

# **Validus Reinsurance, Ltd.**

(Incorporated in Bermuda)

Consolidated financial statements

**For the Years Ended December 31, 2010 and 2009**

(expressed in U.S. dollars)



## Report of Independent Auditors

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

In our opinion, the accompanying consolidated balance sheets and the related consolidated statements of operations and comprehensive income, of shareholder's equity and of cash flows present fairly, in all material respects, the financial position of Validus Reinsurance, Ltd. and its subsidiaries at December 31, 2010 and December 31, 2009, and the results of their operations and their cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits of these statements in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

A handwritten signature in black ink, appearing to read 'PricewaterhouseCoopers', is written over a horizontal line.

PricewaterhouseCoopers  
Hamilton, Bermuda  
April 8, 2011

**Validus Reinsurance, Ltd.**  
**Consolidated Balance Sheets**  
**As at December 31, 2010 and 2009**

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

	<b>December 31, 2010</b>	<b>December 31, 2009</b>
<b>Assets</b>		
Fixed maturities, at fair value (amortized cost: 2010: \$3,627,710, 2009: \$3,844,366)	\$ 3,670,276	\$ 3,841,192
Short-term investments, at fair value (amortized cost: 2010: \$197,418, 2009: \$358,522)	197,488	358,522
Other investments (amortized cost: 2010: \$18,392, 2009: \$35,941)	21,478	37,616
Cash and cash equivalents	289,127	162,194
Total cash and investments	4,178,369	4,399,524
Premiums receivable	439,431	373,277
Deferred acquisition costs	57,982	54,325
Prepaid reinsurance premiums	17,292	30,195
Securities lending collateral	22,328	90,350
Loss reserves recoverable	80,219	49,808
Paid losses recoverable	3,710	10,690
Intercompany receivable	19,490	13,530
Accrued investment income	27,389	31,076
Other assets	24,564	10,963
<b>Total assets</b>	<b>\$ 4,870,774</b>	<b>\$ 5,063,738</b>
<b>Liabilities</b>		
Reserves for losses and loss expenses	\$ 998,165	\$ 742,510
Unearned premiums	299,250	325,261
Reinsurance balances payable	68,958	44,413
Securities lending payable	23,093	90,106
Net payable for investments purchased	46,235	44,985
Accounts payable and accrued expenses	20,485	51,618
<b>Total liabilities</b>	<b>1,456,186</b>	<b>1,298,893</b>
<b>Shareholder's equity</b>		
Ordinary shares, 1,000,000,000 authorized, par value \$0.10		
Issued and outstanding (2010 – 100,000,000; 2009 - 100,000,000)	10,000	10,000
Additional paid-in capital	2,656,712	2,649,942
Accumulated other comprehensive income	173	173
Retained earnings	747,523	1,104,610
<b>Total shareholder's equity</b>	<b>3,414,408</b>	<b>3,764,725</b>
<b>Non controlling interest</b>	<b>180</b>	<b>120</b>
<b>Total liabilities, shareholder's equity and non controlling interest</b>	<b>\$ 4,870,774</b>	<b>\$ 5,063,738</b>

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

## Validus Reinsurance, Ltd.

### Consolidated Statements of Operations and Comprehensive Income

#### For the Years Ended December 31, 2010 and 2009

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

	December 31, 2010	December 31, 2009
<b>Revenues</b>		
Gross premiums written	\$ 1,101,239	\$ 768,084
Reinsurance premiums ceded	(63,147)	(95,446)
Net premiums written	1,038,092	672,638
Change in unearned premiums	13,108	122,913
Net premiums earned	1,051,200	795,551
Net investment income	113,971	94,973
Gain on bargain purchase, net of amortization	-	330,678
Net realized gains (losses) on investments	23,637	(5,428)
Net unrealized gains on investments	45,276	75,209
Other income	12,499	5,149
Foreign exchange (losses)	(1,237)	(1,407)
<b>Total revenues</b>	<b>1,245,346</b>	<b>1,294,725</b>
<b>Expenses</b>		
Losses and loss expenses	601,610	186,704
Policy acquisition costs	160,599	127,433
General and administrative expenses	66,737	104,380
Share compensation expenses	7,854	19,274
Finance expenses	5,482	1,772
<b>Total expenses</b>	<b>842,282</b>	<b>439,563</b>
<b>Net income before taxes</b>	<b>403,064</b>	<b>855,162</b>
Income tax expense	(91)	(163)
<b>Net income</b>	<b>402,973</b>	<b>854,999</b>
<b>Comprehensive income</b>		
Foreign currency translation adjustments	-	173
<b>Comprehensive income</b>	<b>\$ 402,973</b>	<b>\$ 855,172</b>

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

## Validus Reinsurance, Ltd.

### Consolidated Statements of Shareholder's Equity For the Years Ended December 31, 2010 and 2009

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

	<u>December 31, 2010</u>	<u>December 31, 2009</u>
<b>Common shares</b>		
Balance – Beginning of year	\$ 10,000	\$ 10,000
Issue of common shares	-	-
Balance – End of year	<u>\$ 10,000</u>	<u>\$ 10,000</u>
<b>Additional paid-in capital</b>		
Balance – Beginning of year	\$ 2,649,942	\$ 1,300,593
(Distribution to) contribution by parent company	(1,084)	1,330,075
Share compensation expense	7,854	19,274
Balance – End of year	<u>\$ 2,656,712</u>	<u>\$ 2,649,942</u>
<b>Accumulated other comprehensive income</b>		
Balance – Beginning of year	\$ 173	\$ -
Foreign currency translation adjustment	-	173
Balance – End of year	<u>\$ 173</u>	<u>\$ 173</u>
<b>Retaining earnings</b>		
Balance – Beginning of year	\$ 1,104,610	\$ 468,731
Dividends paid to parent company	(760,060)	(219,120)
Net income	402,973	854,999
Balance – End of year	<u>\$ 747,523</u>	<u>\$ 1,104,610</u>
<b>Total shareholder's equity</b>	<u>\$ 3,414,408</u>	<u>\$ 3,764,725</u>

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

**Validus Reinsurance, Ltd.**  
Consolidated Statements of Cash Flows  
**For the Years Ended December 31, 2010 and 2009**

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

	<u>December 31, 2010</u>	<u>December 31, 2009</u>
<b>Cash flows provided by (used in) operating activities</b>		
Net income for the year	\$ 402,973	\$ 854,999
Adjustments to reconcile net income to cash provided by operating activities:		
Share compensation expense	7,854	19,274
Net realized (gains) losses on sales of investments	(23,637)	5,428
Net unrealized (gains) on investments	(45,276)	(75,209)
Gain on bargain purchase	-	(330,678)
Amortization of premiums on fixed maturities	24,842	11,116
Non controlling interest held in subsidiary	60	120
Changes in:		
Premiums receivable	(66,154)	37,684
Deferred acquisition costs	(3,657)	14,177
Prepaid reinsurance premiums	12,903	(10,563)
Loss reserves recoverable	(30,411)	37,853
Intercompany receivable	(4,688)	(11,677)
Accrued investment income	3,687	5,756
Other assets	(15,146)	(2,558)
Reserve for losses and loss expenses	255,655	(101,473)
Unearned premiums	(26,011)	(112,349)
Reinsurance balances payable (net of paid losses recoverable)	31,525	12,835
Accounts payable and accrued expenses	(30,967)	(5,256)
<b>Net cash provided by operating activities</b>	<u>493,552</u>	<u>349,479</u>
<b>Cash flows provided by (used in) investing activities</b>		
Proceeds on sales of fixed maturity investments	4,563,623	3,122,226
Proceeds on maturities of investments	252,008	498,785
Purchases of fixed maturity and other investments	(4,582,901)	(3,477,243)
Sales of short-term investments, net	161,074	51,866
Cash paid for subsidiary	(363)	(373,945)
Decrease in securities lending collateral	67,013	15,581
<b>Net cash provided by (used in) investing activities</b>	<u>460,454</u>	<u>(162,730)</u>
<b>Cash flows provided by (used in) financing activities</b>		
Dividends paid to parent company	(760,060)	(219,120)
Decrease in securities lending payable	(67,013)	(15,581)
<b>Net cash used in financing activities</b>	<u>(827,073)</u>	<u>(234,701)</u>
Net increase (decrease) in cash	126,933	(47,952)
<b>Cash and cash equivalents – Beginning of year</b>	162,194	210,146
<b>Cash and cash equivalents – End of year</b>	<u>\$ 289,127</u>	<u>\$ 162,194</u>
<b>Net taxes paid during the year</b>	<u>\$ 95</u>	<u>\$ 190</u>

For significant non cash transactions see note 6.

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

# **Validus Reinsurance, Ltd.**

## **Notes to Consolidated Financial Statements**

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

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### **1. Nature of the business**

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

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

The Company wholly owns the following subsidiaries: Validus Specialty, Inc., Validus Reasegueros, Inc., Validus Services, Inc., Validus Underwriting Risk Services, Inc., Validus Re Chile S.A., Underwriting Risk Services, S.A., Validus Amalgamation Subsidiary, Ltd. (formerly Validus Limited), IPC Re Limited, IPC Underwriting Services Ltd. and Validus Re Europe Limited (formerly, IPC Re Europe Limited). Additionally the Company has a branch based in Singapore.

On September 4, 2009, pursuant to an Amalgamation Agreement, Validus Holdings acquired all of IPC Holdings Ltd’s (“IPC”) outstanding common shares in exchange for 0.9727 its common shares and \$7.50 cash per IPC common share. IPC’s operations were focused on short-tail lines of reinsurance. The primary lines in which IPC conducted business were property catastrophe reinsurance and, to a limited extent, property-per-risk excess, aviation (including satellite) and other short-tail reinsurance on a worldwide basis. The acquisition of IPC was undertaken to gain a strategic advantage in the current reinsurance market and increase the parent company’s capital base. The investment in IPC was transferred to the Company by Validus Holdings in September 2009 as \$1,325,398 of additional paid-in capital.

On March 25, 2010, the Company’s investment in Validus Research Inc. was transferred to Validus Holdings.

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

The consolidated financial statements include the financial statements of Validus Re and its wholly-owned subsidiaries. The consolidated financial statements also include a variable interest entity AlphaCat Fund Ltd. and AlphaCat High Return Fund Ltd. (jointly referred to as “AlphaCat”) and their subsidiaries AlphaCat Master Fund Ltd. and AlphaCat Reinsurance Ltd. The non controlling interest in AlphaCat, which does not derive any income, is held by the parent company and is shown on the Company’s consolidated balance sheet.

These consolidated financial statements have been prepared in accordance with generally accepted accounting principles in the United States of America (“U.S. GAAP”). Certain amounts in prior periods have been reclassified to conform to current period presentation. All significant intercompany accounts and transactions have been eliminated. The preparation of financial statements in conformity with U.S. GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from these estimates. The major estimates reflected in the Company’s consolidated financial statements include the reserve for losses and loss expenses, premium estimates for business written on a proportional basis, reinsurance recoverable balances including the provision for unrecoverable reinsurance recoverable balances and investment valuation. The term “ASC” used in these notes refers to Accounting Standard Codifications issued by the United States Financial Accounting Standards Board (“FASB”). The consolidated financial statements include the results of operations and cash flows of IPC, since the date of acquisition of September 4, 2009.

# Validus Reinsurance, Ltd.

## Notes to Consolidated Financial Statements

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

### 3. *Significant accounting policies*

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

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

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

#### (b) **Policy acquisition costs**

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

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

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

#### (d) **Reinsurance**

In the normal course of business, the Company seeks to reduce the potential amount of loss arising from claims events by reinsuring certain levels of risk assumed in various areas of exposure with other insurers or reinsurers. The accounting for reinsurance ceded depends on the method of reinsurance. If the policy is on a "losses occurring during" basis, reinsurance premiums ceded are expensed (and any commissions thereon are earned) on a pro-rata basis over the period the reinsurance coverage is provided. If the policy is a "risks attaching during" policy, reinsurance premiums ceded are expensed (and any

# Validus Reinsurance, Ltd.

## Notes to Consolidated Financial Statements

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

commissions thereon are earned) in line with the gross premiums earned to which the risk attaching policy relates. Prepaid reinsurance premiums represent the portion of premiums ceded applicable to the unexpired term of policies in force. Mandatory reinstatement premiums ceded are recorded and expensed at the time a loss event occurs. Reinsurance recoverables are based on contracts in force. The method for determining the reinsurance recoverable on unpaid loss and loss expenses involves actuarial estimates of unpaid losses and loss expenses as well as a determination of the Company's ability to cede unpaid losses and loss expenses under its reinsurance treaties. The use of different assumptions could have a material effect on the provision for uncollectible reinsurance. To the extent the creditworthiness of the Company's reinsurers was to deteriorate due to adverse events affecting the reinsurance industry, such as a large number of major catastrophes, actual uncollectible amounts could be significantly greater than the Company's provision. Amounts recoverable from reinsurers are estimated in a manner consistent with the underlying liabilities. Provisions are made for estimated unrecoverable reinsurance.

### (e) Investments

Fair value is defined as the price received to transfer an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date reflecting the highest and best use valuation concepts. The FASB guidance for "Fair Value Measurement and Disclosure" provides a framework for measuring fair value by creating a hierarchy of fair value measurements that distinguishes market data between observable independent market inputs and unobservable market assumptions of the reporting entity. The guidance further expands disclosures about such fair value measurements. The guidance applies broadly to most existing accounting pronouncements that require or permit fair value measurements (including both financial and non-financial assets and liabilities) but does not require any new fair value measurements. The Company has adopted all authoritative guidance in effect as of the balance sheet date regarding certain market conditions that allow for fair value measurements that incorporate unobservable inputs where active market transaction based measurements are unavailable.

Short-term investments comprise investments with a remaining maturity of less than 90 days at time of purchase and money market funds held at the Company's investment managers.

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

For mortgage-backed securities, and any other investment for which there is a prepayment risk, prepayment assumptions are evaluated and revised as necessary. Any adjustments required due to the resultant change in effective yields and maturities are recognized retrospectively. Prepayment fees or call premiums that are only payable to the Company when a security is called prior to its maturity, are earned when received and reflected in net investment income.

### (f) Derivative instruments

The Company uses derivative instruments in the form of foreign currency forward exchange contracts to manage foreign currency risk. A foreign currency forward exchange contract involves an obligation to purchase or sell a specified amount of a specified currency at a future date at a price set at the time of the contract. Foreign currency forward exchange contracts will not eliminate fluctuations in the value of our assets and liabilities denominated in foreign currencies but rather allow the Company to establish a rate of exchange for a future point in time. The foreign currency forward exchange contracts are recorded as derivatives at fair value with changes recorded as a net foreign exchange gain or loss in the Company's statement of operations.

# Validus Reinsurance, Ltd.

## Notes to Consolidated Financial Statements

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

To qualify for hedge accounting treatment, a derivative must be highly effective in mitigating the designated changes in value or cash flow of the hedged item. The Company formally documents all relationships between designated hedging instruments and hedged items, as well as its risk management objective and strategy for undertaking various hedge transactions. The documentation process includes linking derivatives to specific assets or liabilities on the balance sheet. The Company also formally assesses, both at the hedge's inception and on an ongoing basis, whether the derivatives that are used in hedging transactions are highly effective in offsetting changes in fair values or cash flows of hedged items. The Company assesses the effectiveness of its designated hedges on an individual currency basis. If the ratio obtained with this method is within the range of 80% to 125%, the Company considers the hedge effective.

The Company discontinues hedge accounting prospectively when it is determined that the derivative is no longer highly effective in offsetting changes in the fair value or cash flows of a hedged item; the derivative is de-designated as a hedging instrument; or the derivative expires or is sold, terminated or exercised. To the extent that the Company discontinues hedge accounting, because, based on management's assessment, the derivative no longer qualifies as an effective hedge, the derivative will continue to be carried in the Consolidated Balance Sheets at its fair value, with changes in its fair value recognized in current period net income through unrealized gains (losses).

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

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

### **(h) Foreign exchange**

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

Assets and liabilities of subsidiaries whose functional currency is not the U.S. dollar are translated at prevailing year end exchange rates. Revenue and expenses of such foreign operations are translated at average exchange rates during the year. The net effect of translation differences between functional and reporting currencies in foreign operations, net of applicable deferred income taxes, are included in "accumulated other comprehensive income (loss)".

### **(i) Stock plans**

Validus Holdings accounts for its share plans in accordance with the U.S. GAAP fair value recognition provisions for "Stock Compensation". Accordingly, Validus Holdings recognizes the compensation expense for stock option grants, restricted share grants and performance share awards based on the fair value of the award on the date of grant over the requisite service period, and allocates the expense to its subsidiaries, including the Company, based on the location of employees.

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

Deferred tax assets and liabilities are recorded in accordance with U.S. GAAP "Income Taxes" guidance. Consistent with this guidance, the Company records deferred income taxes which reflect the tax effect of the temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and their respective tax bases.

# Validus Reinsurance, Ltd.

## Notes to Consolidated Financial Statements

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

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

The Company recognizes the tax benefits of uncertain tax positions only where the position is "more likely than not" to be sustained assuming examination by tax authorities. The Company did not recognize any resulting liabilities for unrecognized tax benefits.

### **(k) Business Combinations**

On September 4, 2009, the investment in IPC was transferred to the Company by the parent company. The transaction was accounted for as an acquisition method business combination. Accordingly, the purchase price was allocated to assets and liabilities based on their estimated fair value at the acquisition date. The excess of the value of the net assets acquired over the purchase price was recorded as gain on bargain purchase and is shown as a separate component of revenues in the Company's Consolidated Statements of Operations and Comprehensive Income for year ended December 31, 2009. IPC's accounting policies have been conformed to those of the Company.

### **(l) Other investments**

Other investments consist of an investment in a fund of hedge funds and a deferred compensation trust. All investment transactions are recorded on a first-in-first-out basis and realized gains and losses on the sale of investments are determined on the basis of amortized cost. Other investments are carried at fair value with interest and dividend income, income distributions and realized and unrealized gains and losses included in net investment income. The fair value of other investments is generally established on the basis of the net valuation criteria established by the managers of the investments. These net valuations are determined based upon the valuation criteria established by the governing documents of such investments. In addition, due to a lag in reporting, some of the Company's fund managers, fund administrators, or both, are unable to provide final fund valuations as of the Company's current reporting date. In these circumstances, the Company estimates the fair value of these funds by starting with the prior month's fund valuation, adjusting these valuations for capital calls, redemptions or distributions and the impact of changes in foreign currency exchange rates, and then estimating the return for the current period. In circumstances in which the Company estimates the return for the current period, it uses all credible information available. This principally includes preliminary estimates reported by its fund managers, obtaining the valuation of underlying portfolio investments where such underlying investments are publicly traded and therefore have a readily observable price, using information that is available to the Company with respect to the underlying investments, reviewing various indices for similar investments or asset classes, as well as estimating returns based on the results of similar types of investments for which the Company has reported results, or other valuation methods, as necessary. Actual final fund valuations may differ, perhaps materially so, from the Company's estimates and these differences are recorded in the period they become known as a change in estimate.

## **4. Recent accounting pronouncements**

In June 2009, the FASB issued authoritative guidance on accounting for "Transfers and Servicing" (ASC 860). This update addresses practices that have developed that are not consistent with the original intent and key requirements and concerns that derecognized financial assets and related obligations should continue to be reported in the transferors' financial statements. This update is effective for financial asset transfers in the interim and annual periods beginning after November 15, 2009. The adoption of this guidance has not had a material impact on the Company's consolidated financial statements.

# Validus Reinsurance, Ltd.

## Notes to Consolidated Financial Statements

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

In June 2009, the FASB issued authoritative guidance which amends the “Consolidation” guidance that applies to Variable Interest Entities (“VIEs”) (ASC 810). This update amends the guidance for the identification of VIEs and their primary beneficiaries and the financial statement disclosures required. This update is effective for interim and annual periods beginning after November 15, 2009. The adoption of this update has not had a material impact on the Company’s consolidated financial statements.

In January 2010, the FASB issued authoritative guidance on “Fair Value Measurements and Disclosures” (ASC 820). This update requires additional disclosures regarding (1) significant transfers in and out of Levels 1 and 2 and the reasons that such transfers were made; (2) inputs and valuation techniques used to measure fair value for financial assets and liabilities that fall in either Level 2 or Level 3; (3) the activity within Level 3 fair value measurements, including information on a gross basis for purchases, sales, issuances, and settlements; and (4) disaggregation of financial assets and liabilities measured at fair value into classes of financial assets and liabilities. This guidance is effective for interim and annual reporting periods beginning after December 15, 2009, except for Level 3 reconciliation disclosures which are effective for interim and annual periods beginning after December 15, 2010. The adoption of this update has not had a material impact on the Company’s consolidated financial statements.

In March 2010, the FASB issued authoritative guidance which clarifies the “Embedded Derivatives” guidance (ASC 815). All entities that enter into contracts containing an embedded credit derivative feature related to the transfer of credit risk that is not only in the form of subordination of one financial instrument to another will be affected by the amendments. The amendments in this update are effective for interim periods beginning after June 15, 2010. As the Company has not entered into contracts containing an embedded credit derivative feature related to the transfer of credit risk that is not only in the form of subordination of one financial instrument to another, the adoption of this update did not impact the Company’s consolidated financial statements.

In April 2010, the FASB issued authoritative guidance which clarifies the “Stock Compensation” guidance (ASC 718). This guidance clarifies the accounting for certain employee share-based payment awards. Awards with an exercise price denominated in the currency of a market in which a substantial portion of the entity’s equity securities trades would not be considered to contain a condition that is not a market, performance or service condition. Therefore, an entity would not classify such an award as a liability if it otherwise qualifies as equity. This accounting guidance is effective for accounting periods beginning after December 15, 2010, with earlier application permitted. The adoption of this update did not impact the Company’s consolidated financial statements.

In October 2010, the FASB issued Accounting Standards Update No. 2010-26, “Accounting for Costs Associated with Acquiring or Renewing Insurance Contracts” (“ASU 2010-26”). The objective of ASU 2010-26 is to address diversity in practice regarding the interpretation of which costs relating to the acquisition of new or renewal insurance contracts qualify for deferral. ASU 2010-26 is effective for interim and annual periods beginning after December 15, 2011 and may be applied prospectively or retrospectively. The Company has assessed the impact of this guidance and has concluded that it does not have an impact on the Company’s consolidated financial statements. The Company early adopted this update effective January 1, 2011.

### ***5. Variable interest entity***

The Company owns 100% of the non-voting participating shares in AlphaCat. Although the Company does not have voting control over this entity the Company will absorb the expected losses, and will receive the expected residual returns, of this entity. AlphaCat and its subsidiaries AlphaCat Master Fund Ltd. and AlphaCat Reinsurance Ltd. participate in fully collateralized property-catastrophe transactions and invest in catastrophe bonds and other collateralized capital market based insurance-linked securities. These consolidated financial

# Validus Reinsurance, Ltd.

## Notes to Consolidated Financial Statements

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

statements include net assets of \$156,993 (2009: \$106,308) relating to AlphaCat and its subsidiaries. The assets are primarily included in fixed maturities and short-term investments. A non-controlling interest, of \$180 (2009: \$120) held by the parent company, is shown on the consolidated balance sheet.

### **6. Business combinations**

On September 4, 2009, pursuant to an Amalgamation Agreement, the parent company acquired all of the outstanding common shares of IPC in exchange for 0.9727 of Validus Holdings' common shares and \$7.50 cash per IPC common share. IPC's operations are focused on short-tail lines of reinsurance. The primary lines in which IPC conducted business were property catastrophe reinsurance and, to a limited extent, property-per-risk excess, aviation (including satellite) and other short-tail reinsurance on a worldwide basis. The IPC Acquisition was undertaken to gain a strategic advantage in the then current reinsurance market where capacity had been depleted and to increase the parent company's capital base.

The aggregate purchase price paid by the parent company was \$1,746,224 for adjusted tangible net assets acquired of \$2,076,902. During 2009 the global financial crisis and related market illiquidity led to several publicly traded companies trading at substantial discounts. This was the primary factor responsible for a purchase price less than the book value of IPC's net assets, and the recognition of a bargain purchase gain on acquisition.

The estimates of fair values for tangible assets acquired and liabilities assumed were determined by management based on various market and income analyses and asset appraisals. Significant judgment was required to arrive at these estimates of fair value and changes to assumptions used could have led to materially different results.

An adjustment of \$50,000 was made to IPC's net assets acquired in respect of the termination fee (the "Max Termination Fee") paid under the Agreement and Plan of Amalgamation among Max Capital Group Ltd. ("Max"), IPC and IPC Limited. This Max Termination Fee was advanced to IPC by Validus Holdings on July 9, 2009, but was repayable in certain circumstances.

In addition, at closing the parent company recorded a \$21,671 intangible asset for the acquired IPC customer relationships. This intangible asset was related to the acquired broker distribution network and was fair valued using a variation of the income approach. Under this approach, the parent company estimated the present value of expected future cash flows to an assumed hypothetical market participant resulting from the existing IPC customer relationships, considering attrition, and discounting at a weighted average cost of capital.

# Validus Reinsurance, Ltd.

## Notes to Consolidated Financial Statements

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

The composition of purchase price and fair value of net assets acquired is summarized as follows:-

The composition of purchase price and fair value of net assets acquired is summarized as follows:

### Total allocable purchase price

IPC shares outstanding at September 4, 2009	56,110,096
Exchange ratio	0.9727
Validus Holdings common shares issued	54,578,268
Validus Holdings closing share price on September 4, 2009	\$ 24.10

Total value of Validus Holdings shares to be issued	\$ 1,315,337
Total cash consideration paid at \$7.50 per IPC share	420,826
Share compensation awards issued to IPC employees pursuant to the Amalgamation Agreement and earned prior to the Amalgamation	10,061

### Total allocable purchase price

1,746,224

### Tangible Assets Acquired

Cash and investments	\$ 2,463,374
Receivables(a)	202,278

### Tangible Assets Acquired

2,665,652

### Liabilities Acquired

Net loss reserves and paid losses recoverable	\$ 304,957
Unearned premiums, net of expenses	180,370
Other liabilities	<u>53,423</u>

### Liabilities acquired

538,750

### Net tangible assets acquired, at fair value

2,126,902

Max Termination Fee

(50,000)

### Net tangible assets acquired, at fair value, adjusted

2,076,902

### Bargain purchase gain before establishment of intangible assets

330,678

Intangible asset — customer relationships

21,671

### Bargain purchase gain on acquisition of IPC

352,349

Amortization of intangible asset — customer relationships

(21,671)

### Gain on bargain purchase

\$ 330,678

(a) The fair value of receivables approximates the gross contractual amounts receivable.

The bargain purchase gain above has been presented as a separate line item in the Company's Consolidated Statements of Operations and Comprehensive Income. As of December 31, 2009, the customer relationships intangible asset was fully amortized by the Company as it was not expected to significantly contribute to the company's future cash flows.

## Validus Reinsurance, Ltd.

### Notes to Consolidated Financial Statements

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

The parent company also incurred transaction and termination expenses related to the IPC acquisition. Transaction expenses are primarily comprised of legal, corporate advisory, and audit related services and amounted to \$29,448. Termination expenses are primarily comprised of severance costs and accelerated share compensation costs in connection with certain IPC employment contracts that have been terminated and amounted to \$14,131.

The following selected audited information has been provided to present a summary of the results of IPC since the acquisition date, that have been included within the Company's consolidated financial statements for the year ended December 31, 2009:

	<b>From Acquisition Date to December 31, 2009</b>
Net premiums written	\$ (4,974)
Total revenue	161,188
Total expenses	33,370
Net income	<u>\$ 127,818</u>

# Validus Reinsurance, Ltd.

## Notes to Consolidated Financial Statements

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

### Supplemental Pro Forma Information

Operating results of IPC have been included in the consolidated financial statements from the September 4, 2009 acquisition date. The following selected unaudited pro forma financial information has been provided to present a summary of the combined results of the Company and IPC, assuming the transaction had been effected on January 1, 2009. The unaudited pro forma data is for informational purposes only and does not necessarily represent results that would have occurred if the transaction had taken place on the basis assumed above.

	<b>Year Ended December 31, 2009 (unaudited)</b>
<b>Revenues</b>	
Gross premiums written	\$ 2,008,578
Reinsurance premiums ceded	(239,412)
Net premiums written	1,769,166
Change in unearned premiums	(57,338)
Net premiums earned	1,711,828
Net investment income	163,944
Net realized (losses) on investments	(4,717)
Net unrealized gains on investments	189,789
Other income	4,603
Realized gain on repurchase of debentures	4,444
Foreign exchange gains	4,294
<b>Total revenues</b>	<b>2,074,185</b>
<b>Expenses</b>	
Losses and loss expenses	556,550
Policy acquisition costs	289,600
General and administrative expenses	209,510
Share compensation expenses	33,751
Finance expenses	44,513
<b>Total expenses</b>	<b>1,133,924</b>
<b>Net income before taxes</b>	<b>940,261</b>
Tax benefit	3,759

### 7. Investments

The Company's investments in fixed maturities are classified as trading and carried at fair value, with related net unrealized gains or losses included in earnings. The Company has adopted all authoritative guidance in effect as of the balance sheet date regarding certain market conditions that allow for fair value measurements that incorporate unobservable inputs where active market transaction based measurements are unavailable.

#### (a) Classification within the fair value hierarchy

Under U.S. GAAP, a company must determine the appropriate level in the fair value hierarchy for each fair value measurement. The fair value hierarchy prioritizes the inputs, which refer broadly to assumptions market participants would use in pricing an asset or liability, into three levels. It gives the highest priority to quoted prices (unadjusted) in active markets for identical assets or liabilities and the lowest priority to

# Validus Reinsurance, Ltd.

## Notes to Consolidated Financial Statements

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

unobservable inputs. The level in the fair value hierarchy within which a fair value measurement in its entirety falls is determined based on the lowest level input that is significant to the fair value measurement in its entirety.

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

Level 1 primarily consists of financial instruments whose value is based on quoted market prices or alternative indices including overnight repos and commercial paper. Level 2 includes financial instruments that are valued through independent external sources using models or other valuation methodologies. These models are primarily industry-standard models that consider various assumptions, including time value, yield curve, prepayment speeds, default rates, loss severity, current market and contractual prices for the underlying financial instruments, as well as other relevant economic measures. Substantially all of these assumptions are observable in the marketplace, can be derived from observable data or are supported by observable levels at which transactions are executed in the marketplace. The Company performs internal procedures on the valuations received from independent external sources. Financial instruments in this category include U.S. and U.K. Treasuries, sovereign debt, corporate debt, catastrophe bonds, U.S. agency and non-agency mortgage, asset-backed securities and bank loans. Level 3 includes financial instruments that are valued using market approach and income approach valuation techniques. These models incorporate both observable and unobservable inputs. A hedge fund is the only financial instrument in this category as at December 31, 2010.

The Company's external investment advisors had noted illiquidity and dislocation in the non-Agency RMBS market for the period September 30, 2008 through to June 30, 2010. During this period, the Company identified certain non-Agency RMBS securities in its portfolio trading in inactive markets ("identified RMBS securities"). In order to gauge market activity for the identified RMBS securities, the Company, with assistance from external investment advisors, reviewed the pricing sources for each security in the portfolio. The Company utilized various pricing vendors to obtain market pricing information for investment securities.

Consistent with U.S. GAAP, market approach fair value measurements for securities trading in inactive markets are not determinative. In weighing the fair value measurements resulting from market approach and income approach valuation techniques, the Company previously placed less reliance on the market approach fair value measurements. The income approach valuation technique determines the fair value of each security on the basis of contractual cash flows, discounted using a risk-adjusted discount rate. As the income approach valuation technique incorporates both observable and significant unobservable inputs, the securities were included as Level 3 assets with respect to the fair value hierarchy. The foundation for the income approach was the amount and timing of future cash flows.

During the three month period ended September 30, 2010, the Company, with assistance from external investment advisors, determined that market activity had increased for the identified RMBS securities. Therefore, a market approach valuation technique was adopted for the identified RMBS securities. Because the market approach incorporates observable inputs, the identified RMBS securities were classified as Level 2 with respect to the fair value hierarchy at September 30, 2010. During the three months ended December 31, 2010, the Company liquidated substantially all of the identified RMBS securities which had previously been classified as Level 3 securities.

Other investments consist of an investment in a fund of hedge funds and a deferred compensation trust held in mutual funds. During the fourth quarter of 2009, a majority of the fund of hedge funds was redeemed. The remaining portion is a side pocket valued at \$12,892 at December 31, 2010. While a redemption request has been submitted, the timing of receipt of proceeds on the side pocket is unknown. The fund investment manager

# Validus Reinsurance, Ltd.

## Notes to Consolidated Financial Statements

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

provides monthly reported net asset values ("NAV") with a one-month delay in its valuation. As a result, the fund investment manager's November 30, 2010 NAV was used as a partial basis for fair value measurement in the Company's December 31, 2010 balance sheet. The fund investment manager's NAV relies on an estimate of the performance of the fund based on the month end positions from the underlying third-party funds. The Company utilizes the fund investment manager's primary market approach estimated NAV that incorporates relevant valuation sources on a timely basis. As this valuation technique incorporates both observable and significant unobservable inputs, the fund of hedge funds is classified as a Level 3 asset. To determine the reasonableness of the estimated NAV, the Company assesses the variance between the estimated NAV and the one-month delayed fund investment manager's NAV. Immaterial variances are recorded in the following reporting period.

At December 31, 2010, the Company's investments are allocated between levels 1, 2 and 3 as follows:

	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>	<u>Total</u>
U.S. Government and Government Agency	-	\$ 1,288,032	\$ -	\$ 1,288,032
Non-U.S. Government and Government Agency	-	357,569	-	357,569
States, municipalities, political subdivision	-	21,072	-	21,072
Agency residential mortgage-backed securities	-	329,764	-	329,764
Non-Agency residential mortgage-backed securities	-	51,237	-	51,237
U.S. corporate	-	1,056,293	-	1,056,293
Non-U.S. corporate	-	407,536	-	407,536
Bank loans	-	52,566	-	52,566
Catastrophe bonds	-	58,736	-	58,736
Asset-backed securities	-	31,634	-	31,634
Commercial mortgage-backed Securities	-	15,837	-	15,837
Total fixed maturities	-	3,670,276	-	3,670,276
Short-term investments	189,032	8,456	-	197,488
Hedge fund	-	-	12,892	12,892
Mutual Fund	-	8,586	-	8,586
<b>Total</b>	<u>\$ 189,032</u>	<u>\$ 3,687,318</u>	<u>\$ 12,892</u>	<u>\$ 3,889,242</u>

## Validus Reinsurance, Ltd.

### Notes to Consolidated Financial Statements

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

At December 31, 2009, the Company's investments are allocated between levels 1, 2 and 3 as follows:

	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>	<u>Total</u>
U.S. Government and Government Agency	-	\$ 1,451,169	\$ -	\$ 1,451,169
Non-U.S. Government and Government Agency	-	455,184	-	455,184
States, municipalities, political subdivision	-	16,322	-	16,322
Agency residential mortgage-backed securities	-	440,155	-	440,155
Non-Agency residential mortgage-backed securities	-	47,775	85,336	133,111
U.S. corporate	-	873,870	-	873,870
Non-U.S. corporate	-	362,997	-	362,997
Bank loans	-	-	-	-
Catastrophe bonds	-	52,351	-	52,351
Asset-backed securities	-	22,578	-	22,578
Commercial mortgage-backed Securities	-	33,455	-	33,455
Total fixed maturities	-	3,755,856	85,336	3,841,192
Short-term investments	358,522	-	-	358,522
Hedge fund	-	-	25,670	25,670
Mutual Fund	-	11,946	-	11,946
<b>Total</b>	<u>\$ 358,522</u>	<u>\$ 3,767,802</u>	<u>\$ 111,006</u>	<u>\$ 4,237,330</u>

At December 31, 2010, Level 3 investments totalled \$12,892 (2009: \$111,006), representing 0.3% (2009: 2.6%) of total investments measured at fair value on a recurring basis.

## Validus Reinsurance, Ltd.

### Notes to Consolidated Financial Statements

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

The following tables present 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, 2010 and 2009:

	<b>Year Ended December 31, 2010</b>		
	<b>Fixed Maturity Investments</b>	<b>Other Investments</b>	<b>Total Fair Market Value</b>
Level 3 investments — Beginning of period \$	85,336	\$ 25,670	\$ 111,006
Payments and purchases	-	-	-
Sales and maturities	-	(13,850)	(13,850)
Realized gains	-	662	662
Unrealized (losses) gains	(6,307)	410	(5,897)
Amortization	(11,841)	-	(11,841)
Transfers (out)	(67,188)	-	(67,188)
Level 3 investments — End of period	<u>\$ -</u>	<u>\$ 12,892</u>	<u>\$ 12,892</u>

	<b>Year Ended December 31, 2009</b>		
	<b>Fixed Maturity Investments</b>	<b>Other Investments</b>	<b>Total Fair Market Value</b>
Level 3 investments — Beginning of period \$	104,661	\$ -	\$ 104,661
Payments and purchases	-	115,351	115,351
Sales and maturities	(822)	(92,004)	(92,826)
Realized (losses) gains	(1,284)	1,609	325
Unrealized (losses) gains	(7,329)	714	(6,615)
Amortization	(16,547)	-	(16,547)
Transfers in	6,657	-	6,657
Level 3 investments — End of period	<u>\$ 85,336</u>	<u>\$ 25,670</u>	<u>\$ 111,006</u>

**(b) Net investment income**

Net investment income is derived from the following sources for the years ended December 31, 2010 and 2009:

	<b>December 31, 2010</b>	<b>December 31, 2009</b>
Fixed maturities and short-term investments	\$ 113,345	\$ 95,482
Cash and cash equivalents	6,287	815
Securities lending income	200	772
Total gross investment income	<u>119,832</u>	<u>97,069</u>
Investment expenses	(5,861)	(2,096)
<b>Net investment income</b>	<u>\$ 113,971</u>	<u>\$ 94,973</u>

# Validus Reinsurance, Ltd.

## Notes to Consolidated Financial Statements

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

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

	<u>December 31, 2010</u>	<u>December 31, 2009</u>
Fixed maturities, short-term investments and cash equivalents		
Gross realized gains	\$ 66,637	\$ 28,996
Gross realized (losses)	(43,000)	(34,424)
Net realized gains (losses) on investments	23,637	(5,428)
Net unrealized (losses) gains on securities lending	(1,009)	6,977
Change in net unrealized gains on investments	46,285	68,232
<b>Total net realized gains (losses) and change in unrealized gains (losses) on investments</b>	<u>\$ 68,913</u>	<u>\$ 69,781</u>

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

The amortized cost, gross unrealized gains (losses) and estimated fair value of investments at December 31, 2010 are as follows:

	<u>Amortized Cost</u>	<u>Gross Unrealized gains</u>	<u>Gross Unrealized losses</u>	<u>Estimated fair value</u>
U.S. Government and Government Agency	\$ 1,280,473	\$ 13,802	\$ (6,243)	\$ 1,288,032
Non-U.S. Government and Government Agency	351,049	6,904	(384)	357,569
States, municipalities, political subdivision	21,153	75	(156)	21,072
Agency residential mortgage-backed securities	317,074	13,062	(372)	329,764
Non-Agency residential mortgage-backed securities	56,618	15	(5,396)	51,237
U.S. corporate	1,041,570	21,739	(7,016)	1,056,293
Non-U.S. corporate	403,070	6,588	(2,122)	407,536
Bank loans	52,612	58	(104)	52,566
Catastrophe bonds	56,990	2,042	(296)	58,736
Asset-backed securities	31,536	223	(125)	31,634
Commercial mortgage-backed securities	15,565	272	-	15,837
Total fixed maturities	3,627,710	64,780	(22,214)	3,670,276
Total short-term investments	197,418	70	-	197,488
Total other investments	18,392	3,086	-	21,478
<b>Total</b>	<u>\$ 3,843,520</u>	<u>\$ 67,936</u>	<u>\$ (22,214)</u>	<u>\$ 3,889,242</u>

# Validus Reinsurance, Ltd.

## Notes to Consolidated Financial Statements

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

The amortized cost, gross unrealized gains (losses) and estimated fair value of investments at December 31, 2009 are as follows:

	<u>Amortized Cost</u>	<u>Gross Unrealized gains</u>	<u>Gross Unrealized losses</u>	<u>Estimated fair value</u>
U.S. Government and Government Agency	\$ 1,448,749	\$ 6,923	\$ (4,503)	\$ 1,451,169
Non-U.S. Government and Government Agency	454,066	1,997	(879)	455,184
States, municipalities, political subdivision	16,310	68	(56)	16,322
Agency residential mortgage-backed securities	428,288	12,426	(559)	440,155
Non-Agency residential mortgage-backed securities	172,116	481	(39,486)	133,111
U.S. corporate	856,447	18,290	(867)	873,870
Non-U.S. corporate	361,783	3,697	(2,483)	362,997
Catastrophe bonds	51,236	1,244	(129)	52,351
Asset-backed securities	22,754	274	(450)	22,578
Commercial mortgage-backed securities	32,617	838	-	33,455
Total fixed maturities	<u>3,844,366</u>	<u>46,238</u>	<u>(49,412)</u>	<u>3,841,192</u>
Total short-term investments	358,522	-	-	358,522
Total other investments	<u>35,941</u>	<u>1,675</u>	<u>-</u>	<u>37,616</u>
<b>Total</b>	<u>\$ 4,238,829</u>	<u>\$ 47,913</u>	<u>\$ (49,412)</u>	<u>\$ 4,237,330</u>

The following table sets forth certain information regarding the investment ratings of the Company's fixed maturities portfolio as at December 31, 2010 and 2009. Investment ratings are the lower of Moody's or Standard & Poor's rating for each investment security, presented in Standard & Poor's equivalent rating. For investments where Moody's and Standard & Poor's ratings are not available, Fitch ratings are used and presented in Standard & Poor's equivalent rating.

	<u>December 31, 2010</u>		<u>December 31, 2009</u>	
	<u>Estimated fair value</u>	<u>% of total</u>	<u>Estimated fair value</u>	<u>% of total</u>
AAA	\$2,113,832	57.6%	\$ 2,458,144	64.0%
AA	351,816	9.6%	423,302	11.0%
A	824,008	22.5%	744,133	19.4%
BBB	175,691	4.8%	11,131	0.3%
Investment grade	<u>3,465,347</u>	<u>94.5%</u>	<u>3,636,710</u>	<u>94.7%</u>
BB	128,270	3.4%	95,486	2.5%
B	45,660	1.2%	59,117	1.5%
CCC	28,884	0.8%	45,193	1.2%
D/NR	2,115	0.1%	4,686	0.1%
Non-Investment grade	<u>204,929</u>	<u>5.5%</u>	<u>204,482</u>	<u>5.3%</u>
<b>Total Fixed Maturities</b>	<u>\$ 3,670,276</u>	<u>100.0%</u>	<u>\$ 3,841,192</u>	<u>100.0%</u>

The amortized cost and estimated fair value amounts for fixed maturity securities held at December 31, 2010 and 2009 are shown by contractual maturity. Actual maturity may differ from contractual maturity because

# Validus Reinsurance, Ltd.

## Notes to Consolidated Financial Statements

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

certain borrowers may have the right to call or prepay certain obligations with or without call or prepayment penalties.

	December 31, 2010		December 31, 2009	
	Amortized cost	Estimated fair value	Amortized cost	Estimated fair value
Due in one year or less	\$ 311,254	\$ 313,337	\$ 150,645	\$ 152,001
Due after one year through five years	2,663,515	2,698,369	2,696,196	2,716,745
Due after five years through ten years	170,925	169,306	291,454	292,851
Due after ten years	61,223	60,792	50,296	50,296
	<u>3,260,917</u>	<u>3,241,804</u>	<u>3,188,591</u>	<u>3,211,893</u>
Asset-backed and mortgage-backed Securities	420,793	428,472	655,775	629,299
<b>Total</b>	<u>\$ 3,627,710</u>	<u>\$ 3,670,276</u>	<u>\$ 3,844,366</u>	<u>\$ 3,841,192</u>

The Company and its parent have a five year, \$500,000 secured letter of credit facility provided by a syndicate of commercial banks. At December 31, 2010, approximately \$268,944 (December 31, 2009: \$225,823) of letters of credit were issued and outstanding under this facility for which \$325,532 of investments were pledged as collateral (December 31, 2009: \$314,857). In 2007, a sister company, Talbot Holdings Ltd. ("Talbot"), entered into a \$100,000 standby letter of credit facility which provides Funds at Lloyd's. On November 19, 2009 Talbot Holdings Ltd. entered into the Second Amendment to the Talbot FAL Facility to reduce the commitment from \$100,000 to \$25,000. At December 31, 2010, \$25,000 (2009: \$25,000) of letters of credit were issued and outstanding under this facility for which \$45,504 of the Company investments were pledged as collateral (2009: \$128,798). In addition, \$240,388 of investments were held in trust at December 31, 2010 (December 31, 2009: \$109,165).

The parent company assumed two letters of credit facilities as part of the IPC Acquisition. A Credit Facility between IPC, IPCRe Limited, the Lenders party thereto and Wachovia Bank, National Association (the "IPC Syndicated Facility") and a Letters of Credit Master Agreement between Citibank N.A. and IPCRe Limited (the "IPC Bi-Lateral Facility"). At March 31, 2010, the IPC Syndicated Facility was closed. At December 31, 2010, the IPC Bi-Lateral Facility had \$68,063 (December 31, 2009: \$96,047) letters of credit issued and outstanding for which \$105,310 (December 31, 2009: \$219,004) of investments were held in an associated collateral account.

### (d) Securities lending

The Company participates in a securities lending program whereby certain securities from its portfolio are loaned to third parties for short periods of time through a lending agent. The Company retains all economic interest in the securities it lends and receives a fee from the borrower for the temporary use of the securities. Collateral in the form of cash, government securities and letters of credit is required at a rate of 102% of the market value of the loaned securities and is held by a third party. As at December 31, 2010, the Company had \$22,566 (2009: \$88,146) in securities on loan. During the year ended December 31, 2010, the Company recorded a \$1,009 unrealized loss on this collateral on its Statements of Operations (2009: unrealised gain \$6,977).

# Validus Reinsurance, Ltd.

## Notes to Consolidated Financial Statements

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

Securities lending collateral reinvested includes corporate floating rate securities and overnight repo with an average reset period of 17.6 days (2009: 26.1 days). As at December 31, 2010, the securities lending collateral reinvested by the Company in connection with its securities lending program was allocated between Levels 1, 2 and 3 as follows:

	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>	<u>Total</u>
Corporate	\$ -	\$ 229	\$ -	\$ 229
Asset-backed securities	-	5,005	-	5,005
Short-term investments	2,644	14,450	-	17,094
<b>Total</b>	<u>\$ 2,644</u>	<u>\$ 19,684</u>	<u>\$ -</u>	<u>\$ 22,328</u>

As at December 31, 2009, the securities lending collateral reinvested by the Company in connection with its securities lending program was allocated between Levels 1, 2 and 3 as follows:

	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>	<u>Total</u>
Corporate	\$ -	\$ 14,123	\$ -	\$ 14,123
Agency	-	9,363	-	9,363
Asset-backed securities	-	6,153	-	6,153
Short-term investments	730	59,981	-	60,711
<b>Total</b>	<u>\$ 730</u>	<u>\$ 89,620</u>	<u>\$ -</u>	<u>\$ 90,350</u>

The following table sets forth certain information regarding the investment ratings of the Company's securities lending collateral reinvested as at December 31, 2010 and December 31, 2009. Investment ratings are the lower of Moody's or Standard & Poor's rating for each investment security, presented in Standard & Poor's equivalent rating. For investments where Moody's and Standard & Poor's ratings are not available, Fitch ratings are used and presented in Standard & Poor's equivalent rating.

	<u>December 31, 2010</u>		<u>December 31, 2009</u>	
	<u>Estimated fair value</u>	<u>% of total</u>	<u>Estimated fair value</u>	<u>% of total</u>
AAA	\$ 5,454	24.4%	\$ 33,501	37.1%
AA+	11,003	49.3%	12,011	13.3%
AA	-	0.0%	4,998	5.5%
AA-	2,998	13.5%	19,910	22.0%
A+	-	0.0%	9,999	11.1%
A	-	0.0%	9,006	10.0%
NR	229	1.0%	195	0.2%
	<u>19,684</u>	<u>88.2%</u>	<u>89,620</u>	<u>99.2%</u>
NR – Short-term investments (1)	2,644	11.8%	730	0.8%
<b>Total</b>	<u>\$ 22,328</u>	<u>100.0%</u>	<u>\$ 90,350</u>	<u>100.0%</u>

(1) This amount relates to short-term investments and is therefore not a rated security.

# Validus Reinsurance, Ltd.

## Notes to Consolidated Financial Statements

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The amortized cost and estimated fair value amounts for securities lending collateral reinvested by the Company at December 31, 2010 and December 31, 2009 are shown by contractual maturity below. Actual maturity may differ from contractual maturity because certain borrowers may have the right to call or prepay certain obligations with or without call or prepayment penalties.

	December 31, 2010		December 31, 2009	
	Amortized cost	Estimated fair value	Amortized cost	Estimated fair value
Due in one year or less	\$ 17,093	\$ 17,095	\$ 68,895	\$ 70,074
Due after one year through five years	6,000	5,233	21,211	20,276
<b>Total</b>	<b>\$ 23,093</b>	<b>\$ 22,328</b>	<b>\$ 90,106</b>	<b>\$ 90,350</b>

### (e) Junior Subordinated Deferrable Debentures

On April 29, 2008, the Company purchased from an unaffiliated financial institution \$45,700 principal amount of the parent company's 8.480% Junior Subordinated Deferrable Debentures due 2037 at an aggregate price of \$36,560, plus accrued and unpaid interest of \$474.

On December 1, 2009, the Company purchased from an unaffiliated financial institution \$14,500 principal amount of the parent company's 8.480% Junior Subordinated Deferrable Debentures due 2037 at an aggregate price of \$9,933, plus accrued and unpaid interest of \$246.

The estimated fair value of the purchased Junior Subordinated Deferrable Debentures at December 31, 2010 and 2009 was \$54,258 and \$50,296, respectively.

### 8. Derivative Instruments Used in Hedging Activities

The Company enters into derivative instruments for risk management purposes, specifically to economically hedge unmatched foreign currency exposures. During the year, the Company entered into a foreign currency forward exchange contract to mitigate the foreign currency exposure of unpaid losses denominated in Chilean Pesos (CLP). The following table summarizes information on the location and amount of the derivative fair value on the consolidated balance sheet at December 31, 2010:

Derivatives designated as hedging instruments:	Notional Amount	Asset Derivatives		Liability Derivatives	
		Balance Sheet location	Fair value	Balance Sheet location	Fair value
Foreign exchange contract	\$75,000	Other assets	\$2,905	Other liabilities	\$ -

There were no derivatives on the balance sheet at December 31, 2009.

### (a) Classification within the fair value hierarchy

As described in Note 7 "Investments", under U.S. GAAP, a company must determine the appropriate level in the fair value hierarchy for each fair value measurement. We estimate the fair value for this asset derivative using a valuation obtained from an independent external source. The assumptions used within the valuation are observable in the marketplace, can be derived from observable data or are supported by

# Validus Reinsurance, Ltd.

## Notes to Consolidated Financial Statements

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observable levels at which transactions are executed in the marketplace. Accordingly, we classified this derivative within Level 2 of the fair value hierarchy.

### (b) Derivative instruments designated as a fair value hedge

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

The following table provides the total impact on earnings relating to the derivative instrument formally designated as a fair value hedge along with the impact of the related hedged item for the year end December 31, 2010:

Derivatives designated as hedging instruments:	Notional Amount	Asset Derivatives		Liability Derivatives	
		Balance Sheet	Fair value	Balance Sheet	Fair value
		location		location	
		Other assets		Other liabilities	
Foreign exchange contract	\$75,000		\$2,905		\$ -

### 9. Premiums Receivable

Premiums receivable are composed of premiums in the course of collection, net of commissions and brokerage, and premiums accrued but unbilled, net of commissions and brokerage. The following is a breakdown of the components of receivables at December 31, 2010 and 2009:

	Premiums in course of collection	Premiums accrued but unbilled	Total
Balance at December 31, 2009	\$ 277,881	\$ 95,396	\$ 373,277
Change during 2010	(185,793)	251,947	66,154
Balance at December 31, 2010	\$ 92,088	\$ 347,343	\$439,431

	Premiums in course of collection	Premiums accrued but unbilled	Total
Balance at December 31, 2008	\$ 134,745	\$ 100,542	\$ 235,287
Change during 2009	143,136	(5,146)	137,990
Balance at December 31, 2009	\$ 277,881	\$ 95,396	\$373,277

# Validus Reinsurance, Ltd.

## Notes to Consolidated Financial Statements

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### 10. Reserves for losses and loss expenses

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

The following table represents an analysis of paid and unpaid losses and loss expenses incurred and a reconciliation of the beginning and ending unpaid loss expenses as at December 31, 2010 and 2009:

	<b>December 31, 2010</b>	<b>December 31, 2009</b>
Reserve for losses and loss expenses, beginning of period	\$ 742,510	\$ 535,888
Losses and loss expenses recoverable	(49,808)	(84,523)
Net reserves for losses and loss expenses, beginning of period	\$ 692,702	\$ 451,365
Net reserves acquired on IPC transfer	-	304,957
Increase (decrease) in net losses and loss expenses incurred in respect of losses occurring in		
Current year	672,227	239,676
Prior years	(70,617)	(52,972)
Total incurred losses and loss expenses	601,610	186,704
Total net paid losses	(379,274)	(254,996)
Foreign exchange	2,908	4,672
Net reserve for losses and loss expenses, end of period	917,946	692,702
Loss and loss expenses recoverable	80,219	49,808
Reserve for losses and loss expenses, end of period	<u>\$ 998,165</u>	<u>\$ 742,510</u>

Incurred losses and loss adjustment expenses comprise:

	<b>December 31, 2010</b>	<b>December 31, 2009</b>
Gross losses and loss adjustment expenses	\$ 673,895	\$ 188,924
Reinsurance recoverable	(72,285)	(2,220)
Total incurred losses and loss adjustment expenses	<u>\$ 601,610</u>	<u>\$ 186,704</u>

# Validus Reinsurance, Ltd.

## Notes to Consolidated Financial Statements

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

The December 31, 2010 and 2009 gross reserves balance comprises reserves for reported claims of \$523,388 and \$397,133, respectively, and reserves for claims incurred but not reported of \$474,777 and \$345,377, respectively. The net (favourable) unfavourable development on prior years by line of business is as follows:

	Line of business			
	Property	Marine	Specialty	Total
December 31, 2010	\$ (49,831)	\$ (17,616)	\$ (3,170)	\$ (70,617)
December 31, 2009	\$ (65,109)	\$ 19,628	\$ (7,491)	\$ (52,972)

The amount recorded represents management's best estimate of expected losses and loss expenses on premiums earned.

For the year ended December 31, 2010, the property and specialty lines experienced favorable development of \$49,831 and \$3,170, respectively, primarily due to lower than expected claims development. The marine lines experienced \$17,616 of favorable development primarily due to higher than expected recoveries associated with 2007 California wildfires, as well as lower than expected claims development.

For the year ended December 31, 2009, the property lines experienced \$65,109 of favorable development primarily due to the reclassification of losses from onshore energy exposures during the 2007 California wildfires to the marine line and reduced loss estimates for Hurricane Ike, the June 2008 Midwest flood event and October 2007 Peruvian mining loss, as well as lower than expected claim development elsewhere. The marine lines experienced \$19,628 of adverse development primarily due to the reclassification from the property line and increased loss estimates for Hurricanes Ike and Gustav.

### 11. Reinsurance

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

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

The effects of reinsurance on premiums written and earned for the years ended December 31, 2010 and 2009 are as follows:

	December 31, 2010		December 31, 2009	
	Written	Earned	Written	Earned
Assumed	\$1,101,239	\$1,127,249	\$ 768,084	\$ 880,435
Ceded	(63,147)	(76,049)	(95,446)	(84,884)
<b>Total</b>	<b>\$1,038,092</b>	<b>\$1,051,200</b>	<b>\$ 672,638</b>	<b>\$ 795,551</b>

#### b) Credit risk

The Company evaluates the financial condition of its reinsurers and monitors concentration of credit risk arising from its exposure to individual reinsurers. The reinsurance program is generally placed with reinsurers whose rating, at the time of placement, was A- or better rated by Standard & Poor's or the equivalent with

# Validus Reinsurance, Ltd.

## Notes to Consolidated Financial Statements

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other rating agencies. Exposure to a single reinsurer is also controlled with restrictions dependent on rating. Of the \$83,930 reinsurance recoverable and paid losses recoverable at December 31, 2010, \$23,750 was fully collateralized and \$17,502 was from reinsurers with ratings of A+ (2009: \$50,840 was fully collateralized and \$8,340 was from reinsurers with ratings of A+).

	<u>December 31, 2010</u>		<u>December 31, 2009</u>	
	<b>Reinsurance Recoverable</b>	<b>% of Total</b>	<b>Reinsurance Recoverable</b>	<b>% of Total</b>
Top 10 reinsurers	\$ 79,364	94.6%	\$ 57,531	95.1%
Other reinsurers' balances < \$1 million	4,566	5.4%	2,967	4.9%
<b>Total</b>	<b>\$ 83,930</b>	<b>\$ 100.0%</b>	<b>\$ 60,498</b>	<b>100.0</b>

### 12. Share capital

#### (a) Authorized and issued

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

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

#### (b) Dividends

The Company declared dividends of \$7.60 per share for the year ended December 31, 2010 (2009: \$2.19).

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

During the year ended December 31, 2010 additional paid in capital increased by \$6,770 as follows:

	\$
(Distribution to) parent company	(1,084)
Share compensation expense	7,854
	<u>6,770</u>

During the year ended December 31, 2009, additional paid in capital increased by \$1,349,349 arising from the transfer of IPC from the parent company, stock option and share compensation expenses and a contribution of fixed maturity investments from the parent company.

# Validus Reinsurance, Ltd.

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### 13. Retirement plans

The Company provides pension benefits to eligible employees through various plans which are managed externally and sponsored by the Company. All pension plans are structured as defined contribution retirement plans. The Company's contributions are expensed as incurred. The Company's expenses for its defined contribution retirement plans for the year ended December 31, 2010 and 2009 were \$1,746 and \$2,349, respectively.

### 14. Stock plans

#### (a) Long Term Incentive Plan and Short Term Incentive Plan

Validus Holdings' Long Term Incentive Plan ("LTIP") provides for grants to employees of any options, stock appreciation rights ("SARs"), restricted shares, restricted share units, performance shares, dividend equivalents or other share-based awards. In addition, the Company may issue restricted share awards or restricted share units in connection with awards issued under its annual Short Term Incentive Plan ("STIP"). The total number of shares reserved for issuance under the LTIP and STIP is 13,126,896 shares of which 7,597,957 shares are remaining. The LTIP and STIP are administered by the Validus Holdings Compensation Committee of the Board of Directors. No SARs have been granted to date. Grant prices are established at the estimated fair market value of the Validus Holdings' common shares at the date of grant.

#### (b) Options

Options may be exercised for voting common shares upon vesting. Options have a life of 10 years and vest either rateably or at the end of the required service period from the date of grant. All options granted in 2009 were as a result of the IPC Acquisition. Grant prices are established at the estimated fair value of Validus Holding's common shares at the date of grant using the Black-Scholes option-pricing model.

The following weighted average assumptions were used for all grants:

Year	Weighted Average	Weighted Average	Expected Life	Expected Volatility
	Risk Free Interest Rate			
2008	3.5%	3.2%	7	30.0%
2009	3.9%	3.7%	2	34.6%
2010 (1)	n/a	n/a	n/a	n/a

(1) Validus Holdings did not grant any stock option awards during the year ended December 31, 2010.

Expected volatility is based on stock price volatility of comparable publicly-traded companies. The Company used the simplified method consistent with U.S. GAAP authoritative guidance on stock compensation expenses to estimate expected lives for options granted during the period as historical exercise data is not available and the options met the requirement as set out in the guidance.

Share compensation expenses of \$1,352 were recorded for the year ended December 31, 2010 (2009: \$4,158). The expenses represent the proportionate accrual of the fair value of each grant based on the remaining vesting period.

At December 31, 2010, there were \$430 (2009: \$4,713) of total unrecognized share compensation expenses that are expected to be recognized over a weighted-average period of 0.6 years (2009: 1.3 years).

# Validus Reinsurance, Ltd.

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### (c) Restricted share awards

Restricted shares granted under the LTIP and STIP vest either ratably or at the end of the required service period and contain certain restrictions for the vesting period, relating to, among other things, forfeiture in the event of termination of employment and transferability. Share compensation expenses of \$6,284 (2009: \$9,603) were recorded for the year ended December 31, 2010. The expenses represent the proportionate accrual of the fair value of each grant based on the remaining vesting period. At December 31, 2010 there were \$17,132 (2009: \$25,129) of total unrecognized compensation expenses that are expected to be recognized over a weighted-average period of 1.6 years (2009: 2.9 years).

### (d) Restricted share units

Restricted share units under the LTIP and STIP vest either ratably or at the end of the required service period and contain certain restrictions for the vesting period, relating to, among other things, forfeiture in the event of termination of employment and transferability. Share compensation expenses of \$188 (2009: \$5,513) were recorded for the year ended December 31, 2010. The expenses represent the proportionate accrual of the fair value of each grant based on the remaining vesting period. At December 31, 2010, there were \$46 (2009: \$578) of total unrecognized compensation expenses that are expected to be recognized over a weighted-average period of 0.1 years (2009: 2.5 years).

### (e) Performance share awards

The Performance Share Awards ("PSAs") contain a performance based component. The performance component relates to the Validus Holdings' compounded growth in the Dividend Adjusted Diluted Book Value per Share over a three year period. For PSAs granted in 2010, the Validus Holdings' grant date Diluted Book Value per Share ("DBVPS") is \$29.68, the DBVPS as at December 31, 2009. The Dividend Adjusted Performance Period End DBVPS will be the DBVPS as at December 31, 2012. The fair value estimate earns over the requisite attribution period and the estimate will be reassessed at the end of each performance period which will reflect any adjustments in the consolidated statements of income in the period in which they are determined. Share compensation expenses of \$30 were recorded for the year ended December 31, 2010 (2009: \$nil). The expenses represent the proportionate accrual of the fair value of each grant based on the remaining vesting period. At December 31, 2010, there were \$444 (December 31, 2009: \$nil) of total unrecognized share compensation expenses that are expected to be recognized over a weighted-average period of 0.4 years (December 31, 2009: 0 years).

### (f) Total share compensation expenses

The breakdown of share compensation expenses for the years ended December 31, 2010 and 2009 are as follows:

	<u>December 31, 2010</u>	<u>December 31, 2009</u>
Options	\$ 1,352	\$ 4,158
Restricted share awards	6,284	9,603
Restricted share units	188	5,513
Performance share awards	30	-
Total share compensation expenses	<u>\$ 7,854</u>	<u>\$ 19,274</u>

## 15. Income taxes

The Company provides for income taxes based upon amounts reported in the financial statements and the provisions of currently enacted tax laws. The Company is registered in Bermuda and is subject to Bermuda law with respect to taxation. Under current Bermuda law, the Company is not taxed on any Bermuda income or

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capital gains taxes and has received an undertaking from the Bermuda Minister of Finance that, in the event of any Bermuda income or capital gains taxes being imposed, the Company will be exempt from those taxes until March 28, 2016. At the present time no such taxes are levied in Bermuda.

The Company has subsidiaries with operations in the United States, Chile and Ireland that are subject to the tax laws of those countries. Under current law, these subsidiaries are taxed at the applicable corporate tax rates.

Income before tax by jurisdiction is as follows:

	Year ended December 31, 2010	Year ended December 31, 2009
Income before tax - Bermuda	\$ 402,854	\$ 861,362
Income (loss) before tax - Others	210	(6,200)
Income before tax - Total	<u>\$ 403,064</u>	<u>\$ 855,162</u>

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

	Year ended December 31, 2010	Year ended December 31, 2009
Current	\$ 91	\$ 163
Deferred	-	-
Income tax expense	<u>\$ 91</u>	<u>\$ 163</u>

The weighted average expected tax provision has been calculated using pre-tax accounting income in each jurisdiction multiplied by that jurisdiction's applicable statutory tax rate. A reconciliation of the difference between the provision for income taxes and the expected tax provision at the weighted average tax rate for the years ended December 31, 2010 and 2009 is provided below.

	Year ended December 31, 2010	Year ended December 31, 2009
Expected tax provision at Bermuda Statutory Rate of 0%	\$ -	\$ -
Effect of taxable income generated in: Canada	91	171
Difference between weighted average and actual tax expense	<u>-</u>	<u>(8)</u>
Income tax expense	<u>\$ 91</u>	<u>\$ 163</u>

### 16. Commitments and contingencies

#### (a) Concentrations of credit risk

The Company's investments are managed following prudent standards of diversification. The Company attempts to limit its credit exposure by purchasing high quality fixed income investments to maintain an average portfolio credit quality of AA- or higher with mortgage and commercial mortgage-backed issues having an aggregate weighted average credit quality of AAA. In addition, the Company limits its exposure to

# Validus Reinsurance, Ltd.

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any single issuer to 3% or less, excluding treasury and agency securities. With the exception of the Company's bank loan portfolio, the minimum credit rating of any security purchased is Baa3/BBB- and where investments are downgraded, the Company permits a holding of up to 2% in aggregate market value, or 10% with written pre-authorization. At December 31, 2010, 3.9% of the portfolio, excluding bank loans, had a split rating below Baa3/BBB- and the Company did not have an aggregate exposure to any single issuer of more than 1.4% of its investment portfolio, other than with respect to government and agency securities.

The Company underwrites a significant amount through brokers and credit risk exists should any of these brokers be unable to fulfill their contractual obligations with respect to the payments of insurance and reinsurance balances to the Company. These companies are large, well established, and there are no indications that any of them are financially troubled. No other broker and no one insured or reinsured accounted for more than 10% of gross premiums written for the periods mentioned.

The following table shows the percentage of gross premiums written by broker for the years ended December 31, 2010 and 2009:

	<u>December 31,</u> <u>2010</u>	<u>December 31,</u> <u>2009</u>
Marsh & McLennan	34.4%	33.3%
Willis Group Holdings Ltd.	19.3%	16.4%
Aon Benfield Group Ltd.	28.9%	39.1%

### (b) Employment agreements

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

### (c) Operating leases

The Company leases office space and office equipment under operating leases. Total rent expense with respect to these operating leases for the year ended December 31, 2010 was approximately \$1,086 (2009: \$1,376). Future minimum lease commitments are as follows:

2011	788
2012	275
2013	298
2014	310
2015 and thereafter	<u>321</u>
Total minimum future rentals	<u>\$ 1,992</u>

## 17. Credit facilities

On March 12, 2007, Validus Re and its parent entered into a \$200,000 three-year unsecured facility, as subsequently amended on October 25, 2007 and September 4, 2009. The facility was refinanced at maturity on March 12, 2010 with a three-year \$340,000 syndicated unsecured letter of credit facility and a \$60,000 bilateral unsecured letter of credit facility which provides for letter of credit availability for Validus Re and its

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subsidiaries (the "Three Year Facilities") (the full \$400,000 of which is available for letters of credit and/or revolving loans).

On March 12, 2007, Validus Re and its parent entered into a \$500,000 five-year secured letter of credit facility, as subsequently amended on October 25, 2007, July 24, 2009 and March 12, 2010, which provides for letter of credit availability for Validus Re and its subsidiaries (the "Five Year Facility" and together with the Three Year Facility, the "Credit Facilities"). The Credit Facilities were provided by a syndicate of commercial banks arranged by J.P. Morgan Securities Inc. and Deutsche Bank Securities Inc.

As amended, the Credit Facilities contain covenants that include, among other things, (i) the requirement that Validus Holdings initially maintain a minimum level of consolidated net worth of at least 70% of consolidated net worth and commencing with the end of the fiscal quarter ending December 31, 2009 to be increased quarterly by an amount equal to 50% of Validus Holdings' consolidated net income (if positive) for such quarter plus 50% of any net proceeds received from any issuance of common shares during such quarter, (ii) the requirement that Validus Holdings maintain at all times a consolidated total debt to consolidated total capitalization ratio not greater than 0.35:1.00, and (iii) the requirement that Validus Re and any other material insurance subsidiaries of Validus Holdings maintain a financial strength rating by A.M. Best of not less than "B++" (Fair). For purposes of covenant compliance (i) "net worth" is calculated with investments carried at amortized cost and (ii) "consolidated total debt" does not include the Validus Holdings' junior subordinated deferrable debentures. The credit facilities also contain restrictions on Validus Holdings' ability to pay dividends and other payments in respect of equity interests at any time that Validus Holdings is otherwise in default with respect to certain provisions under the credit facilities, make investments, incur debt at its subsidiaries, incur liens, sell assets and merge or consolidate with others.

As of December 31, 2010, there was \$268,944 in outstanding letters of credit under the Five Year Facility (December 31, 2009: \$225,823) and \$nil outstanding under the Three Year Facility (December 31, 2009: \$nil).

On September 4, 2009, the parent company entered into the Second Amendment to the Credit Facilities to provide for, among other things, the IPC Acquisition.

On November 28, 2007, Talbot entered into a \$100,000 standby Letter of Credit facility (the "Talbot FAL Facility") to provide Funds at Lloyd's for the 2008 and 2009 underwriting years of account; this facility is guaranteed by Validus Holdings and is secured against the assets of Validus Re. The Talbot FAL Facility was provided by a syndicate of commercial banks arranged by Lloyds TSB Bank plc and ING Bank N.V., London Branch.

On November 19, 2009, the parent company entered into an Amendment and Restatement of the Talbot FAL Facility to reduce the commitment from \$100,000 to \$25,000, and to extend the support to the 2010 and 2011 underwriting years of account.

As amended, the Talbot FAL Facility contains affirmative covenants that include, among other things, (i) the requirement that Validus Holdings initially maintain a minimum level of consolidated net worth of at least 70% of consolidated net worth and commencing with the end of the fiscal quarter ending September 30, 2009 to be increased quarterly by an amount equal to 50% of Validus Holdings' consolidated net income (if positive) for such quarter plus 50% of any net proceeds received from any issuance of common shares during such quarter, and (ii) the requirement that Validus Holdings maintain at all times a consolidated total debt to consolidated total capitalization ratio not greater than 0.35:1.00.

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

# Validus Reinsurance, Ltd.

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under the Credit Facilities. As of December 31, 2010 Talbot had \$25,000 in outstanding letters of credit under this facility.

IPC obtained letters of credit through the IPC Syndicated Facility and the IPC Bi-Lateral Facility (the "IPC Facilities"). In July, 2009, certain terms of these facilities were amended including suspending IPCRe's ability to increase existing letters of credit or to issue new letters of credit. Effective March 31, 2010, the IPC Syndicated Facility was closed. As of December 31, 2010, \$68,063 (2009: \$96,047) of outstanding letters of credit were issued under the IPC Bi-Lateral Facility.

As of December 31, 2010 and throughout the reporting periods presented, Validus Holdings was in compliance with all covenants and restrictions under the credit facilities.

Finance expenses were \$5,482 for the year ended December 31, 2010 (2009: \$1,772). Finance expenses consist of fees relating to our credit facility.

### **18. Related party transactions**

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

On December 8, 2005, the Company entered into agreements with BlackRock Financial Management, Inc. ("BlackRock") under which BlackRock provided investment management services for part of the Company's investment portfolio. For the year ended December 31, 2009 BlackRock was deemed to be a related party due to a combination of Merrill Lynch (a shareholder of BlackRock) being a shareholder in Validus Holdings and having an employee on the Validus Holdings' Board of Directors during this period. For the year ended December 31, 2010, BlackRock was no longer a related party. Investment management fees earned by BlackRock for the year ended December 31, 2009 were \$1,484. Management believes that the fees charged were consistent with those that would have been charged in arm's-length transactions with unrelated third parties.

On December 8, 2005, the Company entered into agreements with Goldman Sachs Asset Management and its affiliates ("GSAM") under which GSAM provides investment management services for a portion of the Company's investment portfolio. Goldman Sachs entities, own 9,634,782 non-voting shares in Validus Holdings, hold warrants to purchase 1,604,410 non-voting shares, and have an employee on the Validus Holdings' Board of Directors who does not receive compensation from Validus Holdings. For the years ended December 31, 2010 and 2009, Sumit Rajpal, a director of Validus Holdings, served as Managing Director of Goldman, Sachs and Co., GSAM's parent company. Subsequent to year end Mr. Rajpal resigned from the Board of Directors of Validus Holdings. Investment management fees earned by GSAM for the year ended December 31, 2010 were \$1,150 (2009: \$824) of which \$209 was included in accounts payable and accrued expenses at December 31, 2010 (2009: \$246). Management believes that the fees charged were consistent with those that would have been charged in arm's-length transactions with unrelated third parties.

Vestar Capital entities own 7,786,770 shares in Validus Holdings, hold warrants to purchase 972,810 shares and have an employee on Validus Holdings' Board of Directors who does not receive compensation from Validus Holdings. Sander M. Levy, a director of Validus Holdings, serves as Managing Director of Vestar Capital Partners. During 2009, Vestar Capital entities were shareholders of PARIS RE Holdings, Limited ("Paris Re"). On July 4, 2009, PartnerRe Ltd. ("PartnerRe") acquired the outstanding shares of Paris Re and as a result Paris Re was not a related party of the Company during the year ended December 31, 2010. However, for the year ended December 31, 2009, pursuant to reinsurance agreements with Paris Re, the

# Validus Reinsurance, Ltd.

## Notes to Consolidated Financial Statements

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

Company recognized gross premiums written of \$5,176, and earned premium adjustments of \$5,918, respectively.

Aquiline Capital Partners, LLC and its related companies (“Aquiline”), which own 6,255,943 shares in Validus Holdings, hold warrants to purchase 3,043,246 shares, and has two employees on the Board of Directors who do not receive compensation from Validus Holdings, are shareholders of Group Ark Insurance Holdings Ltd. (“Group Ark”). Christopher E. Watson, a director of Validus Holdings, also serves as a director of Group Ark. Pursuant to reinsurance agreements with a subsidiary of Group Ark, the Company recognized gross premiums written during the year ended December 31, 2010 of \$2,239 (2009: \$nil) of which \$378 was included in premiums receivable at December 31, 2010 (2009: \$nil). Earned premium adjustments of \$1,024 were incurred during the year ended December 31, 2010 (2009: \$nil).

Aquiline is also a shareholder of Tiger Risk Partners LLC (“Tiger Risk”). Christopher E. Watson, a director of Validus Holdings serves as a director of Tiger Risk. Pursuant to certain reinsurance contracts, the Company recognized brokerage expenses paid to Tiger Risk during the year ended December 31, 2010 of \$1,461 (2009: \$1,231), of which \$792 was included in accounts payable and accrued expenses at December 31, 2010 (2009: \$643).

On November 24, 2009, the Company entered into an Investment Management Agreement with Conning, Inc. (“Conning”) to manage a portion of the Company’s investment portfolio. Aquiline acquired Conning on June 16, 2009. John J. Hendrickson and Jeffrey W. Greenberg, directors of Validus Holdings, each serve as a director of Conning Holdings Corp., the parent company of Conning, and Michael Carpenter, the Chairman of Talbot Holdings, Ltd. serves as director of a subsidiary of Conning Holdings Corp. Investment management fees earned by Conning for the year ended December 31, 2010 were \$379 (2009: \$13), of which \$97 was included in accounts payable and accrued expenses at December 31, 2010 (2009: \$13).

Pursuant to a reinsurance agreement, the Company has written premiums from a subsidiary of Talbot Holdings Ltd. (“Talbot”) of \$91,746 for the year ended December 31, 2010 (2009: \$66,749). A balance due from Talbot’s subsidiary of \$102,649 was included in premiums receivable at December 31, 2010 (2009: \$69,823). Unearned premiums included unearned premiums related to this contract of \$26,047 at December 31, 2010 (2009: \$22,431). The contract terms were negotiated on an arms-length basis. Talbot is 100% owned by the parent company.

# Validus Reinsurance, Ltd.

## Notes to Consolidated Financial Statements

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

### 19. Statutory and regulatory requirements

Validus Re and IPC Re Limited (“IPC Re”) are registered as Class 4 companies and AlphaCat Reinsurance Ltd. (“AlphaCat”) is registered as a Class 3 company under The Insurance Act 1978 (Bermuda), Amendments Thereto and Related Regulations (“the Act”). Under the Act, the companies are required to prepare and file Statutory Financial Statements and a Statutory Financial Return. The Act requires Validus Re and IPC Re to maintain minimum share capital of \$1,000 and AlphaCat to maintain minimum share capital of \$120 and to meet a minimum solvency margin (the amount by which statutory assets exceed statutory liabilities) equal to the greater of 50% of net premiums written or 15% of the net reserve for losses and loss adjustment expenses in the case of Validus Re and IPC Re and 20% of the first \$6,000 net premiums written plus 15% of net premiums written in excess of \$6,000 or 15% of the net reserve for losses and loss adjustment expenses in the case of AlphaCat. The companies are also required to maintain a minimum liquidity ratio whereby the value of its relevant assets is not less than 75% of the amount of its relevant liabilities. Relevant assets include cash and cash equivalents, investments and insurance balances receivable. Certain categories of assets do not qualify as relevant assets under the statute. The relevant liabilities are total general business insurance reserves and total other liabilities.

For Class 4 statutory filings, the Bermuda Monetary Authority (“the BMA”) requires the use of a risk-based capital model, or Bermuda Solvency Capital Requirement (“BSCR”), as a tool to assist the BMA in measuring risk and determining appropriate capitalization. Validus Re met these requirements at December 31, 2010 and December 31, 2009. IPC Re has received an exemption from the requirement to produce the BSCR for the years ended December 31, 2010 and 2009.

Statutory financial data based on audited filings for Validus Re, AlphaCat and IPC Re is set out below:

	Validus Re		AlphaCat		IPC Re	
	December 31,		December 31,		December 31,	
	2010	2009	2010	2009	2010	2009
Minimum statutory capital and surplus	\$ 510,571	\$ 335,802	\$ 120	\$ 120	\$ 29,972	\$ 187,690
Actual statutory capital and surplus	4,035,000	3,576,958	123	120	296,854	1,950,211
Minimum share capital	1,000	1,000	120	120	1,000	1,000
Actual share capital	2,667,249	2,659,942	120	120	296,942	1,451,910
Minimum relevant assets	802,357	586,287	71,061	35,019	184,643	269,847
Actual relevant assets	3,869,217	2,283,968	94,870	46,812	512,509	2,248,900

The Bermuda Companies Act 1981 limits the Company’s ability to pay dividends and distributions to shareholders. Validus Re, IPC Re and AlphaCat are required to obtain approval from the regulatory authorities before reducing statutory capital, as set out in the previous year’s financial statements, by 15% or more. In addition, any payment of dividends which would exceed 25% of Validus Re’s or IPC Re’s total Statutory Capital and Surplus as shown on the Statutory Balance Sheet in relation to the previous financial year requires the Company’s directors to affirm that the Company continues to meet the relevant margins.

**Validus Reinsurance, Ltd.**

**Notes to Consolidated Financial Statements**

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

## **Validus Reinsurance, Ltd.**

### **Notes to Consolidated Financial Statements**

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

#### **20. Subsequent events**

The Company has evaluated subsequent events that have occurred subsequent to December 31, 2010, through the date the financial statements were issued:

- During late December 2010 and continuing into early January 2011, persistent rains in Eastern Australia caused severe flooding. There was damage throughout much of the state of Queensland, including the state capital city of Brisbane;
- During late January 2011, and continuing in March 2011, civil unrest and violence occurred in several North African and Middle Eastern countries;
- During January 2011, persistent rains in South Eastern Australia caused severe flooding in the city of Victoria;
- On February 3, 2011, Cyclone Yasi, classified as a category 5 cyclone, made landfall in northern Queensland, Australia. The storm caused widespread damage to property and crops which was followed by severe flooding; and
- In early February 2011, Maersk Oil's Gryphon floating production storage and offloading vessel in the North Sea sustained severe damage in heavy storms;
- On February 21, 2011, an earthquake measuring 6.3 on the Richter scale struck the South Island of New Zealand near Christchurch causing significant loss of life and damage to property.
- On March 11, 2011, an earthquake measuring 9.0 on the Richter scale occurred off the Eastern coast of Japan. The earthquake and subsequent tsunami caused significant loss of life and damage to property.

The Company is continuing to review its in-force contracts and preliminary loss information from clients for the events described above and expects that 2011 losses, either individually or when aggregated, may have a material impact on its shareholder's equity.