEARS ENDED DECEMBER 31, 2010 AND 2009

15. Notes Payable and Debt and Financing Arrangements (Continued)

The revolving credit facilities were unutilized at December 31, 2010 and 2009.

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

On December 14, 2009, the £450 million letter of credit facility issued on November 14, 2007 that was supporting the Company's syndicates at Lloyd's of London terminated. This facility was replaced by a \$750 million bilateral secured letter of credit facility.

On December 31, 2008, a \$150 million unsecured letter of credit facility expired and was not replaced.

The Company has several letter of credit facilities provided on a syndicated and bilateral basis from commercial banks. These facilities are utilized primarily to support non-admitted insurance and reinsurance operations in the U.S. and capital requirements at Lloyd's. The commercial facilities are scheduled for renewal before 2012. In addition to letters of credit, the Company has established insurance trusts in the U.S. that provide cedants with statutory relief required under state insurance regulation in the U.S. It is anticipated that the commercial facilities may be renewed on expiry but such renewals are subject to the availability of credit from banks utilized by the Company and may be renewed with materially different terms and conditions. In the event that such credit support is insufficient, the Company could be required to provide alternative security to cedants. This could take the form of additional insurance trusts supported by the Company's investment portfolio or funds withheld using the Company's cash resources. The value of letters of credit required is driven by, among other things, loss development of existing reserves, the payment pattern of such reserves, the expansion of business written by the Company and the loss experience of such business.

In general, all of the Company's bank facilities, indentures and other documents relating to the Company's outstanding indebtedness (collectively, the "Company's Debt Documents"), as described above, contain cross default provisions to each other and the Company's Debt Documents (other than the 6.5% Guaranteed Senior Notes indentures) contain affirmative covenants. These covenants provide for, among other things, minimum required ratings of the Company's insurance and reinsurance operating subsidiaries and the level of secured indebtedness in the future. In addition, generally each of the Company's Debt Documents provide for an event of default in the event of a change of control of the Company or some events involving bankruptcy, insolvency or reorganization of the Company. The Company's credit facilities also contain minimum consolidated net worth covenants.

Under the Company's five-year credit facility, in the event that XL Insurance (Bermuda) Ltd and XL Re Ltd fail to maintain a financial strength rating of at least "A-" from A.M. Best, an event of default would occur.

The 6.5% Guaranteed Senior Notes indenture contains a cross default provision. In general, in the event that the Company defaults in the payment of indebtedness in the amount of \$50.0 million or more, an event of default would be triggered under both the 6.5% Guaranteed Senior Notes indentures.

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

XL INSURANCE (BERMUDA) LTD

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued) FOR THE YEARS ENDED DECEMBER 31, 2010 AND 2009

16. 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 derivatives are designated as hedging instruments. The accounting for derivatives which are designated as hedging instruments is described in Note 2(h), “Significant Accounting Policies – Derivative Instruments.” The following table summarizes information on the location and gross amounts of derivative fair values contained in the consolidated balance sheet as at December 31, 2010 and 2009:

	December 31, 2010				December 31, 2009			
	Asset Derivative Notional Amount	Asset Derivative Fair Value (1)	Liability Derivative Notional Amount	Liability Derivative Fair Value (1)	Asset Derivative Notional Amount	Asset Derivative Fair Value (1)	Liability Derivative Notional Amount	Liability Derivative Fair Value (1)
<i>(U.S. dollars in thousands)</i>								
Derivatives designated as hedging instruments:								
Interest rate contracts (2)	\$ 161,028	\$ 74,368	\$ –	\$ –	\$ 2,169,642	\$ 238,639	\$ 95,948	\$ (8,225)
Foreign exchange contracts.....	1,384,745	43,226	244,731	(12,161)	596,072	7,526	–	–
Total derivatives designated as hedging instruments.....	\$ 1,545,773	\$ 117,594	\$ 244,731	(12,161)	\$ 2,765,714	\$ 246,165	\$ 95,948	\$ (8,225)
Derivatives not designated as hedging instruments:								
<i>Investment Related Derivatives:</i>								
Interest rate exposure	\$ 117,689	\$ 281	\$ 41,063	\$ –	\$ 111,875	\$ 1,248	\$ 1,800	\$ (6)
Foreign exchange exposure.....	82,395	1,377	272,724	(6,329)	545,319	9,070	314,361	(8,226)
Credit exposure	128,450	8,143	532,000	(5,295)	214,650	13,244	741,388	(18,198)
Financial market exposure	135,912	705	4,575	(27)	306,464	1,983	–	–
<i>Financial Operations Derivatives: (3)</i>								
Credit exposure	–	–	246,292	(25,887)	–	–	271,704	(18,386)
<i>Other Non-Investment Derivatives:</i>								
Guaranteed minimum income benefit contract	–	–	80,025	(21,190)	–	–	86,250	(22,909)
Modified coinsurance funds withheld contract	–	–	72,509	–	–	–	71,695	(266)
Total derivatives not designated as hedging instruments.....	\$ 464,446	\$ 10,506	\$ 1,249,188	\$ (58,728)	\$ 1,178,308	\$ 25,545	\$ 1,487,198	\$ (67,991)

- (1) Derivative instruments in an asset or liability position are included within Other Assets or Other Liabilities, respectively, in the Balance Sheet.
- (2) At December 31, 2010 and December 31, 2009, the Company held net cash collateral related to these derivative assets of \$23.0 million and \$169.1 million, respectively. The collateral balance is included within cash and cash equivalents and the corresponding liability to return the collateral has been offset against the derivative asset within the balance sheet as appropriate under the netting agreement.
- (3) Financial operations derivatives represent interests in variable interest entities as described in Note 18, “Variable Interest Entities.”

(a) Derivative Instruments Designated as Fair Value Hedges

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

At December 31, 2010, a portion of the Company’s liabilities are hedged against changes in the applicable designated benchmark interest rate. Interest rate swaps are also used to hedge the changes in fair value of certain fixed rate liabilities and fixed income securities due to changes in the designated benchmark interest rate. In addition, the Company utilizes foreign exchange contracts to hedge the fair value of certain fixed income securities as well as to hedge certain net investments in foreign operations.

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**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
FOR THE YEARS ENDED DECEMBER 31, 2010 AND 2009**

16. Derivative Instruments (Continued)

(a) Derivative Instruments Designated as Fair Value Hedges (Continued)

On June 7, 2010, the Company settled the interest rate contracts designated as fair value hedges of certain issues of the Company's notes payable and debt. The derivative contracts were settled for a gain of \$21.6 million. The cumulative increase recorded to the carrying value of the hedged notes payable and debt, representing the effective portion of the hedging relationship, will be amortized through interest expense over the remaining term of the debt. From the date of settlement through December 31, 2010, \$3.9 million of the balance was recorded as a reduction of interest expense. The remaining balance of \$17.7 million will be amortized over the weighted average period of 3.2 years remaining to maturity of the debt.

On October 27, 2010, the Company settled three interest rate contracts designated as fair value hedges of certain of the Company's deposit liability contracts. The derivative contracts were settled for a gain of \$149.5 million. The cumulative increase recorded to the carrying value of the deposit liability, representing the effective portion of the hedging relationship, will be amortized through interest expense over the remaining term of the deposit liability contracts. From the date of settlement through December 31, 2010, \$1.9 million of the balance was recorded as a reduction of interest expense. The remaining balance of \$147.6 million will be amortized over the weighted average period of 36.3 years remaining on these deposit contracts.

The following table provides the total impact on earnings relating to derivative instruments formally designated as fair value hedges along with the impacts of the related hedged items for years ended December 31, 2010 and 2009:

Hedged Items – Amount of Gain/(Loss) Recognized in Income Attributable to Risk					
	Gain/(Loss) Recognized in Income on Derivative	Deposit Liabilities	Fixed Maturity Investments	Notes Payable and Debt	Ineffective Portion of Hedging Relationship – Gain/(Loss)
December 31, 2010 <i>(U.S. dollars in thousands)</i>					
Derivatives Designated as Fair Value Hedges:					
Interest rate exposure	\$ 94,068				
Foreign exchange exposure.....	19,856				
Total	<u>\$ 113,924</u>	<u>\$ (84,393)</u>	<u>\$ (27,266)</u>	<u>\$ (15,940)</u>	<u>\$ (13,675)</u>

Hedged Items – Amount of Gain/(Loss) Recognized in Income Attributable to Risk					
	Gain/(Loss) Recognized in Income on Derivative	Deposit Liabilities	Fixed Maturity Investments	Notes Payable and Debt	Ineffective Portion of Hedging Relationship– Gain/(Loss)
December 31, 2009 <i>(U.S. dollars in thousands)</i>					
Derivatives Designated as Fair Value Hedges:					
Interest rate exposure	\$(212,215)				
Foreign exchange exposure.....	7,526				
Total	<u>\$(204,689)</u>	<u>\$ 201,398</u>	<u>\$ 1,711</u>	<u>\$ 1,206</u>	<u>\$ (374)</u>

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

The periodic coupon settlements resulted in an increases to net investment income of \$2.3 million for year ended December 31, 2010 and increases to net investment income of \$22.4 million for year ended December 31, 2009.

The periodic coupon settlements also resulted in decreases to interest expense of \$49.8 million and \$20.1 million for years ended December 31, 2010 and 2009, respectively.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued) FOR THE YEARS ENDED DECEMBER 31, 2010 AND 2009

16. Derivative Instruments (Continued)

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

The Company utilizes foreign exchange contracts to hedge the fair value of certain net investments in foreign operations. During 2010 and 2009, the Company entered into foreign exchange contracts that were formally designated as hedges of the investment in foreign subsidiaries with functional currencies of U.K. sterling and the Euro. The weighted average U.S. dollar equivalent of foreign denominated net assets of approximately \$834 million and \$425 million was hedged during 2010 and 2009, respectively, which resulted in a derivative loss of \$16.5 million and a derivative gain of \$7.5 million being recorded in the cumulative translation adjustment account within AOCI for each period, respectively. There was no ineffectiveness resulting from these transactions.

(c) Derivative Instruments Not Formally Designated As Hedging Instruments

The following table provides the total impact on earnings relating to derivative instruments not formally designated as hedging instruments under authoritative accounting guidance. The impacts are all recorded through Net realized and unrealized gains (losses) on derivatives in the income statement for years ended December 31, 2010 and 2009:

	Amount of Gain (Loss) Recognized in Income on Derivative	
	2010	2009
<i>(U.S. dollars and shares in thousands)</i>		
Derivatives not designated as hedging instruments:		
Investment Related Derivatives:		
Interest rate exposure.....	\$ 3,511	\$ 9,124
Foreign exchange exposure	(15,610)	9,497
Credit exposure.....	(6,316)	(51,579)
Financial market exposure.....	2,125	3,948
Financial Operations Derivatives:		
Credit exposure.....	(7,281)	(2,667)
Other Non-Investment Derivatives:		
Guaranteed minimum income benefit contract.....	1,719	4,644
Modified coinsurance funds withheld contract.....	9,948	(388)
Weather and Energy Derivatives:		
Structured weather risk management products	—	2,979
Total derivatives not designated as hedging instruments	(11,904)	(24,442)
Amount of gain (loss) recognized in income from ineffective portion of fair value hedges.....	(13,675)	(374)
Net realized and unrealized gains (losses) on derivative instruments	<u>\$ (25,579)</u>	<u>\$ (24,816)</u>

The Company's objectives in using these derivatives are explained in sections (d) and (e) of this note below.

(c)(i) Investment Related Derivatives

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

Investment Related Derivatives – Interest Rate Exposure

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

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued) FOR THE YEARS ENDED DECEMBER 31, 2010 AND 2009

16. Derivative Instruments (Continued)

(c)(i) Investment Related Derivatives (Continued)

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 primarily within its Life operations portfolio. These contracts are not designated as specific hedges for financial reporting purposes and therefore, realized and unrealized gains and losses on these contracts are recorded in income in the period in which they occur. These contracts generally have maturities of twelve months or less.

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.

Investment Related Derivatives – Credit Exposure

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

Investment Related Derivatives – Financial Market Exposure

Stock index futures may be purchased within the Company's investment portfolio in order to create synthetic equity exposure and to add value to the portfolio with overlay strategies where market inefficiencies are believed to exist. The Company previously wrote a number of resettable strike swaps contracts relating to an absolute return index and diversified baskets of funds. From time to time, the Company may enter into other financial market exposure derivative contracts on various indices including, but not limited to, inflation and commodity contracts.

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

At December 31, 2010 and December 31, 2009, the credit derivative exposures outside of the Company's investment portfolio consisted of two contracts written by the Company: one that provides credit protection on the senior tranches of a structured finance transaction, and the other a European project finance loan participation. The aggregate outstanding exposure for the two contracts is \$246.3 million (\$226.4 million principal and \$19.9 million interest), and \$271.7 million (\$244.9 million principal and \$26.8 million interest), weighted average contractual term to maturity of 5.3 years and 6.0 years, a total liability recorded of \$25.9 million and \$18.4 million, and underlying obligations with an average credit rating of B— and A, respectively.

The credit protection related to the structured finance transaction is a credit default swap that was executed in 2000. The underlying collateral is predominantly securitized pools of leveraged loans and bonds. The transaction is in compliance with most of the coverage tests except the overcollateralization tests. As a result, both interest and principal proceeds are currently redirected to amortize the senior most notes, which reduces the Company's exposure sooner than originally anticipated. Management continues to monitor its underlying performance and is comfortable with the collateral coverage. The European project finance loan participation benefits from an 80% deficiency guarantee from the German state and federal governments.

At December 31, 2010, there were no reported events of default on these obligations. Credit derivatives are recorded at fair values, which are 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.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued) FOR THE YEARS ENDED DECEMBER 31, 2010 AND 2009

16. Derivative Instruments (Continued)

(c)(iii) Other Non-Investment Derivatives

The Company entered into derivatives as part of its contingent capital facility 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 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. 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.

(c)(iv) Weather and Energy Derivatives

Prior to August 2008, the Company offered weather and energy risk management products in insurance or derivative form to end-users and managed the risks in the OTC and exchange traded derivative markets or through the use of quota share or excess of loss arrangements. However, as part of the Company's strategy to focus on its core lines of business within its Insurance and Reinsurance segments, the Company closed this unit in August 2008 and ceased writing such weather and energy risk management products. 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 majority of existing weather and energy contracts expired at the end of 2008 and the remainder expired during 2009.

(d) Contingent Credit Features

Certain derivatives agreements entered into by the Company or its subsidiaries contain rating downgrade provisions that permit early termination of the agreement by the counterparty if collateral is not posted following failure to maintain certain credit ratings from one or more of the principal credit rating agencies. If the Company were required to early terminate such agreements due to a rating downgrade, it could potentially be in a net liability position at time of settlement. The aggregate fair value of all derivatives agreements containing such rating downgrade provisions that were in a liability position on December 31, 2010 and 2009 was \$25.9 million and \$30.8 million, respectively. The Company has not been required to post collateral under any of these agreements as of December 31, 2010 or 2009, respectively.

17. Variable Interest Entities

At times, the Company has utilized VIEs both indirectly and directly in the ordinary course of the Company's business.

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

The Company has a limited number of remaining outstanding credit enhancement exposures including written financial guarantee and credit default swap contracts. The obligations related to these transactions are often securitized through variable interest entities. The Company is not the primary beneficiary of these variable interest entities as contemplated in current authoritative accounting guidance. For further details on the nature of the obligations and the size of the Company's maximum exposure see Note 2(q), "Recent Accounting Pronouncements," and Note 16, "Derivative Instruments."

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued) FOR THE YEARS ENDED DECEMBER 31, 2010 AND 2009

18. Commitments and Contingencies

(a) Concentrations of Credit Risk

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

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

The Company’s reinsurance assets at December 31, 2010 and 2009 amounted to \$3.8 billion and \$4.0 billion, respectively, and resulted from reinsurance arrangements in the course of its operations. A credit exposure exists with respect to reinsurance assets as they may be uncollectible. The Company manages its credit risk in its reinsurance relationships by transacting with reinsurers that it considers financially sound, and if necessary, the Company may hold collateral in the form of funds, trust accounts and/or irrevocable letters of credit. This collateral can be drawn on for amounts that remain unpaid beyond specified time periods on an individual reinsurer basis.

The Company did not have an aggregate direct investment in any single corporate issuer in excess of 5% of shareholder’s equity at December 31, 2010 or December 31, 2009, which excludes government-backed, government-sponsored enterprises, government-guaranteed paper, cash and cash equivalents, and asset and mortgage backed securities that were issued, sponsored or serviced by the parent.

In addition, the Company underwrites a significant amount of its insurance and reinsurance property and casualty business through brokers and a credit risk exists should any of these brokers be unable to fulfill their contractual obligations with respect to the payments of insurance and reinsurance balances to the Company. During the two years ended December 31, 2010 and 2009, approximately 21% and 18%, respectively, of the Company’s consolidated gross written premiums from property and casualty operations were generated from or placed by Marsh & McLennan Companies. During 2010 and 2009, approximately 21% and 20%, 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. During 2010 and 2009, approximately 11% and 9%, respectively, of the Company’s consolidated gross written premiums from property and casualty operations were generated from or placed by The Willis Group and its subsidiaries. These companies are large, well established companies and there are no indications that any of them are financially troubled. No other broker and no one insured or reinsured accounted for more than 10% of gross premiums written from property and casualty operations in any of the two years ended December 31, 2010 or 2009.

(b) Other Investments

The Company has committed to invest in several limited partnerships and provide liquidity financing to a structured investment vehicle. As of December 31, 2010, the Company has commitments which include potential additional add-on clauses, to fund a further \$111.3 million.

(c) Investments in Affiliates

The Company owns a minority interest in certain closed-end funds, certain limited partnerships and similar investment vehicles, including funds managed by those companies. The Company has commitments, which include potential additional add-on clauses, to invest a further \$25.9 million over the next five years.

XL INSURANCE (BERMUDA) LTD

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued) FOR THE YEARS ENDED DECEMBER 31, 2010 AND 2009

18. Commitments and Contingencies (Continued)

(d) Properties

The Company rents space for certain of its offices under leases that expire up to 2031. Total rent expense under operating leases for the years ended December 31, 2010 and 2009 was approximately \$31.8 million and \$34.4 million, respectively. Future minimum rental commitments under existing operating leases are expected to be as follows:

Year Ended December 31,
(U.S. dollars in thousands)

2011	\$ 31.7
2012	28.1
2013	23.9
2014	17.4
2015	15.0
2016-2031	55.3
Total minimum future rentals	<u>\$ 171.4</u>

During 2003, the Company entered into a purchase, sale and leaseback transaction to acquire new office space in London. The Company has recognized a capital lease asset of \$107.4 million and \$118.0 million, and deferred a gain of \$32.6 million and \$35.9 million related to this lease at December 31, 2010 and 2009, 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 \$237.1 million and annually for the next five years are as follows:

Year Ended December 31,
(U.S. dollars in thousands)

2011	\$ 10.9
2012	11.3
2013	11.5
2014	11.8
2015	12.1
2016-2028	179.5
Total future minimum lease payments	<u>\$ 237.1</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 U.S. corporate income taxes (other than withholding taxes on dividend income) on the basis that they are not engaged in a trade or business or otherwise subject to taxation in the U.S. However, because definitive identification of activities which constitute being engaged in a trade or business in the U.S. is not provided by the Internal Revenue Code of 1986, regulations or court decisions, there can be no assurance that the Internal Revenue Service will not contend that the Company or its non-U.S. subsidiaries are engaged in a trade or business or otherwise subject to taxation in the U.S. If the Company or its non-U.S. subsidiaries were considered to be engaged in a trade or business in the U.S. (and, if the Company or such subsidiaries were to qualify for the benefits under the income tax treaty between the U.S. and Bermuda and other countries in which the Company operates, such businesses were attributable to a "permanent establishment" in the U.S.), 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, 2010 and 2009, \$2.4 billion and \$3.0 billion of letters of credit were outstanding, of which 21.1% and 21.3%, respectively, were collateralized by the Company's investment portfolios, primarily supporting U.S. non-admitted business and the Company's Lloyd's syndicates' capital requirements.

XL INSURANCE (BERMUDA) LTD

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued) FOR THE YEARS ENDED DECEMBER 31, 2010 AND 2009

18. Commitments and Contingencies (Continued)

(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 following information highlights ongoing legal proceedings related to the Company.

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 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 and Indian Harbor Insurance Company. 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 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. On August 16, 2010, the Third Circuit affirmed in large part the District Court's dismissal. The Third Circuit reversed the dismissal of certain Sherman Act and RICO claims alleged against several defendants including two of the Company's subsidiaries but remanded those claims to the District Court for further consideration of their adequacy. In light of its reversal and remand of certain of the federal claims, the Third Circuit also reversed the District Court's dismissal (based on the District Court's declining to exercise supplemental jurisdiction) of the state-law claims against all defendants. On October 1, 2010 the remaining defendants including two of the company's subsidiaries filed motions to dismiss the remanded federal claims and the state-law claims. The motions have been fully briefed and await the District Court's decision.

Various XL entities have been named as defendants in three of the many tag-along actions that have been consolidated into the MDL for pretrial purposes. The complaints in these tag-along actions make allegations similar to those made in 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 Lloyd's syndicates 861, 588 and 1209. 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." On October 12, 2007, a complaint in a third tag-along action 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. against many named defendants including X.L. America, Inc., XL Insurance America, Inc., XL Specialty Insurance Company and XL Insurance (Bermuda) Ltd. By order entered on or about October 5, 2010, the District Court ruled that the tag-along actions, including the three in which the XL entities are named defendants, will remain stayed pending the District Court's decision on defendants' October 1, 2010 motions to dismiss the remaining claims in the Class Action.

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, 2010 and 2009.

Legal actions are subject to inherent uncertainties, and future events could change management's assessment of the probability or estimated amount of potential losses from pending or threatened legal actions. Based on available information, it is the opinion of management that the ultimate resolution of pending or threatened legal actions, both individually and in the aggregate, will not result in losses having a material effect on the Company's financial position or liquidity at December 31, 2010.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued) FOR THE YEARS ENDED DECEMBER 31, 2010 AND 2009

18. Commitments and Contingencies (Continued)

(h) Financial and Other Guarantee Exposures

As part of the Company's legacy financial guarantee business, the Company's outstanding financial guarantee contracts at December 31, 2010 included the reinsurance of 37 financial guarantee contracts with total insured contractual payments outstanding of \$204.8 million (\$198.7 million of principal and \$6.1 million of interest) and having a remaining weighted-average contract period of 13.2 years. These contracts provide credit support for a variety of collateral types. On August 5, 2010, \$386.5 million of notional financial guarantee exposure (including principal and interest) on a Chilean toll road structure was eliminated when the issuer decided to prepay the debt. Following this elimination, the remaining largest exposures are comprised of (i) \$108.3 million notional financial guarantee on three notes backed by zero coupon bonds and bank perpetual securities; (ii) \$47.5 million notional financial guarantee on a collateralized fund obligation with a collateral cushion in excess of 60% of the Company's exposure that is currently being wound-up in an orderly manner and (iii) the remaining \$49.0 million of financial guarantees is comprised of 33 separate transactions with varying forms of underlying collateral, including pre-2000 vintage asset backed securities and municipal government bonds. The underlying financial guarantees are diversified and not individually significant.

The total gross claim liability and unearned premiums recorded at December 31, 2010 associated with the Company's legacy financial guarantee business were \$23.5 million and \$0.6 million, respectively. Of the contracts noted above, three contracts with total insured contractual payments outstanding of \$9.8 million had experienced an event of default and were considered by the Company to be non-performing at December 31, 2010, while the remaining were considered to be performing at such date.

During January 2011, management commuted 32 of the financial guarantee transactions noted above, including the three non-performing transactions. This commutation eliminated \$41.9 million of notional financial guarantee exposure (including principal and interest) for a payment of \$22.1 million. This amount was included in the gross claim liability at December 31, 2010.

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.

At December 31, 2009, the Company's outstanding financial guarantee contracts included the reinsurance of 41 financial guarantee contracts with total insured contractual payments outstanding of \$713.6 million (\$568.2 million of principal and \$145.4 million of interest) and having a remaining weighted-average contract period of 11.5 years. The total gross claim liability and unearned premiums recorded at December 31, 2009 were \$14.5 million and \$1.5 million, respectively. Of the contractual exposure existing at December 31, 2009, the Company had reinsured \$423.8 million with subsidiaries of Syncora, however, at December 31, 2009, there were no gross claims liabilities or recoverables recorded. Of the 41 contracts noted above, three contracts with total insured contractual payments outstanding of \$16.1 million had experienced an event of default and were considered by the Company to be non-performing at December 31, 2009, while the remaining 38 contracts were considered to be performing at such date.

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

Under the Termination Agreement, the Company paid \$38 million to EIB, and all of the Company's exposures under the EIB guarantees, with aggregate par outstanding of approximately \$900 million, were eliminated. In addition, a further \$0.5 million was paid to EIB for expenses in relation to the termination. Pursuant to the obligations of Syncora Holdings and its affiliates (collectively "Syncora") under the Master Commutation, Release and Restructuring Agreement (the "Master Agreement"), dated July 28, 2008, as amended, among the Company and affiliates, Syncora, and certain of Syncora's credit default swap counterparties, Syncora paid the Company \$15.0 million. The net cost of this transaction is reflected in the Company's Consolidated Statement of Income as "Loss on Termination of Guarantee." For further historical information regarding the above-mentioned EIB guarantees and the Master Agreement, see Note 4, "Syncora Holdings Ltd. ("Syncora")."

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued) FOR THE YEARS ENDED DECEMBER 31, 2010 AND 2009

19. Compensation Plans

(a) Stock Plans

The company's ultimate parent, XL Group PLC, operates stock-based performance incentive programs, which provide for grants of stock options and restricted stock to employees of the Company. The plans are administered by the Board of Directors and the Compensation Committee of the Board of Directors of XL Group PLC.

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

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

(c) Options

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

	2010	2009
Dividend yield.....	3.25%	3.25%
Risk free interest rate	2.67%	2.38%
Volatility	71.09%	94.27%
Expected lives	6.0 years	6.0 years

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

During the years ended December 31, 2010 and 2009, the Company granted 455,455 and 534,000 options, respectively, to purchase its ordinary shares to directors and employees related to incentive compensation plans, with a weighted average grant-date fair value of \$9.29 and \$3.13, respectively. During the years ended December 31, 2010 and 2009, the Company recognized \$7.2 million and \$8.7 million, respectively, of compensation expense, net of tax, related to its stock option plan. Total intrinsic value of stock options exercised during the years ended December 31, 2010 and 2009 was \$0.2 million and nil, respectively.

The following is a summary of stock options as of December 31, 2010, and related activity for the year then ended for the Company:

	Number of Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term	Aggregate Intrinsic Value (000s)
Outstanding – beginning of year.....	8,546,782	\$ 50.08	5.9 years	\$ 7,397
Granted	455,455	18.42		
Exercised.....	(10,000)	19.62		
Cancelled/Expired.....	(381,424)	54.67		
Outstanding – end of year	8,610,813	\$ 49.53	5.1 years	\$ 15,016
Options exercisable	5,527,692	\$ 65.80	3.6 years	\$ 3,928

XL INSURANCE (BERMUDA) LTD

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued) FOR THE YEARS ENDED DECEMBER 31, 2010 AND 2009

19. Compensation Plans (Continued)

c) Options (Continued)

The aggregate intrinsic value in the table above represents the total pre-tax intrinsic value (the difference between the Company's closing stock price on the last trading day of the 2010 fiscal year and the exercise price, multiplied by the number of in-the-money-options) that would have been received by the option holders had all option holders exercised their options on December 31, 2010. Total unrecognized stock based compensation expense related to non-vested stock options was approximately \$6.8 million as of the end of December 31, 2010, related to approximately 3.2 million options, which is expected to be recognized over a weighted-average period of 1.0 years. No options were exercised during 2009. The exercise price of the Company's outstanding options granted is the market price of the Company's ordinary shares on the grant date, except that during 2004, 295,000 options were granted with an exercise price of \$88.00 when the market price was \$77.10.

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

Restricted stock awards issued under the 1991 Performance Incentive Program vest as set forth in the applicable award agreements. These shares contained certain restrictions prior to vesting, relating to, among other things, forfeiture in the event of termination of employment and transferability.

During 2010 and 2009, the Company granted nil and 40,000 shares, respectively, of its restricted common stock to its directors and employees related to incentive compensation plans, with a weighted average grant date fair value per share of nil and \$14.34, respectively. During the years ended December 31, 2010 and 2009, \$13.5 million and \$26.4 million, respectively, was charged to compensation expense related to restricted stock awards. Total unrecognized stock based compensation expense related to non-vested restricted stock awards was approximately \$7.8 million as of the end of December 31, 2010, related to approximately 0.4 million restricted stock awards, which is expected to be recognized over 0.9 years.

Non-vested restricted stock awards as of December 31, 2010 and for the year then ended for the Company were as follows:

	Number of Shares (thousands)	Weighted- Average Grant Date Fair Value
Unvested at December 31, 2009	945	\$ 46.67
Granted	-	\$ -
Vested	(440)	\$ 50.75
Forfeited.....	(4)	\$ 45.09
Unvested at December 31, 2010	<u>501</u>	<u>\$ 42.88</u>

During the year ended December 31, 2010, the Company granted approximately 1.2 million restricted stock units to officers of the Company and its subsidiaries with an aggregate grant date fair value of approximately \$22.4 million. During the year ended December 31, 2010, \$7.5 million was charged to compensation expense related to restricted stock units. Each restricted stock unit represents the Company's obligation to deliver to the holder one ordinary share upon satisfaction of the three year vesting term. Restricted stock units are granted at the closing market price on the day of grant and entitle the holder to receive dividends declared and paid in the form of additional ordinary shares contingent upon vesting.

During the year ended December 31, 2010, the Company granted 1.2 million performance units (representing a potential maximum share payout of approximately 2.4 million ordinary shares) to certain employees with an aggregate grant date fair value of approximately \$20.6 million. During the year ended December 31, 2010, \$5.4 million was charged to compensation expense related to performance units. The performance units vest after three years and entitle the holder to shares of the Company's stock. There are no dividend rights associated with the performance units. Each grant of performance units has a target number of shares, with final payouts ranging from 0% to 200% of the grant amount depending upon a combination of corporate and business segment performance along with each employee's continued service through the vest date. Performance targets are based on relative and absolute financial performance metrics.

XL INSURANCE (BERMUDA) LTD

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued) FOR THE YEARS ENDED DECEMBER 31, 2010 AND 2009

20. 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 compensation (base salary and annual bonus) into the plan each month. The Company's contribution generally vests over five years. The Company's expenses for its qualified contributory defined contribution retirement plans were \$37.7 million and \$36.9 million at December 31, 2010 and 2009, respectively.

Defined benefit plans

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

U.S. Plan

A qualified non-contributory defined benefit pension plan exists to cover a number of its U.S. employees. This plan also includes a non-qualified supplemental defined benefit plan designed to compensate individuals to the extent that their benefits under the Company's qualified plan are curtailed due to 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.

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, 2010 and 2009 was \$3.0 million and \$3.3 million, respectively, representing the entire unfunded projected benefit obligations.

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

	<u>2010</u>	<u>2009</u>
Net Benefit Cost – Weighted-average assumptions for the year ended December 31		
Discount rate	6.00%	6.00%
Expected long-term rate of return on plan assets	8.00%	8.50%
Benefit Obligation – Weighted-average assumptions as of December 31		
Discount rate	5.59%	6.00%

The U.S. Retirement plan assets at December 31, 2010 and 2009 consist of two mutual funds. The first fund employs a core bond portfolio strategy that seeks maximum current income and price appreciation consistent with the preservation of capital and prudent risk taking with a focus on investing in intermediate-term high quality bonds from the fastest growing economies in the Pacific Rim, including Japan.

The second fund seeks long term growth of capital by investing in a diversified group of domestic and international companies. Using a quantitative approach, portfolio managers identify companies that are expected to outperform in the next six to twelve months and include them in the fund.

The fair value of the U.S. Plan assets at December 31, 2010 and 2009 was \$25.1 million and \$22.0 million, respectively. As both of the retirement plan's investments are mutual funds, they fall within Level 1 in the fair value hierarchy.

XL INSURANCE (BERMUDA) LTD

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued) FOR THE YEARS ENDED DECEMBER 31, 2010 AND 2009

20. Retirement Plans (Continued)

Defined benefit plans (Continued)

U.K. Plans

A contributory defined benefit pension plan exists in the U.K., but has been closed to new entrants since 1996. The Scheme has approximately 110 members, of whom approximately 70 are active or deferred members of the Scheme. Benefits are based on length of service and compensation as defined in the Trust Deed and Rules, and the Plan is subject to triennial funding valuations, the most recent of which was conducted in 2009 and was reported in 2010. The \$2.9 million deficit is being funded over a 10 year period. Current contribution rates are 24.6% and 3% of pensionable salary for employer and employee, respectively.

The U.K. pension plan assets are held in a separate Trustee administered fund to meet long term liabilities to past and present employees. The table below shows the composition of the Plan's assets and the fair value of each major category of plan assets as of December 31, 2010 and 2009, as well as the potential returns of the different asset classes. The total of the asset values held in various externally managed portfolios are provided by third party pricing vendors. There is no significant concentration of risk within plan assets.

<i>(U.S. dollars in thousands)</i>	Expected Return on Assets for 2010	Value at December 31, 2010	Expected Return on Assets for 2009	Value at December 31, 2009
The assets in the scheme and the expected rates of return were as follows:				
Equities	7.50%	\$ 5,542	6.70%	\$ 3,774
Gilts.....	4.50%	1,249	3.70%	1,951
Corporate Bonds	5.70%	1,187	6.50%	1,501
Other (cash).....	4.20%	254	2.00%	318
Total market value of assets.....		<u>\$ 8,232</u>		<u>\$ 7,544</u>

In addition, during 2003 six members who are still employed by the Company in the U.K. transferred from a defined benefit plan into a defined contribution plan. These employees have a contractual agreement with the Company that provides a "no worse than final salary pension" guarantee in the event that they are employed by the Company until retirement, whereby the Company guarantees to top-up their defined contribution pension to the level of pension that they would have been entitled to receive had they remained in the defined benefit scheme. The pension liability recorded with respect to these individuals was \$3.4 million and \$2.9 million at December 31, 2010 and 2009, respectively, representing the entire unfunded projected obligation.

European Plans

Certain contributory defined benefit pension plans exist in several European countries, most notably Germany, which are closed to new entrants. Benefits are generally based on length of service and compensation defined in the related agreements. Included in the projected obligation amounts of \$66.3 million and \$57.0 million at December 31, 2010 and 2009, respectively, in the table below, are total unfunded projected obligations in relation to the European defined benefit schemes of \$16.0 million and \$14.3 million, respectively.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued) FOR THE YEARS ENDED DECEMBER 31, 2010 AND 2009

20. Retirement Plans (Continued)

Defined benefit plans (Continued)

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

The status of the above mentioned plans at December 31, 2010 and 2009 is as follows:

(U.S. dollars in thousands)

Change in projected benefit obligation:

	2010	2009
Projected benefit obligation – beginning of year	\$ 56,998	\$ 54,134
Service cost (1)	737	977
Interest cost	3,021	2,980
Actuarial (gain) / loss	8,197	(1,210)
Benefits and expenses paid	(1,419)	(1,359)
Foreign currency losses / (gains)	(1,207)	1,476
Projected benefit obligation – end of year	<u>\$ 66,327</u>	<u>\$ 56,998</u>

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

Change in plan assets:

	2010	2009
Fair value of plan assets – beginning of year	\$ 29,548	\$ 20,917
Actual return on plan assets	3,138	4,928
Employer contributions	1,295	5,600
Benefits and expenses paid	(995)	(994)
Foreign currency gains (losses)	(249)	803
Actuarial (losses) / gains	557	(1,706)
Other transfers to defined contribution plan	–	–
Fair value of plan assets – end of year	<u>\$ 33,294</u>	<u>\$ 29,548</u>
Funded status – end of year	<u>\$ (33,033)</u>	<u>\$ (27,450)</u>
Accrued pension liability	<u>\$ 33,033</u>	<u>\$ 32,250</u>

The components of the net benefit cost for the years ended December 31, 2010 and 2009 are as follows:

(U.S. dollars in thousands)

Components of net benefit cost:

	2010	2009
Service cost	\$ 736	\$ 977
Interest cost	3,021	2,980
Expected return on plan assets	(1,985)	(1,610)
Amortization of net actuarial loss	198	131
Net benefit cost	<u>\$ 1,970</u>	<u>\$ 2,478</u>

XL INSURANCE (BERMUDA) LTD

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued) FOR THE YEARS ENDED DECEMBER 31, 2010 AND 2009

21. Accumulated Other Comprehensive Income (Loss)

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

<i>(U.S. dollars in thousands)</i>	<u>Before Tax Amount</u>	<u>Tax (Benefit) Expense</u>	<u>Net of Tax Amount</u>
Year Ended December 31, 2010:			
Unrealized gains on investments:			
Unrealized gains arising during year	\$ 767,001	\$ (46,859)	\$ 813,860
Less reclassification for (losses) realized in income	(142,779)	(5,369)	(137,410)
Net unrealized gains on investments.....	909,780	(41,490)	951,270
Change in net unrealized gain on future policy benefit reserves.....	(3,714)	–	(3,714)
Change in underfunded pension liability	(2,619)	–	(2,619)
Foreign currency translation adjustments	47,351	(3,600)	50,951
Change in accumulated other comprehensive income	<u>\$ 950,798</u>	<u>\$ (45,090)</u>	<u>\$ 995,888</u>
Year Ended December 31, 2009:			
Unrealized gains on investments:			
Unrealized gains arising during year	\$ 1,250,328	\$ 97,942	\$ 1,152,386
Less reclassification for (losses) realized in income	(1,255,770)	(32,050)	(1,223,720)
Net unrealized gains on investments.....	2,506,098	129,992	2,376,106
Change in net unrealized gain on future policy benefit reserves.....	5,382	–	5,382
Change in underfunded pension liability	(2,255)	–	(2,255)
Foreign currency translation adjustments	169,263	(11,627)	180,890
Change in accumulated other comprehensive income	<u>\$ 2,678,488</u>	<u>\$ 118,365</u>	<u>\$ 2,560,123</u>

The December 31 balance of each component of accumulated other comprehensive income (loss) for 2010 and 2009 are as follows:

Year Ended December 31	2010	2009
<i>(U.S. dollars in thousands)</i>		
Accumulated unrealized gains (losses) on investments, net of tax	\$ 72,066	\$ (804,888)
OTTI losses recognized in other comprehensive income, net of tax	(144,906)	(219,222)
Accumulated foreign currency translation	104,439	53,488
Accumulated underfunded pension liability	(14,899)	(8,566)
Total.....	<u>\$ 16,700</u>	<u>\$ (979,188)</u>

22. Dividends

The company paid a dividend of \$833.3 million in 2010, \$487.2 million was cash, \$312.8 million was investments and \$33.3 million was reduction of inter company balances. The company paid a dividend of \$2,071.5 million in 2009, \$394 million was cash, \$1,046.6 million was investments and \$630.9 million was reduction of inter company balances.

XL INSURANCE (BERMUDA) LTD

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued) FOR THE YEARS ENDED DECEMBER 31, 2010 AND 2009

23. Taxation

The Company and its Bermuda subsidiaries are not subject to any income, withholding or capital gains taxes under current Bermuda law. In the event that there is a change such that these taxes are imposed, the Bermuda subsidiaries would be exempted from any such tax until March 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 until March 31, 2011 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.

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, 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 certain undistributed earnings of foreign subsidiaries. If the earnings were to be distributed, as dividends or otherwise, such amounts may be subject to withholding taxation in the state of the paying entity. During 2010, the Company revised its capital strategy such that it is no longer able to positively assert that all earnings arising in the U.S. will be permanently reinvested in that jurisdiction and accordingly, a provision for withholding taxes arising in respect of U.S. earnings has been made. No withholding taxes are accrued with respect to the earnings of the Company's subsidiaries arising outside the U.S. as it is the intention that all such earnings will remain reinvested indefinitely.

The Company adopted the provisions of the final authoritative guidance on accounting for uncertainty in income taxes, on January 1, 2007. The Company did not recognize any liabilities for unrecognized tax benefits as a result of its implementation and has not recognized any liabilities in subsequent accounting periods.

The Company has open examinations by tax authorities in Ireland, the U.K., the U.S. and France. The years under review are 2006 to 2009, 2007 and 2008, 2006 to 2009, and 2008 and 2009, respectively. The Company believes that these examinations will be concluded within the next 24 months; however, it is not currently possible to estimate the outcome of these examinations.

The Company has open tax years, that are potentially subject to examinations by local tax authorities, in the following major tax jurisdictions, the U.S. 2010, the U.K. 2009 to 2010, Switzerland 2007 to 2010; Ireland 2005 to 2010, Germany 2006 to 2010 and France 2007 to 2010.

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. At December 31, 2010 and 2009, the Company has no accrued liabilities relating to interest and penalties.

The income tax provisions for the years ended December 31, 2010 and 2009 are as follows:

Year Ended December 31

(U.S. dollars in thousands)

	<u>2010</u>	<u>2009</u>
Current expense:		
U.S.....	\$ 40,413	\$ 29,112
Non U.S.....	41,262	90,079
Total current expense	\$ 81,675	\$ 119,191
Deferred expense (benefit):		
U.S.....	\$ 18,225	\$ (4,604)
Non U.S.....	63,037	(62)
Total deferred expense (benefit)	\$ 81,262	\$ (4,666)
Total Tax Expense	\$ 162,937	\$ 114,525

The weighted average expected tax provision has been calculated using the pre-tax accounting income (loss) in each jurisdiction multiplied by that jurisdiction's applicable statutory tax rate. The applicable statutory tax rates of the most significant jurisdictions contributing to the overall taxation of the Company are, Ireland 12.5% and 25%, Bermuda 0%, the U.S. 35%, the U.K. 28%, Switzerland 7.83% and 21.2%, Germany 15%, and France 34.43%. Reconciliation of the difference between the provision for income taxes and the expected tax provision at the weighted average tax rate for the years ended December 31, 2010 and 2009 is provided below:

XL INSURANCE (BERMUDA) LTD

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
FOR THE YEARS ENDED DECEMBER 31, 2010 AND 2009

23. Taxation (Continued)

(U.S. dollars in thousands)

	<u>2010</u>	<u>2009</u>
Expected tax provision at weighted average rate	\$ 88,822	\$ 123,354
Permanent differences:		
Non-taxable investment income.....	(10,176)	(5,715)
Non-taxable income.....	3,838	(91,968)
Prior year adjustments	16,594	(15,360)
State, local and foreign taxes	44,120	59,835
Valuation allowance	(7,251)	11,439
Allocated investment income	12,386	20,045
Stock options	3,323	6,222
Non-deductible expenses.....	11,281	6,673
Total tax expense.....	<u>\$ 162,937</u>	<u>\$ 114,525</u>

Significant components of the Company's deferred tax assets and liabilities as of December 31, 2010 and 2009 were as follows:

(U.S. dollars in thousands)

	<u>2010</u>	<u>2009</u>
Deferred Tax Asset:		
Net unpaid loss reserve discount	\$ 105,313	\$ 102,657
Net unearned premiums.....	57,289	45,786
Compensation liabilities	42,347	48,904
Net operating losses.....	274,278	314,026
Investment adjustments	8,941	18,300
Pension	6,290	6,356
Bad debt reserve	10,502	1,483
Guarantee fund recoupment	—	4,346
Untaxed Lloyd's result	—	12,772
Net unrealized depreciation on investments	6,004	18,972
Stock options	11,097	12,519
Depreciation	7,131	16,680
Net unrealized capital losses.....	—	32,289
Net realized capital losses	117,358	86,440
Deferred intercompany capital losses	142,300	168,700
Other	9,527	23,325
Deferred tax asset, gross of valuation allowance.....	<u>\$ 798,377</u>	<u>\$ 913,555</u>
Valuation allowance	506,542	517,582
Deferred tax asset, net of valuation allowance	<u>\$ 291,835</u>	<u>\$ 395,973</u>
Deferred Tax Liability:		
Net unrealized appreciation on investments	52,972	51,764
Unremitted earnings	—	1,015
Deferred acquisition costs	19,601	14,651
Currency translation adjustments	11,115	9,407
Deferred gain on investments	—	1,613
Regulatory reserves	149,650	127,186
Untaxed Lloyd's result	16,028	—
Other	8,565	221
Deferred tax liability.....	<u>\$ 257,931</u>	<u>\$ 205,857</u>
Net Deferred Tax Asset	<u>\$ 33,904</u>	<u>\$ 190,116</u>

XL INSURANCE (BERMUDA) LTD

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued) FOR THE YEARS ENDED DECEMBER 31, 2010 AND 2009

23. Taxation (Continued)

The valuation allowance at December 31, 2010 and December 31, 2009 of \$506.5 million and \$517.6 million, respectively, related primarily to net operating loss carry forwards in Switzerland and net unrealized capital losses and realized capital loss carry forwards in the U.S. that may not be realized within a reasonable period. As of December 31, 2010, the Company had realized capital loss carry forwards of approximately \$745.7 million in the U.S. (\$261.0 million tax effected), against which a valuation allowance of approximately \$261.0 million had been established. Included within the capitalized realized losses are \$406.6 million of losses arising from the sale of investments to a group company (\$142.3 million tax effected), against which a valuation allowance of \$142.3 million has been established. These losses cannot be utilized to offset any future U.S. realized capital 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, 2010, net operating loss carry forwards in the U.K. were approximately \$152.4 million and have no expiration. As of December 31, 2010, net operating loss carry forwards in Switzerland were approximately \$1.1 billion and will expire in future years through 2017.

Management has reviewed historical taxable income and future taxable income projections for its 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 \$152.4 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 \$41.5 million.

Shareholder's equity at December 31, 2010 and 2009 reflected tax benefits of nil and nil, respectively, related to compensation expense deductions for stock options exercised by the Company's U.S. subsidiaries.

24. 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 in which the Company operates, 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, 2010 and 2009 are summarized below. 2010 information is preliminary as many regulatory returns are due later in 2011 for many jurisdictions in which the Company does business, and accordingly, 2010 information summarized below is subject to revision.

	Bermuda (1)		U.S. (2)		U.K., Europe and Other	
	2010	2009	2010	2009	2010	2009
<i>(U.S. dollars in thousands)</i>						
Required statutory capital and surplus	\$ 4,623,084	\$ 4,714,422	\$ 640,834	\$ 641,160	\$ 1,128,062	\$ 1,275,211
Actual statutory capital and surplus (3)	\$ 9,159,019	\$ 8,541,341	\$ 2,273,711	\$ 2,191,298	\$ 3,195,809	\$ 3,091,259

(1) Required statutory capital and surplus represents 100% BSCR level for principal Bermuda operating subsidiaries.

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

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

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

XL INSURANCE (BERMUDA) LTD

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued) FOR THE YEARS ENDED DECEMBER 31, 2010 AND 2009

24. Statutory Financial Data (Continued)

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.

Bermuda Operations

In early July 2008, the Insurance Amendment Act of 2008 was passed, which introduced a number of changes to the Bermuda Insurance Act 1978, such as allowing the Bermuda Monetary Authority (BMA) to prescribe standards for an enhanced capital requirement and a capital and solvency return that insurers and reinsurers must comply with. The Bermuda Solvency Capital Requirement (BSCR) employs a standard mathematical model that can relate more accurately the risks taken on by (re)insurers to the capital that is dedicated to their business. Insurers and reinsurers may adopt the BSCR model or, where an insurer or reinsurer believes that its own internal model better reflects the inherent risk of its business, an in-house model approved by the BMA. Class 4 (re)insurers, such as the Company, were required to implement the new capital requirements under the BSCR model beginning with fiscal years ending on or after December 31, 2009. The Company's capital requirements 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 and one of its Bermuda subsidiaries, XL Re Ltd, are prohibited from declaring or paying dividends of more than 25% of each of their prior year's statutory capital and surplus unless the Company filed with the Bermuda Monetary Authority a signed affidavit by at least two members of the Company's Board of Directors and the Company's Principal Representative 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, 2010 and 2009, the maximum dividend that the Bermuda operating entities could pay, without a signed affidavit, having met minimum levels of statutory capital and surplus and liquidity requirements, was approximately \$1.3 billion and \$1.3 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 in an aggregate amount in any twelve month period that exceeds the lesser of 10 percent of XLRA's statutory policyholders' surplus or 100 percent of its "adjusted net investment income," as defined. The New York State insurance law also provides that any distribution that is a dividend may only be paid out of statutory earned surplus. At December 31, 2010, and 2009, XLRA had statutory earned surplus of \$184.3 million and \$126.0 million, respectively. At December 31, 2010, XLRA's statutory policyholders' surplus was \$2.3 billion, and accordingly, the maximum amount of dividends XLRA can declare and pay in 2011, without prior regulatory approval, is \$184.3 million. At December 31, 2010, none of the seven property and casualty subsidiaries of XLRA had a statutory earned deficit, while at December 31, 2009 one had a statutory earned deficit of \$3.4 million.

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 Bermuda is held in Ireland (\$1.6 billion at December 31, 2010) and the U.K. (\$1.1 billion at December 31, 2010). 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.

XL INSURANCE (BERMUDA) LTD

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued) FOR THE YEARS ENDED DECEMBER 31, 2010 AND 2009

25. Related Party Transactions

For detailed information regarding the Company's transactions with Syncora see Note 4, "Syncora Holdings Ltd."

At December 31, 2010, the Company owned minority stakes in seven independent investment management companies ("Investment Manager Affiliates"). At December 31, 2009, the Company owned minority stakes in nine independent investment management companies. 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 Manager Affiliates.

In the normal course of business, the Company enters into certain quota share reinsurance contracts with a subsidiary of one of its other strategic affiliates, ARX Holding Corporation. During the year ended December 31, 2010, these contracts resulted in reported net premiums written of \$71.1 million, net losses incurred of \$33.1 million and reported acquisition costs of \$32.8 million. During the year ended December 31, 2009, these contracts resulted in reported net premiums written of \$44.1 million, net losses incurred of \$20.1 million and reported acquisition costs of \$19.1 million. Management believes that these transactions are conducted at market rates consistent with negotiated arms-length contracts.

In addition, the Company had entered into a reinsurance contract with another strategic affiliate, ITAU. The reinsurance contract resulted in reported net premiums of approximately \$3.1 million, loss reserves of \$1.2 million, and reported acquisition costs of \$1.4 million during the year ended December 31, 2009.

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.

As at December 31, 2010 the Company and its subsidiaries had balances due from related parties of \$425.0 million. These amounts are all due from XL Group Limited or companies directly controlled by them. XL Group Ltd is the immediate subsidiary of XL Group Plc, a Company domiciled in Ireland and listed on the New York Stock Exchange. XL Group Ltd has a Long Term Debt Rating of BBB+ (Stable) and the Company considers there is no recoverability issue with regard to this asset.

26. Subsequent Events

During December 2010, the Company recorded preliminary loss estimates of the total loss exposure in 2010 to the Queensland floods, net of reinsurance and reinstatement premium, of approximately \$23.3 million, of which \$18.3 million is attributable to the Insurance segment and \$5.0 million to the Reinsurance segment. The Australian flooding events continued in 2011 so additional losses in the range of \$75-95 million are expected in the first quarter of 2011.

On March 9, 2011, the Company announced preliminary net loss estimates, pretax and net of reinsurance and reinstatement premium, ranging from approximately \$70 million to \$85 million, for the earthquake that struck Christchurch, New Zealand on February 22, 2011. The majority of this loss estimate is attributable to the reinsurance segment.

On April 4, 2011, the Company announced preliminary net loss estimates for the March 11, 2011 earthquake and tsunami in Japan, pretax and net of reinsurance and reinstatement premiums, ranging from approximately \$190 million to \$290 million, with approximately 70 percent attributable to the reinsurance segment. The wide range reflects the continued uncertainty regarding the event, including whether coverage levels will be reached under certain policies.

The Company's loss estimates are based on combinations of its review of individual treaties and policies expected to be impacted, commercial model outputs, client data received to the date the estimates are made, and consideration of expectations of total insured market loss estimates if available, both from published sources and the Company's internal analysis. The Company's loss estimates involve the exercise of considerable judgment due to the complexity and scale of the insured events, and are accordingly subject to revision as additional information becomes available. Important factors that could cause actual losses may differ materially from these preliminary estimates, include the preliminary nature of reports and estimates of loss and damage to date.