

AUDITED CONSOLIDATED FINANCIAL
STATEMENTS

Endurance Specialty Insurance Ltd
December 31, 2008 and 2007
with Report of Independent Auditors

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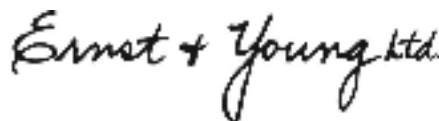
REPORT OF INDEPENDENT AUDITORS

The Board of Directors and Shareholders of Endurance Specialty Insurance Ltd.

We have audited the accompanying consolidated balance sheets of Endurance Specialty Insurance Ltd. as of December 31, 2008 and 2007, and the related consolidated statements of income and comprehensive (loss) income, changes in shareholder's equity, and cash flows for the years then ended. 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 in accordance with auditing standards generally accepted in the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. We were not engaged to perform an audit of the Company's internal control over financial reporting. Our audits included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also 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.

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of Endurance Specialty Insurance Ltd. at December 31, 2008 and 2007, and the consolidated results of its operations and its cash flows for the years then ended in conformity with U.S. generally accepted accounting principles.

The image shows a handwritten signature in black ink that reads "Ernst & Young Ltd." The signature is written in a cursive, flowing style.

Hamilton, Bermuda
February 27, 2009

ENDURANCE SPECIALTY INSURANCE LTD.
CONSOLIDATED BALANCE SHEETS

DECEMBER 31, 2008 AND 2007
(In thousands of United States dollars, except share amounts)

	2008	2007
ASSETS		
Investments		
Fixed maturity investments available for sale, at fair value (amortized cost: \$4,047,368 and \$4,556,061 at December 31, 2008 and 2007, respectively)	\$ 3,875,137	\$ 4,589,054
Short-term investments, available for sale at fair value (amortized cost \$111,322 and \$12,646 at December 31, 2008 and 2007)	111,333	12,646
Preferred equity securities, available for sale at fair value	25,360	58,536
Other investments	284,263	358,128
Total investments	4,296,093	5,018,364
Cash and cash equivalents	1,045,996	543,273
Premiums receivable, net	609,387	723,832
Deferred acquisition costs	160,870	168,968
Securities lending collateral	112,940	173,041
Prepaid reinsurance premiums	149,591	122,594
Losses recoverable	557,834	187,354
Accrued investment income	30,872	38,519
Goodwill and intangible assets	200,791	206,632
Deferred tax asset	18,838	-
Other assets	44,904	36,917
Total assets	\$ 7,228,116	\$ 7,219,494
LIABILITIES		
Reserve for losses and loss expenses	\$ 3,235,456	\$ 2,892,224
Reserve for unearned premiums	885,488	855,085
Deposit liabilities	58,622	108,943
Reinsurance balances payable	233,561	162,899
Securities lending payable	115,603	173,041
Debt	122	1,496
Due to affiliates	4,947	7,503
Deferred tax liability	-	2,547
Other liabilities	62,996	80,196
Total liabilities	4,596,795	4,283,934
Commitments and contingent liabilities		
SHAREHOLDER'S EQUITY		
Common shares		
12,000,000 issued and outstanding (2007 - 12,000,000)	12,000	12,000
Additional paid-in capital	2,076,270	2,076,270
Accumulated other comprehensive (loss) income	(129,536)	61,273
Retained earnings	672,587	786,017
Total shareholder's equity	2,631,321	2,935,560
Total liabilities and shareholder's equity	\$ 7,228,116	\$ 7,219,494

See accompanying notes to the consolidated financial statements.

ENDURANCE SPECIALTY INSURANCE LTD.
CONSOLIDATED STATEMENTS OF INCOME AND COMPREHENSIVE (LOSS) INCOME
FOR THE YEARS ENDED DECEMBER 31, 2008 AND 2007
(In thousands of United States dollars)

	<u>2008</u>	<u>2007</u>
Revenues		
Gross premiums written	\$ 2,246,420	\$ 1,781,115
Ceded premiums written	(462,130)	(206,140)
Net premiums written	<u>1,784,290</u>	<u>1,574,975</u>
Change in unearned premiums	(17,805)	19,825
Net premiums earned	1,766,485	1,594,800
Net investment income	130,049	280,662
Net realized investment losses	(57,037)	(18,129)
Other underwriting (loss) income	(3,973)	1,602
Total revenues	<u>1,835,524</u>	<u>1,858,935</u>
Expenses		
Net losses and loss expenses	1,135,431	749,081
Acquisition expenses	299,913	307,576
General and administrative expenses	203,571	200,126
Amortization of intangibles	10,675	5,286
Net foreign exchange losses	53,712	7,971
Total expenses	<u>1,703,302</u>	<u>1,270,040</u>
Income before income taxes	132,222	588,895
Income tax benefit (expense)	10,188	(19,268)
Net income	<u>142,410</u>	<u>569,627</u>
Other comprehensive (loss) income		
Net unrealized holding (losses) gains on investments arising during the period (net of applicable deferred income taxes in 2008 - (\$12,252) and 2007 - (\$10,014))	(218,816)	49,257
Reclassification adjustment for net realized losses included in net income	57,037	18,129
Foreign currency translation adjustments	(29,030)	4,479
Other comprehensive (loss) income	<u>(190,809)</u>	<u>71,865</u>
Comprehensive (loss) income	<u>\$ (48,399)</u>	<u>\$ 641,492</u>

See accompanying notes to the consolidated financial statements.

ENDURANCE SPECIALTY INSURANCE LTD.
CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDER'S EQUITY
FOR THE YEARS ENDED DECEMBER 31, 2008 AND 2007
(In thousands of United States dollars)

	<u>2008</u>	<u>2007</u>
Common shares		
Balance, beginning and end of year	\$ 12,000	\$ 12,000
Additional paid-in capital		
Balance, beginning and end of year	2,076,270	2,076,270
Accumulated other comprehensive (loss) income		
Cumulative foreign currency translation adjustments:		
Balance, beginning of year	33,331	28,852
Foreign currency translation adjustments	(29,030)	4,479
Balance, end of year	4,301	33,331
Unrealized holding (losses) gains on investments:		
Balance, beginning of year	27,942	(39,444)
Net unrealized holding (losses) gains arising during the period, net of reclassification adjustment	(161,779)	67,386
Balance, end of year	(133,837)	27,942
Total accumulated other comprehensive (loss) income	(129,536)	61,273
Retained earnings		
Balance, beginning of year	786,017	641,550
Net income	142,410	569,627
Dividends on common shares	(255,840)	(425,160)
Balance, end of year	672,587	786,017
Total shareholder's equity	<u>\$ 2,631,321</u>	<u>\$ 2,935,560</u>

See accompanying notes to the consolidated financial statements.

ENDURANCE SPECIALTY INSURANCE LTD.
CONSOLIDATED STATEMENTS OF CASH FLOWS
FOR THE YEARS ENDED DECEMBER 31, 2008 AND 2007
(In thousands of United States dollars)

	<u>2008</u>	<u>2007</u>
Cash flows provided by operating activities:		
Net income	\$ 142,410	\$ 569,627
Adjustments to reconcile net income to net cash provided by operating activities:		
Amortization of net (discount) premium on investments	(396)	3,641
Amortization of other intangibles and depreciation	16,481	12,243
Net realized investment losses	57,037	18,129
Deferred taxes	(35,212)	9,783
Equity in loss (earnings) of unconsolidated ventures	111,570	(21,286)
Premiums receivable, net	114,445	32,828
Deferred acquisition costs	8,098	(6,263)
Prepaid reinsurance premiums	(26,997)	16,197
Losses recoverable	(370,480)	(7,632)
Accrued investment income	7,647	2,188
Other assets	(9,412)	(6,663)
Reserve for losses and loss expenses	343,232	48,122
Reserve for unearned premiums	30,403	(33,386)
Deposit liabilities	(50,321)	(52,081)
Reinsurance balances payable	71,159	(62,909)
Due to affiliates	(2,556)	(1,164)
Other liabilities	96,171	(16,787)
Net cash provided by operating activities	<u>503,279</u>	<u>504,587</u>
Cash flows provided by (used in) investing activities:		
Proceeds from sales of fixed maturity investments	3,109,607	3,112,796
Proceeds from sales of short term investments	33,240	-
Proceeds from maturities and calls on fixed maturity investments	753,055	676,498
Proceeds from maturities and calls on short term investments	132,446	-
Proceeds from redemptions of other investments	15,345	5,126
Purchases of fixed maturity investments	(3,430,195)	(3,652,611)
Purchases of short term investments	(264,320)	(12,646)
Purchase of other investments	(53,050)	(88,900)
Purchases of fixed assets	(4,374)	(4,062)
Change in securities lending collateral received	60,101	53,721
Net cash paid in acquisitions	(24,545)	(109,813)
Net cash provided by (used in) investing activities	<u>327,310</u>	<u>(19,891)</u>
Cash flows used in financing activities:		
Dividends paid	(255,840)	(425,160)
Proceeds from bank debt	784	-
Repayments of bank debt	(2,159)	-
Change in securities lending collateral	(57,438)	(53,721)
Net cash used in financing activities	<u>(314,653)</u>	<u>(478,881)</u>
Effect of exchange rate changes on cash and cash equivalents	(13,213)	9,984
Net increase in cash and cash equivalents	502,723	15,799
Cash and cash equivalents, beginning of year	543,273	527,474
Cash and cash equivalents, end of year	<u>\$ 1,045,996</u>	<u>\$ 543,273</u>

See accompanying notes to the consolidated financial statements.

ENDURANCE SPECIALTY INSURANCE LTD.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

(Amounts in tables expressed in thousands of United States dollars, except Ratios and share amounts)

1. Organization

Endurance Specialty Insurance Ltd. ("Endurance Bermuda") was organized in Bermuda on November 30, 2001 and is a wholly owned subsidiary of Endurance Specialty Holdings Ltd. ("Endurance Holdings").

On December 14, 2001, Endurance Bermuda completed a private offering of 12 million common shares for gross cash proceeds of \$1.2 billion. Under the terms of an Exchange Offer dated July 22, 2002, the shareholders of Endurance Bermuda transferred their interest in Endurance Bermuda to Endurance Holdings in exchange for an identical shareholding in Endurance Holdings.

Endurance Bermuda writes specialty lines of insurance and reinsurance on a global basis through its own operations and through the operations of its six wholly owned operating subsidiaries: Endurance Worldwide Insurance Limited ("Endurance U.K."), domiciled in London, England; Endurance Reinsurance Corporation of America ("Endurance U.S. Reinsurance"), domiciled in Delaware; American Agri-Business Insurance Company, domiciled in Texas and managed by ARMtech Insurance Service, Inc. (together, "ARMtech"); Endurance American Insurance Company ("Endurance American"), domiciled in Delaware; Endurance American Specialty Insurance Company ("Endurance American Specialty"), domiciled in Delaware and American Merchants Casualty Company ("American Merchants"), domiciled in Delaware.

2. Summary of significant accounting policies

The consolidated financial statements have been prepared on the basis of accounting principles generally accepted in the United States ("U.S. GAAP") and include the accounts of Endurance Bermuda and its wholly owned subsidiaries, which are collectively referred to herein as the "Company." All intercompany transactions and balances have been eliminated in consolidation. The following are significant accounting and reporting policies adopted by the Company:

(a) Premiums and related expenses

The Company's insurance premiums are earned pro rata over the terms of the applicable risk period specified in the insurance policy. The Company's insurance policies cover losses occurring or claims made during the term of the policy. Generally, the Company receives a fixed premium which is identified in the policy and is recorded on the inception date of the contract or when premiums are determinable and earned evenly over the policy term. This premium will only adjust if the underlying insured values adjust. Accordingly, the Company monitors the underlying insured values and records additional or return premiums in the period in which amounts are reasonably determinable.

ENDURANCE SPECIALTY INSURANCE LTD.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

(Amounts in tables expressed in thousands of United States dollars, except ratios and share amounts)

2. Summary of significant accounting policies, cont'd.

(a) Premiums and related expenses, cont'd.

The Company's reinsurance premiums are earned in proportion to the amount of reinsurance protection provided over the terms of the applicable risk period established in the reinsurance contract. Reinsurance contracts written on a losses occurring basis cover losses which occur during the term of the reinsurance contract, typically 12 months. Accordingly, the Company earns the premium on a losses occurring reinsurance contract evenly over the reinsurance contract term. Reinsurance contracts written on a policies attaching basis cover losses from the underlying insurance policies incepting during the terms of the reinsurance contracts. Losses under a policies attaching reinsurance contract may occur after the end date of the reinsurance contract, so long as they are losses from policies which began during the reinsurance contract period. The Company typically earns the premiums for policies attaching reinsurance contracts over a 24 month period in proportion to the amount of reinsurance protection provided to reflect the extension of the risk period past the term of the contract and the varying levels of reinsurance protection provided during the reinsurance contract period.

In addition to the applicable risk period, the Company's estimate of its reinsurance premiums written is based on the type of reinsurance contracts underwritten. For excess of loss reinsurance contracts, the deposit premium, as defined in the contract, is generally considered to be the best estimate of the reinsurance contract's written premium at inception. The Company earns reinstatement premiums upon the occurrence of a loss under the reinsurance contract. Reinstatement premiums are calculated in accordance with the contract terms based upon the ultimate loss estimate associated with each contract. For proportional reinsurance contracts, the Company estimates premium, commissions and related expenses based on ceding company estimates and also utilizes judgment in establishing proportional reinsurance contract estimates.

Premiums on the Company's excess of loss and proportional reinsurance contracts are estimated by management at the time the business is underwritten. Accordingly, this is the amount the Company records as written premium in the period the reinsurance contract is underwritten. As actual premiums are reported by the ceding companies, management evaluates the appropriateness of the original premium estimates and any adjustments to these estimates are recorded in the period in which they become known.

Acquisition expenses 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 and general and administrative expenses are shown net of commissions, other fees and expense allowances associated with and earned on ceded business. 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. Anticipated net investment income is considered in determining the recoverability of deferred acquisition costs.

ENDURANCE SPECIALTY INSURANCE LTD.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

(Amounts in tables expressed in thousands of United States dollars, except ratios and share amounts)

2. Summary of significant accounting policies, cont'd.

(b) Reserve for losses and loss expenses

The Company's reserve for losses and loss expenses includes case reserves and reserves for losses incurred but not reported (referred to as "IBNR reserves"). Case reserves are established for losses that have been reported, but not yet paid. IBNR reserves represent the estimated ultimate cost of events or conditions that have not been reported to or specifically identified by the Company, but have occurred. Case reserves and IBNR reserves are established by management based on reports from reinsurance intermediaries, ceding companies and insureds, and consultations with independent legal counsel. In addition, reserves for IBNR losses and loss expenses are established by management based on reported losses and loss expenses, and actuarially determined estimates of ultimate losses and loss expenses.

The Company uses a variety of actuarial methods to estimate the ultimate losses and loss expenses incurred by the Company. One actuarial method used by the Company to estimate reserves for losses and loss expenses is the expected loss ratio approach, which is based on expected results independent of current loss reporting activity. This approach is typically used for immature loss periods (i.e., the current accident year). Another actuarial method used by the Company to estimate reserves for losses and loss expenses is known as the Bornhuetter-Ferguson method. The Bornhuetter-Ferguson method uses an initial loss estimate (expected loss technique) for each underwriting quarter by business line and type of contract. The portion of the initial loss estimate that is the IBNR reserve is then reduced in each subsequent quarter by the losses reported for that business segment during that quarter. Over time, the IBNR reserve will be reduced and will be replaced with the actual losses reported to the Company. Management uses these multiple actuarial methods, supplemented with professional judgment, to establish the best estimate of reserves for losses and loss expenses.

The Company's loss and loss expense reserves are reviewed regularly, and adjustments, if any, are reflected in earnings in the period in which they become known. The establishment of new loss and loss expense reserves or the adjustment of previously recorded loss and loss expense reserves could result in significant positive or negative changes to the Company's financial condition for any particular period. While management believes the Company's estimate of loss and loss expense reserves is sufficient, the ultimate loss experience may not be as reliably predicted as may be the case with other insurance and reinsurance operations, and it is possible losses and loss expenses may be materially different than the total reserve for losses and loss expenses recorded by the Company.

(c) Deposit accounting

A portion of the Company's assumed proportional reinsurance agreements contain occurrence limitations or loss sensitive provisions, such as adjustable or sliding scale commissions, that may impact the ultimate amounts paid to or received from ceding companies based on loss experience. In some loss scenarios, these features would result in the ceding company's results not being proportional to the Company's results from the proportional agreement, and such differences may be meaningful. The Company evaluates these contracts on an individual basis in accordance with the provisions of Statement of Financial Accounting Standards ("SFAS") No. 113 - "Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts" ("SFAS No. 113").

ENDURANCE SPECIALTY INSURANCE LTD.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

(Amounts in tables expressed in thousands of United States dollars, except ratios and share amounts)

2. Summary of significant accounting policies, cont'd.

(c) Deposit accounting, cont'd.

For the years ended December 31, 2008 and 2007, the Company entered into a small number of reinsurance contracts that did not fall within the criteria for reinsurance accounting under SFAS No. 113. The Company has accounted for these contracts by the deposit method of accounting specified by Statement of Position 98-7 - "Deposit Accounting: Accounting for Insurance and Reinsurance Contracts That Do Not Transfer Insurance Risk." Consequently, these contracts were accounted for as contracts which either transfer only significant timing risk or transfer only significant underwriting risk. The determination of the appropriate method of accounting for these contracts requires significant judgment and analysis, particularly with respect to assumptions about the variability and likelihood of potential future losses. Under the deposit method of accounting, revenues and expenses from reinsurance contracts are not recognized as written premium and incurred losses. Instead, income or loss associated with contracts determined to transfer only significant timing risk is recognized as a component of net other underwriting (loss) income over the estimated claim settlement period while income or loss associated with contracts determined to transfer only significant underwriting risk is recognized as net other underwriting (loss) income over the contract risk period.

(d) Reinsurance

Losses recoverable represent estimates of losses and loss expenses that will be recovered from reinsurers. Amounts recoverable from reinsurers are estimated in a manner consistent with the provisions of the reinsurance agreements and consistent with the establishment of the Company's reserve for losses and loss expenses. Ceding commissions earned on ceded business are classified as an offset to acquisition and general and administrative expenses.

(e) Investments

The Company currently classifies all of its fixed income investments, which consist of fixed maturity investments, short-term investments and preferred equity securities, as "available for sale" and, accordingly, they are carried at estimated fair value, with related net unrealized gains or losses excluded from earnings and included in shareholders' equity as a component of accumulated other comprehensive (loss) income. The Company determines the fair value of its fixed income securities in accordance with Statement of Financial Accounting Standards No. 157 ("SFAS No. 157"), which defines fair value and establishes a fair value hierarchy based on inputs to the various valuation techniques used for each fair value measurement. The use of valuation techniques for any given investment requires a significant amount of judgment and consideration of factors specific to the underlying investment. Fair value measurements determined by the Company seek to maximize observable inputs and minimize the use of unobservable inputs.

ENDURANCE SPECIALTY INSURANCE LTD.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

(Amounts in tables expressed in thousands of United States dollars, except ratios and share amounts)

2. Summary of significant accounting policies, cont'd.

(e) Investments, cont'd.

For mortgage-backed and other asset-backed debt securities, fair value includes estimates regarding prepayment assumptions, which are based on current market conditions. Amortized cost in relation to these securities is calculated using a constant effective yield based on anticipated prepayments and estimated economic lives of the securities. When actual prepayments differ significantly from anticipated prepayments, the effective yield is recalculated to reflect actual payments to date. Changes in estimated yield are recorded on a retrospective basis, which results in future cash flows being used to determine current book value.

Realized investment gains and losses are recognized in earnings using the specific identification method. Interest on fixed maturity securities is recorded in net investment income when earned and adjusted for any amortization of premium or discount.

Investments are reviewed for declines in value that are considered to be other-than-temporary. This review involves consideration of several factors including (i) the time period in which there has been a significant decline in value, (ii) the expected maturity of the investment, (iii) the significance of the decline, (iv) an analysis of the liquidity, business prospects and overall financial condition of the issuer, and (v) the Company's intent and ability to hold the investment for a period of time sufficient for the value to recover. If the decline in fair value is determined to be other-than-temporary, the cost of the security is written down to fair value and the amount is included in net realized investment losses in the Consolidated Statements of Income and Comprehensive (Loss) Income.

Other investments are accounted for using the equity method of accounting whereby the initial investment is recorded at cost. The carrying amounts of these investments are increased or decreased to reflect the Company's share of income or loss, which is included in net investment income, and are decreased for dividends. Due to the timing of the delivery of the final valuations reported by the managers of certain of our alternative funds, our investments in those alternative funds are estimated based on the most recently available information including period end valuation statements, period end estimates, or, in some cases, prior month or quarter valuation statements.

The Company participates in a securities lending program whereby fixed income securities are loaned by the Company to third parties, primarily major brokerage firms and commercial banks. The Company retains all economic interest in the securities it lends, retains the earnings and cash flows associated with the loaned securities 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% - 105% of the market value of the loaned securities and is monitored and maintained by the lending agent. The securities lending collateral, excluding letters of credit, is reported as a separate line item with a corresponding liability related to the Company's obligation to return the collateral. The Company had \$112.6 million and \$169.3 million in securities on loan at December 31, 2008 and 2007, respectively.

ENDURANCE SPECIALTY INSURANCE LTD.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

(Amounts in tables expressed in thousands of United States dollars, except ratios and share amounts)

2. Summary of significant accounting policies, cont'd.

(f) Cash equivalents

Cash equivalents include highly liquid short-term deposits and securities with maturities of ninety days or less at the time of purchase. Cash equivalents are valued at amortized cost, which approximates fair value due to the short-term, liquid nature of these securities.

(g) Intangible assets

Identifiable intangible assets and goodwill that arise from business combinations are accounted for in accordance with SFAS No. 141R, "Business Combinations", and SFAS No. 142, "Goodwill and Other Intangible Assets." Identifiable intangible assets are amortized in accordance with their useful lives. Goodwill and intangible assets with indefinite useful lives are not amortized but are tested for impairment annually or more often if impairment indicators arise.

(h) Foreign exchange

Assets and liabilities of foreign operations whose functional currency is not the United States dollar are translated at exchange rates in effect at the balance sheet date. Revenues and expenses of such foreign operations are translated at weighted average exchange rates during the year. The effect of the translation adjustments for foreign operations is included in accumulated other comprehensive income, net of applicable deferred income taxes. Other monetary assets and liabilities denominated in foreign currencies are revalued at the exchange rates in effect at the balance sheet date with the resulting foreign exchange gains and losses included in earnings. Revenues and expenses denominated in foreign currencies are translated at the prevailing exchange rate on the transaction date.

(i) Derivatives

SFAS No. 133 "Accounting for Derivative Instruments and Hedging Activities," as amended on January 1, 2001, requires the recognition of all derivative financial instruments including embedded derivative instruments, as either assets or liabilities in the Consolidated Balance Sheets and measurement of those instruments at fair value. The accounting for gains and losses associated with changes in the fair value of a derivative and the effect on the financial statements depends on its hedge designation and whether the hedge is highly effective in achieving offsetting changes in the fair value of the asset or liability hedged.

The Company's investment strategy allows for the use of derivative instruments, subject to strict limitations. The Company's investment managers currently utilize foreign currency forward contracts to minimize the effect of fluctuating foreign currencies and to gain exposure to interest rate differentials between differing market rates. These contracts do not qualify, and are not designated, as hedges and the realized and unrealized gains (losses) are recognized in net investment realized losses in the Consolidated Statements of Income and Comprehensive (Loss) Income.

ENDURANCE SPECIALTY INSURANCE LTD.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

(Amounts in tables expressed in thousands of United States dollars, except ratios and share amounts)

2. Summary of significant accounting policies, cont'd.

(j) Income taxes

The Company accounts for income taxes in accordance with the Financial Accounting Standards Board's ("FASB") Interpretation No. 48, "Accounting for Uncertainty in Income Taxes - an interpretation of FASB statement No. 109" ("FIN 48") for its subsidiaries operating in taxable jurisdictions. Deferred income taxes reflect the net tax effect of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for income tax purposes. A valuation allowance is provided when it is more likely than not that some portion of the deferred tax assets will not be realized. FIN 48 allows for the recognition of tax benefits of uncertain tax positions only where the position is more likely than not to be sustained assuming examination by tax authorities. A liability is established for any tax benefit claimed in a tax return in excess of this threshold. Income tax related interest and penalties are included as income tax expense.

(k) Stock compensation and other stock plans

The Company has a stock-based employee and non-employee Director incentive plan ("2007 Equity Incentive Plan") and other stock plans which are described more fully in Note 14. The Company accounts for issuances under its stock plans in accordance with the fair value recognition provisions of SFAS No. 123, "Accounting for Stock-Based Compensation," prospectively to all employee awards granted, modified, or settled after January 1, 2002, as subsequently amended by SFAS No. 148 "Accounting for Stock-Based Compensation—Transition and Disclosure." Awards under the 2007 Equity Incentive Plan vest over periods of up to four years. Effective January 1, 2006, the Company implemented SFAS No. 123(R) under the modified prospective method with no material impact on the Company's financial position or results of operations.

(l) Use of estimates

The preparation of financial statements in conformity with U.S. GAAP requires management to make estimates and assumptions that affect the reported and disclosed amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

(m) Variable interest entity

The Company applies the guidance in FASB Interpretation No. 46 (Revised December 2004) "Consolidation of Variable Interest Entities" ("FIN 46(R)"), which defines a variable interest entity as a corporation, partnership, trust or any other legal structure used for business purposes that either does not have equity investors with voting rights or has equity investors that do not provide sufficient financial resources for the entity to support its activities. Based on the criteria included in FIN 46(R), the Company determined that it has a relationship with a variable interest entity. FIN 46(R) requires a variable interest entity to be consolidated by a company if that company is subject to a majority of the risk of loss from the variable interest entity's activities or is entitled to receive a majority of the entity's residual returns or both.

ENDURANCE SPECIALTY INSURANCE LTD.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

(Amounts in tables expressed in thousands of United States dollars, except ratios and share amounts)

2. Summary of significant accounting policies, cont'd.

(m) Variable interest entity, cont'd.

The Company's relationship with the variable interest entity, described in more detail in Note 6, does not meet the requirements for consolidation as established under FIN 46(R) nor does the Company have any exposure to or risk of loss from its involvement with the variable interest entity.

(n) Reclassifications

Certain comparative information has been reclassified to conform to current year presentation.

(o) Recent accounting pronouncements

In December 2007, the FASB issued FAS No. 141(R), Business Combinations ("FAS 141(R)") and FAS No. 160, Noncontrolling Interests in Consolidated Financial Statements—an amendment of Accounting Research Bulletin No. 51 ("FAS 160"). FAS 141(R) requires the acquiring entity in a business combination to recognize the full fair value of assets acquired and liabilities assumed in the transaction (whether a full or partial acquisition); establishes the acquisition-date fair value as the measurement objective for all assets acquired and liabilities assumed; requires expensing of most transaction and restructuring costs; and requires the acquirer to provide additional disclosures on the nature and financial effect of the business combination. FAS 141(R) applies to all transactions or other events in which the acquirer obtains control of one or more businesses, even if control is not obtained by purchasing equity interests or net assets. FAS 160 requires reporting entities to present noncontrolling (minority) interests as equity (as opposed to as a liability or mezzanine equity) and provides guidance on the accounting for transactions between an entity and noncontrolling interests. Both FAS 141(R) and FAS 160 apply prospectively to business combinations for which the acquisition date is on or after December 15, 2008, except for the presentation and disclosure requirements of FAS 160, which will be applied retrospectively for all periods presented. The Company does not expect the adoption of these statements to have a material impact on the Company's financial condition or results of operations.

Statement of Financial Accounting Standards No. 159 "The Fair Value Option for Financial Assets and Financial Liabilities - Including an amendment of FASB Statement of No. 115" was effective January 1, 2008. The Company did not elect the fair value option for any of its financial assets or financial liabilities under this statement.

In February 2008, the FASB issued Financial Staff Position SFAS 157-2 "Effective Date of FASB Statement No. 157," which permits a one-year deferral of the application of SFAS 157 to non-financial assets and non-financial liabilities, except those that are recognized or disclosed at fair value in the financial statements on a recurring basis. The Company will adopt the provisions of SFAS 157 for non-financial assets and non-financial liabilities on January 1, 2009 and is currently evaluating the impact of these provisions on its results of operations and financial condition.

ENDURANCE SPECIALTY INSURANCE LTD.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

(Amounts in tables expressed in thousands of United States dollars, except ratios and share amounts)

2. Summary of significant accounting policies, cont'd.

(o) Recent accounting pronouncements, cont'd.

In April 2008, the FASB issued FASB Staff Position 142-3, "Determination of the Useful Lives of Intangible Assets," which amends the factors that should be considered in developing renewal or extension assumptions used to determine the useful life of an intangible asset. Staff Position 142-3 is effective for fiscal years beginning after December 15, 2008 and interim periods within those fiscal years. The Company is currently evaluating the impact of Staff Position 142-3 on its results of operations and financial condition.

In October 2008, the FASB issued FSP SFAS 157-3, "Determining the Fair Value of a Financial Asset When the Market for That Asset Is Not Active," which clarifies the application of SFAS 157 for inactive markets and provides an example to illustrate key considerations in determining the fair value of a financial asset in an inactive market. Revisions resulting from a change in valuation technique or its application shall be accounted for as a change in accounting estimate. FSP SFAS 157-3 was effective on issuance, including prior periods for which financial statements have not been issued. The Company adopted FSP SFAS 157-3 in October and applied the guidance to the financial statements as of September 30, 2008. The adoption of FSP SFAS 157-3 did not impact the Company's results of operations or financial position.

In January 2009, the FASB issued FSP EITF 99-20-1, "Amendments to the Impairment Guidance of EITF Issue No. 99-20," which modifies the basis on which securities are deemed to be other-than-temporarily impaired under EITF Issue No. 99-20. Under FSP EITF 99-20-1, management may exercise judgment in its assessment of impairments regarding the probability of future cash flows and not rely exclusively on market participant assumptions regarding future cash flows. FAS EITF 99-20-1 is effective for interim and annual periods ending after December 15, 2008, and shall be applied prospectively. The Company adopted FSP EITF 99-20-1 and applied the guidance to the financial statements as at December 31, 2008. The adoption of FSP EITF 99-20-1 did not materially impact the Company's results of operations or financial position.

ENDURANCE SPECIALTY INSURANCE LTD.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

(Amounts in tables expressed in thousands of United States dollars, except ratios and share amounts)

3. Investments

The amortized cost, fair value and related gross unrealized gains and losses on the Company's securities classified as available for sale at December 31, 2008 and 2007 are as follows:

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
DECEMBER 31, 2008				
U.S. government and agencies securities	\$ 614,000	\$ 43,772	\$ (24)	\$ 657,748
Non-U.S. government securities	274,939	14,247	(21)	289,165
Corporate securities	596,936	7,761	(20,439)	584,258
Mortgage-backed securities				
Agency mortgage-backed securities	1,145,281	35,137	(1,420)	1,178,998
Non-agency mortgage-backed securities	1,144,872	233	(228,312)	916,793
Asset-backed securities	271,340	11	(23,176)	248,175
Total fixed maturity investments	<u>\$ 4,047,368</u>	<u>\$ 101,161</u>	<u>\$ (273,392)</u>	<u>\$ 3,875,137</u>
Short term investments	111,322	11	-	111,333
Preferred equity securities	26,003	-	(643)	25,360
Total	<u><u>\$ 4,184,693</u></u>	<u><u>\$ 101,172</u></u>	<u><u>\$ (274,035)</u></u>	<u><u>\$ 4,011,830</u></u>
DECEMBER 31, 2007				
U.S. government and agencies securities	\$ 431,326	\$ 11,963	\$ (11)	\$ 443,278
Non-U.S. government securities	282,683	2,290	(647)	284,326
Corporate securities	865,379	6,926	(6,139)	866,166
Mortgage-backed securities				
Agency mortgage-backed securities	1,292,098	14,194	(3,532)	1,302,760
Non-agency mortgage-backed securities	1,226,337	12,446	(4,788)	1,233,995
Asset-backed securities	458,238	1,961	(1,670)	458,529
Total fixed maturity investments	<u>\$ 4,556,061</u>	<u>\$ 49,780</u>	<u>\$ (16,787)</u>	<u>\$ 4,589,054</u>
Short term investments	12,646	-	-	12,646
Preferred equity securities	60,406	7	(1,877)	58,536
Total	<u><u>\$ 4,629,113</u></u>	<u><u>\$ 49,787</u></u>	<u><u>\$ (18,664)</u></u>	<u><u>\$ 4,660,236</u></u>

ENDURANCE SPECIALTY INSURANCE LTD.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

(Amounts in tables expressed in thousands of United States dollars, except ratios and share amounts)

3. Investments, cont'd.

The following tables summarize, for all available for sale securities in an unrealized loss position at December 31, 2008 and 2007, the aggregate fair value and gross unrealized loss by length of time the security has continuously been in an unrealized loss position.

	<u>Less than 12 months</u>		<u>12 months or greater</u>		<u>Total</u>	
	<u>Unrealized Losses</u>	<u>Fair Value</u>	<u>Unrealized Losses</u>	<u>Fair Value</u>	<u>Unrealized Losses</u>	<u>Fair Value</u>
DECEMBER 31, 2008						
U.S. government and agencies securities	\$ (24)	\$ 2,256	\$ -	\$ -	\$ (24)	\$ 2,256
Non-U.S. government securities	(21)	7,574	-	-	(21)	7,574
Corporate securities	(16,563)	268,544	(3,876)	27,438	(20,439)	295,982
Mortgage-backed securities						
Agency mortgage-backed securities	(566)	52,878	(854)	38,353	(1,420)	91,231
Non-agency mortgage-backed securities	(177,498)	696,149	(50,814)	172,466	(228,312)	868,615
Asset-backed securities	(18,250)	222,316	(4,926)	20,848	(23,176)	243,164
Total fixed maturity investments	<u>\$ (212,922)</u>	<u>\$1,249,717</u>	<u>\$ (60,470)</u>	<u>\$ 259,105</u>	<u>\$(273,392)</u>	<u>\$1,508,822</u>
Short term investments	-	-	-	-	-	-
Preferred equity securities	(643)	2,745	-	-	(643)	2,745
Total	<u><u>\$ (213,565)</u></u>	<u><u>\$1,252,462</u></u>	<u><u>\$ (60,470)</u></u>	<u><u>\$ 259,105</u></u>	<u><u>\$(274,035)</u></u>	<u><u>\$1,511,567</u></u>

At December 31, 2008, 672 available for sale securities were in an unrealized loss position. Of those, 174 securities had been in a continuous unrealized loss position for twelve months or greater. The unrealized loss position of these securities was principally a result of credit spread widening. During the year ended December 31, 2008, the Company identified securities which were considered to be other-than-temporarily impaired and wrote down the cost of such securities to fair value at the time of impairment, resulting in realized losses of \$82.1 million during the period.

At December 31, 2008, the remaining unrealized losses on the Company's available for sale securities were primarily due to widening of credit spreads relating to market illiquidity, rather than any significant credit downgrades on these securities. Because the Company has the ability and intent to hold these securities until recovery, the Company currently believes it is probable that it will collect all amounts due according to their respective contractual terms. Therefore, the Company does not consider these securities to be other-than-temporarily impaired at December 31, 2008.

ENDURANCE SPECIALTY INSURANCE LTD.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

(Amounts in tables expressed in thousands of United States dollars, except ratios and share amounts)

3. Investments, cont'd.

	Less than 12 months		12 months or greater		Total	
	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value
DECEMBER 31, 2007						
U.S. government and agencies securities	\$ (11)	\$ 8,598	\$ -	\$ -	\$ (11)	\$ 8,598
Non-U.S. government securities	(114)	15,635	(533)	55,467	(647)	71,102
Corporate securities	(2,954)	179,723	(3,185)	216,781	(6,139)	396,504
Mortgage-backed securities						
Agency mortgage-backed securities	(92)	31,560	(3,440)	280,382	(3,532)	311,942
Non-agency Mortgage-backed securities	(2,075)	276,362	(2,713)	220,484	(4,788)	496,846
Asset-backed securities	(1,319)	102,132	(351)	59,396	(1,670)	161,528
Total fixed maturity investments	<u>\$ (6,565)</u>	<u>\$ 614,010</u>	<u>\$ (10,222)</u>	<u>\$ 832,510</u>	<u>\$ (16,787)</u>	<u>\$ 1,446,520</u>
Short term investments	-	-	-	-	-	-
Preferred equity securities	(987)	38,229	(890)	19,192	(1,877)	57,421
Total	<u>\$ (7,552)</u>	<u>\$ 652,239</u>	<u>\$ (11,112)</u>	<u>\$ 851,702</u>	<u>\$ (18,664)</u>	<u>\$ 1,503,941</u>

At December 31, 2007, 702 available for sale securities were in an unrealized loss position. Of those, 331 securities had been in a continuous unrealized loss position for twelve months or greater. The unrealized loss position of these securities was principally a result of changes in the interest rate environment. During the year ended December 31, 2007, the Company identified securities which were considered to be other-than-temporarily impaired. Consequently, the cost of such securities was written down to fair value at the time of impairment, and the Company realized losses of \$17.3 million in relation to these securities for 2007.

At December 31, 2008, the Company held insurance enhanced bonds (asset-backed and municipal securities), in the amount of approximately \$30.3 million, which represented approximately 0.8% of our available for sale fixed income portfolio. The overall credit quality of the insured bond portfolio was an average rating of "A" from Moody's and "A" from Standard & Poor's. The overall credit quality of the financial guarantors had an average rating of "Ba" by Moody's and "BBB" by Standard & Poor's. The financial guarantors of the Company's insurance enhanced bonds include Financial Guarantee Insurance Company (\$10.5 million), Ambac Financial Group, Inc. (\$10.6 million), Financial Security Assurance Inc. (\$4.9 million), MBIA Insurance Corporation (\$4.0 million), and Syncora Holdings Ltd. (\$0.3 million).

At December 31, 2008, the Company held \$25.4 million of perpetual preferred equity securities. The Company evaluated these preferred equity securities for potential impairment in a manner similar to the evaluation procedures utilized for its debt securities. In addition, the Company examined each security held for deterioration in the credit quality of the issuer to determine if the preferred equity securities held should be deemed impaired. Included in the other-than-temporary impairments of \$82.1 million above was \$24.0 million of impairments related to the Company's preferred equity securities.

ENDURANCE SPECIALTY INSURANCE LTD.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

(Amounts in tables expressed in thousands of United States dollars, except ratios and share amounts)

3. Investments, cont'd.

The following table summarizes the composition of the available for sale portfolio by investment ratings assigned by rating agencies at December 31, 2008 and 2007. In some cases, where bonds are unrated, the rating of the issuer has been applied.

<u>Ratings</u>	<u>2008</u>		<u>2007</u>	
	Fair Value	Percentage	Fair Value	Percentage
U.S. government and agencies securities	\$ 657,748	16.4%	\$ 455,924	9.8%
AAA / Aaa	2,787,924	69.5%	3,415,821	73.3%
AA / Aa	163,718	4.1%	342,323	7.3%
A / A	327,829	8.2%	370,720	8.0%
BBB	29,902	0.7%	11,718	0.2%
Below BBB	43,776	1.1%	63,496	1.4%
Not rated	933	0.0%	234	0.0%
Total	<u>\$ 4,011,830</u>	<u>100.0%</u>	<u>\$ 4,660,236</u>	<u>100.0%</u>

Contractual maturities of available for sale securities are shown below as of December 31, 2008 and 2007. Expected maturities may differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

	<u>2008</u>		<u>2007</u>	
	<u>Amortized Cost</u>	<u>Fair Value</u>	<u>Amortized Cost</u>	<u>Fair Value</u>
Due within one year	\$ 216,788	\$ 217,393	\$ 209,417	\$ 209,467
Due after one year through five years	890,635	916,957	982,002	991,128
Due after five years through ten years	365,577	375,824	335,432	339,317
Due after ten years	150,200	157,690	125,589	125,040
Mortgage-backed securities				
Agency mortgage-backed securities	1,145,281	1,178,998	1,292,098	1,302,760
Non-agency mortgage-backed securities	1,144,872	916,793	1,226,337	1,233,995
Asset-backed securities	271,340	248,175	458,238	458,529
Total	<u>\$ 4,184,693</u>	<u>\$ 4,011,830</u>	<u>\$ 4,629,113</u>	<u>\$ 4,660,236</u>

The components of net investment income for the years ended December 31, 2008 and 2007 are as follows:

	<u>2008</u>	<u>2007</u>
Available for sale investments	\$ 245,208	\$ 258,312
Other investments	(111,570)	21,286
Cash and cash equivalents	6,654	10,530
	<u>\$ 140,292</u>	<u>\$ 290,128</u>
Investment expenses	(10,243)	(9,466)
Net investment income	<u>\$ 130,049</u>	<u>\$ 280,662</u>

ENDURANCE SPECIALTY INSURANCE LTD.

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(Amounts in tables expressed in thousands of United States dollars, except ratios and share amounts)

3. Investments, cont'd.

The analysis of realized investment losses for the years ended December 31, 2008 and 2007, respectively, is as follows:

	2008	2007
Gross realized gains	\$ 48,840	\$ 11,831
Gross realized losses excluding other-than-temporary impairments	(23,742)	(12,630)
Other-than-temporary impairment losses	(82,135)	(17,330)
Net realized investment losses	\$ (57,037)	\$ (18,129)

In addition to the Company's available for sale investment portfolio, the Company invests in a portfolio of alternative investments and high yield loan funds (the "Funds"). The Funds invest largely in senior secured distressed debt, derivatives, equity long and short positions, senior secured bank debt and high yield securities and are included in the Company's balance sheet under other investments. At December 31, 2008 and 2007, the Company had invested, net of capital returned, a total of \$326.5 million and \$285.6 million, respectively, in the Funds. At December 31, 2008 and 2007, the carrying value of the Funds was \$284.3 million and \$358.1 million, respectively. Certain of the Funds are subject to redemption restriction provisions (see Note 11).

The Company also participates in a securities lending program whereby fixed income securities are loaned by the Company to third parties, primarily major brokerage firms and commercial banks. The borrowers of the Company's securities provide the Company with collateral, typically in cash, which the Company separately maintains. The Company invests such cash collateral in other securities. In the first quarter of 2008, the Company restricted future investment of cash collateral in its securities lending program to overnight repurchase agreements. Previously, the Company allowed investments in U.S. Treasuries, U.S. government agencies securities, mortgage-backed securities, asset-backed securities and corporate fixed income securities. At December 31, 2008, the cash collateral was invested in senior credit card and auto asset-backed securities, bank notes, debentures and overnight repurchase agreements. Securities with an estimated fair value of \$112.6 million and \$169.3 million were on loan under the program at December 31, 2008 and December 31, 2007, respectively. The Company was liable for cash collateral under the Company's control of \$115.6 million and \$173.0 million at December 31, 2008 and December 31, 2007, respectively. As of December 31, 2008 and December 31, 2007, the fair value of the investments purchased with the cash collateral received from the borrower was \$112.9 million and \$173.0 million. The investments purchased with the cash collateral had an average credit quality rating of "Aa1" by Moody's and "AA" by Standard & Poor's. All securities on loan are issued on a term or overnight basis and are subject to daily recall at the Company's discretion.

ENDURANCE SPECIALTY INSURANCE LTD.

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(Amounts in tables expressed in thousands of United States dollars, except ratios and share amounts)

4. Fair value measurement

On January 1, 2008, the Company adopted Statement of Financial Accounting Standards (“SFAS”) No. 157, “Fair Value Measurement” (“SFAS No. 157”). SFAS No. 157 clarifies the definition of fair value, establishes a framework for measuring fair value, and expands disclosures about fair value measurements.

Under SFAS No. 157, a company must determine the appropriate level in the fair value hierarchy for each fair value measurement. The fair value hierarchy in SFAS No. 157 prioritizes the inputs, which refer broadly to assumptions market participants would use in pricing an asset or liability, into three levels, which are described in detail below. 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. The three levels of the hierarchy are as follows:

Level 1 Unadjusted quoted prices in active markets for identical assets or liabilities.

Level 2 Quoted prices for similar assets in markets that are active, quoted prices for identical or similar assets in markets that are not active or inputs that are observable either directly or indirectly. Level 2 inputs include quoted prices for similar assets or liabilities other than quoted prices in Level 1; quoted prices in markets that are not active; or other inputs that are observable or can be derived principally from or corroborated by observable market data for substantially the full term of the assets or liabilities.

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

In accordance with SFAS No. 157, the Company maximizes the use of observable inputs in its valuation techniques and applies unobservable inputs only to the extent that observable inputs are unavailable. The major classes of assets and liabilities carried at fair value by the Company at December 31, 2008 included fixed maturity investments, short term investments, preferred equity securities and securities lending collateral.

ENDURANCE SPECIALTY INSURANCE LTD.

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(Amounts in tables expressed in thousands of United States dollars, except ratios and share amounts)

4. Fair value measurement, cont'd.

The determination of fair values in the absence of quoted market prices is based on: (i) valuation methodologies; (ii) securities we deem to be comparable; and (iii) assumptions deemed appropriate given the circumstances. The fair value estimates are made at a specific point in time, based on available market information and judgments about financial instruments, including estimates of the timing and amounts of expected future cash flows and the credit standing of the issuer or counterparty. Factors considered in estimating fair value include: coupon rate, maturity, estimated duration, call provisions, sinking fund requirements, credit rating, industry sector of the issuer, and quoted market prices of comparable securities. The use of different methodologies and assumptions may have a material effect on the estimated fair value amounts.

The Company's available for sale investments are comprised of a variety of different securities, which are leveled based on the valuation technique and inputs used in their valuation. The valuation of current issue U.S. government securities are generally based on Level 1 inputs, which use the market approach valuation technique. The valuation of the Company's other available for sale investments, including non-current U.S. government treasury securities, corporate debt and U.S. agency and non-agency mortgage, asset-backed securities, short term investments and preferred equity securities generally incorporate significant Level 2 inputs using the market and income approach techniques. The Company may assign a lower level to inputs typically considered to be Level 2 based on its assessment of liquidity and relative level of uncertainty surrounding the inputs. Prices provided by independent pricing services and independent broker quotes can vary widely, even for the same security.

There have been no material changes in the Company's valuation techniques since the adoption of SFAS No. 157 effective January 1, 2008. On October 10, 2008, the FASB issued Staff Position No. 157-3, "Determining the Fair Value of a Financial Asset When Market for That Asset is Not Active," which provided further clarification on fair value measurement for financial assets in inactive markets. The adoption of this statement did not impact the Company's results of operations or financial position.

ENDURANCE SPECIALTY INSURANCE LTD.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

(Amounts in tables expressed in thousands of United States dollars, except ratios and share amounts)

4. Fair value measurement, cont'd.

The following table sets forth the Company's available for sale investments categorized by the level within the SFAS No. 157 hierarchy in which the fair value measurements fall, on a recurring basis at December 31, 2008:

	Fair Value Measurements at December 31, 2008			
	Total at December 31, 2008	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
U.S. government and agencies securities	\$ 657,748	\$ 48,464	\$ 609,284	\$ -
Non-U.S. government securities	289,165	-	289,165	-
Corporate securities	584,258	-	582,628	1,630
Mortgage-backed securities				
Agency mortgage-backed securities	1,178,998	-	1,178,998	-
Non-agency mortgage-backed securities	916,793	-	912,825	3,968
Asset-backed securities	248,175	-	248,175	-
Total fixed maturity securities	<u>\$ 3,875,137</u>	<u>\$ 48,464</u>	<u>\$ 3,821,075</u>	<u>\$ 5,598</u>
Short term investments	111,333	-	111,333	-
Preferred equity securities	25,360	-	25,360	-
Total	<u><u>\$ 4,011,830</u></u>	<u><u>\$ 48,464</u></u>	<u><u>\$ 3,957,768</u></u>	<u><u>\$ 5,598</u></u>

Level 3 assets represented less than 1% of the Company's total assets at December 31, 2008.

ENDURANCE SPECIALTY INSURANCE LTD.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

(Amounts in tables expressed in thousands of United States dollars, except ratios and share amounts)

4. Fair value measurement, cont'd.

The following table presents the securities lending collateral reinvested by the Company in connection with its securities lending program, categorized by the level within the SFAS No. 157 hierarchy in which the fair value measurements fall, on a recurring basis at December 31, 2008:

	Fair Value Measurements at December 31, 2008			
	Total at December 31, 2008	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Securities lending collateral	\$ 112,940	-	\$ 112,940	-

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

	Total
Level 3 as of January 1, 2008	\$ 23,795
Total net realized and unrealized losses:	
Included in earnings	(1,034)
Included in other comprehensive loss	(10,552)
Purchases, issuances and settlements	(9,495)
Net transfers in of Level 3	2,884
Level 3 as of December 31, 2008	\$ 5,598

Losses on Level 3 securities in the amount of (\$0.8) million, representing realized losses due to other-than-temporary impairments, were included in earnings (net realized investment losses) for the year ended December 31, 2008 and were attributable to the change in unrealized gains or losses related to fixed maturity investments still held at December 31, 2008.

ENDURANCE SPECIALTY INSURANCE LTD.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

(Amounts in tables expressed in thousands of United States dollars, except ratios and share amounts)

5. Reserve for losses and loss expenses

Activity in the reserve for losses and loss expenses for the years ended December 31, 2008 and 2007 is summarized as follows:

	<u>2008</u>	<u>2007</u>
Net reserve for losses and loss expenses, January 1	\$ 2,704,870	\$ 2,657,442
Incurred related to:		
Current year	1,291,971	908,468
Prior years	(156,540)	(159,387)
Total incurred	<u>1,135,431</u>	<u>749,081</u>
Paid related to:		
Current year	(565,115)	(83,331)
Prior years	(562,792)	(677,987)
Total paid	<u>(1,127,907)</u>	<u>(761,318)</u>
Acquired reserves (Note 10)	-	23,879
Foreign currency translation	(34,772)	35,786
Net reserve for losses and loss expenses, December 31	2,677,622	2,704,870
Losses and loss expenses recoverable	557,834	187,354
Reserve for losses and loss expenses, December 31	<u>\$ 3,235,456</u>	<u>\$ 2,892,224</u>

During 2008, the Company's estimated ultimate losses for prior accident years were reduced by \$156.5 million (2007 - \$159.4 million) due to lower claims emergence than originally estimated by the Company. During 2008, the Company experienced favorable development in the Reinsurance segment of \$85.5 million in the short tail, long tail and other lines of business. In the Insurance segment, the Company experienced \$71.0 million of favorable development primarily in relation to the long tail healthcare line of business during 2008. During 2007, the Company experienced favorable development in the Insurance segment of \$80.4 million in both the Company's short and long tail lines of business and \$79.0 million of favorable development in the Company's Reinsurance segment primarily in relation to the short tail lines of business.

Reserves for losses and loss expenses are based in part upon the estimation of losses resulting from catastrophic events. Estimation of these losses and loss expenses are based upon the Company's historical claims experience and is inherently difficult because of the Company's short operating history and the possible severity of catastrophe claims. Therefore, the Company uses both proprietary and commercially available models, as well as historical reinsurance industry catastrophe claims experience in addition to its own historical data for purposes of evaluating trends and providing an estimate of ultimate claims costs.

ENDURANCE SPECIALTY INSURANCE LTD.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

(Amounts in tables expressed in thousands of United States dollars, except ratios and share amounts)

5. Reserve for losses and loss expenses, cont'd.

A significant portion of the Company's contracts and policies cover excess layers for high severity exposures. Underwriting results and ultimate claims payments for this type of coverage are therefore not typically reported to the Company until later in the contract and policy lives. As a result, the level of losses paid to date is not necessarily indicative of expected future results.

6. Reinsurance

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

	Year Ended December 31, 2008		Year Ended December 31, 2007	
	Earned	Written	Earned	Written
Direct	\$ 1,331,635	\$ 1,426,366	\$ 696,038	\$ 741,556
Assumed	866,235	820,054	1,121,274	1,039,559
Ceded	(431,385)	(462,130)	(222,512)	(206,140)
	<u>\$ 1,766,485</u>	<u>\$ 1,784,290</u>	<u>\$ 1,594,800</u>	<u>\$ 1,574,975</u>

The Company purchases reinsurance to reduce its exposure to risk of loss in certain insurance and reinsurance lines of business. Loss recoverables are recorded as assets if the reinsurer is deemed able to meet its obligations. Ceded reinsurance contracts do not relieve the Company from its obligations to policyholders. The Company remains primarily liable to its policyholders for the portion reinsured to the extent that any reinsurer does not meet the obligations assumed under the reinsurance agreements.

During the year ended December 31, 2008, the Company recorded ceded losses of \$574.4 million (2007 - \$58.6 million). At December 31, 2008, the Company has an allowance for estimated uncollectible premiums receivable of \$2.4 million (2007 - Nil) and no allowance for estimated uncollectible losses recoverable (2007 - Nil).

In August 2006, in order to protect the Company against the risk of a severe catastrophe event or the occurrence of multiple significant catastrophe events, Endurance Bermuda acquired \$235 million of multi-year, collateralized catastrophe reinsurance from Shackleton Re Limited ("Shackleton"), a Cayman Island reinsurance company. On August 1, 2006, Shackleton financed the reinsurance coverage provided to Endurance Bermuda through the issuance of a \$125 million risk-linked catastrophe bond pursuant to Rule 144A under the Securities Act of 1933 and the entrance into a \$110 million multi-year risk-linked credit facility.

ENDURANCE SPECIALTY INSURANCE LTD.

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(Amounts in tables expressed in thousands of United States dollars, except ratios and share amounts)

6. Reinsurance, cont'd.

The reinsurance consisted of three separate coverages. The first coverage was \$125 million of reinsurance for earthquake risk in California from August 1, 2006 through January 31, 2008. The second coverage consisted of \$60 million of protection for hurricanes in the U.S. Northeast, Gulf Coast and certain inland states. The final coverage provided \$50 million of reinsurance for losses resulting from hurricanes or California earthquakes following occurrence of a major hurricane or California earthquake. The second and third coverages provided protection from August 1, 2006 through July 31, 2008.

The reinsurance coverage provided by Shackleton to Endurance Bermuda was based on a modeled loss trigger designed to closely mimic the exposures in the Company's portfolio of insurance and reinsurance business. Upon the occurrence of a hurricane or earthquake in the covered territories, the parameters of the catastrophe event are determined and modeled against the notional portfolios.

If the modeled loss exceeded the designated attachment point for the peril at issue, then Endurance Bermuda could have made a recovery under the applicable reinsurance agreement. The amount recoverable was related to and limited by the Company's ultimate net loss from the loss event. Endurance Bermuda was not entitled to any recovery from Shackleton.

Shackleton was a variable interest entity under the provisions of FASB Interpretation No. 46(R), "Consolidation of Variable Interest Entities." The Company was not the primary beneficiary of Shackleton and was therefore not required to consolidate Shackleton in its consolidated financial statements. The Company had no exposure to loss as a result of its involvement with Shackleton.

7. Deposit accounting

For the years ended December 31, 2008 and 2007, the Company entered into contracts accounted for as deposits with gross premiums of \$5.1 million and \$28.6 million, respectively, and recorded other underwriting (loss) income of (\$4.0) million and \$1.6 million, respectively, related to such contracts. Gross premiums associated with treaties deemed to transfer only significant underwriting risk were \$2.9 million and \$17.5 million during 2008 and 2007, respectively. Gross premiums associated with treaties deemed to transfer only significant timing risk were \$2.2 million and \$11.1 million during 2008 and 2007, respectively.

8. Debt and financing arrangements

The Company and Endurance Holdings are parties to a letter of credit and revolving credit facility agreement with a consortium of lenders. On May 8, 2007, the Company and Endurance Holdings amended its existing credit facility among Endurance Holdings, various designated subsidiary borrowers, fifteen lending institutions and JPMorgan Chase Bank, N.A. as Administrative Agent to, among other things, increase the size of the facility to \$1,175 million from \$925 million and to extend the maturity of the facility to May 8, 2012 (the "Credit Agreement").

ENDURANCE SPECIALTY INSURANCE LTD.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

(Amounts in tables expressed in thousands of United States dollars, except ratios and share amounts)

8. Debt and financing arrangements, cont'd.

On July 18, 2007, the Company and Endurance Holdings entered into the First Amendment to the Credit Agreement, to, among other things, modify the restrictive covenants in the Credit Agreement to permit Endurance Holdings to pay dividends on its preference shares following the occurrence of certain defaults as defined pursuant to the terms of the Credit Agreement. As amended, the credit facility is referred to as the "2007 Credit Facility".

The full amount of the 2007 Credit Facility is available for revolving credit borrowings and for the issuance of letters of credit. The proceeds of the facility may be used for general corporate and working capital purposes, to finance potential acquisitions and for the repurchase of Endurance Holdings' outstanding publicly or privately issued securities. So long as the Company and Endurance Holdings are not in default under the terms of the facility, the Company and Endurance Holdings may request that the size of the facility be increased by \$500 million, provided that no participating lender is obligated to increase its commitments under the facility.

Up to \$675 million of borrowings or letter of credit issuances under the 2007 Credit Facility may be collateralized by a portion of the investment portfolio of such subsidiary borrowing under the facility. The facility allows for the issuance of up to \$200 million in multicurrency letters of credit and up to \$300 million of fronted letters of credit that may also be multicurrency letters of credit. Endurance Holdings guarantees the obligations of its subsidiaries that are parties to the 2007 Credit Facility.

The interest rate for revolving loans under the 2007 Credit Facility is either (i) the higher of (a) the Federal Funds Effective Rate plus 0.5% and (b) the prime commercial lending rate of JPMorgan Chase Bank or (ii) LIBOR plus a fee ranging from 0.165% to 0.375% depending on the Company's leverage ratio and if the loan is collateralized or uncollateralized. For letters of credit issued on a collateralized basis, the Company and Endurance Holdings are required to pay a fee ranging from 0.165% to 0.29% on the daily stated amount of such letters of credit. For letters of credit issued on an uncollateralized basis, the Company and Endurance Holdings are required to pay a fee ranging from 0.275% to 0.375% on the daily stated amount of such letters of credit. In addition, the 2007 Credit Facility requires the Company and Endurance Holdings to pay to the lenders a facility fee and a utilization fee.

The 2007 Credit Facility requires the Company's and Endurance Holdings' compliance with certain customary restrictive covenants. These include certain financial covenants, such as maintaining a leverage ratio (no greater than 0.35:1.00 at any time) and a consolidated tangible net worth (no less than \$1.4 billion at any time). In addition, each of the Company's and Endurance Holdings' regulated insurance subsidiaries that have a claims paying rating from A.M. Best must maintain a rating of at least B++ at all times. The terms of the facility generally restrict the declaration or payment of dividends if the Company or Endurance Holdings is already in default or the payment or declaration would cause a default under the terms of the credit facility.

The 2007 Credit Facility also contains customary event of default provisions, including failure to pay principal or interest under the facility, insolvency of the Company or Endurance Holdings, a change in control of the Company or Endurance Holdings, a breach of the Company's or Endurance Holdings' representations or covenants in the facility or a default by the Company or Endurance Holdings under its other indebtedness.

ENDURANCE SPECIALTY INSURANCE LTD.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

(Amounts in tables expressed in thousands of United States dollars, except ratios and share amounts)

8. Debt and financing arrangements, cont'd.

Upon the occurrence of an event of default under the 2007 Credit Facility, the lenders can terminate their commitments under the revolving credit facility, require repayment of any outstanding revolving loans, give notice of termination of any outstanding letters of credit in accordance with their terms, require the delivery of cash collateral for outstanding letters of credit and foreclose on any security held by the lenders under the 2007 Credit Facility.

9. Derivatives

The Company currently uses foreign currency forward contracts in its investment portfolios to minimize the effect of fluctuating foreign currencies and to gain exposure to interest rate differentials between differing market rates. For the years ended December 31, 2008 and 2007, the Company recognized a realized foreign exchange gain (loss) on forward contracts of approximately \$544,000 and (\$527,100), respectively.

10. Goodwill and intangibles assets

The following table shows an analysis of goodwill and intangible assets for the years ended December 31, 2008 and 2007:

	Goodwill	Intangible assets with indefinite lives	Intangible assets with finite lives	Total
Net balance at December 31, 2007	\$ 80,666	\$ 17,229	\$ 108,737	\$ 206,632
Additions	4,512	-	322	4,834
Amortization	-	-	(10,675)	(10,675)
Net balance at December 31, 2008	<u>\$ 85,178</u>	<u>\$ 17,229</u>	<u>\$ 98,384</u>	<u>\$ 200,791</u>
Gross balance	\$ 85,178	\$ 17,229	\$ 130,059	\$ 232,466
Accumulated Amortization	-	-	(31,675)	(31,675)
Net balance	<u>\$ 85,178</u>	<u>\$ 17,229</u>	<u>\$ 98,384</u>	<u>\$ 200,791</u>

On December 7, 2007, Endurance U.S. Holdings, Inc., a direct wholly-owned subsidiary of Endurance Bermuda acquired all outstanding stock of ARMtech. ARMtech underwrites crop insurance primarily through the U.S. federally sponsored Multiple Peril Crop Insurance Program. The base purchase price was \$120 million, which the Company paid in 2007. An additional \$3.2 million was recorded in 2008 as determined in accordance with the terms of the purchase agreement. In connection with the acquisition of ARMtech, the Company recorded a total of \$45.2 million of goodwill and \$96.7 million of intangible assets. The intangible assets acquired consisted principally of internally developed software, non-compete agreements, state licenses and customer relationships with expected lives between five and fifteen years.

ENDURANCE SPECIALTY INSURANCE LTD.

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(Amounts in tables expressed in thousands of United States dollars, except ratios and share amounts)

10. Goodwill and intangibles assets, cont'd.

On June 8, 2007, the Company completed the purchase of American Merchants Casualty Company, an admitted insurer in the United States and the District of Columbia. The fair value of the U.S. state licenses was \$2.2 million at acquisition and was recorded as an intangible asset with an indefinite life.

No impairment of the Company's goodwill or intangible assets was noted following the annual impairment review for the years ended December 31, 2008 and 2007. The Company expects the amortization of the intangible assets with finite lives to approximate \$10.4 million for years 2009 to 2011, \$9.6 million for 2012, \$6.3 million for 2013 and \$51.5 million for all years thereafter.

11. Commitments and contingencies

Concentrations of credit risk. The areas where significant concentrations of credit risk may exist include loss recoverables, investments and cash and cash equivalents. The Company's reinsurance recoverables at December 31, 2008 and 2007 amounted to \$557.8 million and \$187.4 million, respectively, and resulted from reinsurance arrangements entered into in the normal course of operations. A credit exposure exists with respect to reinsurance recoverables as they may become uncollectible. The Company manages its credit risk in its reinsurance relationships by transacting with reinsurers that it considers financially sound and, if necessary, the Company may hold collateral in the form of funds, trust accounts and/or irrevocable letters of credit. This collateral can be drawn on for amounts that remain unpaid beyond specified time periods on an individual reinsurer basis. As of December 31, 2008, \$187.9 million of losses recoverable (2007 - \$117.1 million) was due from reinsurers rated A- or better by A.M. Best or Standard & Poor's. An additional \$369.5 million (2007 - \$67.6 million) of losses recoverable was due from a U.S. government sponsored reinsurance program as of December 31, 2008.

As of December 31, 2008, substantially all the Company's cash and investments were held by four custodians. The Company's investment guidelines limit the amount of credit exposure to any one issuer other than the U.S. Treasury and certain other foreign government obligations rated AAA.

Major production sources. The following table shows the percentage of gross premiums written before deposit accounting adjustments generated through the Company's largest brokers for the years ended December 31, 2008 and 2007:

<u>Broker</u>	<u>2008</u>	<u>2007</u>
Aon Benfield ⁽¹⁾	14.3%	21.3%
Marsh & McLennan Companies, Inc.	14.2%	25.6%
Willis Companies	10.9%	14.0%
Total of largest brokers	<u>39.4%</u>	<u>60.9%</u>

⁽¹⁾ On November 11, 2008, Aon Corporation completed its acquisition of Benfield Group Limited. The table above shows the gross premiums brokered by these entities on a consolidated basis for all years presented.

ENDURANCE SPECIALTY INSURANCE LTD.

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(Amounts in tables expressed in thousands of United States dollars, except ratios and share amounts)

11. Commitments and contingencies, cont'd.

Letters of credit. As of December 31, 2008, the Company had issued letters of credit of \$635.5 million (December 31, 2007 - \$574.4 million) under its credit facility in favor of certain ceding companies.

Investment commitments. As of December 31, 2008 and 2007, the Company had pledged cash and cash equivalents and fixed maturity investments of \$147.9 million and \$223.2 million, respectively, in favor of certain ceding companies to collateralize obligations. As of December 31, 2008 and 2007, the Company had also pledged \$591.9 million and \$594.7 million of its cash and fixed maturity investments as required to meet collateral obligations for \$550.8 million and \$532.3 million in letters of credit outstanding under its credit facility, respectively. In addition, at December 31, 2008 and 2007, cash and fixed maturity investments with fair values of \$234.8 million and \$120.3 million were on deposit with U.S. state regulators, respectively, and cash and fixed maturity investments with fair values of \$14.2 million and \$33.8 million were on deposit with Canadian regulators, respectively.

The Company is subject to certain commitments with respect to other investments at December 31, 2008 and 2007. The Company is generally subject to redemption restriction provisions of between one to five years from the date of acquisition and rolling redemption restrictions on a one or two year basis thereafter. The Company requested redemptions of \$15.2 million at December 31, 2008 to be received during 2009 subject to the funds discretion on the next available redemption date. No redemptions were requested at December 31, 2007. Due to redemption restrictions, the Company was prohibited from requesting redemptions during 2008 of \$69.7 million (2007 - \$157.9 million) of its other investments held at December 31, 2008. In addition, as of December 31, 2008, the Company was committed to investing a further \$1.7 million (2007 - \$29.4 million) in various investment funds classified as other investments.

Reinsurance commitments. In the ordinary course of business, the Company enters into reinsurance agreements which may include terms which could require the Company to collateralize certain of its obligations as a result of certain triggering events, as defined in such agreements.

Employment agreements. The Company has entered into employment agreements with certain officers that provide for equity incentive awards, executive benefits and severance payments under certain circumstances.

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11. Commitments and contingencies, cont'd.

Operating Leases. The Company leases office space and office equipment under operating leases. Future minimum lease commitments at December 31, 2008 are as follows:

Year Ending December 31,	Amount
2009	\$ 10,343
2010	10,340
2011	10,459
2012	10,384
2013	8,714
2014 and thereafter	21,668
	\$ 71,908

Total rent expense under operating leases for the year ended December 31, 2008 was \$10.1 million (2007 - \$10.2 million).

Legal Proceedings. The Company is party to various legal proceedings generally arising in the normal course of its business. While any proceeding contains an element of uncertainty, the Company does not believe that the eventual outcome of any litigation or arbitration proceeding to which it is presently a party could have a material adverse effect on its financial condition or business. Pursuant to the Company's insurance and reinsurance agreements, disputes are generally required to be finally settled by arbitration.

12. Shareholders equity

The Company's share capital at December 31, 2008 and 2007 is comprised as follows:

	2008	2007
Common shares		
Authorized - \$1.00 par value each	20,000,000	20,000,000
Issued, outstanding and fully paid:		
Ordinary common shares - \$1.00 par value each	\$ 12,000	\$ 12,000

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(Amounts in tables expressed in thousands of United States dollars, except ratios and share amounts)

13. Related party transactions

Affiliates of Endurance Bermuda include Endurance Holdings, its parent company, and Endurance Services Limited (“Endurance Services”), a company which provides general corporate services to the subsidiaries of Endurance Holdings.

At December 31, 2008, the Company had a net balance of \$0.8 million (2007 - \$1.1 million due to) owing from Endurance Holdings.

At December 31, 2008, the Company had a net balance of \$5.8 million (2007 - \$6.4 million due to) due to Endurance Services.

14. Stock-based employee compensation plans

The Company has a stock-based employee compensation plan and certain other stock plans. Endurance Holdings charges the Company for the stock based compensation awards granted to employees of the Company that are based on the fair value of the awards and the underlying vesting periods.

At its meeting on February 28, 2007, Endurance Holdings’ Board of Directors adopted the 2007 Equity Incentive Plan (“2007 Plan”) to allow for the issuance of equity incentives to non-employee directors of the Company and Endurance Holdings and eligible employees of Endurance Holdings and the Company and its subsidiaries. The 2007 Plan was approved by Endurance Holdings’ shareholders at the Annual General Meeting of Shareholders held on May 9, 2007. As such, Endurance Holdings’ existing Amended and Restated 2002 Stock Option Plan and the Amended and Restated 2003 Non-Employee Director Incentive Plan were merged into the new 2007 Plan.

The 2007 Plan allows Endurance Holdings to grant to employees and non-employee directors restricted shares, restricted share units, stock appreciation rights, share bonuses, options to purchase Endurance Holdings’ ordinary shares and other forms of equity incentive awards, as determined by the Compensation Committee of Endurance Holdings’ Board of Directors.

In September and November 2007, Endurance Holdings offered to exchange the outstanding restricted share units held by current employees of Endurance Holdings for new restricted shares. The new restricted shares have substantially the same terms and fair value as the restricted share units, except that dividends on the restricted shares are paid in cash rather than in the form of additional restricted share units and holders of restricted shares are entitled to vote such shares at Endurance Holdings annual or special general meeting of shareholders.

At Endurance Holdings’ exclusive option restricted share units may be settled in cash, ordinary shares or in a combination thereof. With respect to certain subsidiaries, Endurance Holdings generally withholds an amount sufficient to satisfy any federal, state or local withholding tax requirements associated with awards under the 2007 Plan.

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14. Stock-based employee compensation plans, cont'd.

Under the terms of the 2007 Plan, and after the consolidation of Endurance Holdings' previous plans, a total of 2,100,000 ordinary shares have been reserved for issuance. Endurance Holdings issues new ordinary shares upon the exercise of outstanding options or settlement of a vested restricted share unit. As of December 31, 2008, 1,136,109 ordinary shares remained available for issuance under the 2007 Plan. For the years ended December 31, 2008 and 2007, the Company recognized \$9.6 million and \$5.9 million, respectively, of stock based compensation expenses for charges from Endurance Holdings from grants of awards under the 2007 Equity Plan.

Employee Share Purchase Plans

The Company has the following employee share purchase plans: the Employee Share Purchase Plan ("ESPP") and the 2005 Sharesave Scheme. On October 26, 2005, Endurance Holdings' shareholders approved the ESPP and the 2005 Sharesave Scheme. Neither the ESPP nor the 2005 Sharesave Scheme is subject to any provisions of the Employee Retirement Income Security Act of 1974 as amended, and neither plan is a qualified plan within the meaning of Section 402(a) of the Internal Revenue Code of 1986, as amended (the "Code"). The ESPP is a qualified plan under Section 423 of the Code. Total expenses related to these plans for the year ended December 31, 2008 were approximately \$164,000 (2007 - \$128,500).

Following approval by the shareholders, 200,000 of Endurance Holdings' ordinary shares, par value \$1.00 per share, were reserved for issuance under the ESPP. Under the terms of the ESPP, employees of Endurance Holdings and certain of its subsidiaries may purchase Endurance Holdings' ordinary shares at a 15% discount to the closing market price on the purchase date. Participants are eligible to receive dividends on the shares purchased in the ESPP and are also entitled to vote such shares at any annual or special meeting of shareholders. These shares are restricted from sale, transfer or certification for one year from the purchase date.

Under the terms of the 2005 Sharesave Scheme, all U.K. eligible employees may save between £5 and £250 per month for three, five or seven years, as determined by the Company. At the end of the savings period, participating employees' savings may be used to purchase Endurance Holdings' ordinary shares at an exercise price, which was established at a 15% discount to the closing market price on the date the options were granted. Participating employees may terminate their participation in the 2005 Sharesave Scheme and receive a refund of their contributed funds. The 2005 Sharesave Scheme was approved by Her Majesty's Revenue on February 20, 2006.

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15. Pension plan

The Company provides pension benefits to eligible employees through various defined contribution plans sponsored by the Company. Under the Company's defined contribution plans, the Company makes contributions to its employees' accounts in amounts ranging from 4% to 10% of its employees' eligible earnings. In addition, under certain defined contribution plans, employee contributions may be supplemented by matching contributions made by the Company based on the level of employee contribution. Lastly, the Company may provide additional contributions, depending on its annual financial performance. The employee and Company contributions in the defined contribution plans are invested at the election of each employee in one or more of several investment portfolios offered by third party investment advisors. Contributions for the year ended December 31, 2008 resulted in an expense of \$5.3 million being recorded in earnings (2007 - \$5.0 million).

16. Statutory requirements and dividend restrictions

Endurance Bermuda's ability to pay dividends and make capital distributions is subject to certain regulatory restrictions based on the enhanced capital requirement calculated using the Bermuda standard model in addition to limits on the amount of Endurance Bermuda's premiums written and net reserves for losses and loss expenses, subject to an overall minimum capital and surplus requirement of \$100 million. At December 31, 2008, Endurance Bermuda can pay approximately \$339 million (2007 - \$1,042 million) to Endurance Holdings without prior approval under Bermuda law. In addition, Endurance Bermuda is required to maintain a minimum statutory liquidity ratio and solvency margin.

The combined statutory capital and surplus and combined statutory net income for the Company's principal operating subsidiaries in their respective jurisdictions were as follows:

	<u>Bermuda</u>	<u>United States</u>	<u>Other⁽¹⁾</u>
<u>Statutory capital and surplus</u>			
At December 31, 2008	\$ 2,114,519	\$ 608,957	NA ⁽²⁾
At December 31, 2007	2,817,154	605,601	\$ 239,722
<u>Statutory net income</u>			
For the year ended December 31, 2008	\$ 202,816	\$ 5,647	NA ⁽²⁾
For the year ended December 31, 2007	537,733	21,126	\$ 17,297

(1) Includes Endurance U.K. and the Company's Singapore and Zurich branches.

(2) Endurance U.K. and the Company's Singapore branch are currently completing 2008 statutory profit and loss statements. The Company's Zurich branch had no statutory filing requirement at or for the year ended December 31, 2008.

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16. Statutory requirements and dividend restrictions, cont'd.

Endurance U.S. Reinsurance, Endurance American, Endurance American Specialty and American Merchants are subject to regulation by the Delaware Department of Insurance. ARMtech is subject to regulation by the Texas Department of Insurance. Dividends for each U.S. operating subsidiary are limited to the greater of 10% of policyholders' surplus or statutory net income, excluding realized capital gains. In addition, dividends may only be declared or distributed out of earned surplus. At December 31, 2008, Endurance U.S. Reinsurance, Endurance American and Endurance American Specialty did not have earned surplus and thus were precluded from declaring or distributing dividends during 2009 without the prior approval of the applicable insurance regulator. If the parent company is also an insurer, as is the case with Endurance American, Endurance American Specialty and American Merchants, the parent company or companies must also meet their own dividend eligibility requirements in order to pass along any dividends received from subsidiary insurance companies. At December 31, 2008, American Merchants and ARMtech (with notice to the Texas Department of Insurance) could pay dividends of \$5.7 million and \$3.5 million (2007 - \$5.4 million and \$6.3 million), respectively, without prior regulatory approval.

Under the jurisdiction of the United Kingdom's Financial Services Authority ("FSA"), Endurance U.K. must maintain a margin of solvency at all times, which is determined based on the type and amount of insurance business written. The FSA regulatory requirements impose no explicit restrictions on Endurance U.K.'s ability to pay a dividend, but Endurance U.K. would have to notify the FSA 28 days prior to any proposed dividend payment. Dividends may only be distributed from profits available for distribution. At December 31, 2008, Endurance U.K. did not have profits available for distribution.

17. Taxes

The Company is not required to pay any income or capital gains taxes in Bermuda. The Company has received an assurance from the Minister of Finance of Bermuda under the Exempted Undertakings Tax Protection Act of 1966 of Bermuda, as amended, that in the event any legislation is enacted in Bermuda imposing any tax computed on profits or income, or computed on any capital asset, gain or appreciation or any tax in the nature of estate duty or inheritance tax, such tax shall not be applicable to the Company until March 28, 2016 provided that the assurance is subject to the condition that it will not prevent the application of any taxes payable by the Company in respect of real property or leasehold interests in Bermuda held by it. Endurance Bermuda intends to operate in a manner such that it will owe no United States tax other than premium excise tax and withholding taxes on certain investments.

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17. Taxes, cont'd.

The Company's subsidiaries based in Canada, the United Kingdom and United States are subject to income taxes in their respective jurisdictions.

The income tax benefit (expense) was as follows for the years ended December 31, 2008 and 2007, respectively:

	2008	2007
Current income tax expense	\$ (11,690)	\$ (9,460)
Deferred income tax benefit (expense)	21,878	(9,808)
Income tax benefit (expense)	\$ 10,188	\$ (19,268)

Of the 2008 current income tax expense, \$22.0 million related to taxes incurred in the United States (2007 - \$8.1 million) and \$11.0 million related to current income tax benefits in the United Kingdom (2007 - \$Nil). Of the deferred income tax benefit (expense), \$21.8 million and \$Nil related to deferred income tax benefits (expenses) in the United States and the United Kingdom, respectively (2007 - \$2.0 million and (\$11.8) million).

The actual income tax benefit (expense) attributable to income for the years ended December 31, 2008 and 2007 differed from the amount computed by applying the combined effective rate of 0% under Bermuda law to income before income tax benefit, as a result of the following:

	2008	2007
Computed expected tax expense	\$ -	\$ -
Tax benefit (expense) effect of foreign taxes	15,598	(12,078)
Valuation allowance	(5,410)	(7,190)
	\$ 10,188	\$ (19,268)

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17. Taxes, cont'd.

Deferred income taxes represent the tax effect of the differences between the book and tax bases of assets and liabilities. Net deferred income tax assets and liabilities consisted of the following as of December 31, 2008 and 2007:

	2008	2007
Deferred income tax assets:		
Unearned premiums	\$ 13,310	\$ 13,904
Loss reserves	26,739	20,647
Net operating loss carry forward	22,960	14,398
Unrealized investment losses	6,659	-
Deferred compensation	2,710	2,752
Start-up costs	1,406	1,835
Deferred interest	17,811	10,269
Realized investment losses	7,736	3,443
Other	5,757	6,943
Total deferred tax assets	105,088	74,191
Deferred income tax liabilities:		
Deferred acquisition costs	(14,361)	(17,498)
Unrealized investment gains	(6,314)	(4,725)
Unrealized foreign exchange gain	(13,659)	(2,588)
Temporary differences related to acquisition	(31,339)	(34,087)
Other	(4,902)	(7,575)
Total deferred tax liabilities	(70,575)	(66,473)
Valuation allowance	(15,675)	(10,265)
Net deferred income tax asset (liability)	\$ 18,838	\$ (2,547)

The Company paid income taxes totaling \$28.1 million and \$23.8 million for the years ended December 31, 2008 and 2007, respectively. Net operating loss carryforwards in the amount of \$82.0 million are available for application against future taxable income in the United Kingdom. These net operating loss carry forwards have no expiration date. There were no income taxes payable at December 31, 2008 or 2007.

A valuation allowance is provided when it is more likely than not that some portion of the deferred tax assets will not be realized. At December 31, 2008, management has established a valuation allowance of \$15.7 million (2007 - \$10.3 million) against realized investment losses and other items for which the Company does not have current plans to produce future realized investment gains and other income.