

**Montpelier Reinsurance Ltd. and  
its subsidiary**

Consolidated Financial Statements  
**December 31, 2008**  
(in millions of U.S. dollars)

## Report of Independent Auditors

To: The Board of Directors and Shareholder of Montpelier Reinsurance Ltd.

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



Hamilton, Bermuda  
June 29, 2009

**MONTPELIER REINSURANCE LTD.  
CONSOLIDATED BALANCE SHEET**

(In millions of U.S. dollars, except share amounts)	December 31, 2008
<b>Assets</b>	
Investment securities, at fair value:	
Fixed maturity investments - trading (amortized cost: \$1,702.8)	\$ 1,654.4
Equity securities - trading (cost: \$310.0)	242.3
Charges (credits) to reconcile net loss to net cash from operations:	135.0
Total investments	2,031.7
Cash and cash equivalents	179.5
Restricted cash	6.8
Reinsurance recoverable on unpaid losses	114.1
Reinsurance recoverable on paid losses	36.4
Premiums receivable	134.2
Unearned premium ceded	21.2
Deferred acquisition costs	19.7
Accrued investment income	13.6
Unsettled sales of investments	1.4
Amounts due from affiliates, net	35.2
Other assets	20.0
<b>Total Assets</b>	<b>\$ 2,613.8</b>
<b>Liabilities</b>	
Loss and loss adjustment expense reserves	\$ 784.8
Unearned premium	143.4
Insurance and reinsurance balances payable	41.0
Unsettled purchases of investments	2.0
Amounts due to affiliates, net	8.4
Accounts payable, accrued expenses and other liabilities	18.0
Total Liabilities	997.6
Commitments and contingent liabilities (see Note 14)	—
<b>Common Shareholder's Equity</b>	
Common shares at \$1.00 par value per share - authorized and issued 1,000,000 shares	1.0
Additional paid-in capital	1,877.6
Retained deficit	(265.6)
Accumulated other comprehensive income	3.2
Total Common Shareholder's Equity	1,616.2
<b>Total Liabilities and Common Shareholder's Equity</b>	<b>\$ 2,613.8</b>

See Notes to Consolidated Financial Statements

**MONTPELIER REINSURANCE LTD.**  
**CONSOLIDATED STATEMENT OF OPERATIONS AND COMPREHENSIVE INCOME**

(In millions of U.S. dollars)	Year Ended December 31, 2008
<b>Revenues</b>	
Gross premiums written	\$ 552.1
Reinsurance premiums ceded	(76.6)
Net premiums written	475.5
Change in net unearned premiums	30.2
Net premiums earned	505.7
Net investment income	82.2
Net realized and unrealized investment losses	(243.4)
Net foreign exchange gains	0.7
Net expense from derivative instruments	(14.3)
Other revenue	0.6
<b>Total revenues</b>	<b>331.5</b>
<b>Expenses</b>	
Underwriting expenses:	
Loss and loss adjustment expenses	280.3
Acquisition costs	81.9
General and administrative expenses	50.0
Non-underwriting expenses:	
Interest and other financing expenses	1.8
<b>Total expenses</b>	<b>414.0</b>
<b>Net loss</b>	<b>(82.5)</b>
Change in fair value of Symetra (see Note 5)	0.9
<b>Comprehensive loss</b>	<b>\$ (81.6)</b>

See Notes to Consolidated Financial Statements

**MONTPELIER REINSURANCE LTD.**  
**CONSOLIDATED STATEMENT OF SHAREHOLDER'S EQUITY**

(In millions of U.S. dollars)	Total common shareholder's equity	Common shares	Additional paid-in capital	Retained deficit	Accumulated other comprehensive income
Balances at January 1, 2008	\$ 1,872.8	\$ 1.0	\$ 2,052.6	\$ (183.1)	\$ 2.3
Net loss	(82.5)	—	—	(82.5)	—
Other comprehensive income	0.9	—	—	—	0.9
Dividends and distributions to common shareholder	(175.0)	—	(175.0)	—	—
<b>Balances at December 31, 2008</b>	<b>\$ 1,616.2</b>	<b>\$ 1.0</b>	<b>\$ 1,877.6</b>	<b>\$ (265.6)</b>	<b>\$ 3.2</b>

See Notes to Consolidated Financial Statements

**MONTPELIER REINSURANCE LTD.  
CONSOLIDATED STATEMENT OF CASH FLOWS**

(In millions of U.S. dollars)	Year Ended December 31, 2008
<b>Cash flows from operations:</b>	
Net loss	\$ (82.5)
Charges (credits) to reconcile net loss to net cash from operations:	
Minority interest expense - Blue Ocean	
Excess of fair value of acquired net assets over cost - Blue Ocean	
Net realized and unrealized investment losses	243.4
Net accretion, amortization and depreciation of assets and liabilities	(3.3)
Net change in:	
Loss and loss adjustment expense reserves	(58.0)
Reinsurance recoverable on paid and unpaid losses	2.1
Unearned premium	(30.2)
Deferred acquisition costs	6.3
Premiums receivable	19.6
Amounts due to/from affiliates, net	(16.9)
Other	4.9
<b>Net cash provided from operations</b>	<b>85.4</b>
<b>Cash flows from investing activities:</b>	
Purchases of fixed maturities	(1,713.7)
Purchases of equity securities	(474.3)
Purchases of other investments	(142.9)
Sales, maturities, calls and pay downs of fixed maturity investments	1,879.5
Sales and redemptions of equity securities	350.4
Sales and redemptions of other investments	20.0
Change in securities lending collateral invested	192.4
Net change in restricted cash	(6.8)
Net acquisitions of capitalized assets	(3.9)
<b>Net cash provided from investing activities</b>	<b>100.7</b>
<b>Cash flows from financing activities:</b>	
Dividends and distributions paid to the Company's shareholder	(175.0)
Change in securities lending payable	(193.4)
<b>Net cash used for financing activities</b>	<b>(368.4)</b>
<b>Effect of exchange rate changes on cash and cash equivalents</b>	<b>0.4</b>
<b>Net decrease in cash and cash equivalents during the year</b>	<b>(181.9)</b>
Cash and cash equivalents - beginning of year	361.4
<b>Cash and cash equivalents - end of year</b>	<b>\$ 179.5</b>

See Notes to Consolidated Financial Statements

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**(Expressed in millions of United States ("U.S.") Dollars,**  
**except per share amounts or as otherwise described)**

**NOTE 1. General**

Montpelier Reinsurance Ltd. (the "Company") was incorporated under the laws of Bermuda on November 14, 2001 and is a wholly-owned subsidiary of Montpelier Re Holdings Ltd. ("MRH"), a Bermuda-based holding company listed on the New York Stock Exchange.

The Company is registered as a Bermuda Class 4 insurer and seeks to identify and underwrite attractive reinsurance and insurance opportunities by utilizing proprietary risk pricing and capital allocation models and catastrophe modeling tools.

**NOTE 2. Summary of Significant Accounting Policies**

***Basis of presentation***

These consolidated financial statements include the accounts of the Company and its wholly-owned subsidiary, Montpelier Investments Holdings Ltd. ("MIHL"). MIHL is a Bermuda company in which certain of the Company's investments are held. All significant inter-company balances have been eliminated.

These financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America. The preparation of financial statements in accordance with generally accepted accounting principles requires management to make estimates and assumptions that affect reported amounts of assets and liabilities, as well as disclosure of contingent assets and liabilities as at the balance sheet date. Estimates also affect the reported amounts of income and expenses for the reporting period. Actual results could differ from those estimates.

***Premiums and related costs***

The Company accounts for insurance and reinsurance policies and contracts that it writes in accordance with Statement of Financial Accounting Standard ("FAS") No. 60, "Accounting and Reporting by Insurance Enterprises", and FAS 113, "Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts". Premiums written are recognized as revenues, net of any applicable underlying reinsurance coverage, and are earned ratably over the term of the related policy or contract. For the majority of the Company's excess-of-loss contracts, written premium is based on the deposit or minimum premium as defined in the contract. Subsequent adjustments, based on reports of actual premium or revisions in estimates by ceding companies, are recorded in the period in which they are determined. For the Company's pro rata contracts and excess-of-loss contracts where no deposit or minimum premium is specified in the contract, written premium is recognized based on estimates of ultimate premiums provided by the ceding companies. Initial estimates of written premium are recognized in the period in which the underlying risks incept. Subsequent adjustments, based on reports of actual premium by the ceding companies, or revisions in estimates, are recorded in the period in which they are determined. Unearned premiums represent the portion of premiums written that are applicable to future insurance or reinsurance coverage provided by policies or contracts in force.

Premiums receivable are recorded at amounts due less any provision for doubtful accounts.

When a reinsurance contract provides for a reinstatement of coverage following a covered loss, the associated reinstatement premium is recorded as both written and earned premium when the Company determines that the loss event has occurred.

Deferred acquisition costs are comprised of ceding commissions, brokerage, premium taxes and excise taxes, each of which relates directly to the writing of insurance and reinsurance contracts. These deferred acquisition costs are generally amortized over the underlying risk period of the related contracts. However, if the sum of a contracts' expected losses and LAE, and deferred acquisition costs exceeds related unearned premiums, a premium deficiency is determined to exist. In this event, deferred acquisition costs are immediately expensed to the extent necessary to eliminate the premium deficiency. If the premium deficiency exceeds deferred acquisition costs then a liability is accrued for the excess deficiency. During the year the Company did not record a premium deficiency.

Included in acquisition costs are profit commissions incurred. Accrued profit commissions are included in insurance and reinsurance balances payable.

### *Loss and LAE reserves*

The Company maintains reserves for losses and LAE to cover the estimated liability for both reported and unreported claims. A significant portion of the Company's current business is in the property catastrophe class of business and other classes with high attachment points of coverage. As a result, reserving for losses relating to such programs can be imprecise. The Company's exposures are also highly leveraged, meaning that the impact of any change in the estimate of total loss incurred by the cedent is magnified in the layers at which the Company's coverage attaches. Additionally, the high-severity, low-frequency nature of the exposures limits the volume of claims experience available from which to reliably predict ultimate losses following a loss event, and renders certain traditional loss estimation techniques inapplicable.

Loss and loss adjustment expense reserves for all classes of business include components for reported claims ("case reserves") and losses incurred but not reported ("IBNR"). Case reserve estimates are initially set on the basis of loss reports received from third-parties. Estimated IBNR reserves consist of a provision for additional development in excess of the case reserves reported by ceding companies as well as a provision for claims which have occurred but which have not yet been reported to us by ceding companies. IBNR reserves are estimated by management using various actuarial methods as well as a combination of the Company's own loss experience, historical insurance industry loss experience, underwriters' experience and management's professional judgment. The Company's internal actuaries review the reserving assumptions and methodologies on a quarterly basis and its loss estimates are subject to an annual corroborative review by independent actuaries using generally accepted actuarial principles. The uncertainties inherent in the reserving process, delays in ceding companies reporting losses, together with the potential for unforeseen adverse developments, may result in loss and LAE reserves being significantly greater or less than the reserve provided at the time of the loss event. The degree of uncertainty is further increased when a significant loss event takes place near the end of a reporting period. Loss and loss adjustment expense reserve estimates are regularly reviewed and updated as new information becomes known. Any resulting adjustments are reflected in income in the period in which they become known.

### *Ceded reinsurance*

In the normal course of business, the Company purchases reinsurance from third-parties in order to manage its exposures. The amount of ceded reinsurance that the Company buys varies from year-to-year depending on its risk appetite, and the availability and cost of ceded reinsurance. Reinsurance premiums ceded are accounted for on a basis consistent with those used in accounting for the underlying premiums assumed, and are reported as a reduction of net premiums written. Certain of the Company's assumed pro-rata contracts incorporate reinsurance protection provided by third-party reinsurers that inures to the Company's benefit. These reinsurance premiums are reported as a reduction in gross premiums written.

The Company remains liable for losses incurred to the extent that any third-party reinsurer is unable or unwilling to make timely payments under reinsurance agreements. Under the Company's reinsurance security policy, reinsurers are generally required to be rated A- or better by A.M. Best at the time the policy is written. The Company also considers reinsurers that are not rated or do not fall within the above rating threshold on a case-by-case basis when collateralized up to policy limits, net of any premiums owed. The Company monitors the financial condition and ratings of its reinsurers on an ongoing basis.

All of the Company's reinsurance purchases to date have represented prospective cover, meaning that the coverage has been purchased to protect us against the risk of future losses as opposed to covering losses that have already been incurred but have not yet been paid. The majority of these reinsurance contracts provide excess-of-loss coverage for one or more lines of business. To a lesser extent, the Company has also purchased quota share reinsurance with respect to specific lines of business. The Company also purchases Industry Loss Warranty Policies ("ILWs") which provide coverage for certain losses provided they are triggered by events exceeding a specified industry loss size as well as the Company's own incurred losses. For non-ILW excess-of-loss reinsurance contracts, the attachment point and exhaustion of these contracts are based solely on the amount of the Company's actual losses incurred from an event or events.

The cost of reinsurance purchased varies based on a number of factors. The initial premium associated with excess-of-loss reinsurance is generally based on the underlying premiums assumed by the Company. As these reinsurance contracts are usually purchased prior to the time the assumed risks are written, ceded premium recorded in the period of inception reflects an estimate of the amount that the Company will ultimately pay. In the majority of cases, the premium initially recorded is subsequently adjusted to reflect premium actually assumed by the Company during the contract period. These adjustments are recorded in the period they are determined, and to date have not been significant. In

addition, losses which pierce excess-of-loss reinsurance cover may generate reinstatement premium ceded, depending on the terms of the contract. This reinstatement premium ceded is recognized as written and expensed at the time the reinsurance recovery is estimated and recorded.

The cost of quota share reinsurance is initially based on the Company's estimated gross premium written related to the specific lines of business covered by the reinsurance contract. As gross premiums are written during the period of coverage, reinsurance premiums ceded are adjusted in accordance with the terms of the quota share agreement.

Reinsurance recoverable on paid losses represent amounts currently due from reinsurers. Reinsurance recoverable on unpaid losses represent amounts collectible from reinsurers once the losses are paid. The recognition of reinsurance recoverable requires two key judgments. The first judgment involves the estimation of the amount of gross IBNR to be ceded to reinsurers. Ceded IBNR is generally developed as part of the Company's loss reserving process and consequently, its estimation is subject to similar risks and uncertainties as the estimation of gross IBNR. The second judgment relates to the amount of the reinsurance recoverable balance that ultimately will not be collected from reinsurers due to insolvency, contractual dispute, or other reasons.

### ***Investments and cash***

Investments are recorded on a trade date basis. The fair value of the investment portfolio is determined based on bid prices (as opposed to ask prices) which are not adjusted for transaction costs. Gains and losses on sales of investments are determined on the first-in, first-out basis and are included in income when realized. Realized gains and losses generally result from the sale of securities. Unrealized gains and losses represent the gain or loss that would result from a hypothetical sale of securities on the reporting date. In instances where the Company becomes aware of a significant unrealized loss with little or no likelihood of recovery, it writes down the cost basis of the investment and recognizes the loss as a realized loss.

Other investments are carried at either fair value or on the equity method of accounting (which is based on underlying net asset values) and consist primarily of investments in limited partnership interests and private investment funds, event-linked securities ("CAT Bonds"), private placements and certain derivative instruments. See Notes 5 and 7.

Net investment income is stated net of investment management, custody and other investment-related expenses. Investment income is recognized when earned and includes interest and dividend income together with the amortization of premiums and the accretion of discounts on fixed maturities purchased at amounts different from their par value.

Cash and cash equivalents include cash and fixed income investments with maturities of less than three months, as measured from the date of purchase. Restricted cash at December 31, 2008 consisted of collateral supporting open short sale investment position.

The Company's letter of credit facilities are secured by investments and cash. See Note 6.

In August 2008, the Company terminated its securities lending program resulting in a realized loss of \$1.0 million. See Note 5. Prior to the termination, the Company lent certain of its fixed maturity investments to other institutions for short periods of time through a lending agent.

The Company maintained control over the securities it lent, retained the earnings and cash flows associated with the loaned securities and received a fee from the borrower for the temporary use of the securities. Collateral in the form of cash, government securities and letters of credit was required at a rate of 102% of the market value of the loaned securities and was monitored and maintained by the lending agent.

The Company reinvested some or all of the collateral received from the borrower in an attempt to achieve a greater investment return. In so doing, the Company retained the investment risk associated with the reinvested collateral.

### ***Funds withheld***

Funds withheld by reinsured companies represent insurance balances retained by ceding companies in accordance with contractual terms. The Company typically earns investment income on these balances during the period the funds are held. At December 31, 2008, funds withheld balances of \$2.4 million were recorded within other assets on the consolidated balance sheet.

### **Recent accounting pronouncements**

On March 19, 2008, the FASB issued FAS 161, entitled "*Disclosures about Derivative Instruments and Hedging Activities an amendment of FASB Statement No. 133.*" The statement is effective for fiscal years beginning after November 15, 2008. FAS 161 amends and enhances the disclosure requirements for derivative instruments and hedging activities. Entities are required to provide enhanced disclosures about: (i) how and why the entity uses derivative instruments; (ii) how derivative instruments and related hedged items are accounted for; and (iii) how derivative instruments and related hedged items affect the entity's financial position, financial performance, and cash flows. The adoption of FAS 161 will have no impact on the Company's operations or financial condition but is expected to expand the Company's current disclosures regarding its derivative instruments.

On April 9, 2009, the FASB issued Staff Position FAS 157-4 ("FSP FAS 157-4"), entitled "*Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly.*" FSP 157-4 outlines factors to be considered by a reporting entity in determining whether a market for an asset or liability is active. These factors include few recent transactions, price quotations that are not based on current information or which vary substantially over time or among market makers, a significant increase in implied liquidity risk premiums, yields or performance indicators, a wide bid-ask spread, a significant decline or absence of a market for new issuances or limited information released publicly. In circumstances where the reporting entity concludes that there has been a significant decrease in the volume of market activity for an asset or liability as compared to normal market activity, transactions or quoted prices may not reflect fair value. In such circumstances, FSP 157-4 requires analysis of the transactions or quoted prices and, where appropriate, adjustment to estimate fair value in accordance with FAS 157. In addition, FSP 157-4 would expand interim disclosures to require a description of the inputs and valuation techniques used to estimate fair value and a discussion of changes during the period. FSP 157-4 is effective for interim and annual reporting periods ending after June 15, 2009, with early adoption permitted. The Company plans to adopt FSP 157-4 during 2009. Adoption of FSP 157-4 is not expected to have a material effect on the Company's operations or financial condition.

### **Foreign currency exchange**

The U.S. dollar is the Company's reporting currency. Transactions involving certain monetary assets and liabilities denominated in foreign currencies have been translated into U.S. dollars at exchange rates in effect at the balance sheet date, and the related revenues and expenses are converted using either specific or average exchange rates for the period, as appropriate. Net foreign exchange gains and losses arising from these activities are reported as a component of net income in the period in which they arise.

### **NOTE 3. Unpaid Loss and LAE Reserves**

The following table summarizes the Company's unpaid loss and LAE reserve activities for the year ended December 31, 2008:

Gross loss and LAE reserves at beginning of year	\$ 842.8
Reinsurance recoverable on unpaid losses	<u>(135.8)</u>
Net loss and LAE reserves at beginning of year	707.0
Net loss and LAE related to:	
Current year	384.7
Prior years	<u>(104.4)</u>
Total	280.3
Net loss and LAE paid related to:	
Current year	(124.9)
Prior year	<u>(191.7)</u>
Total	<u>(316.6)</u>
Net loss and LAE reserves at end of year	670.7
Reinsurance recoverable on unpaid losses	<u>114.1</u>
Gross loss and LAE reserves at end of year	<u><u>\$ 784.8</u></u>

Current year losses incurred during 2008 include significant catastrophic losses from European Windstorm Emma and hurricanes Ike and Gustav, representing a combined net loss of \$181.2 million. Additionally, the Company incurred \$49.2 million of net losses as a result of four individual risk losses.

The favorable loss and LAE development occurring in 2008 that related to prior year losses of \$104.4 million was mainly a result of the reassessment of loss and LAE reserves relating to 2007 European windstorms Kyrill and Gonu, California wildfires, floods in the UK and Australia, the hurricanes that occurred in 2004 & 2005 as well as reductions in losses reported in connection with several large facultative claims.

Reinsurance recoveries of \$35.4 million were netted against the Company's loss and LAE for 2008.

#### **NOTE 4. Ceded Reinsurance With Third-Parties**

The Company remains liable for losses it incurs to the extent that any third-party reinsurer is unable or unwilling to make timely payments under reinsurance agreements.

Under the Company's reinsurance security policy, reinsurers are generally required to be rated "A-" (Excellent) or better by A.M. Best at the time the policy is written. The Company also considers reinsurers that are not rated or do not fall within the above threshold on a case-by-case basis when collateralized up to policy limits, net of any premiums owed. The Company monitors the financial condition and ratings of its reinsurers on an ongoing basis.

The Company records provisions for uncollectible reinsurance recoverable when collection becomes unlikely due to the reinsurer's inability to pay. The Company does not believe that there are any amounts uncollectible from its reinsurers at this time.

Earned reinsurance premiums ceded were \$76.6 million for 2008. Reinsurance recoveries of \$35.4 million were netted against the Company's loss and LAE. In addition to loss recoveries, certain of the Company's ceded reinsurance contracts provide for recoveries of additional premiums, reinstatement premiums and for lost no-claims bonuses, which are incurred when losses are ceded to these reinsurance contracts.

The Company is subject to litigation and arbitration proceedings in the normal course of its business. Such proceedings generally involve reinsurance or insurance contract disputes which are typical for the property and casualty insurance and reinsurance industry in general and are considered in connection with the Company's net loss and LAE reserves.

On October 17, 2007, following the failure of contractually-mandated mediation, the Company received a notice of arbitration from Manufacturers Property and Casualty Limited ("MPCL"), a subsidiary of Manulife Financial Corporation of Toronto, Canada ("Manulife"). The notice involves two contracts pursuant to which the Company purchased reinsurance protection from MPCL (the "Disputed Contracts"). MPCL seeks in the arbitration to rescind, in whole or in part, the Disputed Contracts, and seeks further relief, including but not limited to attorney fees and interest.

Subject to purported reservation of rights, MPCL has to date paid to the Company \$25.5 million in respect of ceded claims under the Disputed Contracts, which is net of deposit, reinstatement and additional premiums.

In the event that MPCL is awarded rescission of the Disputed Contracts, the reduction in total losses expected to be ceded under the Disputed Contracts, net of reinsurance premiums earned and accrued, would total \$73.0 million.

The Company believes that MPCL's case is without merit and that the Disputed Contracts are fully enforceable. In addition, we intend to seek relief from MPCL for attorney fees and interest costs. In the circumstances, the Company believes that the results of the arbitration will not have a materially adverse effect on its financial condition, results of operations or cash flows.

Pursuant to directions given in the arbitration, we do not expect substantive hearings to begin until early 2010.

## NOTE 5. Investments

### *Fixed maturity Investments and Equity Securities*

The table below shows the aggregate cost (or amortized cost) and fair value of the Company's fixed maturity investments and equity securities, by investment type, as of December 31, 2008:

	Cost or Amortized Cost	Fair Value
Fixed maturity investments:		
Mortgage-backed and asset-backed securities	\$ 614.5	\$ 583.7
Corporate debt securities	466.7	443.8
U.S. government securities	350.4	351.6
U.S. government-sponsored enterprise securities	184.3	186.5
Other fixed maturity securities	86.9	88.8
Total fixed maturity investments	<u>\$ 1,702.8</u>	<u>\$ 1,654.4</u>
Equity securities	<u>\$ 310.0</u>	<u>\$ 242.3</u>

As of December 31, 2008, 89% of the Company's fixed maturity investments were either rated "A" (Strong) or better by Standard & Poor's or represented U.S. government or U.S. government-sponsored enterprise securities, 9% were rated "BBB" (Good) or below by Standard & Poor's and 2% were unrated and primarily represented participation in bank loans.

In addition to the equity securities presented above, the Company also had open short equity positions recorded within its other liabilities at December 31, 2008, with a basis of \$6.8 million and a fair value of \$5.9 million.

The contractual maturity of the Company's fixed maturity investments at December 31, 2008 is presented below:

	Amortized Cost	Fair Value
Fixed maturity investments:		
Due in one year or less	\$ 380.9	\$ 381.6
Due after one year through five years	475.9	464.0
Due after five years through ten years	151.0	146.1
Due after ten years	80.4	79.0
Mortgage-backed and asset-backed securities	614.6	583.7
Total fixed maturity investments	<u>\$ 1,702.8</u>	<u>\$ 1,654.4</u>

### *Other Investments*

The Company's investments in limited partnership interests and private investment funds are carried at either their fair value or their underlying net asset value, depending on the Company's ownership share. For those funds carried at fair value, the underlying net asset value is used as a best estimate of fair value. The Company's CAT Bonds, private placement and derivative instruments are carried at fair value.

The table below shows the aggregate cost and carrying value of the Company's other investments, by investment type, as at December 31, 2008:

	Cost	Carrying Value
Other investments carried at net asset value:		
Limited partnership interests and other	\$ 36.8	\$ 33.1
Other investments carried at fair value:		
CAT Bonds	\$ 66.3	\$ 60.9
Limited partnership interests	23.1	17.1
Private placement	20.0	23.1
Derivative instruments	0.3	0.8
Total other investments carried at fair value	<u>\$ 109.7</u>	<u>\$ 101.9</u>
Other investments	<u>\$ 146.5</u>	<u>\$ 135.0</u>

The Company's limited partnership and private investment fund income and the net appreciation or depreciation on CAT Bonds is reported as net realized and unrealized gains (losses) in the Company's statements of operations. The net appreciation or depreciation on the Company's derivative instruments is reported as net revenue (expense) from derivative instruments in the Company's statements of operations.

The Company's investment in the common stock of Symetra Financial Corporation ("Symetra") represents a private placement investment acquired in 2004. The net appreciation or depreciation on Symetra is reported as a separate component of shareholders' equity, with changes therein reported as a component of other comprehensive income. Symetra is routinely reviewed to determine if it has sustained an impairment in value that is considered to be other than temporary. The Company did not sell or recognize any impairment on its investment in Symetra during the periods presented herein.

In May 2008, the Company purchased the CAT Bonds underlying its former CAT Bond Facility for \$71.6 million. CAT Bonds are debt instruments whose principal and interest are forgiven if specified trigger events occur. See Note 7.

The Company also entered into various investment option and futures contracts during 2008. See Note 7.

### ***Fair Value Hierarchy***

FAS 157, "Fair Value Measurements," establishes a hierarchy that prioritizes the inputs to valuation techniques used to measure fair value into the three broad levels described below. The level in the hierarchy within which a given fair value measurement falls is determined based on the lowest level input that is significant to the measurement.

- Level 1 inputs - unadjusted, quoted prices in active markets for identical assets or liabilities.
- Level 2 inputs - information other than quoted prices included within Level 1 that is observable for the asset or liability, either directly or indirectly. Level 2 inputs include quoted prices for similar assets or liabilities in active markets, quoted prices for identical or similar assets or liabilities in markets that are not active, and observable inputs other than quoted prices, such as interest rates and yield curves.
- Level 3 inputs - unobservable inputs.

In accordance with FAS 157, the valuation techniques used by the Company and its pricing services maximize the use of observable inputs; unobservable inputs are used to measure fair value only to the extent that observable inputs are unavailable. Values for U.S. Treasury and publicly traded equity securities are generally based on Level 1 inputs which use the market approach valuation technique. The values for other fixed maturity investments, including mortgage-backed and asset-backed securities, corporate debt securities and U.S. government-sponsored enterprise securities, generally incorporate significant Level 2 inputs, and in some cases, Level 3 inputs, using the market approach and income approach valuation techniques, as specified within FAS 157. There have been no changes in the Company's use of valuation techniques since its adoption of FAS 157.

The following table presents the Company's investment securities carried at fair value, categorized by the level within the FAS 157 hierarchy in which the fair value measurements fall, at December 31, 2008.

	Level 1	Level 2	Level 3	Total Fair Value
Fixed maturity investments	\$ 209.8	\$ 1,285.7	\$ 158.9	\$ 1,654.4
Equity securities	236.6	4.3	1.4	242.3
Other investments	—	70.9	31.0	101.9
Total investments	\$ 446.4	\$ 1,360.9	\$ 191.3	\$ 1,998.6

Investments classified as Level 3 at such dates primarily consisted of the following: (i) with respect to fixed maturity investments, certain corporate bonds, convertible debt and asset-backed securities, many of which are not publicly traded or are not actively traded; (ii) with respect to equity securities, warrants to acquire equity securities and certain non-U.S. equity securities; and (iii) with respect to other investments, the Company's investment in Symetra.

As of December 31, 2008, the Company's total Level 3 assets represented 9.6% of its total assets measured at fair value, respectively.

The following table presents a reconciliation of the beginning and ending balances for all investments measured at fair value on a recurring basis using Level 3 inputs during the year ended December 31, 2008. The Company terminated its securities lending program in August 2008.

	Year Ended December 31, 2008				
	Fixed Maturity Investments	Equity Securities	Other Investments	Securities Lending Collateral	Total Fair Value
Level 3 investments as of January 1, 2008	\$ 193.0	\$ —	\$ 22.3	\$ 99.7	\$ 315.0
Net payments, purchases and sales	98.2	3.8	(1.0)	(98.4)	2.6
Net realized gains (losses)	—	0.1	(0.3)	(0.9)	(1.1)
Net unrealized gains (losses)	(27.3)	(2.5)	1.0	0.3	(28.5)
Net transfers in (out)	(105.0)	—	9.0	(0.7)	(96.7)
Level 3 investments as of December 31, 2008	\$ 158.9	\$ 1.4	\$ 31.0	\$ —	\$ 191.3

In the course of changing investment managers during 2008, the Company was provided with additional information concerning the pricing transparency of certain of its fixed maturities historically classified as Level 3. As a result, the Company transferred securities with a fair value of \$105.0 million from Level 3 into Level 2 during the year.

### Changes in Carrying Value

Changes in the carrying value of the Company's investment portfolio for 2008 consisted of the following:

	Net Realized Gains (Losses) on Investments	Net Unrealized Gains (Losses) on Investments	Net Foreign Exchange Gains (Losses) and Derivative Revenue From Investments <sup>(1)</sup>	Total Changes in Carrying Value Reflected in Earnings	Changes in Carrying Value Reflected in Other Comprehensive Income
Fixed maturity investments	\$ (21.9)	\$ (59.5)	\$ 1.3	\$ (80.1)	—
Equity securities	(5.9)	(97.5)	(4.4)	(107.8)	—
Other investments	(44.5)	(14.5)	(2.3)	(61.3)	0.9
Securities lending	(1.0)	1.4	—	0.4	—

<sup>(1)</sup> Represents realized and unrealized foreign exchange gains from investments and revenue derived from the Company's investments in the CAT Bond Facility, Foreign Exchange Contracts and Investment Options and Futures (See Note 7). These derivatives are carried at fair value as other investments in the Company's consolidated balance sheets.

## Net Investment Income

The Company's net investment income for the year ended December 31, 2008 consisted of the following:

Fixed maturity investments	\$ 77.5
Cash and cash equivalents	1.7
Equity securities	5.4
Other investments	4.7
Interest income earned from affiliates (see Note 13)	0.5
Securities lending income	0.5
Total investment income	90.3
Less investment expenses	(8.1)
Net investment income	<u>\$ 82.2</u>

Investment income from other investments during 2008 consisted primarily of interest earned on CAT Bonds. In May 2008, the Company purchased the CAT Bonds underlying its former CAT Bond Facility. See Note 7.

Sales of investments totaled \$1,686.1 million for 2008. Maturities, calls and paydowns of investments totaled \$563.8 million. There were no non-cash exchanges or involuntary sales of investment securities during 2008.

## NOTE 6. Financing Arrangements

### Letter of Credit Facilities

In the normal course of business, the Company maintains letter of credit facilities and provides letters of credit to third-parties. These letter of credit facilities were secured by collateral accounts containing cash and investments totaling \$724.5 million at December 31, 2008. The following table outlines these facilities as of December 31, 2008:

Secured operational Letter of Credit Facilities	Credit Line	Amount drawn	Expiry Date
Syndicated facility: Tranche B	\$ 225.0	\$ 141.9	Aug. 2010
Syndicated 5-Year facility	\$ 500.0	\$ 40.7	June 2011
Syndicated 5-Year facility	\$ 215.0	\$ 149.7	June 2012
Bilateral facility A	\$ 100.0	\$ 26.6	None
MCL's Lloyd's standby facility	\$ 110.0	\$ 105.0	Dec. 2013

The Company amended its \$225.0 million syndicated secured facility in August 2005. The amendment served to revise this facility from a \$250.0 million three-year facility to a \$225.0 million five-year facility with a revised expiry date of August 2010. This facility is subject to an annual commitment fee of 0.275% on drawn balances and 0.075% on undrawn balances.

The Company amended its \$500.0 million syndicated secured facility in June 2006. The amendment served to revise this facility from a one-year \$1.0 billion facility, which expired in June 2007, to a five-year \$500.0 million facility. This facility is subject to an annual commitment fee of 0.325% on drawn balances and 0.075% on undrawn balances.

The Company entered into a five-year syndicated secured \$250.0 million letter of credit facility in June 2007. During 2008, this facility was reduced to \$215.0 million. This facility is subject to an annual commitment fee of 0.275% on drawn balances and 0.08% on undrawn balances.

The Company entered into a \$100.0 million secured letter of credit facility in November 2005. This facility has no stated expiration date. This facility is subject to an annual commitment fee of 0.20% on drawn balances only.

In June 2007, the Company, MRH and Montpelier Capital Limited ("MCL"), a wholly-owned MRH subsidiary of MRH based in the U.K., entered into a secured £74.0 million standby letter of credit facility through December 31, 2012, which is used to support business underwritten by Syndicate 5151, MRH's Lloyd's syndicate. In October 2008, this facility was increased to £110.0 million with a revised expiry date of December 31, 2013. This facility is subject to an annual commitment fee, currently paid by MCL, of 0.45% on drawn balances and 0.158% on undrawn balances. The Company provides the necessary collateral for the facility and could be required to pay the annual commitment fee associated with this facility in the event that neither MCL nor MRH remits payment.

The agreements governing these facilities contain covenants that limit the Company's ability, among other things, to grant liens on its assets, sell assets, merge or consolidate, incur debt and enter into certain burdensome agreements. In addition, the syndicated secured facilities and the Lloyd's standby facility each require MRH to maintain debt leverage of no greater than 30% and the Company to maintain an A.M. Best financial strength rating of no less than B++. If the Company were to fail to comply with these covenants or fail to meet these financial ratios, the lenders could revoke the facilities and exercise remedies against the collateral. As of December 31, 2008 and 2007, MRH and the Company Re were in compliance with all covenants.

#### NOTE 7. Derivative Contracts

The Company enters into derivative contracts from time to time in order to manage certain of its business risks and to supplement its investing and underwriting activities.

The primary risks the Company seeks to manage through its use of derivative instruments are underwriting risk and foreign exchange risk. Derivative instruments utilized in order to manage the Company's underwriting risk during the period presented below include: (i) an option on hurricane seasonal futures (the "Hurricane Option"), (ii) an Industry Loss Warranty swap contract (the "ILW Swap") and (iii) catastrophe bond protection (the "CAT Bond Protection"). These derivative instruments provide reinsurance-like protection to the Company for specific loss events associated with certain lines of its business. Foreign exchange risk, specifically the Company's risk associated with making claim payments in foreign currencies, is managed through the use of foreign currency exchange agreements (the "Foreign Exchange Contracts").

As an extension of its investing activities, the Company has entered into investment option and futures contracts ("Investment Options and Futures").

As an extension of its underwriting activities, the Company has sold ILW protection (the "ILW Contract") and has participated in a CAT bond facility (the "CAT Bond Facility"). These derivative instruments provide reinsurance-like protection to third-parties for specific loss events associated with certain lines of business.

None of the Company's derivatives is designated as a hedging instrument under FAS 133, entitled "*Accounting for Derivative Instruments and Hedging Activities*."

The following table presents the fair values of the Company's derivative instruments at December 31, 2008:

Derivative contracts recorded as other investments:	
Foreign Exchange Contracts	\$ 0.7
Investment Options and Futures	0.1
CAT Bond Facility	<u>—</u>
Total derivative contracts recorded as other investments	<u>\$ 0.8</u>
Derivative contracts recorded as other liabilities:	
ILW Contract	<u>\$ —</u>

The following table presents the net expense (income) from the Company's derivative instruments during 2008:

Hurricane Option	\$ 1.0
ILW Swap	0.7
CAT Bond Protection	11.9
Foreign Exchange Contracts	4.1
Investment Options and Futures	(1.8)
CAT Bond Facility	(1.0)
ILW Contract	<u>(0.6)</u>
Net expense from derivative instruments	<u>\$ 14.3</u>

The Hurricane Option, ILW Swap, CAT Bond Protection and the ILW Contract had balances of zero at December 31, 2008.

A description of each of the Company's derivative instruments follows:

### ***Hurricane Option***

In March 2008, the Company purchased the Hurricane Option, an option on hurricane seasonal futures traded on the Chicago Mercantile Exchange, in order to provide protection against the Company's eastern U.S. hurricane exposure during the period from June 1, 2008 to November 30, 2008. The maximum possible recovery to the Company under the Hurricane Option was \$5.0 million. The Hurricane Option expired without value.

While outstanding, the fair value of the Hurricane Option was derived based on other observable inputs (Level 2 inputs as defined in FAS 157).

### ***ILW Swap***

In April 2008, the Company entered into the ILW Swap with a third-party in order to provide protection against the Company's U.S. hurricane exposure. In return for a fixed-rate payment of \$0.7 million, the Company receives a floating-rate payment which is triggered on the basis of losses incurred by the insurance industry as a whole through April 30, 2009. The maximum recovery to the Company under the ILW Swap is \$5.0 million.

The fair value of the ILW Swap (which was zero at December 31, 2008) was derived based on unobservable inputs (Level 3 inputs as defined in FAS 157). Through December 31, 2008, no industry loss event occurred which would have triggered a recovery under the ILW Swap by the Company.

### ***CAT Bond Protection***

In December 2005, the Company purchased fully-collateralized coverage for losses sustained from qualifying hurricane and earthquake loss events from a third-party, Champlain, which financed this coverage through the issuance of \$90.0 million in catastrophe bonds to investors under two separate bond tranches, each of which matured on January 7, 2009. The first \$75.0 million tranche ("Class A") covered earthquakes affecting Japan and/or the U.S. The remaining \$15.0 million tranche ("Class B"), provided second event coverage for a U.S. hurricane or earthquake. Both tranches responded to parametric triggers, whereby payment amounts were determined on the basis of modeled losses incurred by a notional portfolio rather than by actual losses incurred by the Company. For that reason, this transaction is accounted for as a derivative, rather than as a reinsurance transaction, and is carried at fair value in accordance with FAS 133 and EITF 99-2.

Contract payments expensed in connection with the CAT Bond Protection were calculated at 12.83% per annum on the first tranche and 13.58% per annum on the second tranche. In addition, during 2006 the Company incurred \$1.9 million in one-time setup costs associated with the CAT Bond Protection.

The fair value of the CAT Bond Protection (which was zero at December 31, 2008) was derived based on unobservable inputs. Through December 31, 2008, no industry loss event occurred which would have triggered a recovery under the CAT Bond Protection by the Company.

### ***Foreign Exchange Contracts***

From time to time the Company has entered into foreign currency exchange agreements which constitute an obligation to purchase or sell a specified currency at a future date at a price set at the inception of the contract. These agreements do not eliminate fluctuations in the value of the Company's assets and liabilities denominated in foreign currencies; rather, they allow the Company to establish a rate of exchange at a future point in time. The Company's open foreign currency agreements at December 31, 2008 were denominated in Swiss francs (CHF), euros (EUR), British pounds (GBP) and Japanese yen (JPY).

The fair value of the Foreign Exchange Contracts is derived based on other observable inputs (Level 2 inputs as defined in FAS 157). At December 31, 2008, the Company was party to outstanding foreign currency exchange agreements having a gross notional exposure of \$33.0 million.

### ***Investment Options and Futures***

During 2008, the Company executed various exchange-traded investment options and futures as part of its investing strategy. As of December 31, 2008, the Company had closed all of its investment futures and held open long options with a fair value of \$0.1 million.

The fair value of the open options is derived based on other observable inputs (Level 2 inputs as defined in FAS 157).

### ***CAT Bond Facility***

In June 2006, the Company entered into the CAT Bond Facility under which the Company is entitled to receive contract payments from a third-party in return for assuming mark-to-market risk on a portfolio of securitized catastrophe risks. The difference between the notional capital amounts of the catastrophe bonds and their market value is marked to market over the terms of the bonds; the difference is settled on a monthly basis. These marked-to-market adjustments, in addition to any interest earned on the bonds, are included as a component of net revenue (expense) from derivative instruments in the Company's statement of operations.

During the second quarter of 2008, the CAT Bond Facility was terminated and the Company purchased the underlying CAT Bonds from the counterparty at their fair value. As a result, the CAT Bonds are now held on the Company's consolidated balance sheets as other investments. See Note 5.

The fair value of the CAT Bond Facility was derived based on other observable inputs (Level 2 inputs as defined in FAS 157).

### ***ILW Contract***

In August 2007, the Company entered into the ILW Contract with a third-party under which qualifying loss payments are triggered exclusively by reference to the level of losses incurred by the insurance industry as a whole rather than by losses incurred by the insured. The ILW Contract provided the insured with \$15.0 million of second-event protection resulting from industry losses of a stated amount and expired on August 13, 2008 without any required payment by the Company.

The ILW Contract covered losses resulting from all natural perils within the U.S. and was carried at fair value in accordance with EITF 99-2 and FAS 133. The fair value of the ILW Contract was derived based on unobservable inputs (Level 3 inputs as defined in FAS 157). The ILW Contract had a fair value of zero at December 31, 2008.

## **Note 8. Common Shareholders' Equity**

### ***Dividends and Distributions***

The Company declared and paid dividends and distributions to MRH during 2008 of \$175 million.

## **Note 9. Share Based Compensation**

### ***LTIP***

The Long-Term Incentive Plan (the "LTIP") is the primary long-term incentive plan for MRH and its subsidiaries (collectively "Montpelier"). At the discretion of Compensation and Nominating Committee of MRH's Board of Directors (the "CN Committee"), incentive awards, the value of which is based on MRH's common shares, may be made to plan participants. Currently, Montpelier's share-based incentive awards under the LTIP consist of awards of performance shares and restricted share units ("RSUs").

The Company is required to reimburse MRH in cash for share-based amounts paid to the Company's plan participants.

### **Performance Shares**

From 2002 to 2007, performance shares were a significant element of Montpelier's LTIP awards in terms of prospective value. At target payout, each performance share represents the fair value of one MRH common share. At the end of a performance period, which is generally the three-year period following the date of grant, a plan participant may receive a harvest of between zero and 200% of the performance shares granted depending on the achievement of specific performance criteria relating to the operating and financial performance of Montpelier over the period. At the discretion of the CN Committee, any final payment in respect of such a grant may take the form of cash, common shares or a combination of both.

For all outstanding performance share awards, the primary performance target for a 100% harvest ratio is the achievement of an underwriting return on an internally generated risk-based capital measure of 16% over the period. Additionally, at the sole discretion of the CN Committee, the performance of certain members of senior management may be further measured by reference to the ratio of the actual return on equity to the return on risk-based capital and may result in an adjustment to the harvest of + / - 25%.

The following table summarizes the Company's performance share activities during the year ended December 31, 2008:

	Target Performance Shares Outstanding	Accrued Expense
Beginning of period	146,500	\$ 4.8
Payments	—	—
New awards	—	—
Forfeitures & Cancellations	10,000	—
Expense recognized	—	(2.8)
End of period	136,500	\$ 2.0

The following table summarizes performance shares outstanding at target and the accrued performance share expense at December 31, 2008, for each outstanding performance cycle:

	Target Performance Shares Outstanding	Accrued expense
Performance cycle:		
2006—2008	70,500	\$ 1.4
2007—2009	66,000	0.6
Total at December 31, 2008	136,500	\$ 2.0

If 100% of the outstanding performance shares had been vested on December 31, 2008, the total additional compensation cost to be recognized would have been \$0.3 million based on current accrual factors (share price and payout assumptions).

### RSUs

RSUs are phantom restricted shares which, depending on the individual award, vest in equal tranches over three, four or five year periods, subject to the recipient maintaining a continuous relationship with the Company (either as an employee, a director or a consultant) through the applicable vesting date. Holders of RSUs are not entitled to voting rights but are entitled to receive cash dividends and distributions.

The Emergency Economic Stabilization Act of 2008, enacted on October 3, 2008 (the "EES Act"), added Section 457A to the U.S. Internal Revenue Code. The Company believes that, effective for periods after December 31, 2008, Section 457A and guidance promulgated by the U.S. Internal Revenue Service thereunder may cause certain LTIP participants (those who are U.S. taxpayers) to be taxed on the fair value of RSUs upon vesting rather than upon subsequent receipt of the underlying common shares.

In order to alleviate this potential mismatch between taxation and receipt of the common shares, the CN Committee resolved, on December 3, 2008, to amend certain outstanding RSU awards to accelerate the distribution of the underlying common shares to coincide more closely with the vesting date. This amendment to the award agreements did not change the applicable vesting date, but allowed participants to receive their common shares during the same period in which they will be taxable. Prior to the EES Act, RSUs were payable in common shares only at the end of the RSU term.

Throughout 2006 and 2007, RSU awards consisted solely of: (i) grants made to induce individuals to join the Company; (ii) grants made to retain certain key employees; (iii) grants made to reward employees exhibiting outstanding individual performance; and (iv) grants made to non-management members of the Board of Directors as part of their total remuneration. In each of these cases, the number of RSUs granted to the recipient were fixed and determinable on the grant date ("Fixed RSUs").

During 2008 Montpelier also began using a new form of RSU award, in addition to Fixed RSUs, as the principal component of its ongoing long-term incentive compensation for employees ("Variable RSUs"). Variable RSUs are contingent awards in which the actual number of RSUs to be awarded is dependent on Company performance during the initial year (the "Initial RSU Period") of the four year award cycle. The actual number of Variable RSUs is not fixed and determinable until the completion of the Initial RSU Period and, during that period, the number of RSUs expected to be awarded for that cycle may fluctuate, perhaps significantly. For the RSU award cycle from 2008 to 2011, the actual number of Variable RSUs projected to be awarded has been determined based on a 2008 target ROE of 11.2%, assuming a standardized investment return. With respect to the 2008 to 2011 award cycle, at an achieved ROE of 11.2% the Company projects a grant of approximately 190,000 Variable RSUs to participants, at an ROE of 5.2% the Company would not expect to grant any Variable RSUs to participants and at an ROE of 21.2% the Company projects a grant of approximately 380,000 Variable RSUs to participants. Based on an estimated ROE achieved for 2008 of 8.2%, the Company projects the number of its Variable RSUs to be granted for the 2008-2011 award cycle to be 103,405.

The following table summarizes the Company's RSU activity for the year ended December 31, 2008:

	RSUs Outstanding	Unamortized Grant Date Fair Value
Beginning of period	411,460	\$ 1.6
Fixed RSUs Awarded	37,500	0.6
Variable RSUs projected to be awarded	103,405	1.7
Change in assumptions, including expected forfeitures	—	(0.1)
Payments	(206,835)	—
Actual forfeitures	(15,667)	—
Expense recognized	—	(2.2)
End of period	<u>329,863</u>	<u>\$ 1.6</u>

In determining the initial grant date fair value of RSUs, a zero to five percent discount to the then market value of the shares is applied as sale restrictions may remain after RSUs are vested, depending on the date and term of the award.

The Company also assumes a 3% to 9% forfeiture rate. Actual forfeitures are periodically compared to assumed forfeitures for reasonableness.

During 2008, the Company revised its expected RSU forfeiture assumptions and, in light of the changes made to certain outstanding RSU awards in 2008 resulting from the EES Act, eliminated or reduced its sale restriction discount. The net impact of these revisions was a \$0.1 million reduction in RSU expense for 2008.

On December 31, 2008, MRH paid out 206,835 vested RSUs to Company participants relating to the 2006 - 2008 award cycle and withheld, at the recipient's election, 27,750 RSUs for the payment of income taxes. As a result, MRH issued 179,085 net shares from its treasury on December 31, 2008 to Company participants. The fair value of the 206,835 vested RSUs paid out during 2008 to Company participants was \$3.5 million.

As of December 31, 2008, 204,093 of the total outstanding RSUs were vested and are payable to Company participants during the first quarter of 2009.

The following table summarizes RSUs outstanding and the unamortized grant date fair value of such RSUs at December 31, 2008, for each award cycle:

Award Date and Cycle	RSUs Outstanding	Unamortized Grant Date Fair Value
Three year RSU awards granted in 2007	188,958	\$ 0.4
Four year RSU awards granted or projected to be granted in 2008	103,405	0.9
Five year RSU awards granted in 2008	37,500	0.3
<b>Total at December 31, 2008</b>	<u><u>329,863</u></u>	<u><u>\$ 1.6</u></u>

The Company expects to incur future RSU expense of \$1.1 million, \$0.3 million and \$0.2 million associated with its outstanding RSUs at December 31, 2008, during 2009, 2010, and 2011, respectively.

#### **Note 10. Income Taxes**

The Company and MIHL are domiciled in Bermuda and have received an assurance from the Bermuda Minister of Finance exempting them from all Bermuda-imposed income, withholding and capital gains taxes until March 2016. At the present time, no such taxes are levied in Bermuda.

The Company does not consider itself to be engaged in a trade or business in the United States and, accordingly, does not expect to be subject to United States income tax.

#### **Note 11. Fair Value of Financial Instruments**

FAS No. 107, "Disclosure about Fair Value of Financial Instruments", requires disclosure of fair value information for certain financial instruments. The Company carries its financial instruments, as defined in FAS 107, on its consolidated balance sheets at fair value.

#### **Note 12. Regulatory Requirements**

##### ***Bermuda Regulation***

The Company is registered under The Insurance Act 1978 (Bermuda), Amendments Thereto and Related Regulations (the "Act") as a Class 4 insurer. Under the Act, the Company is required to annually prepare and file statutory financial statements and a statutory financial return. The Act also currently requires the Company to maintain minimum share capital of \$1.0 million and to meet a minimum solvency margin equal to the greater of \$100.0 million, 50% of net premiums written or 15% of the loss and LAE reserves. For all periods presented herein, the Company Re satisfied these requirements.

Effective December 31, 2008, the Bermuda Monetary Authority ("BMA") introduced a risk-based capital model, the Bermuda Statutory Capital Requirement ("BSCR") as a tool to measure risk and to determine an enhanced capital requirement and target capital level (defined as 120% of the enhanced capital requirement) for Class 4 insurers. While the required statutory capital and surplus has increased under the BSCR, the Company has capital and surplus in excess of the target capital level.

The Company is also required to maintain minimum liquidity ratios, which were met by the Company for all periods presented herein.

The Act limits the maximum amount of annual dividends and distributions that may be paid by the Company. The Company shall not pay dividends to MRH in any year which would exceed 25% of its prior year statutory capital and surplus or reduce its prior year statutory capital by 15% or more, without the prior notification to, and in certain cases the approval of, the BMA. In addition, the Company Re not declare or pay a dividend, or make a distribution out of contributed surplus, if the realisable value of its assets would be less than the aggregate of its liabilities, issued share capital and share premium accounts.

In July 2008, the Bermuda House of Assembly passed the Insurance Amendment Bill 2008 (the "2008 Bill") which created a new supervisory framework for Bermuda insurers. The 2008 Bill established new regulatory capital and solvency requirements for all Bermuda insurers and requires, as of December 31, 2008, that all Class 4 Bermuda insurers prepare and file with the BMA audited financial statements, prepared either in accordance with U.S. GAAP or International Financial Reporting Standards.

#### **Note 13. Related Party Transactions**

On April 1, 2008, the Company and MRH entered into a Letter Agreement with Kernan V. Oberting, the Company's former Chief Financial Officer, setting forth the terms of his departure as a full-time employee, effective May 1, 2008, in order to establish an investment advisory company, KVO Capital Management, LLC ("KVO"). Among other things, the Letter Agreement provided that Mr. Oberting will continue to vest in all in force awards previously granted to him under the Company's Long-Term Incentive Plan prior to 2008 and he will be entitled to receive a pro-rated annual bonus with respect to 2008. The Letter Agreement also provided for the Company to enter into an Investment Management Agreement with KVO (the "Consulting Agreement" and "IMA", respectively).

Pursuant to the IMA, the Company pays KVO a monthly management fee equal to 8.333 basis points of the net asset value of the Company's investment account, which initially consisted of cash and securities in an aggregate amount equal to \$100.0 million, and an annual incentive fee equal to 15% of the Net Profits (as defined in the Consulting Agreement) of the Company's investment account. After December 31, 2010, the Company will pay KVO a monthly management fee that may be reduced based upon the percentage of KVO's aggregate net assets under management that the Company's investment account constitutes.

For 2008, the Company paid KVO an aggregate of \$ 1.0 million for services provided under the Consulting Agreement and the IMA and, at December 31, 2008, owed KVO an additional \$0.1 million for such services provided.

The Company reinsures two affiliates for property and casualty risks on an excess-of-loss and quota share basis. The related statement of operations and balance sheet account balances for the year ended December 31, 2008 are as follows:

Gross premiums written	\$ 54.0
Net premiums earned	50.0
Losses and LAE	34.3
Acquisition costs	9.2
Foreign exchange gains	6.7
Interest income	0.5
Reinsurance balances receivable	\$ 1.6
Deferred acquisition costs	0.2
Loss and LAE reserves	34.9
Unearned premiums	4.0
Insurance and reinsurance balances payable	2.4

The Company receives various services from affiliates. Included in these services are those related to information technology, modelling and marketing, as well as costs incurred by reinsured affiliates that are covered by a quota share agreement. Fees incurred by the Company in connection with these services totaled \$28.6 million in 2008.

In addition to the amounts shown above, the Company was due \$35.2 million from affiliates, and owed \$8.4 million to affiliates as of December 31, 2008. The receivable related primarily to one intercompany quota share agreement, as well as amounts paid on behalf of affiliates for which the Company has not yet been reimbursed. The payable related primarily to incentive compensation paid by MRH that has not yet been reimbursed by the Company.

#### **Note 14. Commitments and Contingent Liabilities**

##### ***Commitments***

As of December 31, 2008, the Company had unfunded commitments to invest \$17.1 million into three separate private investment funds.

The Company leases office space and computer equipment under noncancellable operating leases that expire on various dates. The Company also has various other operating lease obligations that are immaterial in the aggregate.

Future annual minimum commitments under existing noncancellable leases for office space are \$3.0 million for 2009, 2010, 2011, 2012 and 2013 and thereafter.

Future annual minimum commitments under existing noncancellable leases for computer equipment are \$1.1 million, \$1.1 million, \$1.0 million, \$1.0 million and \$0.4 million for 2009, 2010, 2011, 2012 and 2013 and thereafter.

The Company is party to a secured £110.0 million standby letter of credit facility through December 31, 2013, which is used specifically as Funds at Lloyd's to support business to be underwritten by Syndicate 5151. See Note 6.

##### ***Litigation***

The Company is subject to litigation and arbitration proceedings in the normal course of its business. Such proceedings generally involve reinsurance contract disputes which are typical for the property and casualty insurance and reinsurance industry in general and are considered in connection with the Company's net loss and loss expense reserves. See Note 4 for a description of the Company's pending litigation.

### *Concentrations of Credit and Counterparty Risk*

Financial instruments, which potentially subject the Company to concentrations of credit risk, consist principally of investment securities, insurance and reinsurance balances receivable and reinsurance recoverable. See Note 4.

The Company believes that there are no significant concentrations of credit risk from a single issue or issuer within its investment portfolio other than concentrations in U.S. government and U.S. government-sponsored enterprises. The Company did not own an aggregate investment in a single entity, other than U.S. government and U.S. government-sponsored enterprises, in excess of 10% of the Company's common shareholders' equity at December 31, 2008.

The Company's portfolio of corporate and structured investments, such as asset and mortgage-backed securities, are subject to individual and aggregate credit risk. The Company monitors the credit quality of its fixed maturity investments with exposure to subprime and Alternative A markets as well as those fixed maturity investments that benefit from credit enhancements provided by third-party financial guarantors.

Certain of the Company's derivative securities are subject to counterparty risk. The Company routinely monitors this risk

The Company underwrites the majority of its business through brokers and credit risk exists should any of these brokers be unable to fulfill their contractual obligations with respect to payments of balances owed to the Company.