

# **Validus Reinsurance, Ltd.**

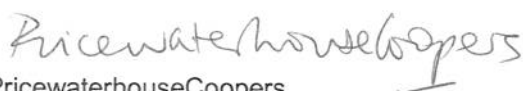
(Incorporated in Bermuda)

Consolidated financial statements  
**For the Years Ended December 31, 2008 and 2007**  
(expressed in U.S. dollars)

## Report of Independent Auditors

To the Board of Directors and Shareholder of Validus Reinsurance, Ltd.:

In our opinion, the accompanying consolidated balance sheets and the related consolidated statements of operations and comprehensive income and the consolidated statements of shareholders' equity and statements of cash flows present fairly, in all material respects, the financial position of Validus Reinsurance, Ltd. and its subsidiaries at December 31, 2008 and December 31, 2007, and the results of their operations and their cash flows for 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.



PricewaterhouseCoopers  
Hamilton, Bermuda  
February 27, 2009

**Validus Reinsurance, Ltd.**  
**Consolidated Balance Sheets**  
**As at December 31, 2008 and 2007**

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

	<b>December 31, 2008</b>	<b>December 31, 2007</b>
<b>Assets</b>		
Fixed maturities, at fair value (amortized cost: 2008; \$1,836,297, 2007; \$1,762,573)	\$ 1,767,749	\$ 1,771,999
Short-term investments, at fair value (amortized cost: 2008; \$196,511; 2007; \$77,309)	196,511	77,314
Cash and cash equivalents	210,146	163,423
<b>Total cash and investments</b>	<b>2,174,406</b>	<b>2,012,736</b>
Premiums receivable	235,287	209,345
Deferred acquisition costs	46,415	45,860
Prepaid reinsurance premiums	15,997	14,786
Securities lending collateral	98,954	164,324
Loss reserves recoverable	84,523	-
Net receivable for investments sold	688	-
Intercompany receivable	1,853	1,567
Accrued investment income	14,204	11,949
Other assets	4,429	5,175
<b>Total assets</b>	<b>\$ 2,676,756</b>	<b>\$ 2,465,742</b>
<b>Liabilities</b>		
Reserves for losses and loss expenses	\$ 535,888	\$ 196,813
Unearned premiums	232,110	259,592
Reinsurance balances payable	17,566	16,736
Securities lending payable	105,688	164,324
Net payable for investments purchased	-	2,696
Accounts payable and accrued expenses	6,180	15,662
<b>Total liabilities</b>	<b>897,432</b>	<b>655,823</b>
Commitments and contingent liabilities		
<b>Shareholders' equity</b>		
Ordinary shares, 1,000,000,000 authorized, par value \$0.10		
Issued and outstanding (2008 – 100,000,000; 2007 - 100,000,000)	10,000	10,000
Additional paid-in capital	1,300,593	1,285,945
Retained earnings	468,731	513,974
<b>Total shareholders' equity</b>	<b>1,779,324</b>	<b>1,809,919</b>
<b>Total liabilities and shareholders' equity</b>	<b>\$ 2,676,756</b>	<b>\$ 2,465,742</b>

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

## Validus Reinsurance, Ltd.

### Consolidated Statements of Operations and Comprehensive Income

#### For the years ended December 31, 2008 and 2007

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

	December 31, 2008	December 31, 2007
<b>Revenues</b>		
Gross premiums written	\$ 687,771	\$ 702,098
Reinsurance premiums ceded	(62,933)	(68,842)
Net premiums written	624,838	633,256
Change in unearned premiums	28,693	(74,227)
Net premiums earned	653,531	559,029
Net investment income	101,994	85,981
Net realized (losses) gains on investments	(9,718)	443
Net unrealized (losses) gains on investments	(84,714)	8,556
Other income	309	-
Foreign exchange (losses) gains	(16,701)	7,495
<b>Total revenues</b>	<b>644,701</b>	<b>661,504</b>
<b>Expenses</b>		
Losses and loss expenses	420,645	175,538
Policy acquisition costs	100,243	70,323
General and administrative expenses	48,324	45,352
Share compensation expense	14,665	9,318
Finance expenses	879	1,378
<b>Total expenses</b>	<b>584,756</b>	<b>301,909</b>
<b>Net income before taxes</b>	<b>59,945</b>	<b>359,595</b>
Income tax expense	(88)	(61)
<b>Net income</b>	<b>\$ 59,857</b>	<b>\$ 359,534</b>
<b>Comprehensive income</b>		
Unrealized losses arising during the year	-	-
Adjustment for reclassification of losses realized in income	-	-
<b>Comprehensive income</b>	<b>\$ 59,857</b>	<b>\$ 359,534</b>

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

## Validus Reinsurance, Ltd.

### Consolidated Statements of Shareholders' Equity For the Years Ended December 31, 2008 and 2007

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

	December 31, 2008	December 31, 2007
<b>Common shares</b>		
Balance – Beginning of year	\$ 10,000	\$ 10,000
Issue of common shares	-	-
Balance – End of year	<u>\$ 10,000</u>	<u>\$ 10,000</u>
<b>Additional paid-in capital</b>		
Balance – Beginning of year	\$ 1,285,945	\$ 1,144,385
(Distribution to) contribution by parent company	(17)	132,242
Stock option expense	4,251	3,919
Share compensation expense	10,414	5,399
Balance – End of year	<u>\$ 1,300,593</u>	<u>\$ 1,285,945</u>
<b>Accumulated other comprehensive income</b>		
Balance – Beginning of year	\$ -	\$ 875
Cumulative effect of adoption of fair value option	-	(875)
Balance – End of year	<u>\$ -</u>	<u>\$ -</u>
<b>Retaining earnings</b>		
Balance – Beginning of year	\$ 513,974	\$ 193,565
Cumulative effect of adoption of fair value option	-	875
Dividends paid to parent company	(105,100)	(40,000)
Net income	59,857	359,534
Balance – End of year	<u>\$ 468,731</u>	<u>\$ 513,974</u>
<b>Total shareholders' equity</b>	<u><u>\$ 1,779,324</u></u>	<u><u>\$ 1,809,919</u></u>

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

**Validus Reinsurance, Ltd.**  
**Consolidated Statements of Cash Flows**  
**For the Years Ended December 31, 2008 and 2007**

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

	<u>December 31,</u> <u>2008</u>	<u>December 31,</u> <u>2007</u>
<b>Cash flows provided by (used in) operating activities</b>		
Net income for the year	\$ 59,857	\$ 359,534
Adjustments to reconcile net income to cash provided by operating activities:		
Share compensation expense	14,665	9,318
Net realized losses (gains) on sales of investments	9,718	(443)
Net unrealized losses (gains) on investments	84,714	(8,556)
Amortization of premiums (discounts) on fixed maturities	2,199	(5,943)
Changes in:		
Premiums receivable	(25,942)	(66,937)
Deferred acquisition costs	(555)	(17,657)
Prepaid reinsurance premiums	(1,211)	(6,541)
Loss reserves recoverable	(84,523)	-
Intercompany receivable	(286)	7,591
Accrued investment income	(2,255)	(5,493)
Other assets	746	191
Reserve for losses and loss expenses	339,075	119,450
Unearned premiums	(27,482)	80,768
Reinsurance balances payable	830	9,298
Accounts payable and accrued expenses	(9,482)	1,130
<b>Net cash provided by operating activities</b>	<u>360,068</u>	<u>475,710</u>
<b>Cash flows provided by (used in) investing activities</b>		
Proceeds on sales of fixed maturity investments	1,161,909	1,287,002
Proceeds on the maturities of investments	715,365	67,650
Purchases of fixed maturities	(1,967,152)	(2,283,235)
(Purchases) sales of short-term investments, net	(118,350)	460,447
Increase (decrease) in securities lending collateral	58,636	(151,997)
<b>Net cash used in investing activities</b>	<u>(149,592)</u>	<u>(620,133)</u>
<b>Cash flows provided by (used in) financing activities</b>		
(Distribution to) contribution by parent company	(17)	132,242
Dividends paid to parent company	(105,100)	(40,000)
(Decrease) increase in securities lending payable	(58,636)	151,997
<b>Net cash (used in) provided by financing activities</b>	<u>(163,753)</u>	<u>244,239</u>
Net increase in cash	46,723	99,816
<b>Cash and cash equivalents – Beginning of year</b>	<u>163,423</u>	<u>63,607</u>
<b>Cash and cash equivalents – End of year</b>	<u>\$ 210,146</u>	<u>\$ 163,423</u>
<b>Net taxes paid during the year</b>	<u>\$ -</u>	<u>\$ 111</u>

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

# Validus Reinsurance, Ltd.

## Notes to Consolidated Financial Statements

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

### 1. *Nature of the business*

Validus Reinsurance, Ltd. (the “Company” or “Validus Re”) was incorporated under the laws of Bermuda on October 19, 2005. The Company is 100% owned by Validus Holdings, Ltd. (the “parent company” or “Validus Holdings”) which was also incorporated under the laws of Bermuda on October 19, 2005. Validus Re is registered as a Class 4 insurer under The Insurance Act 1978 of Bermuda, amendments thereto and related Regulations (“The Act”). The Company offers short-tail reinsurance coverage on a global basis in the Property, Marine & Energy and Specialty lines markets, effective January 1, 2006.

Validus Re commenced operations with approximately \$1,000,000 of equity capital and a balance sheet unencumbered by any historical losses relating to the 2005 hurricane season, the events of September 11, 2001, asbestos or other legacy exposures affecting the industry.

### 2. *Basis of preparation and consolidation*

The consolidated financial statements include the financial statements of Validus Re and its wholly owned subsidiaries, Validus Research Inc., Validus Specialty Inc. and Validus Reasegueros Inc. All significant inter-company accounts and transactions have been eliminated.

These consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America (“US GAAP”). Certain amounts in prior period have been reclassified to conform to current period presentation. The preparation of financial statements in accordance with US GAAP requires management to make estimates and assumptions that affect reported amounts of assets and liabilities, as well as disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. The major estimates reflected in the Company’s consolidated financial statements include the reserve for losses and loss expenses, premium estimates for business written on a line slip or a proportional basis, reinsurance recoverable balances including the provision for unrecoverable reinsurance and investment valuation. While the accruals included in the consolidated financial statements reflect the Company’s best estimates and assumptions, these amounts could ultimately be materially different from the amounts recorded in the consolidated financial statements. The terms “FAS” and “FASB” used in these notes refer to Statements of Financial Accounting Standards issued by the United States Financial Accounting Standards Board.

### 3. *Significant accounting policies*

The following is a summary of the significant accounting policies adopted by the Company:

#### (a) **Premiums**

Reinsurance premiums written are recorded at the inception of the policy and are estimated based on information received from brokers, ceding companies and reinsureds, and any subsequent differences arising on such estimates will be recorded in the periods in which they are determined. Premiums written are earned on a pro-rata basis over the term of the policy. For contracts and policies written on a losses occurring basis, the risk period is generally the same as the contract or policy terms. For contracts written on a policies attaching basis, the risk period is based on the terms of the underlying contracts and policies and is generally assumed to be 24 months. The portion of the premiums written applicable to the unexpired terms of the underlying contracts and policies in force are recorded as unearned premiums. Mandatory reinstatement premiums are recorded at the time a loss event occurs.

# Validus Reinsurance, Ltd.

## Notes to Consolidated Financial Statements

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

### (b) Policy acquisition costs

Policy acquisition costs are costs that vary with, and are directly related to, the production of new and renewal business, and consist principally of commissions and brokerage expenses. Acquisition costs are shown net of commissions earned on reinsurance ceded. These costs are deferred and amortized over the periods in which the related premiums are earned. Deferred acquisition costs are limited to their estimated realizable value based on the related unearned premiums and anticipated claims expenses. The realizable value of the Company's deferred acquisition costs is determined without consideration of investment income. Policy acquisition costs also include profit commission. Profit commissions are recognized when earned.

### (c) Reserve for losses and loss expenses

The reserve for losses and loss expenses includes reserves for unpaid reported losses and for losses incurred but not reported ("IBNR"). The reserve for unpaid reported losses and loss expenses is established by management based on reports from brokers, ceding companies and insureds and represents the estimated ultimate cost of events or conditions that have been reported to, or specifically identified by the Company. The reserve for incurred but not reported losses and loss expenses is established by management based on actuarially determined estimates of ultimate losses and loss expenses. Inherent in the estimate of ultimate losses and loss expenses are expected trends in claim severity and frequency and other factors which may vary significantly as claims are settled. Accordingly, ultimate losses and loss expenses may differ materially from the amounts recorded in the consolidated financial statements. These estimates are reviewed regularly and, as experience develops and new information becomes known, the reserves are adjusted as necessary. Such adjustments, if any, will be recorded in earnings in the period in which they become known. Prior period development arises from changes to loss estimates recognized in the current year that relate to loss reserves incurred in previous calendar years.

### (d) Reinsurance

In the normal course of business, the Company seeks to reduce the potential amount of loss arising from claims events by reinsuring certain levels of risk assumed in various areas of exposure with other insurers or reinsurers. The accounting for reinsurance ceded depends on the method of reinsurance. If the policy is on a "losses occurring during" basis, reinsurance premiums ceded are expensed (and any commissions thereon are earned) on a pro-rata basis over the period the reinsurance coverage is provided. If the policy is a "risks attaching during" policy, reinsurance premiums ceded are expensed (and any commissions thereon are earned) in line with the gross premiums earned to which the risk attaching policy relates. Prepaid reinsurance premiums represent the portion of premiums ceded applicable to the unexpired term of policies in force. Mandatory reinstatement premiums ceded are recorded and expensed at the time a loss event occurs.

Reinsurance recoverables are based on contracts in force. The method for determining the reinsurance recoverable on unpaid loss and loss expenses involves actuarial estimates of unpaid losses and loss expenses as well as a determination of the Company's ability to cede unpaid losses and loss expenses under its reinsurance treaties. The use of assumptions could have a material effect on the provision for uncollectible reinsurance. To the extent the creditworthiness of the Company's reinsurers was to deteriorate due to adverse events affecting the reinsurance industry, such as a large number of major catastrophes, actual uncollectible amounts could be significantly greater than the Company's provision. Amounts recoverable from reinsurers are estimated in a manner consistent with the underlying liabilities. Provisions are made for estimated unrecoverable reinsurance.

# Validus Reinsurance, Ltd.

## Notes to Consolidated Financial Statements

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

### (e) Investments

The Company adopted FAS 157 entitled “Fair Value Measurements” as of January 1, 2007. FAS 157 defines fair value as the price received to transfer an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date reflecting the highest and best use valuation concepts. FAS 157 establishes a framework for measuring fair value in GAAP by creating a hierarchy of fair value measurements that distinguishes market data between observable independent market inputs and unobservable market assumptions by the reporting entity. FAS 157 further expands disclosures about such fair value measurements. FAS 157 applies broadly to most existing accounting pronouncements that require or permit fair value measurements (including both financial and non-financial assets and liabilities) but does not require any new fair value measurements. The Company elected to early adopt this Statement effective January 1, 2007 under the provisions of FAS 159, “The Fair Value Option for Financial Assets and Liabilities Including amendment of FASB Statement No. 115”.

During the third quarter of 2008, the Company adopted FSP FAS 157-3. Consistent with this statement, certain market conditions allow for fair value measurements that incorporate unobservable inputs where active market transaction-based measurements are unavailable.

Prior to January 1, 2007, the Company’s investments in fixed maturities were classified as available-for-sale and carried at fair value, with related net unrealized gains or losses excluded from earnings and included in shareholders’ equity as a component of accumulated other comprehensive income. As discussed above, beginning on January 1, 2007, the Company’s investments in fixed maturities were classified as trading and carried at fair value, with related net unrealized gains or losses included in earnings. The Company believes that accounting for its investment portfolio as trading more closely reflects its investment guidelines. Accounting for the investment portfolio as trading resulted in a cumulative increase in retained earnings of \$875 off-set by a decrease in accumulated other comprehensive income, as described in the consolidated statement of shareholders’ equity. The fair value of investments is based upon quoted market values or industry standard models that consider only assumptions that are observable in the marketplace.

Short-term investments comprise investments with a remaining maturity of less than one year at time of purchase.

All investment transactions are recorded on a first-in-first-out basis and realized gains and losses on sale of investments are determined on the basis of amortized cost. Interest on fixed maturity securities is recorded in net investment income when earned and is adjusted for any amortization of premium or discount.

Prior to January 1, 2007, the Company reviewed the fair value of its investment portfolio to identify declines in fair value below the amortized cost that were other than temporary. This review involved consideration of several factors including (i) the time period during which there had been a significant decline in fair value below amortized cost, (ii) an analysis of the liquidity, business prospects and overall financial condition of the issuer, (iii) the significance of the decline, (iv) an analysis of the collateral structure and other credit support, as applicable, of the securities in question and (v) the Company’s intent and ability to hold the investment for a sufficient period of time for the value to recover. If the Company concluded that a decline in fair values was other than temporary, the cost of the security was written down to fair value below amortized cost and the previously unrealized loss was therefore realized in the period such determination was made. With respect to securities where the decline in value was determined to be temporary and the security’s value was not written down, a subsequent decision could be made to sell that security and realize the loss. Subsequent decisions on security sales were made within the context of

# Validus Reinsurance, Ltd.

## Notes to Consolidated Financial Statements

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

overall risk monitoring, changing information, market conditions generally and assessing value relative to other comparable securities.

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 whereby certain securities from its portfolio are loaned to third parties for short periods of time through a lending agent. The Company retains all economic interest in the securities it lends and receives a fee from the borrower for the temporary use of the securities. Collateral in the form of cash, government securities and letters of credit is required at a rate of 102% of the market value of the loaned securities and is held by a third party.

### **(f) Cash and cash equivalents**

The Company considers time deposits and money market funds with an original maturity of 30 days or less as equivalent to cash.

### **(g) Foreign exchange**

The US Dollar is the functional currency of the Company. Monetary assets and liabilities denominated in foreign currencies are revalued at the exchange rates in effect at the balance sheet date and revenues and expenses denominated in foreign currencies are translated at the prevailing exchange rate on the transaction date with the resulting foreign exchange gains and losses included in earnings.

### **(h) Stock plans**

Validus Holdings accounts for its share plans in accordance with the fair value recognition provisions of FAS No. 123 (revised) "Share-Based Payments." Accordingly, Validus Holdings recognizes the compensation expense for stock option grants and restricted share grants based on the fair value of the award on the date of grant over the requisite service period, and allocates the expense to its subsidiaries, including the Company, based on the location of employees.

### **(i) Income taxes and uncertain tax provisions**

Deferred tax assets and liabilities are recorded in accordance with the provisions of FAS No. 109 "Accounting for Income Taxes". Under FAS No. 109, the Company records deferred income taxes which reflect the tax effect of the temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and their respective tax bases.

The Company is not subject to any income, withholding or capital gains taxes under current Bermuda law. The Company has operations in subsidiary form in the U.S. and Canada that are subject to relevant taxes in those jurisdictions. One of the Company's subsidiaries is deemed to be engaged in business in the United States and is therefore subject to U.S. corporate tax.

The Company adopted the provisions of FASB Interpretation No. 48 "Accounting for Uncertainty in Income Taxes", on January 1, 2007 which requires the Company to recognize the tax benefits of uncertain tax positions only where the position is "more likely than not" to be sustained assuming examination by

# Validus Reinsurance, Ltd.

## Notes to Consolidated Financial Statements

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

tax authorities. The Company did not recognize any liabilities for unrecognized tax benefits as a result of the implementation of FIN 48.

#### **4. Recent accounting pronouncements**

In March 2008, the FASB issued FAS No. 161, “Disclosures about Derivative Instruments and Hedging Activities, an Amendment of FASB Statement 133” (“FAS 161”). This statement expands the disclosure requirements of FAS 133 and requires the reporting entity to provide enhanced disclosures about the objectives and strategies for using derivative instruments, quantitative disclosures about the fair values and amounts of gains and losses on derivative contracts, and credit risk related contingent features in derivative agreements. The statement is effective for financial statements issued for fiscal years and interim periods beginning after November 15, 2008. The adoption of FAS 161 is not expected to have a material impact on the Company’s consolidated financial statements.

In May 2008, the FASB issued FAS No. 162, “The Hierarchy of Generally Accepted Accounting Principles” (“FAS 162”). This statement improves financial reporting by providing a consistent framework for determining what accounting principles should be used when preparing U.S. GAAP financial statements. This statement assigns a hierarchical rank to the various sources of accounting literature from Level A through Level D. The adoption of FAS 162 is not expected to have a material impact on the Company’s consolidated financial statements.

In May 2008, the FASB issued FAS No. 163, “Accounting for Financial Guarantee Insurance Contracts, an interpretation of FASB Statement No. 60” (“FAS 163”). This statement decreases the inconsistencies in Statement No. 60 in the accounting for financial guarantee insurance contracts by insurance companies. FAS 163 addresses the differing views in Statement No. 60 regarding the recognition and measurement of premium revenues and claim liabilities and enhances the disclosure requirements for insurance contracts. FAS 163 is effective for financial statements issued for fiscal years beginning after December 15, 2008. The adoption of FAS 163 is not expected to have a material impact on the Company’s consolidated financial statements.

In June 2008, the FASB issued FASB Staff Position EITF 03-6-1, “Determining Whether Instruments Granted in Share-Based Payment Transactions Are Participating Securities” (“FSP EITF 03-6-1”). FSP EITF 03-6-1 addresses whether instruments granted in share-based payment transactions may be participating securities prior to vesting and, therefore, need to be included in the earnings allocation in computing basic earnings per share (“EPS”) pursuant to the two-class method described in paragraphs 60 and 61 of FASB Statement No. 128, “Earnings per Share.” FSP EITF 03-6-1 is effective for financial statements issued for fiscal years beginning after December 15, 2008. The adoption of FSP EITF 03-6-1 is not expected to have a material impact on the Company’s consolidated financial statements.

In August 2008, the FASB issued proposed amendments to FAS 128, “Earnings per Share” (“proposed amendments to FAS 128”). The proposed amendments to FAS 128 reflect the FASB’s efforts to converge with International Financial Reporting Standards and to improve the guidance on earnings per share (“EPS”). The proposed amendments to FAS 128 would be retrospectively applied to all prior-period EPS data. An effective date has not been established. The Company will continue to evaluate the potential impact of this guidance.

In December 2008, the FASB issued FASB Staff Position FAS 140-4 and FIN 46(R)-8, “Disclosures Related to Asset Transfers, Variable Interest Entities (“VIEs”), and Qualified Special Purpose Entities (“QSPEs”)” (“FSP FAS 140-4 and FIN 46(R)-8”). FSP FAS 140-4 and FIN 46(R)-8 require public companies to provide disclosures similar to those proposed in the pending amendments to Statement 140 and Interpretation 46(R). The FSP requires additional disclosures about transfers of financial assets and an enterprise’s involvement with VIEs, including QSPEs. The FSP is effective for the Company’s December 31, 2008 financial statements. The adoption of FSP FAS 140-4 and FIN 46(R)-8 has not had a material impact on the Company’s consolidated financial statements.

# Validus Reinsurance, Ltd.

## Notes to Consolidated Financial Statements

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

On April 1, 2009, the FASB finalized and issued FSP FAS 141 (R)-1 which amended and clarified FAS 141 (R) and is effective for business combinations whose acquisition date is on or after January 1, 2009. FSP FAS 141(R)-1 has amended FAS 141 (R)'s guidance on the initial recognition and measurement, subsequent measurement and accounting, and disclosure of assets acquired and liabilities assumed in a business combination that arise from contingencies. The adoption of FSP FAS 141 (R)-1 has not had a material impact on the Company's consolidated financial statements, but will impact any future acquisitions.

### 5. *Investments*

During the first quarter of 2007, the Company adopted FAS 157 and FAS 159. Prior to January 1, 2007, the Company's investments in fixed maturities were classified as available-for-sale and carried at fair value, with related net unrealized gains or losses excluded from earnings and included in shareholders' equity as a component of accumulated other comprehensive income. Beginning on January 1, 2007, the Company's investments in fixed maturities were classified as trading and carried at fair value, with related net unrealized gains or losses included in earnings.

#### **(a) Classification within the fair value hierarchy under FAS 157**

Under FAS 157, a company must determine the appropriate level in the fair value hierarchy for each fair value measurement. The fair value hierarchy in FAS 157 prioritizes the inputs, which refer broadly to assumptions market participants would use in pricing an asset or liability, into three levels. It gives the highest priority to quoted prices (unadjusted) in active markets for identical assets or liabilities and the lowest priority to unobservable inputs. The level in the fair value hierarchy within which a fair value measurement in its entirety falls is determined based on the lowest level input that is significant to the fair value measurement in its entirety.

Level 1 inputs are quoted prices (unadjusted) in active markets for identical assets or liabilities that the reporting entity has the ability to access at the measurement date. Level 2 inputs are inputs other than quoted prices within Level 1 that are observable for the asset or liability, either directly or indirectly. A significant adjustment to a Level 2 input could result in the Level 2 measurement becoming a Level 3 measurement. Level 3 inputs are unobservable inputs for the asset or liability.

Level 1 primarily consists of financial instruments whose value is based on quoted market prices or alternative indices but for which the Company typically obtained independent external valuation information including U.S. and U.K. Treasuries, overnight repos and commercial paper. Level 2 includes financial instruments that are valued through independent external sources using models or other valuation methodologies. These models are primarily industry-standard models that consider various assumptions, including time value, yield curve, prepayment speeds, default rates, loss severity, current market and contractual prices for the underlying financial instruments, as well as other relevant economic measures. Sustainably all of these assumptions are observable in the marketplace, can be derived from observable data or are supported by observable levels at which transactions are executed in the marketplace. The Company performs internal procedures on the valuations received from independent external sources. Financial instruments in this category include U.S. Treasuries, sovereign debt, corporate debt and U.S. agency and non-agency mortgage and asset-backed securities. Level 3 includes financial instruments that are valued using market approach and income approach valuation techniques. These models incorporate both observable and unobservable inputs. Financial instruments in this category include certain residential mortgage-backed securities.

## Validus Reinsurance, Ltd.

### Notes to Consolidated Financial Statements

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

At December 31, 2008, the Company's investments are allocated between levels 1, 2 and 3 as follows:

	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>	<u>Total</u>
U.S. Government and Government Agency	\$ -	\$ 449,838	\$ -	\$ 449,838
Non-U.S. Government and Government Agency	-	23,986	-	23,986
Agency residential mortgage-backed securities	-	377,212	-	377,212
Non-Agency residential mortgage-backed securities	-	104,956	104,661	209,617
U.S. corporate	-	387,272	-	387,272
Non-U.S. corporate	-	60,271	-	60,271
Catastrophe bonds	-	10,872	-	10,872
Asset-backed securities	-	87,900	-	87,900
Commercial mortgage-backed securities	-	160,781	-	160,781
Total fixed maturities	-	1,663,088	104,661	1,767,749
Total short-term investments	<u>196,511</u>	<u>-</u>	<u>-</u>	<u>196,511</u>
<b>Total</b>	<u>\$ 196,511</u>	<u>\$ 1,663,088</u>	<u>\$ 104,661</u>	<u>\$ 1,964,260</u>

At December 31, 2007, the Company's investments are allocated between levels 1, 2 and 3 as follows:

	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>	<u>Total</u>
U.S. Government and Government Agency	\$ -	\$ 370,438	\$ -	\$ 370,438
Agency residential mortgage-backed securities	-	491,393	-	491,393
Non-Agency residential mortgage-backed securities	-	188,411	-	188,411
U.S. corporate	-	380,990	-	380,990
Asset-backed securities	-	188,190	-	188,190
Commercial mortgage-backed securities	-	152,577	-	152,577
Total fixed maturities	-	1,771,999	-	1,771,999
Total short-term investments	<u>72,577</u>	<u>4,737</u>	<u>-</u>	<u>77,314</u>
<b>Total</b>	<u>\$ 72,577</u>	<u>\$ 1,776,736</u>	<u>\$ -</u>	<u>\$ 1,849,313</u>

At December 31, 2008, Level 3 investments totalled \$104,661, representing 5.3% of total investments measured at fair value on a recurring basis.

## Validus Reinsurance, Ltd.

### Notes to Consolidated Financial Statements

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

The following table presents a reconciliation of the beginning and ending balances for all investments measured at fair value on a recurring basis using Level 3 inputs during the year ended December 31, 2008 and 2007:

	Residential mortgage-backed securities	
	Year ended December 31, 2008	Year ended December 31, 2007
<b>Level 3 investments - Beginning of period</b>	\$ -	\$ -
Net payments, purchases, sales and maturities	(59)	-
Unrealized losses	(13,294)	-
Amortization	(3,718)	-
Net transfers in	121,732	-
<b>Level 3 investments - End of period</b>	<u>\$ 104,661</u>	<u>\$ -</u>

At December 31, 2008, \$13,294 of unrealized losses was recorded in income attributable to the residential mortgage-backed securities measured at fair value on a recurring basis using Level 3 inputs.

#### (b) Net investment income

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

	<u>December 31, 2008</u>	<u>December 31, 2007</u>
Fixed maturities and short-term investments	\$ 95,573	\$ 82,499
Cash and cash equivalents	7,069	5,558
Securities lending income	1,775	242
Total gross investment income	<u>104,417</u>	<u>88,299</u>
Investment expenses	(2,423)	(2,318)
<b>Net investment income</b>	<u>\$ 101,994</u>	<u>\$ 85,981</u>

# Validus Reinsurance, Ltd.

## Notes to Consolidated Financial Statements

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

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

	<u>December 31, 2008</u>	<u>December 31, 2007</u>
Fixed maturities, short-term investments and cash equivalents		
Gross realized gains	\$ 12,107	\$ 2,820
Gross realized losses	(21,825)	(2,377)
<b>Net realized (losses) gains on investments</b>	<u>(9,718)</u>	<u>443</u>
Change in unrealized (losses) gains of investments	(77,980)	8,556
Change in unrealized loss on securities lending	(6,734)	-
<b>Total net realized (losses) gains and change in unrealized (losses) gains of investments</b>	<u>\$ (94,432)</u>	<u>\$ 8,999</u>

### (c) Fixed maturity and short-term investments

The amortized cost, fair value and gross unrealized gains and losses and fair value of investments at December 31, 2008 are as follows:

	<u>Amortized Cost</u>	<u>Gross Unrealized gain</u>	<u>Gross Unrealized loss</u>	<u>Estimated fair value</u>
U.S. Government and Government Agency	\$ 425,819	\$ 24,019	\$ -	\$ 449,838
Non-U.S. Government and Government Agency	23,357	629	-	23,986
Agency residential mortgage-backed securities	370,174	7,136	(98)	377,212
Non-Agency residential mortgage-backed securities	272,844	4	(63,231)	209,617
U.S. corporate	395,782	1,806	(10,316)	387,272
Non-U.S. corporate	61,067	623	(1,419)	60,271
Catastrophe bonds	11,012	2	(142)	10,872
Asset-backed securities	91,076	-	(3,176)	87,900
Commercial mortgage-backed securities	185,166	-	(24,385)	160,781
Total fixed maturities	<u>1,836,297</u>	<u>34,219</u>	<u>(102,767)</u>	<u>1,767,749</u>
Total short-term investments	196,511	-	-	196,511
<b>Total investments</b>	<u>\$ 2,032,808</u>	<u>\$ 34,219</u>	<u>\$ (102,767)</u>	<u>\$ 1,964,260</u>

## Validus Reinsurance, Ltd.

### Notes to Consolidated Financial Statements

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

The amortized cost, fair value and gross unrealized gains and losses and fair value of investments at December 31, 2007 are as follows:

	<u>Amortized Cost</u>	<u>Gross Unrealized gain</u>	<u>Gross Unrealized loss</u>	<u>Estimated fair value</u>
U.S. Government and Government Agency	\$ 365,221	\$ 5,271	\$ (54)	\$ 370,438
Agency residential mortgage-backed securities	486,974	4,970	(551)	491,393
Non-Agency residential mortgage-backed securities	192,490	633	(4,712)	188,411
U.S. corporate	378,387	3,720	(1,117)	380,990
Asset-backed securities	188,152	636	(598)	188,190
Commercial mortgage-backed securities	151,349	1,276	(48)	152,577
Total fixed maturities	<u>1,762,573</u>	<u>16,506</u>	<u>(7,080)</u>	<u>1,771,999</u>
Total short-term investments	77,309	5	-	77,314
<b>Total investments</b>	<u><u>\$ 1,839,882</u></u>	<u><u>\$ 16,511</u></u>	<u><u>\$ (7,080)</u></u>	<u><u>\$ 1,849,313</u></u>

The following table sets forth certain information regarding the investment ratings of the Company's fixed maturities portfolio as at December 31, 2008 and 2007. Investment ratings are the lower of Moody's or Standard & Poor's rating for each investment security, presented in Standard & Poor's equivalent rating. For investments where Moody's and Standard & Poor's ratings are not available, Fitch ratings are used and presented in Standard & Poor's equivalent rating.

	<u>December 31, 2008</u>		<u>December 31, 2007</u>	
	<u>Estimated fair value</u>	<u>% of total</u>	<u>Estimated fair value</u>	<u>% of total</u>
AAA	\$ 1,346,581	76.2%	\$ 1,480,967	83.6%
AA+	3,962	0.2%	28,093	1.6%
AA	56,701	3.2%	30,791	1.7%
AA-	32,521	1.8%	84,704	4.8%
A+	83,890	4.8%	66,359	3.7%
A	151,499	8.6%	56,705	3.2%
A-	30,852	1.7%	22,271	1.3%
BBB+	1,712	0.1%	2,109	0.1%
BBB	7,172	0.4%	-	-
Investment grade	<u>1,714,890</u>	<u>97.0%</u>	<u>1,771,999</u>	<u>100.0%</u>
BB+	45,439	2.6%	-	-
B+	3,455	0.2%	-	-
B	3,965	0.2%	-	-
Non-Investment grade	<u>52,859</u>	<u>3.0%</u>	<u>-</u>	<u>-</u>
<b>Total</b>	<u><u>\$ 1,767,749</u></u>	<u><u>100.0%</u></u>	<u><u>\$ 1,771,999</u></u>	<u><u>100.0%</u></u>

The amortized cost and estimated fair value amounts for fixed interest securities held at December 31, 2008 and 2007 are shown by contractual maturity. Actual maturity may differ from contractual maturity because certain borrowers may have the right to call or prepay certain obligations with or without call or prepayment penalties.

## Validus Reinsurance, Ltd.

### Notes to Consolidated Financial Statements

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

	December 31, 2008		December 31, 2007	
	Amortized cost	Estimated fair value	Amortized cost	Estimated fair value
Due in one year or less	\$ 196,649	\$ 198,975	\$ 73,144	\$ 73,287
Due after one year through five years	655,818	666,787	629,120	635,435
Due after five years through ten years	8,761	9,433	23,353	24,368
Due after ten years	55,809	57,044	17,991	18,338
	<u>917,037</u>	<u>932,239</u>	<u>743,608</u>	<u>751,428</u>
Asset-backed and mortgage-backed securities	919,260	835,510	1,018,965	1,020,571
<b>Total</b>	<u>\$ 1,836,297</u>	<u>\$ 1,767,749</u>	<u>\$ 1,762,573</u>	<u>\$ 1,771,999</u>

The Company and its parent has a five year, \$500,000 secured letter of credit facility provided by a syndicate of commercial banks. At December 31, 2008 approximately \$199,186 (2007: \$104,524) of letters of credit were issued and outstanding under this facility for which \$258,573 of investments were pledged as collateral (2007: \$109,164). In 2007, a sister company, Talbot Holdings Ltd., entered into a \$100,000 standby letter of credit facility which provides Funds at Lloyd's. At December 31, 2008, \$100,000 (2007: \$100,000) of letters of credit were issued and outstanding under this facility for which \$144,149 of the Company's investments were pledged as collateral (2007: \$118,121). In addition, \$67,968 of investments were held in trust at December 31, 2008 (2007: \$nil).

#### (d) Securities lending

The Company participates in a securities lending program whereby certain securities from its portfolio are loaned to third parties for short periods of time through a lending agent. The Company retains all economic interest in the securities it lends and receives a fee from the borrower for the temporary use of the securities. Collateral in the form of cash, government securities and letters of credit is required at a rate of 102% of the market value of the loaned securities and is held by a third party. As at December 31, 2008, the Company had \$103,266 (2007: \$161,579) in securities on loan. During the year ended December 31, 2008, the Company recorded a \$6,734 unrealized loss on this collateral on its Statements of Operations (2007: \$nil).

Securities lending collateral reinvested is primarily comprised of corporate floating rate securities with an average reset period of 26.7 days (2007: 42.9 days). As at December 31, 2008, the securities lending collateral reinvested by the Company in connection with its securities lending program is allocated between Levels 1, 2 and 3 as follows:

	Level 1	Level 2	Level 3	Total
Corporate	\$ -	\$ 57,574	\$ -	\$ 57,574
Asset-backed securities	-	18,228	-	18,228
Short-term investments	7,390	15,762	-	23,152
	<u>\$ 7,390</u>	<u>\$ 91,564</u>	<u>\$ -</u>	<u>\$ 98,954</u>

## Validus Reinsurance, Ltd.

### Notes to Consolidated Financial Statements

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

As at December 31, 2007, the securities lending collateral reinvested by the Company in connection with its securities lending program are allocated between Levels 1, 2 and 3 as follows:

	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>	<u>Total</u>
Corporate	\$ -	\$ 49,055	\$ -	\$ 49,055
Asset-backed securities	-	11,515	-	11,515
Short-term investments	97,797	5,957	-	103,754
	<u>\$ 97,797</u>	<u>\$ 66,527</u>	<u>\$ -</u>	<u>\$ 164,324</u>

The following table sets forth certain information regarding the investment ratings of the Company's securities lending collateral reinvested as at December 31, 2008 and December 31, 2007. Investment ratings are the lower of Moody's or Standard & Poor's rating for each investment security, presented in Standard & Poor's equivalent rating. For investments where Moody's and Standard & Poor's ratings are not available, Fitch ratings are used and presented in Standard & Poor's equivalent rating.

	<u>December 31, 2008</u>		<u>December 31, 2007</u>	
	<u>Estimated fair value</u>	<u>% of total</u>	<u>Estimated fair value</u>	<u>% of total</u>
AAA	\$ 45,137	45.7%	\$ 18,611	11.3%
AA+	4,784	4.8%	2,999	1.8%
AA	12,789	12.9%	15,997	9.7%
AA-	20,035	20.2%	11,954	7.3%
A+	4,947	5.0%	9,010	5.5%
A	3,782	3.8%	7,956	4.9%
NR	90	0.1%	-	-
	<u>91,564</u>	<u>92.5%</u>	<u>66,527</u>	<u>40.5%</u>
NR (1)	7,390	7.5%	97,797	59.5%
<b>Total</b>	<u>\$ 98,954</u>	<u>100.0%</u>	<u>\$ 164,324</u>	<u>100.0%</u>

(1) This amount relates to cash and is therefore not a rated security.

The amortized cost and estimated fair value amounts for securities lending collateral reinvested held at December 31, 2008 and December 31, 2007 are shown by contractual maturity below. Actual maturity may differ from contractual maturity because certain borrowers may have the right to call or prepay certain obligations with or without call or prepayment penalties.

	<u>December 31, 2008</u>		<u>December 31, 2007</u>	
	<u>Amortized cost</u>	<u>Estimated fair value</u>	<u>Amortized cost</u>	<u>Estimated fair value</u>
Due in one year or less	\$ 24,390	\$ 23,152	\$ 103,793	\$ 104,151
Due after one year through five years	81,298	75,802	60,469	60,173
<b>Total</b>	<u>\$ 105,688</u>	<u>\$ 98,954</u>	<u>\$ 164,262</u>	<u>\$ 164,324</u>

#### (e) Junior Subordinate Deferrable Debentures

On April 29, 2008, the Company purchased from an unaffiliated financial institution \$45,700 principal amount of its 8.480% Junior Subordinated Deferrable Debentures of its parent company, Validus Holdings, due 2037 at an aggregate price of \$36,560, plus accrued and unpaid interest of \$474. The estimated fair value of the Junior Subordinate Deferrable Debentures at December 31, 2008 was \$38,022.

## Validus Reinsurance, Ltd.

### Notes to Consolidated Financial Statements

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

#### 6. *Premiums Receivable*

Premiums receivable are composed of premiums in course of collection, net of commissions and brokerage, and premiums accrued but unbilled, net of commissions and brokerage. The following is a breakdown of the components of receivables at December 31, 2008 and 2007:

	<b>Premiums in course of collection</b>	<b>Premiums accrued but unbilled</b>	<b>Total</b>
Balance at December 31, 2007	\$ 107,020	\$ 102,325	\$ 209,345
Change during 2008	<u>27,725</u>	<u>(1,783)</u>	<u>25,942</u>
Balance at December 31, 2008	<u>\$ 134,745</u>	<u>\$ 100,542</u>	<u>\$ 235,287</u>

	<b>Premiums in course of collection</b>	<b>Premiums accrued but unbilled</b>	<b>Total</b>
Balance at December 31, 2006	\$ 72,500	\$ 69,908	\$ 142,408
Change during 2007	<u>34,520</u>	<u>32,417</u>	<u>66,937</u>
Balance at December 31, 2007	<u>\$ 107,020</u>	<u>\$ 102,325</u>	<u>\$ 209,345</u>

#### 7. *Reserves for Losses and loss expenses*

Reserves for losses and loss expenses are based in part upon the estimation of case losses reported from brokers, insureds and ceding companies. The Company also uses statistical and actuarial methods to estimate ultimate expected losses and loss expenses. The period of time from the occurrence of a loss, the reporting of a loss to the Company and the settlement of the Company's liability may be several months or years. During this period, additional facts and trends may be revealed. As these factors become apparent, case reserves will be adjusted, sometimes requiring an increase or decrease in the overall reserves of the Company, and at other times requiring a reallocation of incurred but not reported reserves to specific case reserves. These estimates are reviewed regularly, and such adjustments, if any, are reflected in earnings in the period in which they become known. While management believes that it has made a reasonable estimate of ultimate losses, there can be no assurances that ultimate losses and loss expense will not exceed the total reserves.

During the third quarter of 2008, Hurricanes Ike and Gustav were significant loss events for the industry. The Company's current hurricane reserve estimates relating to these catastrophes are based on a 'ground up' estimate and analysis of contracts believed to be exposed to these events, together with internal data compiled from underwriters, actuaries and claims personnel. Information from cedants, brokers and industry models has been considered in the process. Actual losses may vary from this estimate. While the amounts included in the consolidated financial statements reflect the Company's best estimates and assumptions, these amounts could ultimately be materially different from the amounts recorded in the consolidated financial statements.

## Validus Reinsurance, Ltd.

### Notes to Consolidated Financial Statements

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

The following table represents an analysis of paid and unpaid losses and loss expenses incurred and a reconciliation of the beginning and ending unpaid loss expense for the years ended December 31, 2008 and 2007:

	<u>December 31, 2008</u>	<u>December 31, 2007</u>
Net Reserves for losses and loss expenses, beginning of year	\$ 196,813	\$ 77,363
Increase in net losses and loss expenses incurred in respect of losses occurring in		
Current year	435,695	192,795
Prior years	<u>(15,050)</u>	<u>(17,257)</u>
Total incurred losses and loss expenses	420,645	175,538
Less net losses and loss expenses paid in respect of losses occurring in		
Current year	102,673	28,907
Prior years	<u>59,198</u>	<u>27,181</u>
Total net paid losses	161,871	56,088
Exchange rate effects	<u>(4,222)</u>	-
Net reserve for losses and loss expenses, end of year	451,365	196,813
Loss reserves recoverable	<u>84,523</u>	-
Reserve for losses and loss expenses, end of year	<u>\$ 535,888</u>	<u>\$ 196,813</u>

Incurred losses and loss adjustment expenses comprise:

	<u>December 31, 2008</u>	<u>December 31, 2007</u>
Gross losses and loss adjustment expenses	\$ 507,632	\$ 175,538
Reinsurance recoverable	<u>(86,987)</u>	-
Total incurred losses and loss adjustment expenses	<u>\$ 420,645</u>	<u>\$ 175,538</u>

The December 31, 2008 and 2007 gross reserves balance comprises reserves for reported claims of \$294,216 and \$71,994, respectively, and reserves for claims incurred but not reported of \$241,672 and \$124,819, respectively. The net favorable development on prior years by segment and line of business is as follows:

	<u>Line of business</u>			
	<u>Property</u>	<u>Marine</u>	<u>Specialty</u>	<u>Total</u>
December 31, 2008	\$ (17,573)	\$ 4,119	\$ (1,596)	\$ (15,050)
December 31, 2007	\$ (13,279)	\$ (2,036)	\$ (1,942)	\$ (17,257)

For the year ended December 31, 2008, the amount recorded represents management's best estimate of expected losses and loss expenses on premiums earned. Favorable loss development on prior years totalled \$15,050. The property line experienced favorable development of \$17,573 due primarily to favorable development on the 2007 UK floods, Australian storm losses, and several other smaller events.

For the year ended December 31, 2007, the amount recorded represents management's best estimate of expected losses and loss expenses on premiums earned. Favorable loss development on prior years totalled \$17,257 and was

# Validus Reinsurance, Ltd.

## Notes to Consolidated Financial Statements

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

experienced in all lines of business. Favorable development was primarily related to better than expected loss experience on the 2006 underwriting year.

### 8. Reinsurance

The Company enters into retrocession agreements in order to mitigate its accumulation of loss, reduce its liability on individual risks, enable it to underwrite policies with higher limits, and increase aggregate capacity. The cession of reinsurance does not legally discharge the Company from its primary liability for the full amount of the policies, and the Company is required to pay the loss and bear collection risk if the reinsurer fails to meet its obligations under the retrocession agreement. Amounts recoverable from reinsurers are estimated in a manner consistent with the underlying liabilities.

#### a) Effects of reinsurance on premiums written and earned

The effects of reinsurance on premiums written and earned for the years ended December 31, 2008 and 2007 is as follows:

	December 31, 2008		December 31, 2007	
	Written	Earned	Written	Earned
Assumed	\$ 687,771	\$ 715,253	\$ 702,098	\$ 621,330
Ceded	(62,933)	(61,722)	(68,842)	(62,301)
<b>Total</b>	<b>\$ 624,838</b>	<b>\$ 653,531</b>	<b>\$ 633,256</b>	<b>\$ 559,029</b>

#### b) Credit risk

The Company evaluates the financial condition of its reinsurers and monitors concentration of credit risk arising from its exposure to individual reinsurers. The reinsurance program is generally placed with reinsurers whose rating, at the time of placement, was A- or better rated by Standard & Poor's or the equivalent with other rating agencies. Exposure to a single reinsurer is also controlled with restrictions dependent on rating. Of the \$84,523 reinsurance recoverable at December 31, 2008, \$83,511 was fully collateralized (2007: \$nil).

#### c) Collateralized quota share retrocession treaties

Between May 8, 2006 and July 28, 2006, Validus Re entered into retrocessional reinsurance agreements with Petrel Re Limited ("Petrel"), a newly-formed Bermuda reinsurance company. These agreements include quota share reinsurance agreements ("Collateralized Quota Shares") whereby Petrel assumes a quota share of certain lines of marine & energy and other lines of business underwritten by Validus Re for unaffiliated third parties for the 2006 and 2007 underwriting years. Under the terms of the reinsurance agreements, the Company has determined it is not required to consolidate the assets, liabilities and results of operations of Petrel per FIN 46(R). Petrel is a separate legal entity of which Validus Re has no equity investment, management or board interests or related party relationships. The collateralized quota share retrocessional reinsurance agreement with Petrel Re Limited was not extended beyond the 2007 underwriting year.

Petrel is required to contribute funds into a trust (the "Trust") for the benefit of Validus Re. Under the Collateralized Quota Shares, the amount required to be on deposit in the Trust is the sum of (i) full aggregate outstanding limits in excess of unpaid premium and related ceding commission on all in force covered policies plus (ii) an amount determined by Validus Re in its discretion to support losses under covered policies (the "Required Amount of Available Assets"). If the actual amounts on deposit in the Trust, together with certain

# **Validus Reinsurance, Ltd.**

## **Notes to Consolidated Financial Statements**

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

other amounts (the "Available Assets"), do not at least equal the Required Amount of Available Assets, Validus Re will, among other things, cease ceding business on a prospective basis.

Validus Re pays a reinsurance premium to Petrel in the amount of the ceded percentage of the original gross written premium on the business reinsured with Petrel less a ceding commission, which includes a reimbursement of direct acquisition expenses as well as a commission to Validus Re for generating the business. The Collateralized Quota Shares also provides for a profit commission to Validus Re based on the underwriting results for the 2007 and 2008 underwriting years on a cumulative basis.

For the year ended December 31, 2008 and 2007, Validus Re ceded \$(1,987) and \$53,195 of premiums written to Petrel through the Collateralized Quota Shares. The earned portion of premiums ceded to Petrel for the year ended December 31, 2008 and 2007 was \$8,223 and \$49,567.

On December 22, 2007, Validus Re entered into a collateralized retrocessional reinsurance agreement with an unaffiliated third party whereby the Company cedes certain business underwritten in the marine offshore energy lines. For the year ended December 31, 2008 and 2007, Validus Re ceded \$19,978 and \$nil, respectively of premiums written through this agreement. The earned portion of premiums ceded for the years ended December 31, 2008 and 2007 were \$19,798 and \$nil respectively.

### **9. Share capital**

#### **(a) Authorized and issued**

The Company's authorized share capital is 1,000,000,000 ordinary shares with a par value of \$0.10 each.

On October 19, 2005, the Company issued 100,000,000 ordinary shares at a price of \$10.00. Proceeds from this issuance were \$1,000,000.

#### **(b) Dividends**

The Company declared a dividend of \$1.05 per share for the year ended December 31, 2008 (2007: \$0.40).

#### **(c) Additional paid in-capital**

The decrease in additional paid in capital during the year ended December 31, 2008 was due to a distribution to the parent company of \$17.

### **10. Retirement plans**

The Company provides pension benefits to eligible employees through various plans which are managed externally and sponsored by the Company. All pension plans are structured as defined contribution retirement plans. The Company's contributions are expensed as incurred. The Company's expenses for its defined contribution retirement plans for the year ended December 31, 2008 and 2007 were \$1,614 and \$979, respectively.

# Validus Reinsurance, Ltd.

## Notes to Consolidated Financial Statements

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

### 11. Stock plans

#### (a) Long-term incentive plan

Validus Holdings' Long Term Incentive Plan ("LTIP") provides for grants to employees of any option, stock appreciation right ("SAR"), restricted share, restricted share unit, performance share, performance unit, dividend equivalent or other share-based award. The total number of shares reserved for issuance under the LTIP is 13,126,896 shares. The LTIP is administered by the Compensation Committee of the Board of Directors. No SARs, performance shares, performance units or dividend equivalents have been granted to date. Grant prices are established at the estimated fair market value of the Validus Holdings' common shares at the date of grant.

Validus Holdings recognizes the compensation expense for stock option grants and restricted share grants based on the fair value of the award on the date of grant over the requisite service period, and allocate the expense to its subsidiaries based on the location of employees.

#### (b) LTIP options

Options granted under the LTIP may be exercised for voting common shares upon vesting. Options have a life of 10 years and vest ratably over five years from the date of grant. Grant prices are established at the estimated fair value of the Validus Holdings' common shares at the date of grant using the Black-Scholes option-pricing model with the following weighted average assumptions used for all grants to date: risk free interest rates of 3.5% (2007: 4.5%), expected life of 7 years (2007: 7 years), expected volatility of 30.0% (2007: 30%) and a dividend yield of 3.2% (2007: nil). Expected volatility is based on stock price volatility of comparable publicly-traded companies. The Company uses the simplified method outlined in the SEC Staff Accounting Bulletin 110 to estimate expected lives for options granted during the period as historical exercise data is not available and the options met the requirement as set out in the bulletin. Share expense of \$4,251 was recorded for the year ended December 31, 2008 (2007: \$3,919) related to the options, with a corresponding increase to additional paid-in capital. The expense represents the proportionate accrual of the fair value of each grant based on the remaining vesting period. At December 31, 2008 there was \$9,139 (2007: \$12,340) of total unrecognized compensation expense related to the outstanding options that is expected to be recognized over a weighted-average period of 2.2 years (2007: 3.1 years).

#### (c) LTIP restricted shares

Restricted shares granted under the LTIP vest either ratably or at the end of the required service period and contain certain restrictions for the vesting period, relating to, among other things, forfeiture in the event of termination of employment and transferability. Share expense of \$10,371 (2007: \$5,399) was recorded for the year ended December 31, 2008 related to the restricted shares. The expense represents the proportionate accrual of the fair value of each grant based on the remaining vesting period. At December 31, 2008 there was \$23,913 (2007: \$14,145) of total unrecognized compensation expense related to the outstanding restricted shares that is expected to be recognized over a weighted-average period of 3.4 years (2007: 3.4 years).

#### (d) Restricted Share Units

Restricted share units under the LTIP vest either ratably or at the end of the required service period and contain certain restrictions for the vesting period, relating to, among other things, forfeiture in the event of termination of employment and transferability. Share expense of \$43 (2007: \$nil) was recorded for the year ended December 31, 2008 related to the restricted shares units. The expense represents the

# Validus Reinsurance, Ltd.

## Notes to Consolidated Financial Statements

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proportionate accrual of the fair value of each grant based on the remaining vesting period. At December 31, 2008, there was \$227 of total unrecognized compensation expense related to the outstanding restricted shares units that is expected to be recognized over a weighted-average period of 4.3 years.

### (e) Total Share Expense

The breakdown of share expense for the years ended December 31, 2008 and 2007 are as follows:

	<u>December 31, 2008</u>	<u>December 31, 2007</u>
LTIP options	\$ 4,251	\$ 3,919
LTIP restricted share units	43	-
LTIP restricted shares	10,371	5,399
Total share compensation expense	<u>\$ 14,665</u>	<u>\$ 9,318</u>

## 12. Taxation

The Company provides for income taxes based upon amounts reported in the financial statements and the provisions of currently enacted tax laws. The Company is registered in Bermuda and is subject to Bermuda law with respect to taxation. Under current Bermuda law, the Company is not taxed on any Bermuda income or capital gains taxes and has received an undertaking from the Bermuda Minister of Finance that, in the event of any Bermuda income or capital gains taxes being imposed, the Company will be exempt from those taxes until March 28, 2016. At the present time no such taxes are levied in Bermuda.

The Company has subsidiaries based in the United States and Canada that are subject to the tax laws of those countries. Under current law, these subsidiaries are taxed at the applicable corporate tax rates. One of the Company's subsidiaries is deemed to be engaged in business in the United States and is therefore subject to US corporate tax.

Income before tax by jurisdiction is as follows:

	<u>Year ended December 31, 2008</u>	<u>Year ended December 31, 2007</u>
Income before tax - Bermuda	\$ 59,706	\$ 359,518
Income before tax - Other	239	77
Income before tax - Total	<u>\$ 59,945</u>	<u>\$ 359,595</u>

Income tax expense is comprised of current and deferred tax as follows:

	<u>Year ended December 31, 2008</u>	<u>Year ended December 31, 2007</u>
Current	\$ 88	\$ 61
Deferred	-	-
Income tax expense	<u>\$ 88</u>	<u>\$ 61</u>

The weighted average expected tax provision has been calculated using pre-tax accounting income in each jurisdiction multiplied by that jurisdiction's applicable statutory tax rate. A reconciliation of the difference between the provision for income taxes and the expected tax provision at the weighted average tax rate for the years ended December 31, 2008 and 2007 is provided below.

# Validus Reinsurance, Ltd.

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	Year ended December 31, 2008	Year ended December 31, 2007
Expected tax provision at Bermuda Statutory Rate of 0%	\$ -	\$ -
Effect of taxable income generated in:		
Canada	101	32
Difference between weighted average and actual tax expense	(13)	29
Income tax expense	<u>\$ 88</u>	<u>\$ 61</u>

The Company adopted the provisions of FASB Interpretation No. 48 (“FIN 48”), Accounting for Uncertainty in Income Taxes, on January 1, 2007. The Company did not recognize any liabilities for unrecognized tax benefits under FIN 48.

### 13. Commitments and contingencies

#### (a) Concentrations of credit risk

The Company’s investments are managed following prudent standards of diversification. The Company attempts to limit its credit exposure by purchasing high quality fixed income investments to maintain an average portfolio credit quality of AA- or higher with mortgage and commercial mortgage-backed issues having an aggregate weighted average credit quality of triple-A. In addition, the Company limits its exposure to any single issuer to 3% or less, excluding treasury and agency securities. The minimum credit rating of any security purchased is A-/A3 and where investments are downgraded, the Company permits a holding of up to 2% in aggregate market value, or 10% with written pre-authorization. At December 31, 2008, 3.5% of the portfolio had a split rating below A-/A3 and the Company did not have an aggregate exposure to any single issuer of more than 1.5% of our investment portfolio, other than with respect to U.S. government and agency securities.

#### (b) Employment agreements

The Company has entered into employment agreements with certain individuals that provide for option awards, executive benefits and severance payments under certain circumstances.

#### (c) Operating leases

The Company leases office space and office equipment under operating leases. Total rent expense with respect to these operating leases for the year ended December 31, 2008 was approximately \$1,067 (2007: \$890). Future minimum lease commitments are as follows:

2009	1,077
2010	1,085
2011	872
2012	235
2013 and thereafter	<u>322</u>
Total minimum future rentals	<u>\$ 3,591</u>

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### 14. Credit facility

On March 12, 2007, Validus Re and its parent entered into a new \$200,000 three-year unsecured facility, as subsequently amended on October 25, 2007, which provides for letter of credit availability for Validus Holdings, Validus Re, its subsidiaries and a new \$500,000 five-year secured letter of credit facility, as subsequently amended, which provides for letter of credit availability for Validus Re and our other subsidiaries. The new credit facilities were provided by a syndicate of commercial banks arranged by J.P. Morgan Securities Inc. and Deutsche Bank Securities Inc. The new credit facilities replaced the existing 364-day \$100,000 senior unsecured revolving credit facility and the existing three-year \$200,000 senior secured letter of credit facility, which have each been terminated.

The credit facilities contain affirmative covenants that include, among other things, (i) the requirement that Validus Holdings initially maintain a minimum level of consolidated net worth of at least \$872,000, and commencing with the end of the fiscal quarter ending March 31, 2007 to be increased quarterly by an amount equal to 50% of Validus Holdings' consolidated net income (if positive) for such quarter plus 50% of any net proceeds received from any issuance of common shares during such quarter, (ii) the requirement that Validus Holdings maintain at all times a consolidated total debt to consolidated total capitalization ratio not greater than 0.35:1.00, and (iii) the requirement that Validus Re and any other material insurance subsidiaries maintain a financial strength rating by A.M. Best of not less than "B++" (Fair). For purposes of covenant compliance (i) "net worth is calculated with investments carried at amortized cost and (ii) "consolidated total debt" does not include the Validus Holdings' junior subordinated deferrable debentures. The credit facilities also contain restrictions on Validus Holdings' ability to pay dividends and other payments in respect of equity interests at any time that Validus Holdings are otherwise in default with respect to certain provisions under the credit facilities, make investments, incur debt at Validus Holdings, incur liens, sell assets and merge or consolidate with others.

On July 2, 2007, Validus Holdings made a draw upon the \$200,000 unsecured credit facility in the amount of \$188,000. These funds were used to fund a portion of the cash purchase price for the Validus Holdings' acquisition of Talbot and associated expenses. The interest rate set in respect of borrowing amounts under its credit facility borrowings as of July 2, 2007 was 6.0% per annum. On July 31, 2007, Validus Holdings fully repaid these borrowings and paid accrued interest with \$188,971 of proceeds from its initial public offering. As of December 31, 2008, there is \$199,186 in outstanding letters of credit under the five-year secured letter of credit facility (2007: \$104,524 under the three-year secured facility) and no amounts outstanding under the three-year unsecured facility (2007: \$Nil).

On November 28, 2007, Talbot entered into a \$100,000 standby Letter of Credit facility (the "Talbot FAL Facility") to provide Funds at Lloyd's; this facility is guaranteed by Validus Holdings and is secured against the assets of Validus Re. The Talbot FAL Facility was provided by a syndicate of commercial banks arranged by Lloyds TSB Bank plc and ING Bank N.V., London Branch. The Talbot FAL Facility contains affirmative covenants that include, among other things, (i) the requirement that Validus Holdings initially maintain a minimum level of consolidated net worth of at least \$1,164,265, and commencing with the end of the fiscal quarter ending December 31, 2007 to be increased quarterly by an amount equal to 50% of Validus Holdings' consolidated net income (if positive) for such quarter plus 50% of any net proceeds received from any issuance of common shares during such quarter, and (ii) the requirement that Validus Holdings maintain at all times a consolidated total debt to consolidated total capitalization ratio not greater than 0.35:1.00. This Talbot FAL Facility replaced the Talbot FAL Facility issued in 2003.

The Talbot FAL Facility also contains restrictions on Validus Holdings' ability to make investments, incur debt at Validus Holdings' subsidiaries, incur liens, sell assets and merge or consolidate with others. Other than in respect of existing and future preferred and hybrid securities, the payment of dividends and other payments in respect of equity interests are not permitted at any time that Validus Holdings are in default with respect to

# Validus Reinsurance, Ltd.

## Notes to Consolidated Financial Statements

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certain provisions under the credit facilities. As of December 31, 2008, Talbot had \$100,000 (2007: \$100,000) in outstanding letters of credit under this facility.

As of December 31, 2008 and throughout the reporting periods presented, where appropriate, Validus Re was in compliance with all covenants and restrictions under the credit facilities.

Finance expenses were \$879 for the year ended December 31, 2008 (2007: \$1,378). Finance expenses consists fees relating to our credit facility.

### **15. Related party transactions**

The transactions listed below are classified as related party transactions as each counterparty has either a direct or indirect shareholding in the parent company.

The Company entered into an agreement on December 8, 2005 with BlackRock Financial Management, Inc. ("BlackRock") under which BlackRock was appointed as an investment manager of part of its investment portfolio. The Company incurred \$1,640 during the year ended December 31, 2008 (2007: \$1,681) of which \$344 was included in accounts payable and accrued expenses at December 31, 2008 (2007: \$686). Merrill Lynch is a shareholder of Blackrock.

The Company entered into an agreement on December 8, 2005 with Goldman Sachs Asset Management and its affiliates ("GSAM") under which GSAM was appointed as an investment manager of part of the Company's investment portfolio. Goldman Sachs entities, which own 14,057,137 shares in Validus Holdings, hold warrants to purchase 1,604,410 shares, and have an employee on the Validus Holding's Board of Directors who does not receive compensation from the Validus Holdings. The Company incurred \$977 during the year ended December 31, 2008 (2007: \$808) of which \$413 was included in accounts payable and accrued expenses at December 31, 2008 (2007: \$409).

Vestar Capital entities, which own 8,571,427 shares in Validus Holdings, hold warrants to purchase 972,810 shares, are shareholders of PARIS RE Holdings Limited ("Paris Re"), and have an employee on Validus Holding's Board of Directors who does not receive compensation from Validus Holdings. Pursuant to reinsurance agreements with Paris Re, the Company recognized gross premiums written of \$6,807 during the year ended December 31, 2008 (2007:\$1,900), of which \$4,412 was included in premiums receivable at December 31, 2008 (2007: \$1,595). The earned premiums adjustment of \$4,457 was recorded for the year ended December 31, 2008 (2007: \$950).

Pursuant to a reinsurance agreement, the Company has written premiums from a subsidiary of Talbot Holdings Ltd. ("Talbot") of \$34,283 for the year ended December 31, 2008 (2007: \$1,000). A balance due from Talbot's subsidiary of \$20,216 was included in premiums receivable at December 31, 2008 (2007: \$1,293). Unearned premiums included unearned premiums related to this contract of \$9,867 at December 31, 2008 (2007: \$1,543). The contract terms were negotiated on an arms-length basis. Effective from the July 2007 date of acquisition, Talbot is 100% owned by the parent company, Validus Holdings, Ltd.

### **16. Statutory financial data**

Validus Re is registered as a class 4 company under The Insurance Act 1978 (Bermuda), Amendments Thereto and Related Regulations ("The Act"). Under the Insurance Act, Validus Re is required to prepare Statutory Financial Statements and to file a Statutory Financial Return. The Act requires Validus Re Ltd. to maintain minimum share capital of \$1,000 and to meet a minimum solvency margin (the amount by which statutory assets exceed statutory liabilities) equal to the greater of 50% of net premiums written or 15% of the net reserve for losses and loss adjustment expenses. Validus Re is also required to maintain a minimum liquidity

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ratio whereby the value of its relevant assets is not less than 75% of the amount of its relevant liabilities. Relevant assets include cash and cash equivalents, investments and insurance balances receivable. Certain categories of assets do not qualify as relevant assets under the statute. The relevant liabilities are total general business insurance reserves and total other liabilities. Effective for statutory filings for the year ended December 31, 2008, the BMA introduced a risk-based capital model, or Bermuda Solvency Capital Requirement (“BSCR”), as a tool to assist the BMA in measuring risk and determining appropriate capitalization. These requirements were met at December 31, 2008 and December 31, 2007.

Statutory financial data based on audited filings for Validus Re is set out below:

	<b>December 31, 2008</b>	<b>December 31, 2007</b>
Minimum statutory capital and surplus	\$ 312,419	\$ 316,628
Actual statutory capital and surplus	1,731,928	1,763,011
Minimum share capital	1,000	1,000
Actual share capital	1,310,593	1,295,945
Minimum relevant assets	594,046	595,016
Actual relevant assets	2,419,597	2,385,789

The Bermuda Companies Act 1981 (the “Companies Act”) limits the Company’s ability to pay dividends and distributions to shareholders. Any payment of dividends which would exceed 25% of its total Statutory Capital and Surplus as shown on the Statutory Balance Sheet in relation to the previous financial year requires the Company’s directors to affirm that the Company continues to meet the relevant margins.