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# **ACE Bermuda Insurance Ltd. and Subsidiaries**

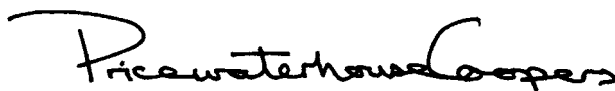
Consolidated Financial Statements  
December 31, 2008 and 2007

April 29, 2009

**Report of Independent Auditors**

To the Board of Directors and Shareholder of  
ACE Bermuda Insurance Ltd.

In our opinion, the accompanying consolidated balance sheets and the related consolidated statements of operations, shareholder's equity, comprehensive (loss) income and cash flows present fairly, in all material respects, the financial position of ACE Bermuda Insurance Ltd. and its subsidiaries at December 31, 2008 and December 31, 2007, 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.



**Chartered Accountants**

# ACE Bermuda Insurance Ltd. and Subsidiaries

## Consolidated Balance Sheets

As at December 31, 2008 and 2007

(in thousands of U.S. dollars)

	<u>2008</u>	<u>2007</u>
<b>Assets</b>		
Investments and cash		
Fixed maturities available for sale, at fair value (amortized cost \$2,703,889 and \$3,244,986)	\$ 2,453,212	\$ 3,257,996
Fixed maturities, held to maturity, at amortized cost (fair value \$160,744 and \$208,246)	170,441	208,340
Equity securities, at fair value (cost - \$254,658 and \$345,643)	222,729	398,747
Short-term investments (amortized cost - \$300,451 and \$328,452)	300,451	328,450
Other investments, at fair value (cost - \$356,902 and \$233,570)	331,270	287,398
Cash	68,746	57,337
Total investments and cash	<u>\$ 3,546,849</u>	<u>\$ 4,538,268</u>
Accrued investment income	\$ 45,786	\$ 46,547
Securities lending collateral	160,277	301,611
Premiums and insurance balances receivable	72,076	50,132
Reinsurance recoverable	417,116	423,130
Deferred policy acquisition costs	24,091	16,127
Prepaid reinsurance premiums	82,572	76,302
Value of reinsurance business assumed	33,370	35,966
Amount due from parent and affiliates	-	16,830
Other assets	177,773	146,717
Investments in partially-owned insurance companies	494,046	485,292
Total assets	<u>\$ 5,053,956</u>	<u>\$ 6,136,922</u>
<b>Liabilities</b>		
Unpaid losses and loss expenses	\$ 2,444,604	\$ 2,406,868
Unearned premiums	324,877	301,961
Funds withheld	906	15,763
Insurance and reinsurance balances payable	109,218	65,432
Deposit liabilities	235,786	245,048
Payables for securities purchased	190,734	374,434
Securities lending payable	169,289	301,611
Amount due to parent and affiliates	47,725	-
Accounts payable and accrued liabilities	78,518	63,025
Total liabilities	<u>\$ 3,601,657</u>	<u>\$ 3,774,142</u>
<b>Shareholder's equity</b>		
Common shares (\$1.00 par value, 1,250,000 shares authorized, issued and outstanding)	\$ 1,250	\$ 1,250
Additional paid-in capital	1,881,217	1,881,217
(Accumulated deficit) retained earnings	(139,483)	348,270
Accumulated other comprehensive (loss) income	(290,685)	132,043
Total shareholder's equity	<u>\$ 1,452,299</u>	<u>\$ 2,362,780</u>
Total liabilities and shareholder's equity	<u>\$ 5,053,956</u>	<u>\$ 6,136,922</u>

The accompanying notes are an integral part of these consolidated financial statements.

# ACE Bermuda Insurance Ltd. and Subsidiaries

## Consolidated Statements of Operations

For the years ended December 31, 2008 and 2007

(in thousands of U.S. dollars)

	<u>2008</u>	<u>2007</u>
<b>Revenues</b>		
Gross premiums written	\$ 630,698	\$ 585,370
Reinsurance premiums ceded	<u>(192,055)</u>	<u>(178,302)</u>
Net premiums written	438,643	407,068
Change in unearned premiums	<u>(8,337)</u>	<u>5,977</u>
Net premiums earned	430,306	413,045
Net investment income	188,325	202,814
Net realized (losses) gains on investments	(282,450)	52,185
Other income	<u>15,152</u>	<u>(58,184)</u>
Total revenues	<u>\$ 351,333</u>	<u>\$ 609,860</u>
<b>Expenses</b>		
Losses and loss expenses	\$ 245,695	\$ 219,656
Policy acquisition costs	36,399	20,261
Administrative expenses	<u>50,366</u>	<u>49,639</u>
Total expenses	<u>\$ 332,460</u>	<u>\$ 289,556</u>
<b>Net income before taxes</b>	\$ 18,873	\$ 320,304
Income tax expense	<u>(4,626)</u>	<u>(5,481)</u>
<b>Net income</b>	<u>\$ 14,247</u>	<u>\$ 314,823</u>

The accompanying notes are an integral part of these consolidated financial statements.

# ACE Bermuda Insurance Ltd. and Subsidiaries

Consolidated Statements of Shareholder's Equity  
For the years ended December 31, 2008 and 2007

(in thousands of U.S. dollars)

	<u>2008</u>	<u>2007</u>
<b>Common shares</b>		
Balance – beginning and end of year	\$ 1,250	\$ 1,250
<b>Additional paid-in capital</b>		
Balance – beginning and end of year	\$ 1,881,217	\$ 1,881,217
<b>(Accumulated deficit) retained earnings</b>		
Balance – beginning of year	\$ 348,270	\$ 200,341
Net income	14,247	314,823
Effect of adoption of FAS 155	-	1,595
Dividends declared	<u>(502,000)</u>	<u>(168,489)</u>
Balance – end of year	\$ <u>(139,483)</u>	\$ <u>348,270</u>
<b>Accumulated other comprehensive (loss) income</b>		
Balance – beginning of year	\$ 132,043	\$ 207,660
Effect of adoption of FAS 155	-	(1,595)
Other comprehensive (loss)	<u>(422,728)</u>	<u>(74,022)</u>
Balance – end of year	\$ <u>(290,685)</u>	\$ <u>132,043</u>
<b>Total shareholder's equity</b>	<u>\$ 1,452,299</u>	<u>\$ 2,362,780</u>

The accompanying notes are an integral part of these consolidated financial statements.

# ACE Bermuda Insurance Ltd. and Subsidiaries

Consolidated Statements of Comprehensive (Loss) Income  
For the years ended December 31, 2008 and 2007

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	<u>2008</u>	<u>2007</u>
<b>Net income</b>	\$ 14,247	\$ 314,823
<b>Other comprehensive (loss)</b>		
Unrealized (depreciation) appreciation arising during the period	(696,446)	(18,610)
Less: reclassification adjustment for net realized losses (gains) included in net income	274,066	(55,005)
Amortization of net unrealized appreciation related to securities transferred to held to maturity	<u>(616)</u>	<u>(577)</u>
Other comprehensive (loss) before income taxes	(422,996)	(74,192)
Income tax benefit related to other comprehensive (loss) items	<u>268</u>	<u>170</u>
Other comprehensive (loss)	<u>\$ (422,728)</u>	<u>\$ (74,022)</u>
<b>Comprehensive (loss) income</b>	<u>\$ (408,481)</u>	<u>\$ 240,801</u>

# ACE Bermuda Insurance Ltd. and Subsidiaries

Consolidated Statements of Cash Flows

For the years ended December 31, 2008 and 2007

	<u>2008</u>	<u>2007</u>
<b>Cash flows from operating activities</b>		
Net income	\$ 14,247	\$ 314,823
Adjustments to reconcile net income to net cash from operating activities:		
Net realized losses (gains) on investments	282,450	(52,185)
Amortization of discount on fixed maturities	(4,936)	(2,045)
Deferred tax benefit (expense)	359	(425)
Unpaid losses and loss expenses, net of reinsurance recoverables	55,934	(242,299)
Unearned premiums, net of prepaid reinsurance	16,646	(4,831)
Accounts payable and accrued liabilities	14,677	23,646
Premiums and insurance balances receivable	(21,943)	(120)
Deferred policy acquisition costs	(7,965)	7,291
Funds withheld	(14,857)	(11,187)
Value of reinsurance business assumed	2,596	81,581
Insurance and reinsurance balances payable	43,653	(6,346)
Accrued investment income	1,227	(2,606)
Equity earnings	(15,141)	62,049
Other	(5,776)	(28,439)
Net cash from operating activities	<u>\$ 361,171</u>	<u>\$ 138,907</u>
<b>Cash flows from investing activities</b>		
Purchases of fixed maturities (available for sale)	(4,711,763)	(7,482,488)
Purchases of equity securities	(106,024)	(178,833)
Sales of fixed maturities (available for sale)	4,756,858	7,157,151
Sales of equity securities	91,269	164,420
Maturities of fixed maturities (held to maturity)	33,213	21,136
Maturities of fixed maturities (available for sale)	187,704	278,698
Net proceeds from the settlement of investment derivatives	(5,646)	(16,382)
Proceeds from the sale of subsidiary (net of cash on hand)	-	3,472
Other	(136,623)	(72,503)
Net cash from/(used for) investing activities	<u>\$ 108,988</u>	<u>\$ (125,329)</u>
<b>Cash flows from financing activities</b>		
Dividends paid	(502,000)	(168,489)
Amounts received from parent company and affiliates, net	44,345	95,611
Net cash used for financing activities	<u>\$ (457,655)</u>	<u>\$ (72,878)</u>
Effect of foreign currency rate changes on cash and cash equivalents	<u>(1,095)</u>	<u>256</u>
<b>Net increase (decrease) in cash</b>	<u>\$ 11,409</u>	<u>\$ (59,044)</u>
<b>Cash – Beginning of year</b>	57,337	116,381
<b>Cash – End of year</b>	<u>\$ 68,746</u>	<u>\$ 57,337</u>

# ACE Bermuda Insurance Ltd. and Subsidiaries

Notes to Consolidated Financial Statements  
December 31, 2008 and 2007

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## **1) Organization**

ACE Bermuda Insurance Ltd. (“the Company”), a wholly-owned subsidiary of ACE Limited (“ACE”), was incorporated with limited liability under Cayman Islands Companies Law. On July 7, 1993, the Company migrated from the Cayman Islands to Bermuda.

The Company wholly-owns the following insurance subsidiaries: Corporate Officers & Directors Assurance Ltd. (“CODA”), ACE Bermuda International Reinsurance (Ireland) Limited (“ABIR”), ACE Bermuda International Insurance (Ireland) Limited (“ABII”), ACE Capital Title Reinsurance Company, Paget Reinsurance International Ltd and Paget Reinsurance Ltd., incorporated in 2008. In addition, the company wholly-owns Sovereign Risk Insurance Ltd., a general managing agency. During 2008, Sovereign Risk Insurance Ltd. incorporated a wholly-owned subsidiary, Sovereign Risk Insurance (Dubai) Ltd., an insurance intermediary. The Company is also a party to certain partially-owned insurance companies with insurance operations as described in footnote 4(d).

## **2) Principal business**

The Company and its subsidiaries provide property and casualty insurance and reinsurance coverage for a diverse group of international clients across a broad range of businesses including: excess liability, professional lines, excess property, political risk and financial lines. The nature of the coverage provided is generally expected to result in low frequency but high severity of individual losses. The reinsurance market is an integral part of the risk management strategy of the Company and coverage has been secured on most major lines of business.

Paget Reinsurance International Ltd. is a rent-a-captive facility and Paget Reinsurance Ltd. is a segregated accounts company. Both primarily reinsure affiliate companies in respect of certain clients throughout the world.

During the years ended December 31, 2008 and 2007, the Company entered into certain related party transactions, as described in note 11.

## **3) Significant accounting policies**

### **a) Basis of presentation**

The accompanying consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States (“GAAP”) and include the accounts of the Company, its subsidiaries and a variable interest entity. All significant intercompany balances and transactions have been eliminated. Certain comparative figures have been reclassified to conform with current year presentation.

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the reporting periods.

# ACE Bermuda Insurance Ltd. and Subsidiaries

Notes to Consolidated Financial Statements  
December 31, 2008 and 2007

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## 3) *Significant accounting policies (cont'd)*

### a) **Basis of presentation (cont'd)**

The Company's principal estimates include:

- unpaid losses and loss expense reserves;
- reinsurance recoverable, including the bad debt provision;
- impairments to the carrying value of the investment portfolio;
- the fair value of certain derivatives; and
- assessment of risk transfer for structured insurance and reinsurance contracts.

While the amounts included in the consolidated financial statements reflect our best estimates and assumptions, these amounts could ultimately be materially different from the amounts currently provided for in the consolidated financial statements.

### b) **Investments**

The Company's fixed maturity investments are classified as either "available for sale" or "held to maturity". The Company's available for sale portfolio is reported at fair value. The Company's held to maturity portfolio comprises securities for which we have the ability and intent to hold to maturity or redemption and is reported at amortized cost. Equity securities are classified as available for sale and are recorded at fair value. Short-term investments comprise securities due to mature within one year of date of purchase. Short-term investments include certain cash and cash equivalents which are part of investment portfolios under the management of external investment managers.

Other investments principally comprise partially owned investment companies. Other investments for which the Company cannot exercise significant influence are carried at fair value with changes in fair value recognized through accumulated other comprehensive income. For these investments, investment income and realized gains and losses are recognized as related distributions are received. The Company accrues its share of the net income or loss of the partially-owned investment companies in other income.

Upon adopting Financial Accounting Standard (FAS) 155, Accounting for Certain Hybrid Financial Instruments — an amendment of FASB Statements No. 133 and 140 (FAS 155) on January 1, 2007, the Company elected to apply the option provided in FAS 155 related to hybrid financial instruments to \$36 million of convertible bond investments that contain embedded derivatives within the Company's available for sale portfolio. Since the convertible bonds were previously carried at fair value, the election did not have an effect on shareholder's equity. However, the election resulted in a reduction of accumulated other comprehensive income and an increase in retained earnings of \$1.5 million as of January 1, 2007. The Company recognizes these hybrid financial instruments at fair value with changes in fair value reflected in net realized (losses) gains.

Investments in partially-owned insurance companies primarily include direct investments that meet the requirements for equity accounting. The Company accrues its share of the net income or loss of the partially-owned insurance companies in other income.

Realized gains or losses on sales of investments are determined on a first-in, first-out basis. Unrealized appreciation (depreciation) on investments is included as a separate component of accumulated other comprehensive income in shareholder's equity. The Company regularly reviews its investments for other than temporary impairment based on: i) certain indicators of an impairment, including the amount of time a security has been in a loss position, the magnitude of the loss position, and whether the security is rated below an investment grade level; ii) the period in which cost is expected to be recovered, if at all, based on various criteria including economic conditions, credit loss experience and other issuer-specific developments; and iii) the Company's ability and intent to hold the security to the expected recovery period.

# ACE Bermuda Insurance Ltd. and Subsidiaries

Notes to Consolidated Financial Statements  
December 31, 2008 and 2007

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## 3) *Significant accounting policies (cont'd)*

### **b) Investments (cont'd)**

If there is a decline in a security's net realizable value, a determination is made as to whether that decline is temporary or other than temporary. If it is believed that a decline in the value of a particular investment is temporary, the decline is recorded as an unrealized loss in shareholder's equity. If it is believed that the decline is other than temporary, the Company writes down the book value of the investment and records a realized loss in the consolidated statements of operations. For fixed income securities, the new cost basis is then amortized up to the anticipated future cash flow through net investment income.

With respect to securities where the decline in value is determined to be temporary and the security's value is not written down, a subsequent decision may be made to sell that security and realize a loss. Subsequent decisions on security sales are the result of changing or unforeseen facts and circumstances (e.g., arising from a large insured loss such as a catastrophe), deterioration of the credit-worthiness of the issuer or its industry, or changes in regulatory requirements. The Company believes that subsequent decisions to sell such securities are consistent with the classification of the majority of the portfolio as available for sale.

The Company utilizes derivative instruments including futures, options and forward currency contracts for the purpose of managing certain investment portfolio risk and exposures (see note 9 for additional discussion of the objectives and strategies employed). These instruments are derivatives and reported at fair value, and recorded as accounts payable and accrued liabilities in the accompanying consolidated financial statements and changes in market value are included in net realized gains or losses on investments in the consolidated statements of operations. Collateral held by brokers equal to a percentage of the total value of open futures contracts is included in short-term investments.

Net investment income includes interest and dividend income together with amortization of market premiums and discounts and is recorded net of investment management and custody fees. For mortgage-backed securities, and any other holdings for which there is a prepayment risk, prepayment assumptions are evaluated and revised as necessary. Any adjustments required due to the resultant change in effective yields and maturities are recognized retrospectively. 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.

The Company participates in a securities lending program operated by a third party banking institution whereby certain assets are loaned out to qualified borrowers and from which the Company earns an incremental return. Borrowers of these securities provide collateral, in the form of either cash or approved securities, of 102% of the fair value of the loaned securities. Each security loan is deemed to be an overnight transaction. Cash collateral is invested in a collateral pool which is managed by the banking institution. The collateral pool is subject to written investment guidelines with key objectives which include the safeguard of principal and adequate liquidity to meet anticipated redemptions. The fair value of the loaned securities is monitored on a daily basis, with additional collateral obtained or refunded as the fair value of the loaned securities changes. The collateral is held by the third party banking institution, and the collateral can only be accessed in the event that the institution borrowing the securities is in default under the lending agreement. As a result of these restrictions, the Company considers its securities lending activities to be non-cash investing and financing activities. An indemnification agreement with the lending agent protects the Company in the event a borrower becomes insolvent or fails to return any of the securities on loan. The fair value of the securities on loan is included in fixed maturities and equity securities. The securities lending collateral is reported as a separate line in total assets with a corresponding liability related to the Company's obligation to return the collateral plus interest.

Refer to Note 10 for a discussion on the determination of fair value for the Company's various investment securities.

# ACE Bermuda Insurance Ltd. and Subsidiaries

Notes to Consolidated Financial Statements  
December 31, 2008 and 2007

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## 3) *Significant accounting policies (cont'd)*

### c) **Premiums**

Premiums are generally recognized as written upon inception of the policy. For multi-year policies for which premiums written are payable in annual installments, only the annual premium is included as written at policy inception, due to the ability of the insured/reinsured to commute or cancel coverage within the term of the policy. The remaining annual premiums are included as written at each successive anniversary date within the multi-year term.

Premiums written are primarily earned on a daily pro rata basis over the terms of the policies to which they relate. Accordingly, unearned premiums represent the portion of premiums written which is applicable to the unexpired portion of the policies in force. For retrospectively rated multi year policies, the amount of premiums recognized in the current period is computed, using a with and without method, as the difference between the ceding enterprise's total contract costs before and after the experience under the contract as of the reporting date.

### d) **Policy acquisition costs**

Policy acquisition costs consist of commissions, premium taxes, underwriting and other costs that vary with and are primarily related to the production of premium. Policy acquisition costs are deferred and amortized over the period in which the related premiums are earned. Deferred policy acquisition costs are reviewed to determine if they are recoverable from future income, including investment income. If such costs are estimated to be unrecoverable, they are expensed.

### e) **Value of reinsurance business assumed**

The value of reinsurance business assumed represents the difference between the estimated ultimate value of the liabilities assumed under retroactive reinsurance contracts and the consideration received under the contract. The value of the reinsurance business assumed is amortized and recorded to loss and loss expenses based on the payment pattern of the losses assumed. The unamortized value is reviewed regularly to determine if it is recoverable under the terms of the contract. If such amounts are estimated to be unrecoverable, they are expensed.

### f) **Unpaid losses and loss expenses**

A liability is established for the estimated unpaid losses and loss expenses of the Company under the terms of, and with respect to, its policies and agreements. These amounts include provision for both reported claims and incurred but not reported ("IBNR") claims.

The methods of determining such estimates and establishing the resulting reserve are reviewed continuously and any adjustments are reflected in operations in the period in which they become known. Future developments may result in losses and loss expenses materially greater or less than the reserve provided.

Included in unpaid losses and loss expenses are liabilities for asbestos and environmental claims and expenses (A&E). These unpaid losses and loss expenses are principally related to claims arising from remediation costs associated with hazardous waste sites and bodily-injury claims related to asbestos products and environmental hazards. The estimation of these liabilities is particularly sensitive to changes in the legal environment, including specific settlements that may be used as precedents to settle future claims. However, the Company does not anticipate future changes in laws and regulations in setting its A&E reserve levels.

# ACE Bermuda Insurance Ltd. and Subsidiaries

Notes to Consolidated Financial Statements  
December 31, 2008 and 2007

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## 3) Significant accounting policies (cont'd)

### f) Unpaid losses and loss expenses (cont'd)

Prior period development arises from changes to loss estimates recognized in the current year that relate to loss reserves first reported in previous calendar years and excludes the effect of losses from the development of earned premiums from previous accident years. For purposes of analysis and disclosure, management views prior period development to be changes in the nominal value of loss estimates from period to period and excludes changes in loss estimates that do not arise from the emergence of claims, such as those related to uncollectible reinsurance, interest, unallocated loss adjustment expenses or foreign currency. Accordingly, specific items excluded from prior period development include the following: gains/losses related to foreign currency translation that affect the valuation of unpaid losses and loss expenses; losses recognized from the early termination or commutation of reinsurance agreements that principally relate to the time value of money; changes in the value of reinsurance business assumed reflected in losses incurred but principally related to the time value of money; and losses that arise from changes in estimates of earned premiums from prior accident years. Except for foreign currency revaluation, which is disclosed separately, these items are included in current year losses.

### g) Deposit liabilities

Deposit liabilities include reinsurance deposit liabilities and contract holder deposit funds. Accretion of deposit liabilities is recorded in investment income. The reinsurance deposit liabilities arise from contracts sold by the Company which are deemed to lack either significant underwriting and/or timing risk. At contract inception, the deposit liability is equal to net cash received by the Company. For certain contracts, an accretion rate is established based on actuarial estimates whereby the deposit liability is adjusted to the estimated amount payable over the term of the contract. The deposit accretion/amortization rate is the rate of return required to fund expected future payment obligations. The Company periodically reassesses the estimated ultimate liability and related expected rate of return. Any resulting changes to the amount of the deposit liability is reflected as an adjustment 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.

### h) Reinsurance

In the ordinary course of business, the Company assumes and cedes reinsurance with other insurance companies. These agreements provide greater diversification of business and minimize the net loss potential arising from large risks. Ceded reinsurance contracts do not relieve the Company of its obligation to its insureds.

For both ceded and assumed reinsurance, risk transfer requirements must be met in order to obtain reinsurance accounting, principally resulting in the recognition of cash flows under the contract as premiums and losses. To meet risk transfer requirements, a reinsurance contract must include insurance risk, consisting of both underwriting and timing risk, and a reasonable possibility of a significant loss for the assuming entity. To assess risk transfer for certain contracts, the Company generally develops expected discounted cash flow analyses at contract inception. If risk transfer requirements are not met, a contract is accounted for using the deposit method.

Deposit accounting requires that consideration received or paid be recorded in the balance sheet as opposed to premiums written or losses incurred in the income statement and any non-refundable fees be earned based on the terms of the contract, see note 3(g).

# ACE Bermuda Insurance Ltd. and Subsidiaries

Notes to Consolidated Financial Statements  
December 31, 2008 and 2007

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## 3) Significant accounting policies (cont'd)

### h) Reinsurance (cont'd)

Reinsurance recoverable includes the balances due from reinsurance companies for paid and unpaid losses and loss expenses that will be recovered from reinsurers, based on contracts in force, and are presented net of a reserve for uncollectible reinsurance that has been determined based upon a review of the financial condition of the reinsurers and other factors. The method for determining the reinsurance recoverable on unpaid losses and loss expenses incurred but not reported involves actuarial estimates as well as a determination of the Company's ability to cede losses and loss expenses under its existing reinsurance contracts. The provision for uncollectible reinsurance is based on an estimate of the amount of the reinsurance recoverable balance that the Company will ultimately be unable to recover due to reinsurer insolvency, a contractual dispute or any other reason. The valuation of this provision includes several judgments including certain aspects of the allocation of reinsurance recoverable on incurred but not reported claims by reinsurer and a default analysis to estimate uncollectible reinsurance. The primary components of the default analysis are reinsurance recoverable balances by reinsurer, net of collateral, and default factors used to determine the portion of a reinsurer's balance deemed uncollectible. The definition of collateral for this purpose requires some judgment and is generally limited to assets held in trust, letters of credit, and liabilities held by the Company with the same legal entity for which it believes there is a right of offset. The determination of the default factor is principally based on the financial rating of the reinsurer and a default factor applicable to the financial rating. 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.

Prepaid reinsurance premiums represent the portion of premiums ceded to reinsurers applicable to the unexpired coverage terms of the reinsurance contracts in force.

### i) Taxes

Income taxes have been provided in accordance with the provisions of FAS No. 109 "Accounting for Income Taxes" ("FAS No. 109") on those operations which are subject to income taxes. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date. A valuation allowance against deferred tax assets is recorded if it is more likely than not that all or some portion of the benefits related to deferred tax assets will not be realized.

### j) Cash

Cash includes cash on demand and deposits with a maturity of three months or less at time of purchase. Cash held by external money managers is included in short-term investments.

### k) Cash flow information

Purchases and sales, or maturities of short-term investments, are recorded net for purposes of the consolidated statements of cash flows and are included within fixed maturities available for sale.

### l) Derivative instruments and hedging activities

The Company recognizes all derivatives as either assets or liabilities in the consolidated balance sheets which are measured at the fair value of the instrument. The Company participates in derivative instruments to mitigate our own financial risks, principally arising from our investment holdings, products sold, or assets and liabilities held in foreign currencies. For these instruments, changes in assets or liabilities measured at fair value are recorded as realized gains or losses in the consolidated statements of operations.

During 2008 and 2007, the Company did not designate any derivatives as hedges.

# ACE Bermuda Insurance Ltd. and Subsidiaries

Notes to Consolidated Financial Statements  
December 31, 2008 and 2007

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## 3) Significant accounting policies (cont'd)

### m) Translation of foreign currencies

Revenues and expenses and the related unearned premiums and deferred acquisition costs denominated in non-U.S. dollar currencies are translated into U.S. dollars at the rates of exchange at the transaction date. Monetary assets and liabilities are translated at the rates of exchange in effect at the end of the period. Transaction gains and losses resulting from foreign currency transactions are recorded in current income.

### n) New accounting pronouncements

*Adopted in 2008*

#### **Fair value measurements**

In September 2006, the FASB issued FAS No. 157, "Fair Value Measurements" ("FAS 157"). FAS 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. FAS 157 focuses on how to measure fair value and establishes a three-level hierarchy for both measurement and disclosure purposes. The fair value hierarchy gives the highest priority to quoted prices in active markets and the lowest priority to unobservable data. Under FAS 157, fair value measurements are separately disclosed by level within the fair value hierarchy. FAS 157 does not expand the use of fair value to any new circumstances. The Company fully adopted FAS 157 effective January 1, 2009. For additional information regarding the partial adoption of FAS 157, refer to the following paragraph and Note 10.

In October 2008, the FASB issued FSP FAS 157-3, Determining Fair Value of a Financial Asset in a Market That is Not Active (FSP FAS 157-3). FSP FAS 157-3 clarifies the application of FAS 157 in an inactive market and provides examples to illustrate key considerations in determining the fair value of a financial asset in an inactive market. FSP FAS 157-3 is effective for the Company for and from the three months ended September 30, 2008. The adoption of FSP FAS 157-3 did not have a material impact on the Company's financial condition or results of operations.

#### **The hierarchy of generally accepted accounting principles**

In May 2008, the FASB issued FAS No. 162, The Hierarchy of Generally Accepted Accounting Principles (FAS 162). FAS 162 identifies the sources of accounting principles and the framework for selecting the principles to be used in the preparation of financial statements of nongovernmental entities that are presented in conformity with GAAP. The adoption of FAS 162 effective September 28, 2008, did not have a material impact on the Company's financial condition or results of operations.

#### **Other-than-temporary impairments**

In January 2009, the FASB issued FSP EITF No. 99-20-1, Amendments to the Impairment Guidance of EITF 99-20 (FSP EITF 99-20-1). FSP EITF 99-20-1 amends EITF 99-20 to closer align its impairment guidance for purchased and retained beneficial interests in securitized financial assets with FAS 115, Accounting for Certain Investments in Debt and Equity Securities. FSP EITF 99-20-1 is effective for interim and annual reporting periods ending after December 15, 2008. While the Company is unable to quantify precisely the impact of adoption of FSP EITF 99-20-1, the Company does not believe it was material to the financial condition and results of operations.

# ACE Bermuda Insurance Ltd. and Subsidiaries

Notes to Consolidated Financial Statements  
December 31, 2008 and 2007

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## 3) Significant accounting policies (cont'd)

### n) New accounting pronouncements (cont'd)

*To be adopted after 2008*

#### **Noncontrolling interests**

In December 2007, the FASB issued FAS No. 160, Noncontrolling Interests in Consolidated Financial Statements – an Amendment of ARB No. 51 (FAS 160). FAS 160 establishes accounting and reporting standards that require that ownership interests in subsidiaries held by parties other than the parent be presented in the consolidated statement of shareholder's equity separately from the parent's equity; the consolidated net income attributable to the parent and noncontrolling interest be presented on the face of the consolidated statements of operations; changes in a parent's ownership interest while the parent retains controlling financial interest in its subsidiary be accounted for consistently; and sufficient disclosure that identifies and distinguishes between the interests of the parent and noncontrolling owners. FAS 160 is effective for fiscal years, and interim periods within those fiscal years, beginning on or after December 15, 2008. The Company does not expect the adoption of FAS 160 to have a material impact on the Company's financial condition or results of operations.

#### **Disclosures about derivative instruments and hedging activities**

In March 2008, the FASB issued FAS No. 161, Disclosures About Derivative Instruments and Hedging Activities (FAS 161). FAS 161 establishes reporting standards that require enhanced disclosures about how and why derivative instruments are used, how derivative instruments are accounted for under FAS 133, and how derivative instruments affect an entity's financial position, financial performance, and cash flows. FAS 161 is effective for fiscal years, and interim periods within those fiscal years, beginning on or after November 15, 2008.

#### **Financial guarantee insurance contracts**

In May 2008, the FASB issued FAS No. 163, Accounting for Financial Guarantee Insurance Contracts – An interpretation of FASB Statement No. 60 (FAS 163). FAS 163 requires that an insurance enterprise recognize a claim liability prior to an event of default when there is evidence that credit deterioration has occurred in an insured financial obligation. It also clarifies how FAS No. 60, Accounting and Reporting by Insurance Enterprises, applies to financial guarantee insurance contracts, including the recognition and measurement to be used to account for premium revenue and claim liabilities, and requires expanded disclosures about financial guarantee insurance contracts. FAS 163 is effective for financial statements issued for fiscal years beginning after December 15, 2008, except for some disclosures about the insurance enterprise's risk management activities. FAS 163 requires that disclosures about the risk management activities of the insurance enterprise be effective for the first period beginning after issuance. Except for those disclosures, earlier application is not permitted. The Company's exposure to FAS 163 is principally through its equity method investment in Assured Guaranty Ltd. The Company is currently evaluating the impact, if any, of adoption of FAS 163 on its financial condition or results of operations.

#### **Equity Method Accounting**

In November 2008, the FASB issued EITF No. 08-6, Equity Method Investment Accounting Considerations (EITF 08-6). EITF 08-6 provides guidance for equity method accounting for specific topics. EITF 08-6 requires an equity method investor account for share issuances, and resulting dilutive effect, by an investee as if the investor had sold a proportionate share of its investment with the resulting gain or loss recognized in earnings. EITF 08-6 is effective for fiscal years, and interim periods within those fiscal years, beginning on or after December 15, 2008. The Company expects the adoption of EITF 08-6 to have a material impact on the Company's result of operations in 2009 due to expected share issuances by Assured Guaranty Ltd.

# ACE Bermuda Insurance Ltd. and Subsidiaries

Notes to Consolidated Financial Statements  
December 31, 2008 and 2007

## 4) Investments

### a) Fixed maturities available for sale

The fair values and amortized costs of fixed maturities available for sale at December 31, 2008 and 2007 are as follows:

	<b>2008</b>		<b>2007</b>
	<b>Fair value</b>	<b>Amortized cost</b>	<b>Fair value</b>
	(in thousands of U.S dollars)		<b>Amortized cost</b>
U.S. treasury and agency	\$ 179,926	158,680	\$ 299,081
Non-U.S. governments	135,290	152,588	23,051
Corporate securities	1,344,360	1,555,579	1,824,718
Mortgage-backed securities	732,414	777,376	1,059,448
States, municipalities and political subdivisions	61,222	59,666	51,698
	<u>\$ 2,453,212</u>	<u>2,703,889</u>	<u>\$ 3,257,996</u>

The gross unrealized appreciation (depreciation) related to fixed maturities available for sale at December 31, 2008 and 2007 are as follows:

	<b>2008</b>		<b>2007</b>
	<b>Gross unrealized appreciation</b>	<b>Gross unrealized depreciation</b>	<b>Gross unrealized appreciation</b>
	(in thousands of U.S. dollars)		<b>Gross unrealized depreciation</b>
U.S. treasury and agency	\$ 21,784	(537)	\$ 11,212
Non-U.S. governments	3,336	(20,633)	1,946
Corporate securities	6,710	(217,929)	35,466
Mortgage-backed securities	18,527	(63,488)	7,270
States, municipalities and political subdivisions	2,043	(490)	1,875
	<u>\$ 52,400</u>	<u>(303,077)</u>	<u>\$ 57,769</u>

Mortgage-backed securities issued by U.S. government agencies are combined with “to be announced” mortgage derivatives held (see note 9(a) (iii)), and are included in the category mortgage-backed securities. Approximately 74% of the total mortgage holdings at December 31, 2008 and 68% at December 31, 2007 are represented by investments in U.S. government agency bonds. The remainder of the mortgage exposure consists of CMO’s (Collateralized Mortgage Obligations) and non-government mortgage-backed securities, the majority of which provide a planned structure for principal and interest payments and carry a “AAA” rating by the major credit rating agencies.

Fixed maturities available for sale at December 31, 2008, by contractual maturity, are as follows. Expected maturities could differ from contractual maturities because borrowers may have the right to call or prepay obligations, with or without call or prepayment penalties.

# ACE Bermuda Insurance Ltd. and Subsidiaries

Notes to Consolidated Financial Statements  
December 31, 2008 and 2007

## 4) Investments (cont'd)

### a) Fixed maturities available for sale (cont'd)

	2008	
	Fair value	Amortized cost
	(in thousands of U.S. dollars)	
<b>Maturity period</b>		
Less than 1 year	\$ 35,327	35,729
1-5 years	630,042	687,747
5-10 years	800,198	926,323
Greater than 10 years	255,231	276,714
	<u>\$ 1,720,798</u>	<u>1,926,513</u>
Mortgage-backed securities	<u>732,414</u>	<u>777,376</u>
Total fixed maturities	<u>\$ 2,453,212</u>	<u>2,703,889</u>

### b) Fixed maturities held to maturity

The fair values and amortized costs of fixed maturities held to maturity at December 31, 2008 and 2007 are as follows:

	2008		2007	
	Fair value	Amortized cost	Fair value	Amortized cost
	(in thousands of U.S. dollars)			
Non-U.S. governments	\$ 20,486	20,094	\$ 7,062	7,032
Corporate securities	66,955	70,142	109,958	110,383
Mortgage-backed securities	70,293	77,217	88,267	87,969
States, municipalities and political subdivisions	<u>3,010</u>	<u>2,988</u>	<u>2,959</u>	<u>2,956</u>
	<u>\$ 160,744</u>	<u>170,441</u>	<u>\$ 208,246</u>	<u>208,340</u>

The gross unrealized appreciation (depreciation) related to fixed maturities held to maturity at December 31, 2008 and 2007 is as follows:

	2008		2007	
	Gross unrealized appreciation	Gross unrealized depreciation	Gross unrealized appreciation	Gross unrealized depreciation
	(in thousands of U.S. dollars)			
Non-U.S. governments	\$ 714	(322)	\$ 41	(11)
Corporate securities	304	(3,491)	539	(964)
Mortgage-backed securities	461	(7,385)	486	(188)
States, municipalities and political subdivisions	<u>22</u>	<u>-</u>	<u>5</u>	<u>(2)</u>
	<u>\$ 1,501</u>	<u>(11,198)</u>	<u>\$ 1,071</u>	<u>(1,165)</u>

# ACE Bermuda Insurance Ltd. and Subsidiaries

Notes to Consolidated Financial Statements  
December 31, 2008 and 2007

## 4) Investments (cont'd)

### b) Fixed maturities held to maturity (cont'd)

Fixed maturities held to maturity at December 31, 2008, by contractual maturity, are shown below. Expected maturities could differ from contractual maturities because borrowers may have the right to call or prepay obligations, with or without call or prepayment penalties.

	2008	
	Fair value	Amortized Cost
	(in thousands of U.S. dollars)	
<b>Maturity period</b>		
Less than 1 year	\$ 22,616	22,788
1-5 years	51,396	53,400
5-10 years	16,439	17,036
	<u>\$ 90,451</u>	<u>93,224</u>
 Mortgage-backed securities	 70,293	 77,217
 Total fixed maturities	 <u>\$ 160,744</u>	 <u>170,441</u>

### c) Equity securities

The gross unrealized appreciation (depreciation) on equity securities at December 31, 2008 and December 31, 2007, are as follows:

	2008		2007	
	(in thousands of U.S. dollars)			
Equity securities – cost	\$ 254,658		345,643	
Gross unrealized appreciation	20,183		82,803	
Gross unrealized depreciation	(52,112)		(29,699)	
			<u>398,747</u>	
 Equity securities – fair value	 <u>\$ 222,729</u>			 <u>398,747</u>

### d) Investments in partially-owned insurance companies

Investments in partially-owned insurance companies at December 31, 2008 and 2007 are comprised of the following:

Company	2008		2007	
	Carrying Value	Ownership Percentage	Carrying Value	Ownership Percentage
	(in thousands of U.S. dollars)			
Freisenbruch Meyer	\$ 8,709	40.00%	\$ 8,709	40.0%
Intrepid Re Holdings Limited	84,085	38.50%	80,541	38.5%
Assured Guaranty	397,064	21.06%	391,854	23.9%
Island Heritage	4,188	10.96%	4,188	11.0%
Total	<u>\$ 494,046</u>		<u>\$ 485,292</u>	

# ACE Bermuda Insurance Ltd. and Subsidiaries

Notes to Consolidated Financial Statements  
December 31, 2008 and 2007

## 4) Investments (cont'd)

### d) Investments in partially-owned insurance companies (cont'd)

Assured Guaranty Ltd. is a Bermuda-based holding company which provides, through its operating subsidiaries, credit enhancement products to the public finance, structured finance, and mortgage markets. Credit enhancement products are financial guarantees or other types of support, including credit derivatives, designed to improve the credit of underlying debt obligations. Using a quoted market price, the fair value of the Company's investment in Assured Guaranty Ltd. was \$218 million and \$508 million at December 31, 2008 and 2007, respectively.

On November 14, 2008, Assured Guaranty Ltd. announced a definitive agreement to purchase Financial Security Assurance, Inc. (FSA) from Dexia SA for a purchase price of \$722 million. The acquisition is expected to close in March 2009. EITF 08-6 requires the Company to account for Assured Guaranty Ltd.'s issuance of shares, and resulting dilutive effect, as if the Company had sold a proportionate share of the investment. Assuming completion of the planned share issuances, the Company will no longer be deemed to exert significant influence over Assured Guaranty Ltd. and must account for the investment as an available-for-sale equity security in accordance with FAS 115, Accounting for Certain Investments in Debt and Equity Securities. FAS 115 requires that the Company to then carry the Assured Guaranty Ltd. investment at fair value with any unrealized gains and losses reflected in other comprehensive income. Assuming Assured Guaranty Ltd. completes its share issuances associated with the FSA acquisition, the Company will be required to reflect the unrealized loss on this investment (i.e., \$179 million as of December 31, 2008) as a reduction in shareholder's equity, a portion of which will be recognized as a realized loss in accordance with EITF 08-6 and a portion of which will be reflected in other comprehensive income in accordance with FAS 115.

### e) Other investments

Other investments for which the Company cannot exercise significant influence are carried at fair value. Partially-owned investment companies over which the Company has significant influence are carried under the equity method of accounting. Other investments at December 31, 2008 and 2007 are as follows:

	2008		2007	
	Fair Value	Cost	Fair Value	Cost
	(in thousands of U.S. dollars)			
Other investments	\$ 5,821	5,821	\$ 6,100	\$ 6,100
Partially-owned investment companies	325,449	324,628	281,298	227,470
Total	\$ 331,270	330,449	\$ 287,398	\$ 233,570

Partially-owned investment companies is comprised of one investment in a highly diversified investment company that invests in a variety of investment styles such as long/short equity, global macro, and credit arbitrage. Included in the highly diversified investment funds are 38 individual limited partnerships covering a broad range of investment strategies including large cap buyouts, specialist buyouts, growth capital, distressed, mezzanine, real estate, and co-investments. The underlying portfolios consist of various public and private debt and equity securities of publicly traded and privately held companies and real estate assets. The underlying investments across various partnerships, geographies, industries, asset types, and investment strategies provide risk diversification within the limited partnership portfolios and the overall investment portfolio.

# ACE Bermuda Insurance Ltd. and Subsidiaries

Notes to Consolidated Financial Statements  
December 31, 2008 and 2007

## 4) Investments (cont'd)

### f) Gross unrealized losses

As of December 31, 2008, there were approximately 1,416 fixed maturities out of a total of 2,393 fixed maturities in an unrealized loss position. The largest single unrealized loss of the fixed maturities was \$2.5 million. There were approximately 51 equity securities out of a total of 87 equity securities in an unrealized loss position. The largest single unrealized loss in the equity securities was \$4.2 million. Most of the fixed maturities in an unrealized loss position were investment grade, below investment grade, and mortgage-backed securities for which fair value declined primarily due to widening credit spreads.

The following tables summarize, for all securities in an unrealized loss position at December 31, 2008 including securities on loan, the aggregate fair value and gross unrealized loss by length of time the security has continuously been in an unrealized loss position. The gross unrealized loss for 2007 was \$0.072 million, with \$0.072 million coming from securities (fixed maturities and equity securities) that had been in an unrealized position for 0 - 12 months.

December 31, 2008	0 - 12 Months		Over 12 Months		Total	
	Fair Value	Gross Unrealized Loss	Fair Value	Gross Unrealized Loss	Fair Value	Gross Unrealized Loss
	(in thousands of U.S. dollars)					
U.S. Treasury and agency	\$ 22,414	\$ (537)	\$ -	\$ -	\$ 22,414	\$ (537)
Foreign bonds	86,323	(15,562)	19,131	(5,394)	105,454	(20,956)
Corporate securities	827,590	(170,317)	356,060	(51,104)	1,183,650	(221,421)
Mortgage-backed securities	201,588	(48,506)	34,309	(22,367)	235,897	(70,873)
States, municipalities, and political subdivisions	20,145	(488)	-	-	20,145	(488)
Total fixed maturities	1,158,060	(235,410)	409,500	(78,865)	1,567,560	(314,275)
Equity securities	128,997	(52,112)	-	-	128,997	(52,112)
Other investments	161,456	(29,457)	12,487	(4,156)	173,943	(33,613)
Total	\$ 1,448,513	\$ (316,979)	\$ 421,987	\$ (83,021)	\$ 1,870,500	\$ (400,000)

Included in the "0 - 12 Months" and "Over 12 Months" aging categories at December 31, 2008, are fixed maturities held to maturity with combined fair values of \$100 million and \$11.6 million, respectively. The associated gross unrealized losses included in the "0-12 Months" and "Over 12 Months" aging categories are \$8.4 million and \$2.8 million, respectively. Fixed maturities in a gross unrealized loss position for over 12 months principally comprise investment grade securities where management anticipates recovery to the amortized cost basis in the near-term and has the ability and intent to hold to recovery. For mortgage-backed securities in a gross unrealized loss position for over 12 months, management also considered credit enhancement in concluding the securities were not other-than-temporarily impaired. Other investments in a gross unrealized loss position for over 12 months principally comprise investments in limited partnerships with diversified underlying portfolios where management anticipates recovery in the near-term and has the ability and intent to hold to recovery.

Each quarter, the Company reviews all of its securities in an unrealized loss position (impaired securities), including fixed maturity securities, securities on loan, equity securities, and other investments, to identify those impaired securities to be specifically evaluated for a potential other-than-temporary impairment (OTTI).

# ACE Bermuda Insurance Ltd. and Subsidiaries

Notes to Consolidated Financial Statements  
December 31, 2008 and 2007

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## 4) Investments (cont'd)

### f) Gross unrealized losses (cont'd)

The Company reviews its investments for OTTI based on the following:

- For fixed maturities, the issuer's financial condition and the Company's assessment (using available market information) of its ability to make future scheduled principal and interest payments on a timely basis;
- the amount of time a security has been in a loss position, the magnitude of the loss position, and whether the security is rated below an investment grade level;
- the period in which cost is expected to be recovered, if at all, based on various criteria including economic conditions, credit loss experience, and other issuer-specific developments;
- the Company's ability and intent to hold the security to the expected recovery period.
- Equity securities in an unrealized loss position for twelve consecutive months were generally impaired.

#### Fixed maturities and equity securities, including securities on loan

A security that meets any of the following criteria is evaluated for a potential OTTI:

- securities that have been in a loss position for the previous eleven consecutive months;
- those securities that have been in a loss position for the previous nine consecutive months and market value is less than 70 percent of amortized cost, or cost for equity securities;
- those securities that are rated below investment grade by at least one major rating agency; or
- those securities subject to EITF 99-20, *Recognition of Interest Income and Impairment on Purchased Beneficial Interests and Beneficial Interests That Continue to Be Held by a Transferor in Securitized Financial Assets*, with contractual cash flows including asset-backed securities, whenever there is an adverse change in the amount or timing of cash flows or indications of a change in credit.

The Company evaluates all other fixed maturity and equity securities for a potential OTTI when the unrealized loss at the balance sheet date exceeds a certain scope, based on both a percentage (i.e., market value is less than 70 percent of amortized cost, or cost for equity securities) and aggregate dollar decline, and/or certain indicators of an OTTI are present including:

- a significant economic event has occurred that is expected to adversely affect the industry in which the issuer participates;
- recent issuer-specific news that is likely to have an adverse affect on operating results and cash flows; or
- a missed or late interest or principal payment related to any debt issuance.

For those securities identified as having a potential OTTI based on the above criteria, the Company estimates a reasonable period of time in which market value is expected to recover to a level in excess of cost, if at all. For fixed maturity securities, factors considered include:

- the degree to which any appearance of impairment is attributable to an overall change in market conditions such as interest rates rather than changes in the individual factual circumstances and risk profile of the issuer;
- the performance of the relevant industry sector;
- the nature of collateral or other credit support;
- whether an issuer is current in making principal and interest payments on the debt securities in question;
- the issuer's financial condition and the Company's assessment (using available market information) of its ability to make future scheduled principal and interest payments on a timely basis; and
- current financial strength or debt rating, analysis, and guidance provided by rating agencies and analysts.

# ACE Bermuda Insurance Ltd. and Subsidiaries

Notes to Consolidated Financial Statements  
December 31, 2008 and 2007

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## 4) Investments (cont'd)

### f) Gross unrealized losses (cont'd)

For equity securities, factors considered include:

- whether the decline appears to be related to general market or industry conditions or is issuer-specific; and
- the financial condition and near-term prospects of the issuer, including specific events that may influence the issuer's operations.

Securities will be assessed to have an OTTI if it is probable that cost will not be recovered or the Company does not have the ability and specific intent to hold the security until its expected recovery. The Company lacks this ability and intent when such a determination would be inconsistent with management's investment objectives such as maximizing total return.

#### Other investments

With respect to other investments that are not traded in a public market, such as venture capital investment funds, the portfolio managers, as well as the Company's internal valuation committee, consider a variety of factors in determining whether or not the investment should be evaluated for OTTI. Indicators of impairment include:

- the fund has reported losses for two consecutive fiscal years;
- a significant economic event has occurred that is expected to adversely affect an industry which the fund has significant exposure to; and
- recent issuer-specific news that is expected to adversely affect a significant holding of the fund.

For those investments identified as having a possible OTTI, the Company determines a reasonable period of time in which market value is expected to recover to a level in excess of cost, if at all. Factors considered include:

- recent trends in financial performance and future expectations of financial performance based on the underlying assets held in the portfolio and market conditions affecting those assets;
- an analysis of whether fundamental deterioration has occurred; and
- the fund's most recent financing event.

These investments will be assessed to have an OTTI if cost is not expected to be recovered or it is concluded that the Company does not have the ability and specific intent to hold the security until its expected recovery.

#### Refinement of the other-than-temporary impairment process

Given recent market conditions, and in light of recent general guidance from the FASB regarding the application of existing guidance during stressed market conditions, the Company has qualitatively evaluated its application of the parameters under which it considers a decline in value to be other-than-temporary. Similar to prior periods, the Company evaluated investments in its portfolio where cost exceeded fair value and made certain judgments as to its ability to recover its cost. The analysis required the Company to consider carefully the duration and severity of decline and the root causes thereof. Specifically, the Company further evaluated whether declines were related to temporary liquidity concerns and current market conditions, and therefore more likely to be temporary, or were instead related to specific credit events or issuer performance, and therefore more likely to be other-than-temporarily impaired.

# ACE Bermuda Insurance Ltd. and Subsidiaries

Notes to Consolidated Financial Statements  
December 31, 2008 and 2007

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## 4) Investments (cont'd)

### f) Gross unrealized losses (cont'd)

In general, and in consideration of the severity of decline across equity and fixed income markets resulting from extreme investor risk aversion, the Company allowed for a higher severity of decline in its analysis given the disconnect between issuer fundamentals and global equity and fixed income market prices. Also, the Company considered that virtually all securities in an unrealized loss position for a duration of less than six months as of December 31, 2008 had declined principally as a result of the financial market crisis that escalated in the third quarter of 2008. Further, for securities in an unrealized loss position for greater than six months, the Company considered whether the severity of the unrealized loss increased significantly since the third quarter in assessing the qualitative aspects of the duration of loss. Using this refined evaluation process resulted in a lower dollar value of investments in an unrealized loss position being deemed other-than-temporarily impaired in comparison to the previous evaluation process. Given the judgments involved in its OTTI process, the Company is unable to quantify the impact of refining its methodology. The Company believes the underlying issuer fundamentals and credit quality of the portfolio support the use of its modified approach.

When there is an OTTI, the Company records a write-down to estimated fair value, which reduces the cost basis. The new cost basis of an impaired security is not adjusted for subsequent increases in estimated fair value. For fixed maturity investments, the discount (or reduced premium) based on the new cost basis is accreted into net investment income and included in income in future periods based upon the amount and timing of expected future cash flows of the security

For certain purchased and retained beneficial interests in securitized financial assets, the Company adopted FSP EITF 99-20-1, effective December 31, 2008. Accordingly, the Company included consideration of management's judgment of the best estimate of cash flows, in contrast to prior periods when market participant assumptions about future cash flows were applied in assessing whether an adverse change in the amount or timing of cash flows exists. While the Company is unable to quantify the impact of adoption of FSP EITF 99-20-1, the Company does not believe it was material to the Company's financial condition or results of operations.

### Securities lending transactions

The Company engages in a securities lending program, which involves lending investments to other institutions for short periods of time. The Company invests the collateral received in short-term funds of high credit quality with the objective of maintaining a stable principal balance. During the third and fourth quarters of 2008 certain investments in the money market mutual funds purchased with the securities lending collateral declined in value resulting in a \$9 million unrealized loss. The unrealized loss is attributable to fluctuations in market values of the underlying performing debt instruments held by the respective mutual funds, rather than default of a debt issuer. The Company concluded that the decline in value was temporary.

# ACE Bermuda Insurance Ltd. and Subsidiaries

Notes to Consolidated Financial Statements  
December 31, 2008 and 2007

## 4) Investments (cont'd)

### g) Net realized (losses) gains and change in net unrealized appreciation or depreciation on investments

The analysis of net realized (losses) gains on investments and the change in net unrealized appreciation or depreciation on investments for the years ended December 31, 2008 and 2007 is as follows:

	<u>2008</u>	<u>2007</u>
	(in thousands of U.S. dollars)	
<b>Fixed maturities</b>		
Gross realized gains	\$ 78,223	\$ 45,416
Gross realized losses	<u>(88,876)</u>	<u>(31,377)</u>
	(10,653)	14,039
<b>Equity securities</b>		
Gross realized gains	38,510	69,547
Gross realized losses	<u>(40,193)</u>	<u>(96)</u>
	(1,683)	69,451
<b>Derivative transactions</b>		
Gross realized gains	-	8,138
Gross realized losses	(3,790)	-
Financial futures contracts – net realized (losses)	<u>(4,712)</u>	<u>(13,620)</u>
	(8,502)	(5,482)
Other than temporary impairments	(261,730)	(22,072)
Currency gains (losses)	118	(3,785)
Other investments – realized losses	-	34
Net realized (losses) gains on investments	<u>\$ (282,450)</u>	<u>\$ 52,185</u>
<b>Change in net unrealized depreciation on investments</b>		
Fixed maturities available for sale	\$ (252,166)	\$ (41,943)
Fixed maturities held to maturity	(616)	(577)
Equity securities	(84,750)	(57,739)
Short-term investments	(17)	(11)
Investments in partially-owned insurance companies	(18,601)	(3,865)
Other investments	<u>(52,917)</u>	<u>19,546</u>
Change in net unrealized depreciation on investments	<u>\$ (409,067)</u>	<u>\$ (84,589)</u>
Total net realized losses and change in net unrealized depreciation on investments	<u>\$ (691,517)</u>	<u>\$ (32,404)</u>

# ACE Bermuda Insurance Ltd. and Subsidiaries

Notes to Consolidated Financial Statements  
December 31, 2008 and 2007

## 4) Investments (cont'd)

### h) Net investment income

Net investment income for the years ended December 31, 2008 and 2007, was derived from the following sources:

	<u>2008</u>	<u>2007</u>
	(in thousands of U.S. dollars)	
Fixed maturities and short-term investments	\$ 182,056	\$ 192,635
Equity securities	12,499	10,538
Other investments	<u>5,872</u>	<u>6,583</u>
Gross investment income	200,427	209,756
Intercompany interest	(1,395)	2,900
Investment expenses	<u>(10,707)</u>	<u>(9,842)</u>
Net investment income	<u>\$ 188,325</u>	<u>\$ 202,814</u>

### i) Other income

Other income is mainly comprised of equity in net income (losses) of partially-owned insurance companies and partially-owned investment companies over which the Company exercises significant influence. In 2008 and 2007 equity in net income (losses) of partially-owned insurance companies includes \$28.3 million and \$(69.4) million of income related to Assured Guaranty.

## 5) Variable Interest Entity

The Company entered into an excess of loss reinsurance agreement in 2003 on a block of long-term disability reinsurance. In accordance with the terms of the reinsurance agreement a separate trust has been established. Upon the expiration of the reinsured liabilities, the Company is entitled to the remainder of the assets, less a \$2 million margin. Although the Company is not the primary beneficiary of this trust, the Company absorbs the majority of the expected losses and receives a majority of the expected residual returns on investment results of the trust assets. These consolidated financial statements include the trust assets and a corresponding deposit liability with an aggregate value of \$230 million (2007 - \$224 million). The assets are primarily included in fixed maturities available for sale.

## 6) Unpaid losses and loss expenses

The reserve for unpaid losses and loss expenses represents estimated ultimate losses and loss expenses less paid losses and loss expenses and is comprised of the following at December 31, 2008 and 2007:

	<u>2008</u>	<u>2007</u>
	(in thousands of U.S. dollars)	
Case and loss expenses reserve	\$ 444,037	\$ 535,785
IBNR loss reserve	<u>2,000,567</u>	<u>1,871,083</u>
Total unpaid losses and loss expenses	<u>\$ 2,444,604</u>	<u>\$ 2,406,868</u>

# ACE Bermuda Insurance Ltd. and Subsidiaries

Notes to Consolidated Financial Statements  
December 31, 2008 and 2007

## 6) Unpaid losses and loss expenses (cont'd)

The Company establishes reserves for the estimated unpaid ultimate liability for losses and loss expenses under the terms of its policies and agreements. These reserves include estimates for both claims that have been reported and for IBNR, and include estimates of expenses associated with processing and settling these claims. The process of establishing reserves for property and casualty claims can be complex and imprecise as it requires the use of informed estimates and judgments. The Company's estimates and judgments may be revised as additional experience and other data become available and are reviewed, as new or improved methodologies are developed, or as current laws change. As part of the evaluation process of loss reserves, the Company annually engages an independent actuarial firm to review the methods and assumptions used in estimating loss and loss expenses reserves.

The Company continually evaluates its estimates of reserves in light of developing information and in light of discussions and negotiations with its insureds. While the Company believes that its reserve for unpaid losses and loss expenses at December 31, 2008 is adequate, new information or trends may lead to future developments in ultimate losses and loss expenses significantly greater or less than the reserves provided. Any such revisions could result in future changes in estimates of losses or reinsurance recoverable, and would be reflected in the Company's consolidated results of operations in the period in which the estimates are changed.

The reconciliation of unpaid losses and loss expenses for the years ended December 31, 2008 and 2007 is as follows:

	<u>2008</u>	<u>2007</u>
	(in thousands of U.S. dollars)	
Gross unpaid losses and loss expenses at beginning of year	\$ 2,406,868	\$ 2,625,680
Reinsurance recoverable on unpaid losses	<u>(401,077)</u>	<u>(396,450)</u>
Net unpaid losses and loss expenses at beginning of year	\$ 2,005,791	\$ 2,229,230
Losses and loss expenses incurred in respect of losses occurring in:		
Current year	\$ 272,936	\$ 228,717
Prior years	<u>(27,241)</u>	<u>(9,061)</u>
Total	<u>\$ 245,695</u>	<u>\$ 219,656</u>
Losses and loss expenses paid in respect of losses occurring in:		
Current year	\$ (38,575)	\$ (9,096)
Prior years	<u>(150,938)</u>	<u>(356,382)</u>
Total	<u>\$ (189,513)</u>	<u>\$ (365,478)</u>
Other movements:		
Value of reinsurance business assumed	\$ (2,795)	\$ (82,398)
Foreign exchange revaluation	(12,292)	6,218
Other	<u>(4,962)</u>	<u>(1,437)</u>
Total	<u>\$ (20,049)</u>	<u>\$ (77,617)</u>
Net unpaid losses and loss expenses at end of year	<u>\$ 2,041,924</u>	<u>\$ 2,005,791</u>
Represented by:		
Gross unpaid losses and loss expenses	\$ 2,444,604	\$ 2,406,868
Reinsurance recoverable on unpaid losses	<u>(402,680)</u>	<u>(401,077)</u>
	<u>\$ 2,041,924</u>	<u>\$ 2,005,791</u>

# ACE Bermuda Insurance Ltd. and Subsidiaries

Notes to Consolidated Financial Statements  
December 31, 2008 and 2007

## 6) Unpaid losses and loss expenses (cont'd)

Prior period development in 2008 is mainly due to favourable development of \$15.6m in our excess property line of business largely relating to the 2005 – 2007 accident years and of \$13.6m in our political risk line of business related to recent favourable loss experience; the remaining prior period development relates to our professional lines and financial solutions lines of business.

Prior period development in 2007 included \$7.2 million caused by favourable developments in our financial solutions line of business related to 2004 and 2005 hurricane losses.

During 2007, the value of reinsurance business assumed movements include the \$78.9 million release of a deferred asset that related to the novation of a loss portfolio transfer contract.

## 7) Reinsurance

The Company purchases reinsurance to manage various exposures, including catastrophic risks. Although reinsurance agreements contractually obligate the Company's reinsurers to reimburse it for the agreed upon portion of its gross paid losses, they do not discharge the primary liability of the Company. Direct, assumed and ceded premiums for the years ended December 31, 2008 and 2007 are as follows:

	<u>2008</u>	<u>2007</u>
	(in thousands of U.S. dollars)	
Premiums written		
Direct	\$ 375,820	\$ 377,162
Assumed	254,878	208,208
Ceded	<u>(192,055)</u>	<u>(178,302)</u>
Net	<u>\$ 438,643</u>	<u>\$ 407,068</u>
Premiums earned		
Direct	\$ 368,732	\$ 371,266
Assumed	234,228	213,456
Ceded	<u>(172,654)</u>	<u>(171,677)</u>
Net	<u>\$ 430,306</u>	<u>\$ 413,045</u>

The Company evaluates the financial condition of its reinsurers and potential reinsurers on a regular basis and also monitors concentrations of credit risk with reinsurers. The composition of the Company's reinsurance recoverable at December 31, 2008 and 2007 is as follows:

	<u>2008</u>	<u>2007</u>
	(in thousands of U.S. dollars)	
Reinsurance recoverable on paid losses and loss expenses	\$ 14,436	\$ 22,053
Reinsurance recoverable on unpaid losses and loss expenses	<u>402,680</u>	<u>401,077</u>
Total reinsurance recoverable	<u>\$ 417,116</u>	<u>\$ 423,130</u>

## 8) Capital stock

The Company's authorized, issued and fully paid share capital is 1,250,000 shares of par value \$1 per share.

# ACE Bermuda Insurance Ltd. and Subsidiaries

Notes to Consolidated Financial Statements  
December 31, 2008 and 2007

## 9) Commitments and contingencies

### a) Derivative instruments

The Company maintains positions in derivative instruments such as futures, options, and foreign currency forward contracts for which the primary purposes are to manage duration and foreign currency exposure, yield enhancement, to obtain an exposure to a particular financial market. In addition, the Company also purchases to be announced mortgage-backed securities as part of its investing activities. The Company records changes in fair value of these instruments as realized gains (losses) in the consolidated statements of operations. None of the derivatives are used as hedges for accounting purposes.

The following table outlines the fair values and notional values of certain derivative instruments at December 31, 2008 and 2007.

	2008		2007	
	Fair Value	Notional Value	Fair Value	Notional Value
	(in thousands of U.S. dollars)			
Future contracts on money market instruments	\$ 1,290	\$ 288,000	\$ 2,894	\$ 1,776,000
Future contracts on notes and bonds	(2,375)	204,600	(350)	159,400
Options on money market instruments	(1,078)	800,000	(155)	233,000
Options on notes and bond futures		-	(547)	110,800
Total	\$ (2,163)	\$ 1,292,600	\$ 1,842	\$ 2,279,200

Derivatives on money market instruments have durations of approximately 3 months regardless of the maturity date of the derivative.

### (i) Foreign currency exposure management

The Company uses foreign currency forward contracts (forwards) to minimize the effect of fluctuating foreign currencies. The forwards purchased are not specifically identifiable against cash, any single security, or groups of securities denominated in those currencies and, therefore, do not qualify as hedges for financial reporting purposes. All realized and unrealized contract gains and losses are reflected in net realized gains (losses) in the consolidated statements of operations. At December 31, 2008 the Company had no open currency forward contracts.

### (ii) Duration management and market exposure

#### Futures

Exchange traded bond and note futures contracts may be used in fixed maturity portfolios as substitutes for ownership of the bonds and notes without significantly increasing the risk in the portfolio. Investments in futures contracts may be made only to the extent that there are assets under management not otherwise committed. Futures contracts give the holder the right and obligation to participate in market movements, determined by the index or underlying security on which the futures contract is based. Settlement is made daily in cash by an amount equal to the change in value of the futures contract times a multiplier that scales the size of the contract.

# ACE Bermuda Insurance Ltd. and Subsidiaries

Notes to Consolidated Financial Statements  
December 31, 2008 and 2007

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## 9) *Commitments and contingencies (cont'd)*

### a) **Derivative instruments (cont'd)**

#### **Options**

Option contracts may be used in the portfolio as protection against unexpected shifts in interest rates, which would thereby affect the duration of the fixed maturity portfolio. By using options in the portfolio, the overall interest rate sensitivity of the portfolio can be reduced. Option contracts may also be used as an alternative to futures contracts in the Company's synthetic equity strategy as described above. An option contract conveys to the holder the right, but not the obligation, to purchase or sell a specified amount or value of an underlying security at a fixed price. The price of an option is influenced by the underlying security, expected volatility, time to expiration, and supply and demand.

For long option positions, the maximum loss is the premium paid for the option. The maximum credit exposure is represented by the fair value of the options held. For short option positions, the potential loss is the same as having taken a position in the underlying security. Short call options are backed in the portfolio with the underlying, or highly correlated, securities and short put options are backed by uncommitted cash for the in-the-money portion.

The credit risk associated with the above derivative financial instruments relates to the potential for non-performance by counterparties. Although non-performance is not anticipated, in order to minimize the risk of loss, management monitors the creditworthiness of its counterparties. The performance of exchange traded instruments is guaranteed by the exchange on which they trade. For non-exchange traded instruments, the counterparties are principally banks which must meet certain criteria according to the Company's investment guidelines. These counterparties are required to have a minimum credit rating of AA- by Standard and Poor's or Aa3 by Moody's. In addition, certain contracts require that collateral be posted once pre-determined thresholds are breached as a result of market movements.

#### *(iii) To be announced mortgage-backed securities (TBA)*

By acquiring a TBA, the Company makes a commitment to purchase a future issuance of mortgage-backed securities. For the period between purchase of the TBA and issuance of the underlying security, the Company's position is accounted for as a derivative in the consolidated financial statements. At December 31, 2008 and 2007, the Company had TBA's with fair values of \$189 million and \$366 million, respectively, and corresponding par amounts of \$184 million and \$371 million, respectively.

#### *(iv) Convertible security investment*

A convertible bond is a debt instrument that can be converted into a predetermined amount of the issuer's equity at certain times prior to the bond's maturity. The convertible option is an embedded derivative which is marked-to-market with changes in fair value recognized in net realized (losses) gains. The debt host instrument is classified in the investment portfolio as available for sale. The Company purchases convertible bonds for their total return and not specifically for the conversion feature. The fair value of hybrid financial instruments at December 31, 2008 and 2007 is \$33 million and \$27 million, respectively.

### **b) Concentrations of credit risk**

The investment portfolio is managed following prudent standards of diversification. Specific provisions limit the allowable holdings of a single issue and issuers. The Company believes that there are no significant concentrations of credit risk associated with its investments.

# ACE Bermuda Insurance Ltd. and Subsidiaries

Notes to Consolidated Financial Statements  
December 31, 2008 and 2007

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## 9) *Commitments and contingencies (cont'd)*

### c) **Credit facilities and financial guarantees**

#### **Revolving credit facility**

ACE and participating subsidiaries (including the Company) have in place a \$500 million unsecured revolving credit facility which was renewed for five years in November 2007, replacing the existing \$600 million revolving credit facility. This facility is available for general corporate purposes and the issuance of letters of credit (LOC's). At December 31, 2008 there were \$142.2 million of LOC's outstanding under this facility.

#### **Letter of credit facilities**

ACE and participating subsidiaries (including the Company) have in place a \$1 billion five year unsecured operational LOC facility which was renewed for five years in November 2007, replacing both the existing \$1 billion unsecured and \$500 million secured operational LOC facilities. At December 31, 2008 there were \$810.6 million of LOC's outstanding under this facility.

Both the revolving credit facility and letter of credit facility require that ACE and/or certain of its subsidiaries continue to maintain certain covenants, including a minimum consolidated net worth covenant and a maximum leverage covenant, which have been met at December 31, 2008.

The Company is jointly liable for all drawings made by ACE or any other participating subsidiaries.

ACE's failure to comply with the covenants under any credit facility would, subject to grace periods in the case of certain covenants, result in an event of default. This could require ACE to repay any outstanding borrowings or to cash collateralize letters of credit under such facility. A failure by ACE (or any of its subsidiaries) to pay an obligation due for an amount exceeding \$50 million would result in an event of default under all of the facilities described above.

#### **Financial guarantees**

- (1) The Company has entered into an undertaking, jointly and severally with ACE Tempest Re to support the obligations of ACE arising under credit default swap agreements of up to \$266 million.

Additionally the Company has entered into an undertaking, jointly and severally with ACE Tempest Re to support the obligations of the following ACE facility:-

The £300 million (approximately \$438 million) syndicated Funds at Lloyd's letter of credit facility, extended in November 2007 to expire no earlier than December 2013. At December 31, 2008, this facility was utilized £175.6 million (approximately \$256.3 million). The Funds at Lloyd's facility requires that collateral be posted if the financial strength rating of ACE falls to S&P BBB+ or lower.

- (2) Premises leases for affiliated companies - \$96 million.

#### **d) Restricted assets**

Included in available for sale fixed maturity securities are assets which have been used as collateral for certain undertakings of the Company. \$254 million in assets serve as collateral for credit default swaps entered into by an affiliated company and \$341 million are restricted assets under regulation 114 trusts.

# ACE Bermuda Insurance Ltd. and Subsidiaries

Notes to Consolidated Financial Statements  
December 31, 2008 and 2007

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## 9) *Commitments and contingencies (cont'd)*

### e) **Legal proceedings**

The Company is subject to claims litigation (more specifically arbitrations) involving disputed interpretations of policy coverages and, in some jurisdictions, direct actions by third parties seeking damages from policyholders. Such contentious matters involving claims on policies issued by the Company, which are typical to the insurance industry in general and in the normal course of business, are considered in the Company's loss and loss-expense reserves. In addition to contentious claims, the Company is subject to lawsuits and regulatory actions in the normal course of business that do not arise from or directly relate to claims on insurance policies. This category of business litigation typically involves, among other things, allegations of underwriting errors or misconduct, employment claims, regulatory activity or disputes arising from business ventures. Although the outcomes of any business litigation involving the Company cannot be predicted with certainty, the Company disputes and will continue to dispute allegations against it that are without merit and believes that the ultimate outcomes of any matters in this category of business litigation will not have a material adverse effect on the financial condition, future operating results or liquidity of the Company, although an adverse resolution of a number of these items could have a material adverse effect on the Company's results of operations in a particular fiscal year.

### **Subpoenas**

ACE and its subsidiaries and affiliates have received numerous subpoenas, interrogatories, and civil investigative demands in connection with certain pending investigations of insurance industry practices. These inquiries have been issued by a number of attorneys general, state departments of insurance, and state and federal regulatory authorities, including the New York Attorney General (NYAG), the Pennsylvania Department of Insurance, and the Securities and Exchange Commission (SEC). These inquiries seek information concerning underwriting practices and non-traditional or loss mitigation insurance products. ACE is cooperating and will continue to cooperate with such inquiries.

### **The Assurance of Discontinuance**

On April 25, 2006, ACE reached a settlement with the Attorneys General of New York, Illinois and Connecticut and the New York Department of Insurance pursuant to which ACE received from these authorities an Assurance of Discontinuance ("AOD"). Under the AOD, these regulators agreed not to file certain litigation against ACE relating to their investigation of certain business practices, and ACE agreed to pay \$80 million (\$66 million after tax) without admitting any liability, and to adopt certain business reforms. Of that \$80 million, \$40 million was paid to the three settling Attorneys General as a penalty. The remaining \$40 million was placed in a fund allocated for distribution to eligible policyholders who execute a release of certain claims they may have against ACE. Approximately \$39 million of this \$40 million has been distributed to such policyholders. Under the AOD, ACE first may use the sums remaining to settle these or similar types of policyholder claims, and then shall use any sums remaining after such settlements to provide additional amounts to those policyholders who initially executed the release. ACE has used the remaining sums to settle similar policyholder claims.

On May 9, 2007, ACE and the Pennsylvania Insurance Department ("Department") and the Pennsylvania Office of Attorney General ("OAG") entered into a settlement agreement. This settlement agreement resolves the issues raised by the Department and the OAG arising from their investigation of ACE's underwriting practices and contingent commission payments. As a result of this settlement agreement, ACE made a \$9 million payment to the Department and agreed to comply with the business practice guidelines that ACE established in 2004 to assure ongoing antitrust compliance in its operations. On October 24, 2007, ACE entered into a settlement agreement with the Attorneys General of Florida, Hawaii, Maryland, Massachusetts, Michigan, Oregon, Texas, West Virginia and the District of Columbia, and the Florida Department of Financial Services and Office of Insurance Regulation. The agreement resolves investigations of ACE's underwriting practices and contingent commission payments. Under the agreement, ACE agreed to pay \$4.5 million without admitting any liability, and to keep in place certain business reforms already in effect.

# ACE Bermuda Insurance Ltd. and Subsidiaries

Notes to Consolidated Financial Statements  
December 31, 2008 and 2007

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## 9) *Commitments and contingencies (cont'd)*

### e) **Legal proceedings (cont'd)**

#### **Business Practice-Related Litigation**

The Company, along with other ACE entities, has been named as a defendant in *New Cingular Wireless Headquarters LLC et al. v. Marsh & McLennan Companies, Inc. et al.* (Case No. 06-5120; United States District Court for the District of New Jersey), a non-class-action lawsuit filed in the Northern District of Georgia but later transferred to the District of New Jersey as a “tag-along” action for coordination with a number of cases that involve similar allegations and were previously consolidated by the Judicial Panel on Multidistrict Litigation. The plaintiffs in *New Cingular* are insurance policyholders who allege that the defendant brokers and insurers conspired to increase premiums and allocate customers through the use of “B” quotes and contingent commissions. The plaintiffs assert the following causes of action against ACE: Federal Racketeer Influenced and Corrupt Organization Act (RICO), federal antitrust law, inducement to breach of fiduciary duty, unjust enrichment, and fraud, and seek compensatory and special damages without specifying an amount. All proceedings in this action are currently stayed. In the main action, the Court granted defendants’ motions to dismiss and dismissed plaintiffs’ antitrust and RICO claims with prejudice on August 31, 2007 and September 28, 2007, respectively. By order dated September 28, 2007, the Court declined to exercise supplemental jurisdiction over plaintiffs’ state law claims and dismissed those claims without prejudice. On October 10, 2007, plaintiffs filed a Notice of Appeal of the antitrust and RICO rulings to the United States Court of Appeals for the Third Circuit. The appeal is fully briefed. Oral argument is tentatively scheduled for April 20, 2009. All proceedings in the “tag-along” actions are currently stayed.

The Company, along with other ACE entities, has also been named in *Sears, Roebuck & Co. et al. v. Marsh & McLennan Companies, Inc. et al.* (Case No. 07-2535) (filed in the Northern District of Georgia). The allegations in this case are similar to the allegations in the *New Cingular* action identified above. On November 19, 2007, the JPML transferred this lawsuit to the above-referenced multidistrict litigation in the District of New Jersey for coordination. As addressed in the preceding paragraph, all proceedings in this “tag-along” action are currently stayed.

## 10) *Fair value measurements*

### **Fair value hierarchy**

The Company partially adopted the provisions of FAS 157 on January 1, 2008. FAS 157 defines fair value as the price to sell an asset or transfer a liability in an orderly transaction between market participants and establishes a three-level valuation hierarchy in which inputs into valuation techniques used to measure fair value are classified. The fair value hierarchy gives the highest priority to quoted prices in active markets and the lowest priority to unobservable data. Inputs in Level 1 are unadjusted quoted prices for identical assets or liabilities in active markets. Level 2 includes inputs other than quoted prices included within Level 1 that are observable for assets or liabilities either directly or indirectly. Level 2 inputs include, among other items, quoted prices for similar assets and liabilities in active markets, quoted prices for identical or similar assets and liabilities in markets that are not active, and inputs other than quoted prices that are observable for the asset or liability such as interest rates and yield curves. Level 3 inputs are unobservable and reflect management’s judgments about assumptions that market participants would use in pricing an asset or liability. A financial instrument’s categorization within the valuation hierarchy is based upon the lowest level of input that is significant to the fair value measurement.

The following is a description of the valuation measurements used for the Company’s financial instruments carried or disclosed at fair value, as well as the general classification of such financial instruments pursuant to the valuation hierarchy.

# ACE Bermuda Insurance Ltd. and Subsidiaries

Notes to Consolidated Financial Statements  
December 31, 2008 and 2007

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## *10) Fair Value Measurements (cont'd)*

### **Fixed maturities**

Fixed maturities with active markets such as U.S. Treasury and agency securities are classified within Level 1 as fair values are based on quoted market prices. For fixed maturities that trade in less active markets, including corporate and municipal securities, fair values are based on the output of “pricing matrix models”, the significant inputs into which include, but are not limited to, yield curves, credit risks and spreads, measures of volatility, and prepayment speeds. These fixed maturities are classified within Level 2. Fixed maturities for which pricing is unobservable are classified within Level 3.

### **Equity securities**

Equity securities with active markets classified in Level 1 as fair values are based on quoted market prices. For nonpublic equity securities, fair values are based on market valuations and are classified within Level 2.

### **Short-term investments**

Short-term investments, which comprise securities due to mature within one year of the date of purchase that are traded in active markets, are classified within Level 1 as fair values are based on quoted market prices. Securities such as commercial paper and discount notes are classified within Level 2 because these securities are typically not actively traded due to their approaching maturity and, as such, their cost approximating par value.

### **Other investments**

Fair values for other investments, principally other direct equity investments, investment funds, and limited partnerships, are based on the net asset value or financial statements and are included within Level 3.

### **Investment derivative instruments**

For actively traded investment derivative instruments, including futures and options, the Company obtains quoted market prices to determine fair value. As such, these instruments are included within Level 1. Forward contracts that are not exchange-traded are priced using a pricing matrix model principally employing observable inputs and, as such, are classified within Level 2.

### **Other derivative instrument**

The other derivative instrument is comprised of a rate of return guarantee contract. The fair value is based on significant unobservable inputs and is classified within Level 3.

# ACE Bermuda Insurance Ltd. and Subsidiaries

Notes to Consolidated Financial Statements  
December 31, 2008 and 2007

## 10) Fair value measurements (cont'd)

The following table presents, by valuation hierarchy, the financial instruments carried or disclosed at fair value, and measured on a recurring basis, as of December 31, 2008.

December 31, 2008	Quoted Prices in Active Markets for Identical Assets or Liabilities	Significant Other Observable Inputs	Significant Unobservable Inputs	Total
	Level 1	Level 2	Level 3	
(in thousands of U.S. dollars)				
<b>Assets:</b>				
Fixed maturities available for sale	\$ 48,827	\$ 2,371,635	\$ 32,750	\$ 2,453,212
Fixed maturities held to maturity	-	160,744	-	160,744
Equity securities	222,703	26	-	222,729
Short-term investments	296,584	3,867	-	300,451
Other investments	-	-	331,270	331,270
Other derivative instruments	-	-	9,160	9,160
Investment derivative instrument	838	-	-	838
<b>Total assets at fair value</b>	<b>\$ 568,952</b>	<b>\$ 2,536,272</b>	<b>\$ 373,180</b>	<b>\$ 3,478,404</b>

The carrying amounts are equal to the fair values of financial instruments at December 31, 2008. The fair values and carrying amounts of financial instruments at December 31, 2007, were as follows:

	2007	
	Fair Value	Carrying Amount
(in thousands of U.S. dollars)		
<b>Assets:</b>		
Fixed maturities available for sale	\$ 3,257,996	\$ 3,257,996
Fixed maturities held to maturity	208,246	208,340
Equity securities	398,747	398,747
Short-term investments	328,450	328,450
Other investments	287,398	287,398
Other derivative instruments	19,798	19,798
<b>Liabilities:</b>		
Investment derivative instruments	95	95

# ACE Bermuda Insurance Ltd. and Subsidiaries

Notes to Consolidated Financial Statements  
December 31, 2008 and 2007

## 10) Fair value measurements (cont'd)

### Level 3 financial instruments

The following table provides a reconciliation of the beginning and ending balances of financial instruments carried or disclosed at fair value using significant unobservable inputs (Level 3) for the year ended December 31, 2008.

	Balance, Beginning of Year	Net Realized Gains/ Losses	Change in Net Unrealized Gains (Losses) Included in Other Comprehensive Income	Purchases, Sales, Issuances, and Settlements, Net	Transfers Into (Out of) Level 3	Balance, End of Year	Change in Net Unrealized Gains (Losses) Relating to Financial Instruments Still Held at December 31, 2008, included in Net Income
(in thousands of U.S. dollars)							
<b>Assets:</b>							
Fixed maturities available for sale	\$ 75,808	\$ (14,348)	\$ (9,386)	\$ (14,765)	\$ (4,559)	\$ 32,750	\$ (9,618)
Equity securities	147	(29)	31	(135)	(14)	-	-
Other investments	287,398	(26,543)	(53,007)	123,332	-	331,270	(26,543)
Other derivative instrument	12,950	(3,790)	-	-	-	9,160	(3,790)
<b>Total assets at fair value</b>	<b>\$ 376,303</b>	<b>\$ (44,710)</b>	<b>\$ (62,362)</b>	<b>\$ 108,432</b>	<b>\$ (4,573)</b>	<b>\$ 373,180</b>	<b>\$ (39,951)</b>

## 11) Related party transactions

During the year ended December 31, 2008 the Company received \$44.3 million (2007 - \$95.6 million) from the parent company and affiliates. The net proceeds received were related to the settlement of inter-company loans and payments received for operating purposes and sundry back-office services provided to various affiliate companies. The amounts due (to) from parent and affiliates are repayable on demand. This includes interest bearing loans totalling \$31.5 million at rates ranging from 3.83% to 7.17%. The remaining balances are interest free. The net interest (expense) income earned during the year ended December 31, 2008 amounted to (\$1.4) million (2007 - \$2.9 million).

At December 31, 2008, the Company maintains a receivable of \$34.5 million (2007 - \$35.5 million) from a not-for-profit organization for which the Board of Directors is principally comprised of ACE management. Such receivable is included in "Other Assets" in the accompanying consolidated balance sheets. The borrower has used related proceeds to finance investments in Bermuda real estate properties, some of which have been rented to ACE employees at rates established by independent, professional real estate appraisers, and intends to use income from the investments to both repay the note and fund future charitable activities. Accordingly, the Company reports the note receivable at the lower of its principal value or the fair value of assets held by the borrower, including the real estate properties, to repay the loan.

# ACE Bermuda Insurance Ltd. and Subsidiaries

Notes to Consolidated Financial Statements  
December 31, 2008 and 2007

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## *11) Related party transactions (cont'd)*

During the year ended December 31, 2008 the Company entered into reinsurance transactions with various affiliated companies which included net premiums earned of \$105 million (2007 - \$74.6 million) and losses and loss expenses, net of recoveries of \$39.7 million (2007 - \$0.9 million). Unpaid losses and loss expenses, net of reinsurance recoverables at December 31, 2008 were \$145.4 million (2007 - \$155.2 million).

## *12) Taxation*

The Company has received an undertaking from the Bermuda government exempting it from all local income, withholding and capital gains taxes until March 28, 2016. At the present time, no such taxes are levied in Bermuda.

The Company's subsidiaries ABIR and ABII are subject to income taxes at a rate of 12.5% and ACE Capital Title Reinsurance Company is subject to income taxes at a rate of 35%.

## *13) Statutory financial data*

The Company and insurance and reinsurance subsidiaries are subject to insurance laws and regulations in the jurisdictions in which they operate. These regulations include restrictions that limit the amount of dividends or other distributions, such as loans or cash advances, available to shareholders without prior approval of the insurance regulatory authorities.

ACE Bermuda Insurance Ltd. is registered under The Insurance Act 1978 (Bermuda), amendments thereto and related regulations (the "Act") as a Class 4 insurer. The Act requires the Company to meet a minimum solvency margin and a minimum liquidity ratio. The Company has satisfied these requirements for 2008 and 2007. Effective December 31, 2008, the Bermuda Monetary Authority ("BMA" or "Authority") introduced a risk-based capital model, the Bermuda Statutory Capital Requirement ("BSCR") as a tool to measure risk and to determine an enhanced capital requirement ("ECR") and target capital level (defined as 120% of the enhanced capital requirement) for Class 4 insurers. While the required statutory capital and surplus has increased under the BSCR, the Company has capital and surplus in excess of the target capital level.

A Class 4 insurer is prohibited from declaring or paying a dividend if in breach of its ECR, solvency margin or minimum liquidity ratio or if the declaration or payment of such dividend would cause such a breach. Where an insurer fails to meet its solvency margin or minimum liquidity ratio on the last day of any financial year, it is prohibited from declaring or paying any dividends during the next financial year without the approval of the Authority. Further, a Class 4 insurer is prohibited from declaring or paying in any financial year dividends of more than 25% of its total statutory capital and surplus (as shown on its previous financial year's statutory balance sheet) unless it files (at least seven days before payment of such dividends) with the Authority an affidavit signed by at least two directors and the insurer's principal representative stating that the declaration of such dividends has not caused the insurer to fail to meet its solvency margin or minimum liquidity ratio. Class 4 insurers must obtain the Authority's prior approval for a reduction by 15% or more of the total statutory capital as set forth in its previous year's financial statements.

ACE Capital Title Reinsurance Company is subject to the New York insurance laws and regulations governing title insurers. A stock dividend may not be declared or distributed if such dividend reduces the Company's surplus to less than 50% of its outstanding capital shares. The maximum amount payable by the Company as a dividend during 2009 is \$200,000. ABIR and ABII have no restrictions on the distribution of dividends except to the extent that they must not exceed cumulative retained earnings. Capital reductions must be approved by the Irish High Court and would also need to be approved by our Insurance Regulator.